SOUTH ASIA

Afghanistan
Bangladesh
Bhutan
India
Maldives
Nepal
Pakistan
Sri Lanka

Afghanistan

Despite deteriorating security, the economy grew steadily in 2010. Inflation increased (toward fiscal year-end), driven largely by import prices. The fiscal position continued to improve but a run on deposits at the leading private bank revealed a significant macroeconomic risk. The government presented an Afghan-led plan for development at the Kabul Conference of donors, but low implementation capacity, weak public sector governance, and perceptions of widespread corruption raise concerns over implementation. Sustainable, self-reliant growth requires significant improvements in security, progress in the Afghan-led reconciliation process, and a better private sector environment.

Economic performance

GDP continued to grow strongly, at 8.2% estimated for FY2010 (ending 20 March 2011), following high growth of 20.4% in FY2009 (Figure 3.14.1). Private consumption remained the economy's main driver, based on continued high external assistance inflows and security spending that fueled demand for production of goods and services, including construction. The wheat harvest was above average, but agricultural growth was below FY2009's record.

The size of the opium economy (not included in the official figures for economic activity) had been declining since 2007 because of crop-substitution policies, but in 2010 its farm gate price more than doubled, owing to plant disease–related lower production levels. This boosted farmers' opium-sourced income, likely complicating the already slow pace of poppy eradication.

In the early months of FY2010 the price deflation of the previous fiscal year continued. Prices began to rise from about May 2010, heavily influenced by food and then by fuel, reflecting rising import prices. Although inflation is projected to average 8.2% in FY2010, in February 2011 prices were 17.9% higher than a year earlier (20.9% food and 13.7% nonfood—Figure 3.14.2).

Afghanistan maintains a managed floating exchange rate regime. The afghani appreciated by around 10% against the US dollar over the period January 2010–February 2011, on high inflows of foreign exchange in the form of donor grants and remittances and on increased demand for domestic currency (Figure 3.14.3). This appreciation, alongside inflation now higher than among trade partners, is causing the real effective exchange rate to appreciate as well, potentially undermining exports.

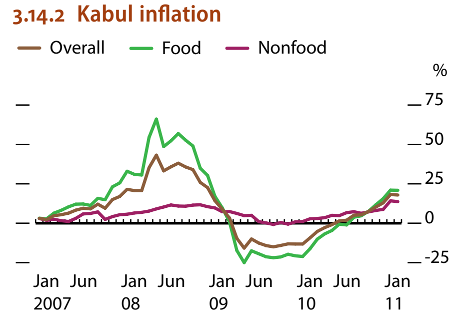
To achieve stability both in domestic prices and the exchange rate, Da Afghanistan Bank, the central bank, targets reserve money (bank reserves and currency in circulation) as its key monetary tool, relying on the issue of its capital notes and foreign currency auctions to control the

3.14.1 GDP growth

Source: Ministry of Finance.

Click here for figure data

3.14.2 Kabul inflation



Sources: Ministry of Agriculture, Irrigation & Livestock. *Agricultural Commodity Price Bulletin*. http://mail.gov.af; Central Statistical Office of Afghanistan; Da Afghanistan Bank.

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This chapter was written by Rehman Rahmani and Tia Raappana of the Afghanistan Resident Mission, ADB, Kabul; and Nina Clare Fenton of the Central and West Asia Department, ADB, Manila.

money supply. The absence of price pressures at the start of the fiscal year allowed it to adopt a relatively expansionary monetary stance for FY2010, in order to accommodate an increase in demand for money stemming from expected economic growth. It targeted reserve money growth in FY2010 at 18.9%, 1.8 percentage points higher than in FY2009.

In view of inflation pressures, however, the central bank is expected to increase interventions in the market. Gross international reserves climbed to $5.0 billion at end-March 2011 (a rise of 19% from 12 months earlier), reflecting higher donor inflows. Reserves are sufficient to finance 14.3 months of imports and can facilitate market intervention to stabilize the economy and currency.

A run on deposits at Kabul Bank, the largest private bank, in the second half of 2010 raised concerns about financial stability, highlighting the need to strengthen central bank supervision (Box 3.14.1). Although the government took steps to stabilize the crisis, the bank's losses (stemming from serious weaknesses in its corporate governance and management) could constitute a heavy fiscal burden.

Following a surge in domestic revenue collection in FY2009, the government continued to improve in this area, and collection is expected to reach 9.8% of GDP in FY2010 (Figure 3.14.4). The good performance was driven by improved tax administration, including a levying of business receipts tax at borders and other structural reforms. Still, the fiscal position (excluding grants) remains among the world's weakest. Development expenditure is almost fully funded by external assistance while fiscal sustainability—domestic revenue as a share of recurrent spending—is expected to decline to around 65% in FY2010 from 72% a year earlier.

This decline is due to upward pressures on recurrent spending, mainly from the higher wage bill owing to the expansion of the Afghan security forces and the rollout of pay and grading reforms for civil servants. Steps toward fiscal sustainability are particularly important given plans to transit to Afghan-led security, since most International Security Assistance Force nations are setting dates for withdrawing their troops.

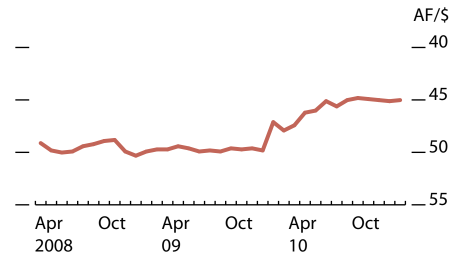
At conferences in London and Kabul in January and July 2010, the government presented refinements to its Afghan-led medium-term plan for development and announced results-based national priority programs to meet its objectives. It also set out public financial-management reforms.

Only an estimated 20% of donor funds are channeled, however, through the government budget, and to increase this share (as committed at the Kabul Conference), the government needs to greatly improve its implementation capacity. It also needs to address broader issues of transparency and accountability in the public sector, including strengthening audits on the use of domestic funds.

The current account deficit (excluding grants) is estimated to have narrowed from 43.6% to 37.6% of GDP in FY2010 (Figure 3.14.5). The narrowing trend reflects the fact that grant-related imports (and grant financing), though increasing in US dollars, are falling relative to nominal GDP. Including grants, the current account balance varies only slightly: it is expected to run a small surplus of 1.9% of GDP in FY2010, switching from a deficit of 1.4%.

During the fiscal year imports increased by 3.7%. The rise was

3.14.3 Nominal exchange rate



Source: Da Afghanistan Bank. http://www.centralbank.gov.af

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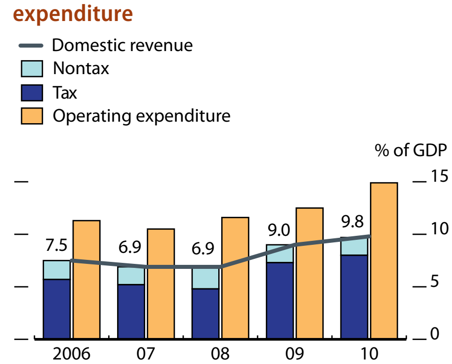
3.14.4 Domestic revenue and operating expenditure



Sources: International Monetary Fund. 2008. *Country Report No.* 08/72. February. http://www.imf.org; Da Afghanistan Bank. 2010. *Selected Economic Indicators*. November.

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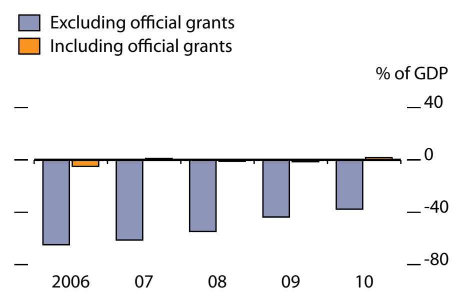
3.14.5 Current account balance



Sources: International Monetary Fund. 2008. *Country Report* No. 08/72. February. http://www.imf.org; Da Afghanistan Bank. 2010. *Selected Economic Indicators*. November.

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attributed to continued high demand from donor-funded projects, particularly for fuel, capital equipment, and food, which together make up almost 80% of imports. Exports (much smaller than imports) rose by 6.9%; the main items remained dried fruits, carpets, and furs.

Economic prospects

GDP growth rates for FY2011 and FY2012 are projected at 8.0% and 8.5%, respectively. These estimates assume that substantial development-partner funding continues; agriculture and services perform well; the resolution of the Kabul Bank crisis is not disruptive; and industry improves, aided by mining-related construction.

If managed effectively, mining has the potential to grow robustly, although its contribution to the budget over the next few years is likely to be modest. The World Bank estimates that even in a low-impact scenario the first significant investment, the Aynak copper mine, could generate budget revenue of around $155 million a year in the construction phase (2011–2015), increasing to $365 million from royalties once the mine is operating. The Hajigak iron ore mine, too, may bring in revenue of $89 million a year after it starts construction in 2013. In the early years of development, combined receipts from these two mines could therefore be over 1% of GDP, but that amount is contingent on strong management.

The government expects in the next few years to make progress on revenue collection, particularly by the possible introduction of a value-added tax, and to increase its fiscal sustainability ratio to above 70%. The tax take should also benefit from increased mining activity, largely through indirect tax revenue in the construction phase. Meeting the 70% target will, though, be challenging under continued pressure on recurrent expenditure. Although external assistance is set to gradually decline, it is likely to be needed to cover at least part of such spending for several years.

Foreign aid will continue to plug the balance-of-payments gap. The current account surplus is expected to fall slightly in FY2011, to 1.4% of GDP (including official transfers), driven by increased imports as international commodity prices rise. Excluding official transfers, the balance should continue its gradual improvement to a deficit of 34.4% of GDP as development assistance falls relative to the size of the economy (though nominally it expands).

Inflation is projected to average 9.8% and 9.1% in FY2011 and FY2012, assuming that prudent monetary policy is adopted as planned and that it can mitigate the impact of rising international commodity prices.

The previous program of the International Monetary Fund ended in September 2010; the government has therefore requested a new Extended Credit Facility, though the Kabul Bank crisis has delayed a board decision.

The government's economic program is likely to set out key actions on resolving Kabul Bank's position and strengthening broader financial supervision measures, while keeping a focus on macroeconomic stability objectives and measures toward fiscal sustainability.

This outlook is subject to several risks, such as worsening security conditions, political instability, weak governance, loss of export

3.14.1 Kabul Bank crisis

Fraudulent loans came to light at Kabul Bank in September 2010, triggering a run on deposits. Despite this huge change to its financial position, the bank still has the largest deposits and branch network in the country, and performs crucial functions such as paying civil service salaries.

The central bank initially placed Kabul Bank under a conservatorship until the bank could be sold to a qualified buyer, or, in the worst case, liquidated.

The government has so far guaranteed $400 million of the bank's deposits but it will probably also need to finance any remaining unfunded liabilities at the time of a sale.

An alternative option, proposed by the International Monetary Fund, would be to place the bank in receivership, which could be expected to ensure more transparent, legally secure, and potentially faster resolution.

Importantly, any improper financial and legal interests would be unquestionably resolved and any further losses prevented. The government's financial exposure could also be limited to a predetermined level. In March 2011, the option of receivership was being considered by the Afghan authorities.

3.14.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.0	8.5
Inflation	9.8	9.1
Current account balance (share of GDP)	1.4	-0.8

Source: ADB estimates.

competitiveness, and new barriers to trade with neighboring countries. The debt relief granted to Afghanistan under the extended heavily indebted poor countries initiative in 2010 has relieved the debt burden by $1.6 billion, taking it to a sustainable level (around 8% of GDP). Still, Afghanistan will stay at high risk of debt distress, particularly if foreign grants (expected to decrease gradually in the medium term) fall heavily.

Development challenges

It is important that the government continues to undertake a strong reform agenda and implement the commitments made at the Kabul Conference. A particular focus should be on strengthening governance, implementation capacity, and accountability of public institutions. The government's development plan should help to ensure that the budget is clearly focused on key policy objectives. Capacity should be strengthened to increase development budget implementation by at least 10%–20% annually, as committed to at the Kabul Conference. At the same time, the national budget process should build on existing systems to better monitor spending effectiveness.

If significant progress were made on all these fronts, development partners would channel more funds through the government budget, helping to align development priorities and increase aid effectiveness.

External assistance is expected to decline over the long term, hence the government needs to focus on the transition to fiscal sustainability. It is expected to continue improving its position by increasing domestic revenue and controlling public expenditure through a robust budget-formulation process.

The government will also want to improve the overall investment climate, so as to encourage private sector growth, promote exports, and reduce dependence on external assistance. The country still ranks the lowest in the region for ease of doing business, according to the World Bank's *Doing Business 2011* report, and this needs to change. Managing the potential mineral wealth well will also be critical.

3.14.2 South Asian rankings on the ease of doing business, 2011

Pakistan	83
Maldives	85
Sri Lanka	102
Bangladesh	107
Nepal	116
India	134
Bhutan	142
Afghanistan	167

Note: Out of 183 countries worldwide.
Source: World Bank. *Doing Business 2011*.

Bangladesh

A strong export rebound will push up growth in FY2011, but a slowing remittance expansion will damp domestic demand. Next year could see better prospects with higher external demand. A major challenge for policy makers will be to balance the needs for taming inflation and for ensuring that credit to the private sector is not stifled. To harness the country's medium-term growth potential, removing infrastructure gaps will be essential, as will enhancing the supply of skilled human resources.

Economic performance

At 5.8% in FY2010 (ended June 2010), GDP growth was marginally higher than the 5.7% of FY2009 (Figure 3.15.1). Helped by favorable weather and continued government support, strong performance by the crop and horticulture subsector boosted agriculture's expansion. This offset a decline in industrial growth due to a fall in external demand and continued shortages of power, gas, and transport facilities. Services also grew only marginally.

On the demand side, growth was again driven by private consumption aided by higher credit flows to the private sector (supporting job creation) and by a boost to public sector wages. Total fixed investment, after remaining stagnant over the past half a decade, rose from 24.4% of GDP in FY2009 to 25.0% in FY2010. The rise in private investment provided the main impetus to performance.

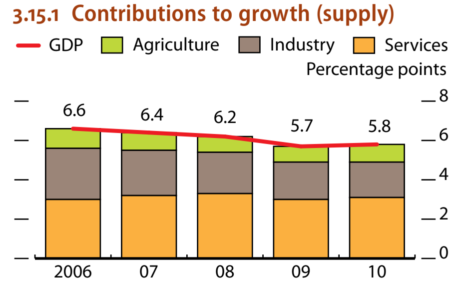
Foreign direct investment is stagnant at less than $1 billion a year. It could see a notable rise, however, if the government makes progress in awarding contracts for gas exploration and in setting up a floating liquefied natural gas terminal, as called for in its plans to address growing power and gas shortages. Foreign as well as local investment could also be lifted by the Special Economic Zone Act that Parliament passed in 2010, which aims to attract more private capital.

Annual average inflation edged up to 7.3% in FY2010 from 6.7% in FY2009 owing to a rapid rise in food prices in the first part of the year; nonfood inflation moderated. In FY2011, year-on-year inflation fell to 7.3% in July (Figure 3.15.2), from 8.7% in June but subsequently trended upward (with some volatility) to reach 9.0% in January 2011. The rise in global food and commodity prices, a continued rapid expansion in private credit, and depreciation of the taka pushed up prices.

To help the poor and vulnerable cope with higher food prices, the government stepped up food distribution operations, strengthened open-market sales of its inventories, and introduced a food-ration system for the ultra-poor.

FY2010's rapid growth in broad money continued into FY2011, reaching 21.7% in December 2010 (Figure 3.15.3), significantly above the

3.15.1 Contributions to growth (supply)



Source: Bangladesh Bureau of Statistics. 2010. *National Accounts Statistics*. November.

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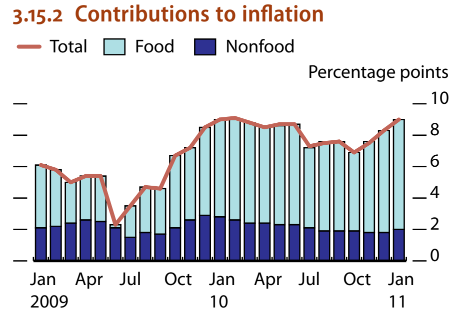
3.15.2 Contributions to inflation



Sources: Bangladesh Bureau of Statistics. *Consumer Price Index (CPI) and Inflation*. Various issues. http://www.bbs.gov.bd

Click here for figure data

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

central bank's annual program target of 15.2%. Private credit, up by 27.6% year on year in December 2010 (against the target of 16.0%) was the main contributing factor. The central bank's tightening of policy rates had little effect on credit expansion. The average lending and deposit rates also remained largely unchanged at 11.2% and 6.0%, respectively, in June–December 2010.

Revenue collection rose briskly with the revenue-to-GDP ratio climbing to 11.5% in FY2010—meeting the budget target—as domestic economic activity picked up a little and tax administration improved. Total spending jumped from 14.3% of GDP in FY2009 to 16.0% in FY2010 as the government adopted an expansionary fiscal stance to offset the impact of the global recession. Spending fell short, however, of the budget target as the annual development program remained underspent because of the lingering weak capacity in key implementing agencies. The fiscal deficit of 4.5% of GDP was well within the target of 5.0%.

After declining in the first half of FY2010, exports grew consistently year on year during the second half, posting growth of 4.2% for the full year (but still much lower than the previous year's 10.1%). Readymade garment exports moved up by only 1.2%, shaving their dominant share of total exports by 2 percentage points to 77.1% in FY2010. Exports of jute goods, petroleum by-products, and engineering products rose briskly.

Imports contracted during the first 3 quarters but reversed this trend in the fourth to show full-year growth of 5.4%, as imports of capital machinery picked up. Import bills for rice and for consumer and intermediate goods fell from their year-earlier levels. Remittance growth, robust at 22.8% in the first half of the fiscal year, decelerated sharply later, posting only 13.4% full-year growth, down from 22.4% the previous year.

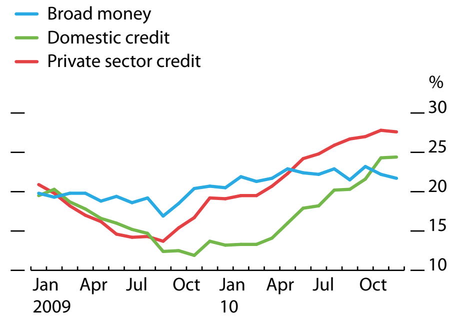
Still, the small expansion in the trade deficit was more than offset by remittance inflows, boosting the current account surplus to $3.7 billion (3.7% of GDP) from $2.4 billion (2.7%) in FY2009 (Figure 3.15.4). The improved position, alongside the lower deficit in the combined capital and financial account, pushed the overall balance-of-payments surplus to $2.9 billion and foreign exchange reserves to $10.7 billion (Figure 3.15.5) at end-June 2010, raising import cover to about 5 months. In the first half of FY2011 foreign exchange reserves showed little increase as the current account surplus largely fell away.

The nominal taka–dollar exchange rate remained stable in FY2010, but depreciated by 2.6% in the first 8 months of FY2011. Nonetheless, with domestic inflation higher than in major trading partners, the real effective exchange rate appreciated by 1.8% year on year in January 2011, implying some erosion in export competitiveness.

The Dhaka Stock Exchange general index more than doubled during FY2010 (Figure 3.15.6). The price–earnings ratio climbed from 18.4 to 24.1 and market capitalization doubled, reaching $38.6 billion (about 39% of GDP). The bullish trend in stock prices continued into the first half of FY2011 as the general index peaked on 5 December—44.0% higher than its end-June 2010 level. Then, a price correction set in, and the index fell by 41.7% by end-February as commercial and merchant banks moved to heavy selling, booking large profits. Nervous retail investors followed suit.

To stabilize the market and shore up investor confidence, the government announced measures including advising commercial and

3.15.3 Growth of monetary indicators



Source: Bangladesh Bank. 2011. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org
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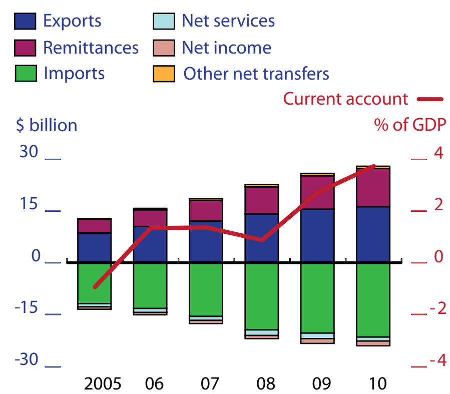
3.15.4 Components of the current account balance



Source: Bangladesh Bank. *Annual Report 2009–2010*. http://www.bangladesh-bank.org
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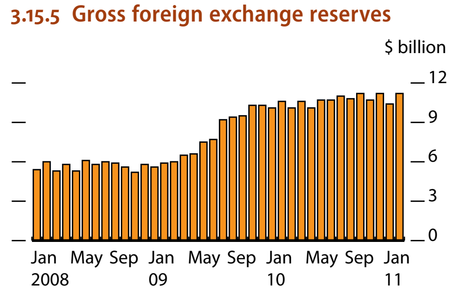
3.15.5 Gross foreign exchange reserves



Source: Bangladesh Bank. 2011. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org
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merchant banks to reinvest their profits, instructing merchant banks to stop the practice of forcing margin clients to sell shares, and removing the index's circuit breaker. The state-owned Investment Corporation of Bangladesh, with seven other state-owned financial institutions, are creating a Tk50 billion (about $715 million) open-ended mutual fund (the Bangladesh Fund) to prop up the market. The government also formed a committee to investigate the causes of market instability.

Economic prospects

Economic forecasts for FY2011 and FY2012 rest on several assumptions. The policy focus on accelerating growth while strengthening efforts to tame inflation will continue, the momentum of budget revenue growth will be maintained, and it will be possible to mobilize more external financing. The government will step up initiatives to boost power generation (including commissioning rental power plants), thereby easing power supply shortages, and will take action to address gas shortfalls. A stable political environment and normal weather conditions are assumed.

GDP growth in FY2011 is projected to climb to 6.3% from 5.8% the previous year. The strong rebound in exports under way will support higher growth, offsetting the effects on domestic demand of the sharp slowdown in remittance growth. The pickup in export-linked domestic industries and tax incentives for domestic industries provided in the FY2011 budget are also expected to bolster economic activity. GDP growth in FY2012 is seen rising further, to 6.7% (Figure 3.15.7), with a continued policy focus on growth and a pickup in external demand.

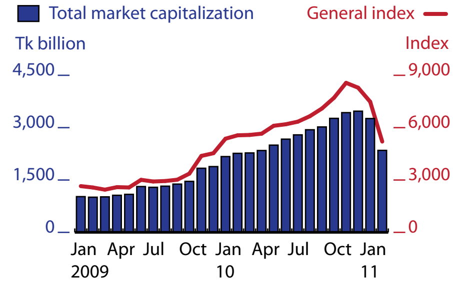
Agricultural growth in FY2011 is expected to ease to 4.1% because of lower acreage sown for the *aus* (summer crop), shrinkage in acreage and inadequate rainfall for the *aman* (monsoon crop), and the high base following the previous year's growth of 4.7%. In FY2012, the sector's growth is expected to strengthen to 4.3%, responding to higher prices following a tighter supply situation in FY2011 and continued policy support.

Industrial growth is expected to rise to 7.5% in FY2011, reflecting higher production for exports and domestic capacity expansion after the previous year's higher investment. Export performance was buoyant in the first 8 months of the fiscal year, recording 40.3% growth (Figure 3.15.8), with all major items growing strongly. Rapid growth in imports of raw materials and capital machinery also point to a better industrial performance. An improvement in the power supply and a rise in business confidence, too, are likely to boost activity. In FY2012, industry is expected to grow strongly at 7.8%, reflecting a rise in external demand and higher domestic capacity.

In FY2011, services growth is forecast to rise slightly to 6.7% from 6.4%, mainly on the strength of industrial and trade and transport activity, as the pulse of trade quickens. Sector growth will rise further to 7.2% in FY2012, reflecting industrial and agricultural strengthening.

The rise in year-on-year inflation is pushing up the 12-month average. Although the central bank's January 2011 monetary policy statement forecast 7.0% inflation for FY2011, it may well come in at 8.0%, rising

3.15.6 Dhaka stock exchange indicators



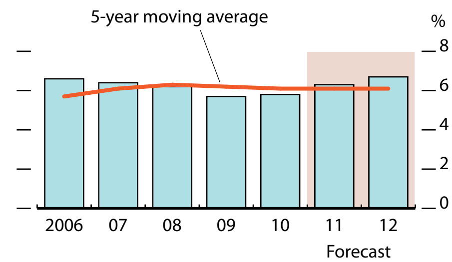
Source: Bangladesh Bank. 2011. *Major Economic Indicators: Monthly Update*. February. http://www.bangladesh-bank.org
Click here for figure data

3.15.1 Selected economic indicators (%)

	2011	2012
GDP growth	6.3	6.7
Inflation	8.0	8.5
Current account balance (share of GDP)	0.2	-0.3

Source: ADB estimates.

3.15.7 GDP growth



Sources: Bangladesh Bureau of Statistics. 2010. *National Accounts Statistics*. November; ADB estimates.
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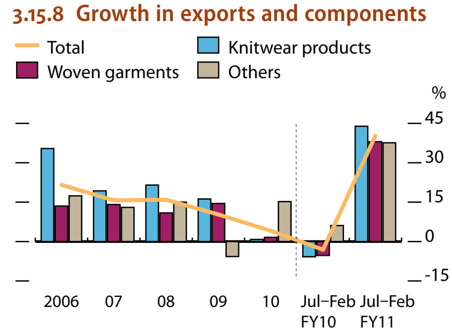
3.15.8 Growth in exports and components



Sources: Bangladesh Bank. 2011. *Major Economic Indicators: Monthly Update*. February; *Annual Report 2009–2010*. http://www.bangladesh-bank.org
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further to 8.5% in FY2012 (Figure 3.15.9). The central bank instructed commercial banks to rein in credit growth and set a deadline for cutting the credit-to-deposit ratio. The marked rise in global commodity prices, the likely further depreciation in the taka, a power tariff increase in February 2011, and expected hikes in fuel and compressed natural gas prices are all seen exerting upward supply-side pressures. Monetary policies are unlikely to fully counter them.

The slower growth in remittance inflows that began around February 2010 intensified in FY2011. Overseas workers remitted $7.5 billion during the first 8 months of FY2011, for growth of only 2.5%—a startling drop from a 19.0% gain in the year-earlier period. The decline is a concern as healthy remittance growth helps to underpin consumer spending and is a key source of domestic demand. Job placements for Bangladeshi workers, who are mostly low-skilled, declined by 10.9% in the first 8 months of FY2011 (Figure 3.15.10), continuing the declines of the previous 2 years. Remittances are likely to grow at very modest rates of 3.0% in FY2011 and 4.0% in FY2012. The latest developments in the Middle East could also affect remittances.

The continued robust performance in export earnings that started in March 2010 raised the prospect of exceeding the FY2011 annual export target of $18.5 billion. In the first 8 months of FY2011, rapid growth in readymade garment exports (woven by 38.0% and knitwear by 43.9%), representing over three-fourths of total exports, was partly due to importing countries replenishing their inventories, though it also reflected a sharp rise in wages in some other garment-exporting countries. Although industry's agreement to raise monthly wages—to about $43–$133 for garment workers—has by and large been pushed through following frequent worker unrest over the past couple of years, it hardly dented wage differentials with competitors.

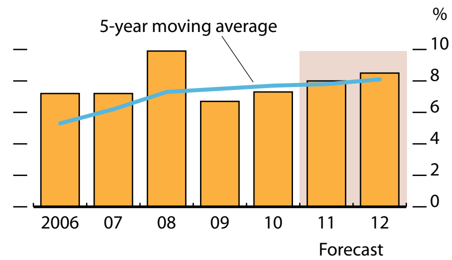
Exports of other items such as frozen foods and jute also grew strongly. Very high export growth in the first part of FY2011 is expected to moderate as inventory rebuilding comes to an end, pointing to a 21.0% expansion in exports for all FY2011. In FY2012, exports are projected to grow by 22.0%.

Exports to the European Union will benefit from relaxed rules of origin (introduced 1 January 2011) under the Generalized System of Preferences. Bangladesh readymade garments are also diversifying their export destinations to countries such as Japan, the Republic of Korea, South Africa, and Turkey.

In tandem with the rise in exports—a large part of which was based on imported raw materials—import payments rose by 40.7% in the first 7 months of FY2011. Imports of food items, industrial raw materials, and capital machinery grew rapidly. Growth in overall imports is set to moderate over the rest of the fiscal year as imports of raw materials for the readymade garment industries slow. The import bill for fuel will rise, however, reflecting volume and price increases. Imports are forecast to grow by 23.0% in FY2011 and 24.0% in FY2012.

The external current account is seen showing a smaller surplus of 0.2% of GDP in FY2011, and then turning into a deficit of 0.3% of GDP in FY2012 (Figure 3.15.11), reflecting slow remittance growth and a widening trade gap.

3.15.9 Inflation



Sources: Bangladesh Bank. 2011. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org; ADB estimates.

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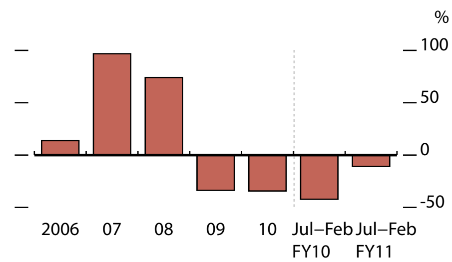
3.15.10 Growth in out-of-country employment



Source: Bangladesh Bank. 2011. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org

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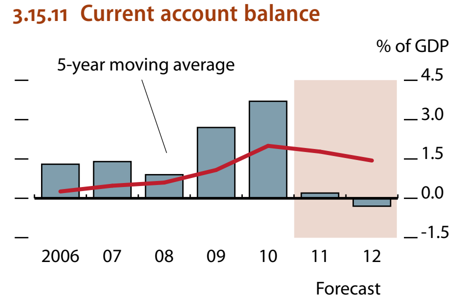
3.15.11 Current account balance



Sources: Bangladesh Bank. 2011. *Annual Report 2009–2010*. http://www.bangladesh-bank.org; ADB estimates.

Click here for figure data

A 3-year program arrangement is expected to be finalized with the International Monetary Fund under its Extended Credit Facility, which will help Bangladesh tackle its growing balance-of-payments needs. The program is expected to catalyze financing and support policy adjustments and reforms conducive to boosting growth, while strengthening the external position (Box 3.15.1).

3.15.1 The Extended Credit Facility

Under a proposed program for a SDR640 million (about $1 billion) loan from the Extended Credit Facility of the International Monetary Fund, the government plans to undertake major reforms to put Bangladesh on a higher growth trajectory.

For raising tax revenue by around 3 percentage points as a share of GDP, it is expected to deepen tax administration reforms, including enacting value-added and income-tax laws. It aims to improve public financial management and operationalize the public–private partnership program for boosting public and private investment.

Reforms under the program are expected to improve monetary and foreign exchange operations, strengthen the finance sector and its oversight (focusing on financial conditions of state-owned commercial banks and the compliance by all banks with new capital-adequacy requirements), and promote the country's integration into the regional and global economy through a more open trade and investment regime.

For containing inflation pressure, the central bank is seen tightening monetary policy, aided by greater interest- and exchange-rate flexibility. It is also likely to work closely with the Securities and Exchange Commission to ensure appropriate actions by commercial banks and their subsidiaries to limit risks from stock market volatility.

The operating losses of the larger power and energy utilities are expected to be brought on the government budget.

Tax collection grew robustly by 28.4% during the first 7 months of FY2011 over the year-earlier period—direct taxes and domestic indirect taxes contributed most to the rise in revenue, although import-based indirect taxes also improved well. The expansion in domestic economic activity and better tax compliance, aided by reforms, are the main factors.

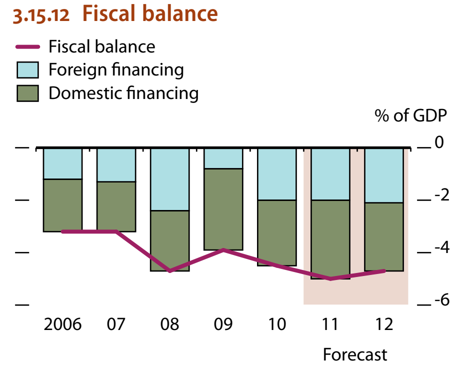
The annual development program's utilization rate in the first 8 months of FY2011 did not improve relative to the previous year, and its annual allocation is unlikely to be fully spent, despite recent government measures such as forming a task force to beef up implementation and progress monitoring.

Nor have any of the sizable resources earmarked for the Bangladesh Infrastructure Finance Fund, set up in the FY2011 budget to finance projects under the public–private partnership mechanism, been drawn on. Although budgetary allocations for food, fuel, fertilizer, and other agricultural inputs will be larger than in FY2010, the chronic underspending of investment allocations is expected to keep the fiscal deficit within its budgeted level of 5.0% of GDP (Figure 3.15.12).

The 11.0% increase in bulk power tariffs in February 2011 will help to cut Bangladesh Power Development Board's losses. The 5.0% hike in retail tariffs will improve the financial performance of power distribution companies.

The Bangladesh Petroleum Corporation (BPC) is nursing sizable losses as the government made no adjustment in domestic administered prices for fuels, even though global oil prices climbed sharply. BPC's losses will rise further as its imports are expected to soar to meet the needs of new power plants using diesel and fuel oil. BPC has arranged additional financing (of about $1.4 billion) from the Islamic Development Bank and

3.15.12 Fiscal balance



Source: Asian Development Outlook database.

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has requested assistance of $500 million from the central bank. It is also looking into additional financing from foreign commercial banks.

For the meantime, the government in the FY2011 budget made initial allocations of Tk25 billion (about $357 million) and Tk15 billion (about $214 million), as loans, to BPC and the Bangladesh Power Development Board.

Several downside risks could derail the projections. A slackening of the global recovery would likely slow export growth and heavily curtail remittances. Higher than projected domestic inflation could affect macroeconomic stability and discourage investment. Finally, inability to bring the planned short-term addition to power supply, such as the commissioning of small, private diesel and fuel-oil generators, and slippage in addressing gas shortages would also slow growth, mainly through their impact on industry.

Development challenges

Two critical challenges to exploit Bangladesh's growth potential are to upgrade infrastructure and to ensure a large, skilled workforce.

A major step in upgrading infrastructure was taken recently: three independent power producer contracts were awarded for generation. Once completed, they will add over 1 gigawatt to the grid, helping to relieve a bottleneck for industrial and employment expansion. Efforts are still needed to take advantage of the public–private partnership mechanism to create projects in infrastructure and to make the Bangladesh Infrastructure Finance Fund operational.

Bangladesh could reap a rich demographic dividend by transforming its large young population into a productive human resource through better education and health care. A balanced combination of public and private sector initiatives in delivering these services is needed.

Another issue is ensuring the availability of land for public and private sector projects. The rapidly declining land available per capita, exacerbated by poorly maintained land records, is making it increasingly difficult to buy land for infrastructure or industrial and commercial use.

A linked emerging challenge is urban congestion, in Dhaka and Chittagong especially, but also in other urban areas. Rapid urbanization is stretching too thin cities' capacity to provide urban services. For easing traffic gridlock in cities, one option is to develop mass rapid transit systems and satellite townships near the major urban areas. Rural and semi-urban areas need to be made more livable with expanded opportunities for better livelihoods.

Bhutan

The economy, which has vast hydropower potential, is driven by the cycle of hydropower building and output. Two hydropower stations are being built and two other projects started preconstruction work in May 2010, ensuring strong growth for the medium term. The main challenges for the government are to try and diversify the economy and create job opportunities.

Economic performance

Growth is estimated to have accelerated to 7.0% in FY2010 (ended 30 June 2010) from 5.7% in FY2009 (Figure 3.16.1). Construction revived with work on the Punatsangchhu I (1,200 megawatts [MW]) and Dagachhu (114 MW) hydropower stations. Services, accounting for nearly two-fifths of GDP, contributed the bulk of the GDP gain, mainly construction related. Agriculture's growth was solid. Despite generating only about 16% of GDP, it engages over 65% of the labor force.

The electricity and water sector—nearly a quarter of GDP—did not contribute to the expansion, as no additional generation capacity has been added since Tala hydropower station came online in FY2007. Tourism was also a drag on growth due to the global downturn: visitor arrivals dropped by 9.3% and foreign exchange earnings by 12.4%.

As Bhutan is linked with India through trade (93.5% of exports and 77.7% of imports) and a currency peg, rising consumer prices in India tend to spill over. Year-on-year inflation rose to 6.1% in the fourth quarter of FY2010 from 3.0% a year earlier (Figure 3.16.2).

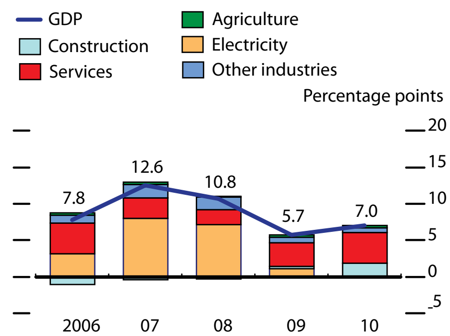
With a pickup in economic activity, growth in broad money accelerated to 30.1% from 24.6%, as domestic assets expanded. Domestic credit, primarily to the private sector, grew by 38.6% in FY2010 from 31.1% in the previous year, reflecting surging personal loans and credit to manufacturing. The sectorwide distribution of credit remained mostly to housing (about one-quarter of the loan portfolio), followed by manufacturing, personal loans, and services (including tourism).

Credit quality improved as nonperforming loans as a share of the total narrowed to 10.1% in June 2010 from 18.3% the previous year, reflecting a fall in such loans in manufacturing, where several export-oriented firms saw an upswing in sales. Banks are well capitalized with a capital-adequacy ratio of 17.1% at end-FY2010.

The budget deficit in FY2010 is estimated at around 6% of GDP, reflecting revisions that sharply raised capital expenditure despite a fall in nontax revenue (Figure 3.16.3). These adjustments stemmed from additional construction spending, including a monastery and other public buildings.

Nontax revenue declined because of a 1-year gap in dividend receipts. (Druk Holding and Investments was set up to own all major state-owned

3.16.1 Contributions to growth (supply)



Source: Royal Monetary Authority. 2011. *Annual Report 2009/10.* http://www.rma.org.bt
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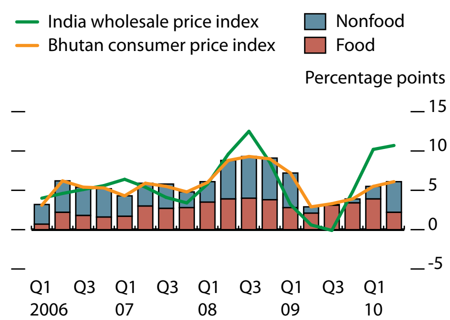
3.16.2 Contributions to inflation



Source: Royal Monetary Authority. 2011. *Annual Report 2009/10.* http://www.rma.org.bt
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3.16.1 Selected economic indicators (%)

	2011	2012
GDP growth	7.5	8.0
Inflation	8.0	7.5
Current account balance (share of GDP)	-20.0	-20.0

Source: ADB estimates.

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

enterprises, including Tala Hydroelectric Project Authority, such that dividends were not immediately passed through to the budget.) The final figure of the fiscal deficit in FY2010, may, however, be substantially lower due to underimplementation of capital investment projects. The fiscal deficit in FY2011 is estimated at 4.4% of GDP. A civil service wage hike effective January 2011 will increase current spending in FY2011 and FY2012.

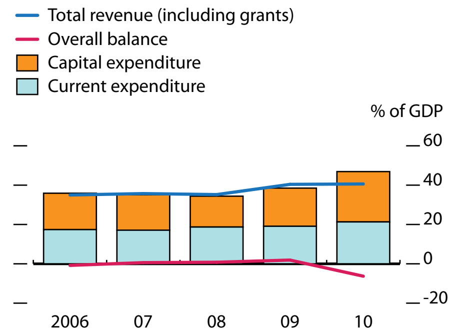
The government has announced tax incentives to stimulate private investment. Foreign direct investment (FDI) projects in FY2010 with an estimated investment of Nu1.1 billion (equivalent to $23.6 million) included an IT park and an agro-industry project.

The trade deficit is estimated to have worsened to 21.5% of GDP in FY2010 from 7.5%, as growth in merchandise imports accelerated markedly (Figure 3.16.4). Imports climbed by 39.0%, mainly because of heavy needs for machinery, transport vehicles, and base metals for the hydropower projects and housing.

Exports rose by only 5.5% as sales of hydropower to India (about two-fifths of total exports) were pretty flat as capacity production has been reached. A jump in budgetary grants, mainly from India, held the current account deficit to 13.5% of GDP in FY2010 from 1.6% the previous year.

The capital and financial account surplus—about half in capital grants and half in borrowing and FDI—nearly offset the current account deficit. The overall balance of payments was in surplus by $94 million, giving an unusually large positive errors and omissions item. Gross international reserves rose to the equivalent of $868.1 million at end-FY2010, equivalent to about 12 months of merchandise imports.

3.16.3 Fiscal indicators



Source: Royal Monetary Authority. 2011. *Annual Report 2009/10*. http://www.rma.org.bt

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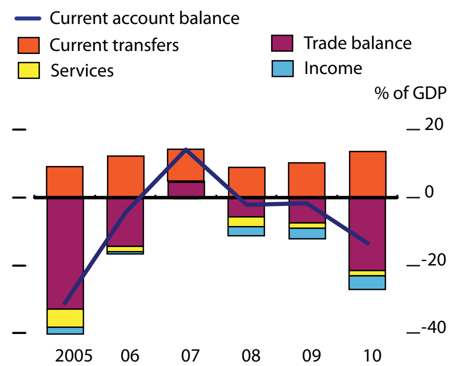
3.16.4 Current account indicators



Source: Royal Monetary Authority. 2011. *Annual Report 2009/10*. http://www.rma.org.bt

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Economic prospects

In addition to the construction of two hydropower stations, preconstruction works for Punatsangchhu II (990 MW) and Mangdechhu (720 MW) projects started in May 2010. Hydropower construction will therefore fuel GDP growth for the next 5 years, even as additional power production capacity and exports come online. Indeed, the government plans by 2020 to see new power stations increase generation capacity to 10,000 MW, about seven times the present level. Accordingly, GDP is estimated to grow by 7.5% in FY2011 and 8.0% in FY2012.

High inflation in India, especially of food, is a concern. Projected higher global commodity price hikes will indirectly affect Bhutan, where inflation is expected to reach 8.0% in FY2011 and moderate to 7.5% in FY2012.

The current account deficit will deteriorate, mainly owing to imports of construction materials for power stations, as well as higher import prices of fuel. Export growth will likely be limited in the next couple of years. Expansion will need to come mainly from manufactured and commodity exports, as no additional power generation capacity will come online.

Although tourism revenue will grow, soaring imports are expected to push the current deficit out to around 20% of GDP in both years. As with past projects, capital inflows from India to finance power plant construction, combined with development assistance, FDI, and some other borrowing, will likely suffice to finance the current account deficit.

3.16.1 Development challenges

The slowdown in economic growth in FY2009, when neither new construction or new production in the power sector were strong, indicates that growth is not being led by productivity improvements or new business ventures. The government's decision to undertake the Thimphu Technology Park and Education City projects are attempts to foster economic diversification by moving toward a knowledge-driven economy.

Generating jobs is hard, as hydropower has small backward linkages and is capital intensive. Speeding up private sector development is therefore crucial to expand job opportunities and diversify the economy.

The government has announced Fiscal Incentives 2010—a broad array of general and sector-specific tax incentives—as well as Foreign Direct Investment Policy 2010, to promote private sector investment.

India

The Indian economy experienced high and broad-based growth over the past fiscal year. Inflation has been the main challenge for policy makers, with the observed pattern of price increases highlighting the need to tackle decisively weaknesses along the domestic agricultural supply chain. Weaker global trade growth and a necessary further tightening of fiscal and monetary policies will slow economic growth marginally in the new fiscal year. However, progress on fiscal consolidation and success in easing supply-side constraints will pay off the following year.

Economic performance

The economy grew by 8.6% in FY2010 (ending March 2011) according to the government's advance estimates. Growth has been broad-based and driven by a solid recovery in agriculture and continued good performance of industry and services (Figure 3.17.1).

Helped by a good monsoon that boosted the *kharif* (summer) crop, agriculture is estimated to grow by 5.4% in FY2010, after 0.4% in FY2009, when a deep and widespread drought (and subsequent flooding) held back farming. Foodgrain production, estimated at 232 million tonnes in FY2010, is 6.4% higher than FY2009's output (though still lower than the record 234 million tonnes in FY2008).

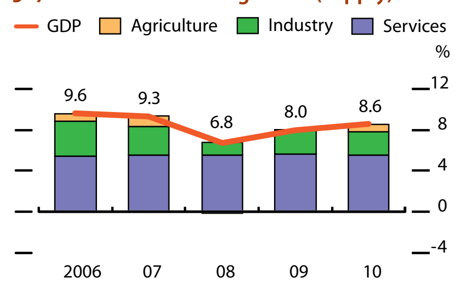
While industry is estimated to record healthy growth of 8.1% in FY2010, the second half saw a moderation of growth. In particular, after growth of 10.1% in the first half, industrial output growth slowed to single-digits in the second.

The main contributors to strong growth in the first half of FY2010 were consumer durables and capital goods. Important infrastructure sectors, such as crude oil, petroleum refining, electricity, and steel, also performed well. Apart from the base effect, the deceleration in the second half has been driven by a slowdown in capital goods production owing to a slowdown in investment. While it is difficult to pin down the exact cause of the investment slowdown, delays in obtaining environmental clearances, difficulties with land acquisition, and the lack of progress on some expected policy reforms may have played a role.

Services are estimated to grow by 9.6% in FY2010, a little lower than the 10.1% growth registered in FY2009. Key drivers included the trade; hotels; transport and communications; and finance, insurance, real estate, and business subsectors. Given the dominance of services, their healthy performance is crucial for high overall growth. This sector accounted for 64% of overall GDP growth in FY2010, down from 71% in FY2009.

The drivers of growth from the expenditure side have also been broad-based (Figure 3.17.2), with healthy contributions from private

3.17.1 Contributions to growth (supply)



Source: Ministry of Statistics and Programme Implementation. http://www.mospi.nic.in (accessed 8 March 2011).

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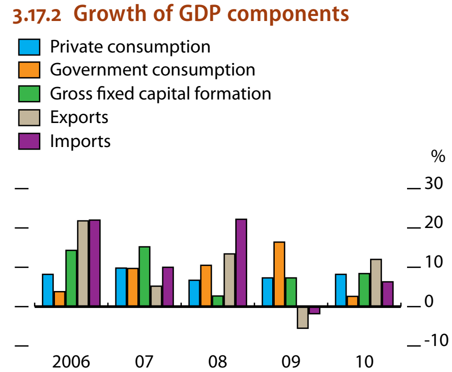
3.17.2 Growth of GDP components



Sources: Ministry of Statistics and Programme Implementation. http://www.mospi.nic.in (accessed 8 March 2011); ADB estimates.

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This chapter was written by Rana Hasan of the India Resident Mission, ADB, New Delhi.

consumption, investment, and exports. While total consumption growth slowed from 8.7% in FY2009 to 7.3% in FY2010, this stemmed from a concurrent sharp decline in growth of government consumption from 16.4% to 2.6%; growth in private consumption—which accounts for more than four-fifths of total consumption—rose from 7.3% to 8.2%.

Similarly, although growth in gross capital formation slowed from 13.8% to 8.8% over the same period, fixed capital formation edged up from 7.3% to 8.4%. Nevertheless, the full figure for FY2010 masks a slowdown in the second half when fixed capital formation growth dropped from double digits in the first half to 6% in the third quarter. In contrast, exports picked up significantly in the second half, leading net exports to contribute positively to growth for the first time in many years.

With the onset of global recovery, investment registered a marked increase from 34.5% of GDP in FY2008 to 36.5% in FY2009, driven by a rise in corporate sector investment of 1.7 percentage points of GDP. The investment rate is estimated by the Economic Advisory Council of the Prime Minister to have increased to 37%. The saving rate recovered somewhat in FY2009 to 33.7% of GDP and appears to have risen marginally to 34% in FY 2010. Both saving and investment remain, however, below their precrisis highs (Figure 3.17.3).

Inflation has been a major concern in FY2010. While monthly year-on-year rates moderated from the double-digits reached in mid-2010, they are estimated to have been 9.2% for the fiscal year. Food inflation has been an important driver, accounting for between a quarter and a third of monthly wholesale price inflation in FY2010.

Much of the initial surge in food inflation in FY2010 (Figure 3.17.4) came from the weak FY2009 monsoon's impact on output and prices of cereals, pulses, and sugar. It has later been driven by subcontinent-specific weather shocks and demand–supply mismatches, as rising incomes and shifting dietary patterns increased demand for vegetables, fruits, and high-protein items. These factors have highlighted the need for dramatically improving production and distribution systems in agriculture.

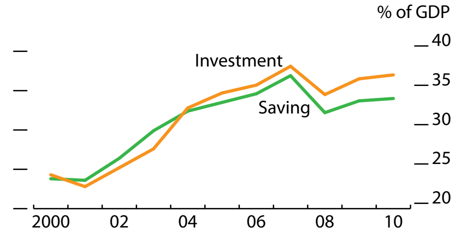
Finally, as the product-based breakdown of the figure shows, price increases in manufactured products have been important and have contributed to worries that inflation expectations are becoming entrenched.

Tackling the problem of high inflation has turned out to be complex. In response to rising inflation and a recovering economy, the Reserve Bank of India (RBI) reversed its accommodative policy stance in March 2010. The RBI has raised the repo rate (the rate at which banks borrow from it) eight times by 200 basis points in FY2010, which now stands at 6.75%; it has also raised the reverse repo rate (the rate at which it borrows money from banks) over the same period, and that now stands at 5.75% (Figure 3.17.5). The central bank also raised the cash-reserve ratio from 5.5% to 6.0% in April 2010.

The RBI recognizes that monetary policy may not be the most effective instrument to deal with supply-side pressures on inflation. But its concern is that the repeated supply shocks that have affected the economy, along with recent petroleum price increases, have generated expectations of high inflation and may contribute to future inflation. The increase in key policy rates has been partly carried out to contain such expectations.

Liquidity tightened considerably owing to an increase in credit growth

3.17.3 Saving and investment ratio



Source: Asian Development Outlook database.

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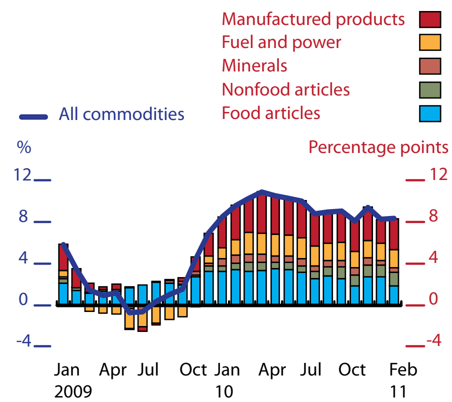
3.17.4 Contributions to inflation



Source: Ministry of Industry and Commerce. http://eaindustry.nic.in (accessed 17 March 2011).

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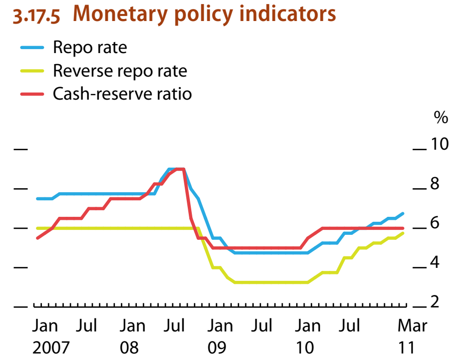
3.17.5 Monetary policy indicators



Source: CEIC Data Company (accessed 18 March 2011).

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and a fall in the deposit growth rate. The latter was driven by depressed real interest rates, withdrawal of deposits by telecoms companies to pay third-generation license fees, and purchases related to initial public offerings. To bolster deposits, banks have begun revising deposit rates upward by 50–75 basis points.

Merchandise exports are expected to climb from $175 billion in FY2009 to $230.3 billion in FY2010, but rising oil prices and resurgent domestic demand have taken imports from $295.5 billion to $362.3 billion (Figure 3.17.6), pushing out the trade deficit from $120.5 billion to $132 billion in FY2010. The first half of FY2010 also recorded sluggish performance of invisibles, largely due to the nonsoftware component of services.

As a result of these trends, the current account deficit is estimated to increase from $38.4 billion in FY2009 to $50.3 billion in FY2010. But a stronger currency and high nominal GDP growth in FY2010 means that, as a share of GDP, the current account deficit is estimated to be around 3.0%, a little higher than FY2009's 2.8%.

The capital account surplus is estimated to have improved from $47.8 billion in FY2009 to $64.6 billion in FY2010. Much of this gain is based on higher portfolio and debt flows, with the former increasing from $32.3 billion during FY009 to $38.8 billion in FY2010. These flows tend to be volatile, however, as seen by a net outflow of portfolio investment of $19.8 billion in November 2010 (Figure 3.17.7).

The upsurge in portfolio inflows was largely due to a global risk rally, leading to higher capital flows to emerging markets and interest shown in some public offerings. These flows helped the stock market to put on 30% in May–October 2010, though it has since declined by about 12.7% (Figure 3.17.8). In contrast, foreign direct investment (FDI) inflows slowed notably, from $35.6 billion in FY2009 to $27.6 billion in FY2010. The deceleration can only partly be explained by a still weak global recovery. Difficulties in land acquisition and environmental issues and slow progress of liberalization of certain sectors such as retail and insurance are likely also to have played a role.

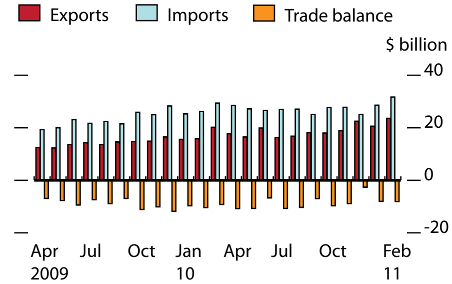
The excess of capital flows over the current account deficit resulted in accretion to foreign exchange reserves, which rose by $17.8 billion to exceed $300 billion in March 2011 (Figure 3.17.9). A part of this rise was due to valuation change as some of the major currencies appreciated against the US dollar during the year.

The rupee has remained quite stable in FY2010. It rose marginally against the US dollar. Inflation higher than in trading partners has led to a modest rise in the real effective exchange rate (Figure 3.17.10).

Better than expected revenue from the sale of third-generation spectrum for high-speed telephony and broadband services, as well as robust GDP growth, helped to reduce the central government's fiscal deficit from 6.4% of GDP in FY2009 to 5.1% in FY2010, thereby restricting the combined deficit of the center and states to around 8.1% (Figure 3.17.11). The ratio of central government gross tax revenue (including states' share) to GDP increased to 10% in FY2010, improving from 9.5% in FY2009, but it remains much lower than the 11.9% achieved in FY2007.

Despite India's strong resilience to the crisis and its ability to post robust growth rates, it has made little progress in some reforms. Moves to increase

3.17.6 Merchandise trade



Source: Reserve Bank of India. http://www.rbi.org.in (accessed 26 March 2011).

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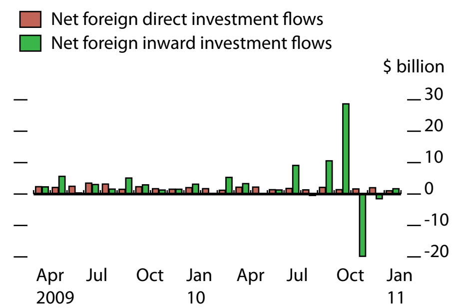
3.17.7 Investment



Source: Reserve Bank of India. http://www.rbi.org.in (accessed 26 March 2011).

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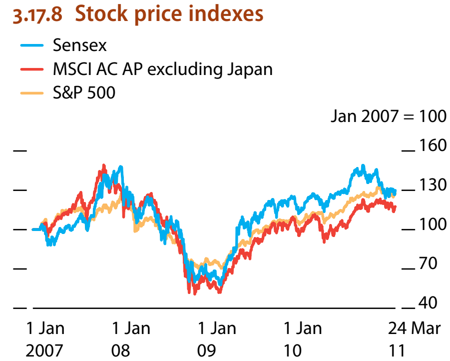
3.17.8 Stock price indexes



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

Source: Bloomberg (accessed 24 March 2011).

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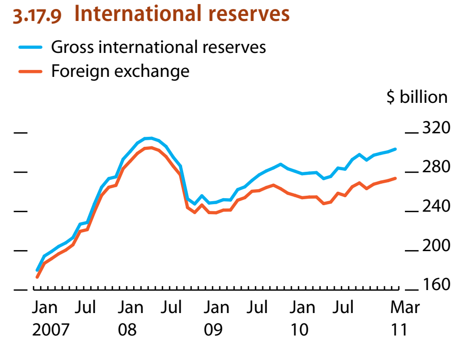
3.17.9 International reserves



Note: Gross international reserves includes gold and SDRs.

Sources: CEIC Data Company; Reserve Bank of India. http://www.rbi.org.in (both accessed 26 March 2011).

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the limit of foreign investment in sectors such as retail and insurance stalled in FY2010. Also, some major industrial projects faced difficulties in getting the required clearances from the environment ministry.

Finally and critically, the move toward a unified goods and services tax (GST), which is an important step for fiscal consolidation, slowed, with the center and states gridlocked in negotiations. The states have been concerned about losing their fiscal autonomy, which would follow from a loss of power to change tax rates. They also have anxieties that a GST would raise their dependence on central government transfers. The center and states are also discussing GST rates, as some states view the proposed revenue-neutral rates as too low. Moreover, they disagree over the taxes to be subsumed under the GST system.

Recent months have, however, seen positive steps on some of these issues. A renewed effort is under way to allow greater FDI in retail and insurance in a phased manner. The environment ministry has allowed through (with conditions) some of the projects initially denied environmental clearance but has asked promoters for some of the others to apply afresh.

On the fiscal front, there is an attempt to move toward direct cash transfers for subsidized fertilizer, liquefied petroleum gas, and kerosene, which are expected to contain the waste and misdirection of these commodities. Last, the government on 21 March introduced to Parliament a constitution amendment bill to facilitate implementation of the GST.

Economic prospects

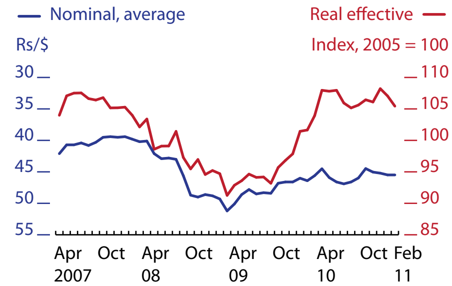
The following forecasts for FY2011 and FY2012 make several assumptions, in addition to those given in the baseline table 1.1.1 in part 1: the monsoons in both 2011 and 2012 will be normal; monetary tightening will continue in FY2011; and the government will broadly adhere to the rigorous fiscal consolidation road map suggested by the 13th Finance Commission.

While domestic pressures on inflation are expected to ease on account of normal monsoons and payoffs from the government's efforts at improving the agricultural supply chain, elevated international oil prices will exert upward pressure on prices. On balance, average inflation for FY2011 and FY2012 is expected to decline to 7.8% and 6.5%, respectively (Figure 3.17.12) on account of a high-base effect and further tightening of monetary policy by the RBI to anchor expectations.

Along with higher input prices due to rising oil prices, monetary tightening will tend to further damp private investment, which was slowing toward the end of FY2010. The government's efforts at fiscal consolidation will, however, help to provide some relief. Especially if consolidation proceeds largely as spelled out in the government's budget for FY2011—spending on subsidies is kept in check and planned infrastructure investment is not compromised—private investment may experience some "crowding in," even as the government reins in its overall spending.

Of course, elevated oil prices suggest that the government may not be able to hit its target for reducing subsidies by 12.5% in FY2011. Even with the move in 2010 to deregulate gasoline (petrol) prices, other fuel prices and natural gas remain under administrative control and the government

3.17.10 Exchange rates



Sources: CEIC Data Company; Bank of International Settlements. http://www.bis.org; (both accessed 26 March 2011).

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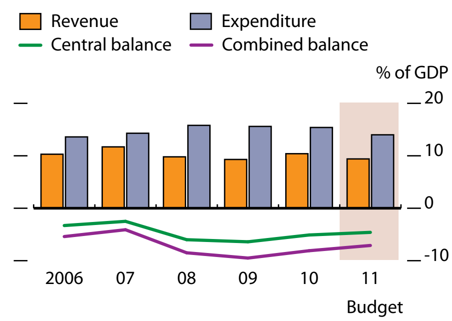
3.17.11 Fiscal indicators



Note: FY2010 is a revised, estimated budget outcome that includes the proceeds from telecoms auctions.

Source: Ministry of Finance. http://indiabudget.nic.in (accessed 21 March 2011).

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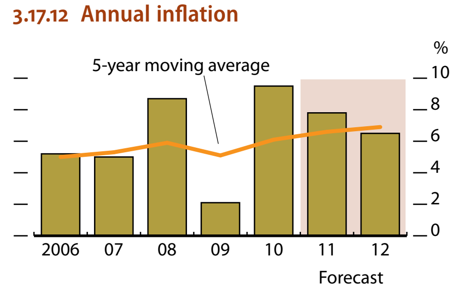
3.17.12 Annual inflation



Source: Asian Development Outlook database.

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is unlikely to raise their prices one-on-one with market conditions. Nevertheless, some reduction in subsidies should be possible and the government's intended move toward direct cash transfers of fuel-related subsidies could have far-reaching consequences in the medium term.

Based on the assumption of normal rainfall and with higher base, agriculture is expected to expand by 3%–4% in FY2011 and FY2012. In addition, proposed increases in public investment in the sector should provide it with a boost. But industry and services will remain the key drivers of growth.

At the same time, some large greenfield manufacturing projects have faced hurdles in terms of acquiring land and obtaining environmental clearance. Although these cases involve complex trade-offs between development, traditional livelihoods, and the environment, policy and regulatory clarity on these issues is crucial.

Yet the government's intention of streamlining the regulatory burden on Indian firms, and the expectation that current restrictions on FDI in multi-brand retail will be relaxed, augur well for both industry and services, especially by FY2012.

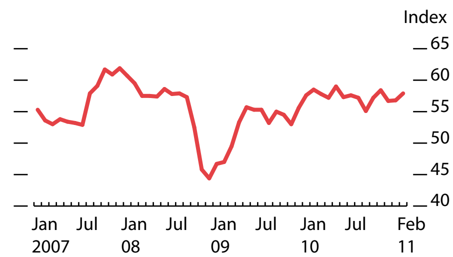
Sustaining growth also depends on external demand, which is assumed to moderate marginally following a rise in global economic risks. A survey by the HSBC Markit Purchasing Managers' Index for both manufacturing and services released in March 2011 shows some improvement, largely due to increase in orders and expansion in new business activity (Figure 3.17.13).

But there are strong downside risks, notably inflation pressure from rising oil prices. In view of the *Asian Development Outlook 2011*'s assumptions for oil prices, as well as monetary and fiscal tightening, GDP growth is expected be a little lower in FY2011 than in FY2010 at 8.2%. It should rise to 8.8% in FY2012 as reform efforts and regulatory clarity boost investment and economic activity more generally.

The current account deficit is very likely to widen over the next 2 years—fairly sharply to 3.5% of GDP in FY2011—driven by a deteriorating trade deficit and moderate growth in invisibles. While foreign capital inflows have covered this deficit relatively comfortably in recent years, trends in FY2010 flag a cause for concern.

As is well known, international flows of portfolio capital can exhibit considerable volatility and thus the slowdown in inflows of FDI to India—in contrast to the pickup observed in other emerging economies—is troubling. The recent budget has relaxed norms for foreign institutional investors in order to attract more foreign capital, especially in infrastructure. But these also need to be backed by an improvement in the regulatory environment in which firms—domestic and foreign—operate.

3.17.13 HSBC India manufacturing purchasing managers index



Source: Bloomberg (accessed 21 March 2011).

Click here for figure data

3.17.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.2	8.8
Inflation	7.8	6.5
Current account balance (share of GDP)	-3.5	-3.3

Source: ADB estimates.

Development challenges

Sustaining high growth and ensuring that it is inclusive remains India's foremost development challenge. Even with the tremendous dynamism exhibited by services—a sector that has contributed almost two-thirds of GDP growth in recent years and now accounts for 55% of GDP and 25% of total employment—it is difficult to see how India will be able to sustain

inclusive growth without boosting agricultural productivity and further strengthening manufacturing. The latter is crucial for employing a young and growing workforce—including those released from farm work—with productive and well-paying jobs.

Agriculture has suffered a secular decline in public investment since the mid-1990s, as well as a steady increase in input subsidies such as those for power and fertilizer. The country is behind comparable countries in investing in new technology, research and development, and infrastructure. For example, it invests only 0.5 % of its agricultural GDP in agricultural research, compared with 0.7 % in developing countries as a whole and as much as 2–3 % in developed countries.

A silver lining to the high food inflation over the past year is the urgency it has generated among policy makers to engineer a second green revolution in India (Box 3.17.1).

The task of transforming manufacturing also deserves the attention of policy makers. A defining feature of India's manufacturing is the overwhelming importance of small firms and the informal sector in jobs (also known as the unorganized sector). Thus 84% of India's manufacturing employment is estimated to be in firms with fewer than 50 workers (Figure 3.17.14), whereas the corresponding shares are 25%–47% for economies such as the PRC; the Republic of Korea; Malaysia; Taipei,China; and Thailand. At small scales of operation, firms can often get caught in a vicious circle of reliance on traditional, low-productivity technologies with limited earnings and few growth prospects.

At the same time, larger enterprises—those operating in the formal (or organized) sector where both productivity and wages tend to be relatively high—have often been stymied by infrastructure and regulatory bottlenecks from expanding. As a result, although employment in the subsector grew robustly in 2004–2008, it still stood at only some 11 million (around 2.5% of the labor force).

From a policy perspective, there are two broad challenges for transforming manufacturing. For the formal subsector, much policy reform has already taken place—such as industrial delicensing in the 1990s and large-scale cutbacks in small-scale sector reservations in the early to mid-2000s.

What remains to be tackled are infrastructure bottlenecks, features of India's labor regulation that impinge on the adjustment of labor use within and across plants and sectors, and difficulties in the acquisition of land and environmental clearances for industrial activity. The government's recent announcement on a manufacturing policy that will tackle various regulatory issues is an opportunity to make headway on difficult institutional and politically sensitive issues.

For the informal subsector, and small and medium-sized enterprises in the formal sector, imperfections in credit markets and lack of awareness and access to markets and technologies add to the infrastructure-related difficulties that these firms face. While the government has in place a variety of interventions for assisting such firms in these areas, the key challenge lies in effectively delivering program services to target enterprises. To make sure that public financing is not wasted, clear benchmarks for success and failure must be adopted, and rigorous monitoring and evaluation systems must be built into the government's programs.

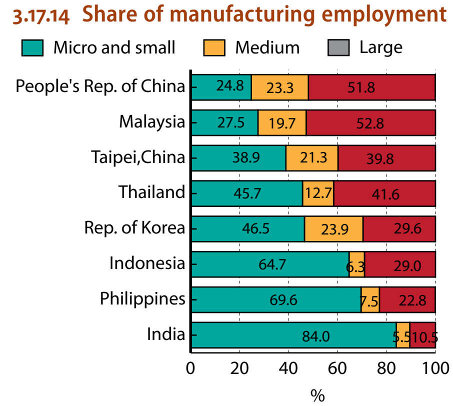
3.17.1 Transforming agriculture

The government has announced higher funding for a slew of programs aimed at dealing with production and distribution bottlenecks for fruits, vegetables, milk, meat, poultry, and fish—items that have been particularly susceptible to large price increases.

Efforts for developing "mega food parks" (for reducing wastage of fruit and vegetables for lack of storage facilities) and augmenting storage capacity and cold chains through public–private approaches are also being promoted. The government will recognize cold chains and postharvest storage facilities as an infrastructure subsector in its own right, making it eligible for any special benefits that apply.

Careful monitoring and evaluation of these efforts is needed to ensure that they have the intended effects. At the same time, state governments must review the operation of the Agricultural Produce Market Committee Act. Revamping this act would allow, for example, agro-processors, private markets, corporations, and exporters to directly deal with farmers and ease restrictions that apply to contract farming and the movement of agricultural produce from one location to another.

3.17.14 Share of manufacturing employment



Notes: Micro and small: 1–49 in all countries except Thailand (1–50 workers); Medium: 50–199 in all countries except Thailand (51–200 workers); Large: 200 or more workers in all countries except Thailand (more than 200 workers)

Source: Rana Hasan and Karl Robert Jandoc. 2010. The distribution of firm size in India: What can survey data tell us? *ADB Economics Working Paper Series* No. 213. Asian Development Bank, Manila.

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Maldives

The Maldives is attempting to push through major fiscal reform, but government efforts to implement deficit-reduction measures have been impeded by political sensitivities. The passage of new tax bills in 2010, although it took longer than scheduled, will generate revenue gains in the near term. Nevertheless, the government will need to formulate a strong medium-term adjustment strategy in order to get its economic program supported by international financial institutions.

Economic performance

The government struggled to implement fiscal reforms in 2010. Since the president's party is in the minority in the *Majlis*, it faced difficulties in pushing reforms through Parliament. The agenda included a Tourist General Service Tax (T-GST) and Business Profit Tax (BPT). As the political situation worsened from midyear—the cabinet resigned en masse—progress in fiscal reforms has slowed, especially in the area of expenditure reduction.

The T-GST was, however, passed in August, becoming effective in January this year; the BPT was passed in December and takes effect in July this year. The fiscal gap would have been larger had it not been for a temporary cut in civil servants' wages. An improvement in revenue on the back of a rebound in tourist arrivals also helped to narrow the budget deficit for the year.

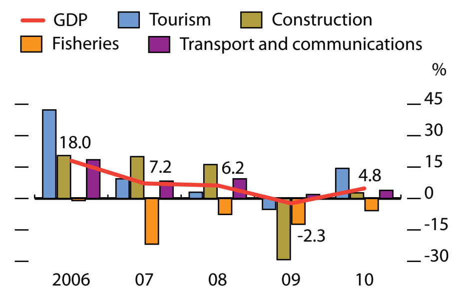
Against this backdrop, GDP growth recovered to 4.8% in 2010 after contracting by 2.3% in 2009 (Figure 3.18.1). A key driver was a better than expected upswing in tourism, which accounts for almost a third of GDP. Tourist arrivals registered a rebound of 20.7% in 2010. An influx of visitors from the People's Republic of China, the Republic of Korea, India, and other Asian countries outpaced a slower renaissance in European arrivals, a market usually accounting for around two-thirds of total visitors (Figure 3.18.2). As tourism gathered momentum, its linked sectors—transport and communications, and wholesale and retail—saw growth of 3.9% and 4.8%.

Fisheries have been performing poorly since 2006, reflecting a decline in the fish catch, and, contracting by 5.8%, were a drag on growth. Despite constituting only 3.2% of GDP, the industry is a major source of employment in many of the outer atolls.

Due to the country's import-dependent nature, rising international prices for fuel and food exerted upward pressure on domestic prices in the second half of 2010 (Figure 3.18.3). Inflation was 5.1% in December 2010, 1.1 percentage points higher than a year earlier.

While credit to the private sector continued to fall (by 2.4% year on

3.18.1 Selected GDP growth indicators



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv

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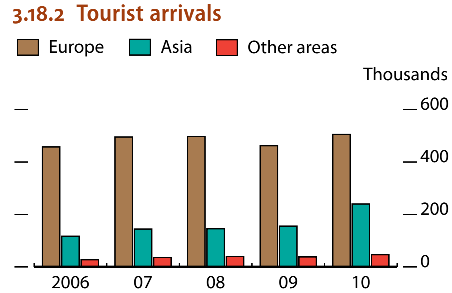
3.18.2 Tourist arrivals



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv

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

year in December 2010), Treasury bills held by banks rose by 28.4% as part of a 32.9% expansion in net credit to the government. Broad money increased by 16.5%. The interest rate on T-bills declined in the first half of 2010, but partly came back during the second (Figure 3.18.4).

The fiscal deficit is estimated to have narrowed to 16.4% of GDP in 2010 from 30.9% in 2009 (Figure 3.18.5). Although total revenue (excluding grants) is expected to have picked up by 14.6%, reflecting a rebound in tourism-related earnings and profits received from the airport concession, it was 11% below the original projection after the T-GST and BPT did not materialize in time to boost 2010 revenue as planned. Expenditure dropped by 10.2% as the government put through temporary fiscal austerity measures, such as wage cuts for public servants.

The Rf12.37 billion ($962.6 million) budget for 2011, passed in December 2010, sets only a slight reduction in the deficit to 15.3% of the GDP. Upfront payments by resort islands for lease extensions, from 25 to 50 years, as well as new tax measures, will increase fiscal revenue. But there is so far no clear road map for long-term expenditure saving.

On the external front, the current account deficit is estimated to have slightly narrowed to 31.3% of GDP in 2010 from 31.8% in 2009, as the gain in tourism receipts was outweighed by higher imports (Figure 3.18.6). While reserves declined through most of the year they spiked in November, on a $74 million upfront payment by the airport concession. This transaction helped to push the overall balance of payments into surplus, lifting gross international reserves by about one-third to $349.9 million in 2010, yielding 3.3 months of import cover. The Maldives Monetary Authority continued its currency peg to US dollar at a rate of Rf12.8, though foreign exchange shortages and a parallel market premium persisted during the year.

Economic prospects

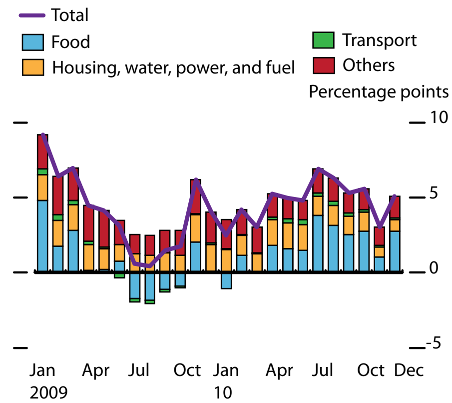
Tourism is likely to lead economic growth. Tourist arrivals from Europe should continue recovering, and the number of Asian tourists will continue growing, as their disposable incomes improve.

The 2011 budget plans about a 25% increase in total expenditure, and the medium-term fiscal framework projects the same level of expenditure in 2012, a marked turnaround from the near 12% decline a year earlier. At nearly three-fifths of GDP if fully carried out, these plans represent a marked expansion in domestic demand. On the basis that planned expenditure is scaled down and tourism makes further gains, GDP is expected to grow by 5.0% in each of the next 2 years.

On the assumption that the global oil and food prices rise substantially in 2011 and moderate in 2012, and budget expenditure pressures on domestic inflation. It is projected that inflation will rise to 8.0% or more in 2011, and moderate to 7.0% in 2012.

Steady economic growth, primarily due to the tourism rebound, and higher international commodity prices will buttress merchandise import growth. Assuming that the currency peg to the US dollar continues, growth in imports will continue to outpace tourism receipts, the current account deficit is expected to widen to 35% of GDP in 2011 and will remain at this level in 2012.

3.18.3 Contributions to inflation



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv
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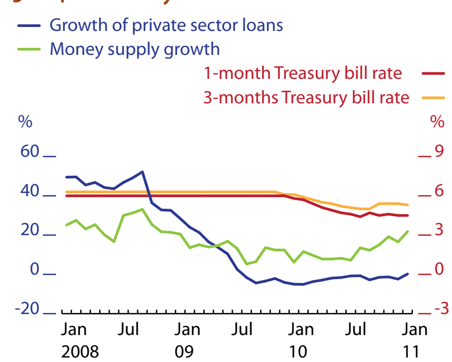
3.18.4 Monetary indicators



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv
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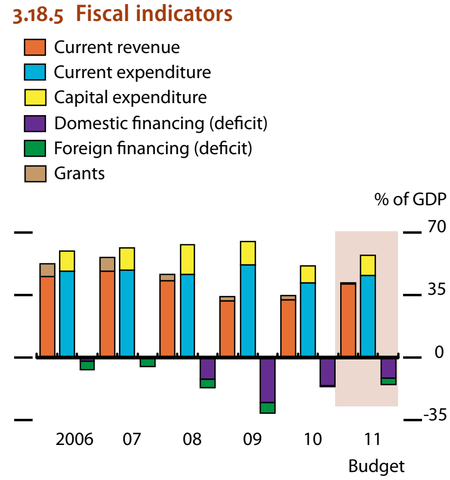
3.18.5 Fiscal indicators



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv
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Development challenges

Persistent fiscal and external imbalances have rendered the country vulnerable to external shocks. International financial institutions have therefore been supporting the government's reform initiatives, including a stand-by arrangement with the IMF. The lack of a political consensus has prevented agreement on the next steps in the country's medium-term adjustment strategy, though these are expected to be resolved in due course.

Reducing income disparities between Malé and the atolls is important. Private sector development, especially promotion of micro-, small- and medium-sized enterprises outside Malé, is therefore critical. Such promotion is also an important mandate of the government through its decentralization policy.

Weak institutions and human resources are major constraints. Public sector institutions face capacity constraints, since pay in the civil service lags far behind the private sector, and second jobs among public employees are common. While heavy reliance on expatriate labor has allowed the Maldives to grow strongly for many years, the downside is that existing institutions do not have adequate capabilities.

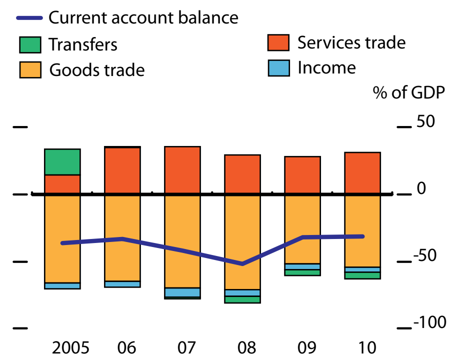
As one of the world's most vulnerable nations to sea-level rise, the government has announced plans to become the first carbon-neutral country in the world within a decade. It is preparing an investment plan along these lines, and hopes that it will not only serve as a blueprint for other nations but also draw world attention to climate change.

3.18.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.0	5.0
Inflation	8.0	7.0
Current account balance (share of GDP)	-35.0	-35.0

Source: ADB estimates.

3.18.6 Current account indicators



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv

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Nepal

Political uncertainties, unfavorable weather, and weakening remittances from workers abroad restrained economic growth in FY2010. Fiscal prudence continued. Growth will fall below the 5-year average of 4.0% in FY2011, primarily reflecting the protracted postconflict transition process, but a modest pickup is foreseen in FY2012, supported by tourism and more vibrant construction activity. Key risks to growth are further delay to completing the transition, high food and oil prices, and potential impact of unrest in the Middle East.

Economic performance

GDP growth inched up to 4.0% in FY2010 (ended 15 July 2010) from 3.8% in FY2009 (Figure 3.19.1). The marginal improvement was made possible by a turnaround in growth in the relatively small industry sector (helped by fewer political strikes), and sustained expansion of services. A deceleration in remittance inflows due to the lagged impact of the global financial crisis weighed on economic activity, as did slowing agricultural output (for a second year) due to a sparse monsoon.

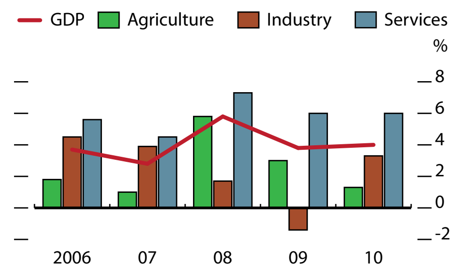
The deceleration in remittance growth, alongside commercial banks' excessive lending to real estate and reduced liquidity in banking, drove interbank borrowing rates to a record high. Inflation stayed close to double digits owing to high food prices in the first half of FY2010 (Figure 3.19.2), which in turn originated in a low domestic crop and India's high food-inflation.

Exports as a share of GDP have been dwindling in the last few years, because low productivity and infrastructure bottlenecks have undermined competitiveness. Conversely, imports as a share of GDP have been showing a trend increase over several years, with growth more pronounced in FY2010, as gold imports swelled. (Gold was the investment of choice, given paucity of attractive alternatives in a correcting real estate market.)

The widening trade deficit, coupled with slowing remittances, took the current account deficit to 2.7% of GDP in FY2010 from a surplus of 4.2% of GDP the year before. This led to a $113 million decline in official reserves. The authorities accessed $42 million from the International Monetary Fund through its Rapid Credit Facility, which provides concessional assistance to low-income countries to tide them over external shocks.

Previous years' fiscal stability was maintained, with the deficit narrowing from 3.3% of GDP in FY2009 to 2.0% of GDP, though this apparent improvement stems from delayed approval of the FY2010 budget and from a continued difficult environment for implementing projects, which kept capital spending to only 70% of target. Revenue collection

3.19.1 GDP growth by sector



Source: Central Bureau of Statistics.

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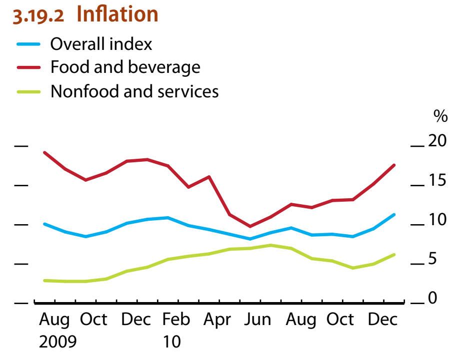
3.19.2 Inflation



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

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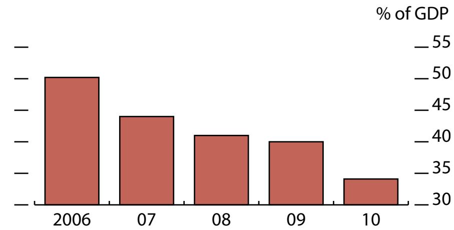
This chapter was written by Yubraj Acharya of the Nepal Resident Mission, ADB, Kathmandu.

preserved its recent positive momentum, helping to offset the continued surge in recurrent spending, notably on civil servants' and teachers' salaries. Small fiscal deficits and large grants by multilateral agencies have helped to improve the public debt position in recent years (Figure 3.19.3).

Despite a challenging political environment, the share of the population living below the national poverty line of about $160 a year is estimated to have declined to 25% in 2010 from 31% in 2004, largely owing to robust remittance inflows, rapid urban growth, a decline in fertility, and rising agricultural wages.

Strides have also been made in other Millennium Development Goals, such as child and maternal mortality, although greater efforts are needed to achieve similar progress in areas such as productive employment and child malnutrition. Efforts are also needed to reduce inequality—currently the highest in South Asia, with a Gini coefficient of 0.47.

3.19.3 National debt



Sources: Ministry of Finance. Financial Comptroller General Office; ADB estimates.

Click here for figure data

3.19.1 Selected economic indicators (%)

	2011	2012
GDP growth	3.8	4.0
Inflation	10.0	8.0
Current account balance (share of GDP)	-0.5	-0.5

Source: ADB estimates.

Economic prospects

Economic performance in FY2011 and FY2012 will rest primarily on progress in the postconflict transition process—currently slow as seen in the 1-year extension, to May 2011, of the tenure of the Constituent Assembly that was elected to draft a new constitution. The political vacuum and drift created following the Government's resignation in June 2010 ended only in February this year. The FY2011 budget was promulgated only by ordinance 4 months into the fiscal year.

All these delays reflect the difficult transition that Nepal is suffering. With little time left for writing the constitution, many of the contentious issues, such as army integration and state restructuring, have yet to be resolved.

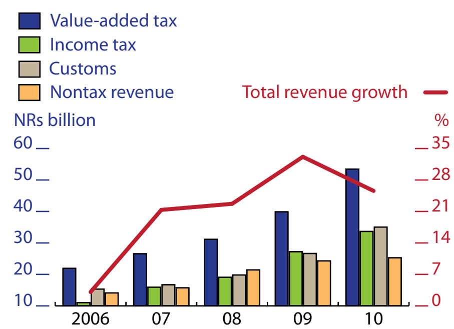
The protracted transition and the associated political disruptions have hit the economy. The delay in announcing the FY2011 budget, for example, has undermined solid progress made recently in revenue mobilization, which achieved 25% average annual growth in the last 4 years (Figure 3.19.4). More important, it has deprived the population of a much hoped-for peace dividend, including greater capital spending (Figure 3.19.5) and development benefits.

GDP growth is forecast to weaken slightly to 3.8% in FY2011. Agriculture is expected to grow by 4.0% in FY2011 (up from 1.3% in FY2010), largely due to a weather-induced recovery in the output of key summer crops (Figure 3.19.6). This improvement will not, however, be enough to offset the deceleration in nonfarm activities.

Political uncertainty, as well as power cuts (lasting as much as 14 hours a day since mid-February this year) will continue to take a toll on nonfarm activities. The tightening FY2011 monetary policy of Nepal Rastra Bank (NRB, the central bank), aimed at stabilizing the real estate market, will further curtail services expansion, to 4.5% growth in FY2011, down from 6.0% in FY2010. A slowdown in construction activity and higher fuel costs will limit industry's growth to 1.0% in FY2011, compared with 3.3% a year earlier.

GDP growth is expected to improve modestly to 4.0% in FY2012 (assuming continued normal weather conditions). A pickup in tourism-related activities driven by the Nepal Tourism Year 2011 campaign should

3.19.4 Revenue indicators



Source: Ministry of Finance. 2010. *Economic Survey Fiscal Year 2009/10*. July. http://www.mof.gov.np

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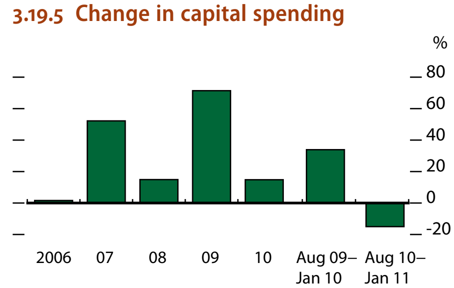
3.19.5 Change in capital spending



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

Click here for figure data

raise services growth to 5.5%. A modest uptick in construction activity, as NRB's policy is absorbed, should lift industry's growth to 1.5%.

Year-on-year inflation reached 11.3% in January, largely reflecting food and fuel price increases. A revision of the consumer price index—lowering the weight for food in line with the Fourth Household Budget Survey, 2005/06—has pulled calculated inflation down by about 1 percentage point relative to the previous method.

Average inflation for FY2011 is expected to be 10.0%. High food and oil prices and the domestic distortions such as power cuts will continue to exert upward pressure, only part of which will be offset by the good harvest. With likely moderation in Indian prices (see the chapter on India) and the government's measures to prohibit transport syndicates' restrictive practices (which have contributed to higher prices), 8.0% average inflation is expected in FY2012.

It is assumed that NRB will not tighten monetary policy further in the rest of FY2011 and FY2012 for two main reasons. First, the current policy stance has already considerably slowed real estate activity. A further tightening could trigger a disruptive correction in house and land prices, worsening the quality of commercial banks' loan portfolios and potentially posing a threat to macroeconomic stability.

Second, the expected moderation of Indian inflation will probably obviate any need for monetary tightening. NRB's attention is likely to be focused on establishing confidence in the banking system and enhancing its supervision capacity. The vulnerability of the commercial banking system has increased significantly in recent years due to a rapid emergence of other financial institutions (Figure 3.19.7). Recurring bank liquidity crunches are manifestations of this vulnerability, as deposits have reportedly been shifted from major commercial banks toward smaller financial entities that offer higher deposit rates, are difficult to supervise, and appear to take on riskier lending.

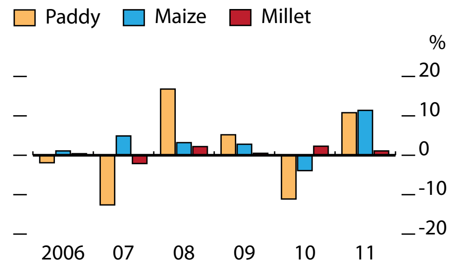
After sharply deteriorating in FY2010, the external position has since recovered significantly (Figure 3.19.8). Although the oil import bill is soaring because of higher prices, overall import growth has slackened, mirroring remittance inflows.

Exports have picked up, partly in response to the tax incentives for exporters announced in the FY2011 budget. As a result, the merchandise trade deficit has been limited to $2.0 billion in the first half of FY2011. Remittances and tourism receipts have offset 90% of this deficit. After an approximate 4% fall in FY2010, external reserves recovered this loss in the first half of FY2011, to reach $2.8 billion in January 2011, worth about 6 months of imports (Figure 3.19.9).

Both domestic and external factors will challenge any further strengthening of the balance of payments in FY2011. Domestic manufacturing is plagued by low productivity and poor infrastructure. Import growth will likely accelerate on higher oil prices, although it will be somewhat offset by remittance inflows, which were growing at about 18% in the first half (Figure 3.19.10). A current account deficit of 0.5% of GDP is expected in FY2011 and FY2012, reflecting little change in trends.

An escalation in political disruptions, if the peace process bogs down, is the key downside risk to growth prospects. A further risk is an abrupt downward correction in the real estate market, which would

3.19.6 Change in summer crop output



Source: Ministry of Agriculture and Cooperatives.

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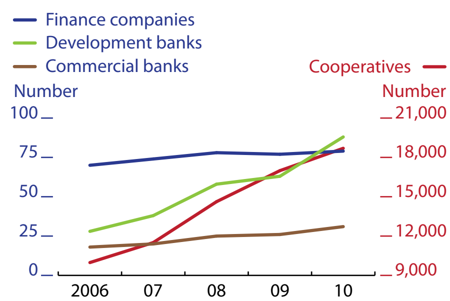
3.19.7 Financial institutions



Source: Nepal Rastra Bank. 2011. *Banking and Financial Statistics*. January.

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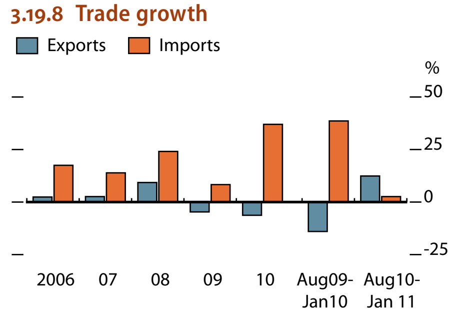
3.19.8 Trade growth



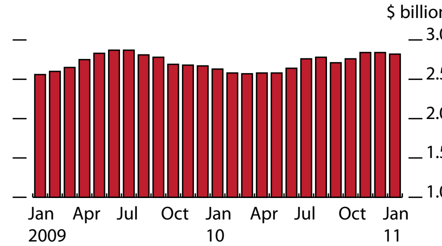
Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

Click here for figure data

no doubt severely undermine revenue mobilization efforts and put many construction-related jobs in jeopardy. Given the high volume of commercial bank lending for real estate, surging loan defaults would repress normal financial activity.

Externally, the unrest in the Middle East is an emerging risk to the steady remittance inflows as the region is a key destination for Nepalese migrant workers. The recent earthquake in Japan could also hit Japanese tourist arrivals and aid flows to Nepal. An additional external risk is the surge in oil prices which could severely strain Nepal's external position and cause a supply shock if domestic prices are not adjusted accordingly. Nepal also remains vulnerable to high global food prices.

3.19.9 Foreign exchange reserves



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

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Development challenges

Creating jobs for the country's burgeoning young population is a major challenge; unless managed properly, it could put at risk the country's economic growth prospects. Some 450,000 workers enter the labor market annually. More than half of them seek—and get—jobs in the Middle East and East Asia, particularly low-end work in construction and manufacturing. But it is Nepal that bears the social costs.

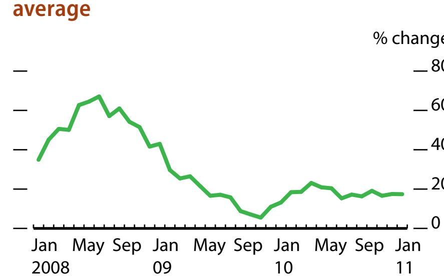
While under- and unemployment are widespread in all segments of the population, the position is particularly depressing for youth. Their nationwide unemployment rate is twice the national average. It is even worse in urban areas, where the decade-long conflict, lack of job opportunities in rural areas, and the concentration of higher level education institutions there have contributed to an influx of younger people.

Labor laws in Nepal—the most rigid in South Asia—are a major block to job creation, and need to be reformed to facilitate quicker recruitment and release of workers. Moreover, the academic curriculum needs to be modified to reflect labor market needs and to facilitate self-entrepreneurship, in part to capitalize on close ties to India and its prominence as a business services hub.

Progress toward completing the peace process, thereby leading to stronger investor confidence, will be important for faster job creation. The policy agenda should aim to strengthen business security, reduce red tape on firms' entry and exit, and scale up current initiatives, such as incentives for entrepreneurs in tourism.

Finally, the authorities should continue to work on developing a clear policy for public–private partnerships. It would assist the country to unlock the massive hydropower potential, paving the way for large infrastructure projects—their implementation has so far remained elusive.

3.19.10 Remittance inflows, 5-month moving average



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

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Pakistan

Pakistan's economy faces considerable challenges. Floods in summer 2010 hit agricultural output and damaged transport and communication. Still high inflation, though recently falling, may well accelerate. Fiscal developments are worrisome: the rollback in recent oil price rises, a partial increase in electricity tariffs, delays in carrying out revenue-increasing measures, broad tax exemptions for residents of flood-affected areas, and continued heavy fiscal support to state-owned enterprises add to pressures on the fiscal deficit. The current account balance is improving, but capital and financial inflows continue to decline. Still, despite devastation and economic distress, growth will likely stay positive.

Economic performance

Pakistan's economic performance in FY2010 (ended June 2010) and into FY2011 reflects largely the same structural weaknesses that contributed to its FY2008 macroeconomic crisis. Energy shortages and security issues held the economic rebound for FY2010 to 4.1% (Figure 3.20.1), slowing growth for FY2008–FY2010 to an average of only 3%, well below the 8% needed to create jobs for the predominately young population.

Little recent progress has therefore been made in raising per capita incomes or reducing poverty. Delays in implementing policy measures and fiscal management practices necessary for macro stability have undermined investment in infrastructure and production capacity.

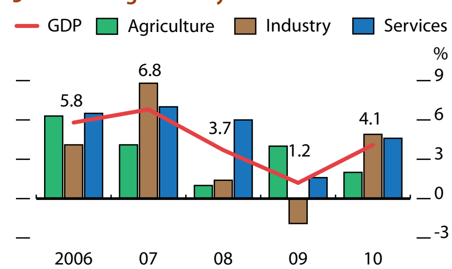
The modest expansion in FY2010 benefited from fiscal and monetary policies in FY2009 that eased macroeconomic imbalances by year-end, and from a decline in inflation that improved consumer confidence. Higher remittances provided additional support to an expansion of private consumption, as did improvements in rural income from increases in administered commodity prices. Heightened security concerns lifted public consumption, pushing total consumption's contribution to growth to nearly 80%.

From the supply side, transitory improvements in large-scale manufacturing partly reversed 2 years of declines and supported a recovery in services, led by wholesale and retail trade. Agriculture expanded by a modest 2%, due to weak performance by major crops.

The fragility of the recovery was underscored by continued investment contractions. Infrastructure shortages and security issues contributed to a 5.1% decline of gross private capital formation. Gross fixed capital formation contracted by 2.0% in FY2010, coming on the heels of an 11.3% decline the previous year.

FY2010 also saw a third consecutive year of declines in investment in large-scale manufacturing (down 15.4%) and electricity and gas (11.0% lower). Overall, the steady decline in total gross fixed investment as a

3.20.1 GDP growth by sector



Source: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk

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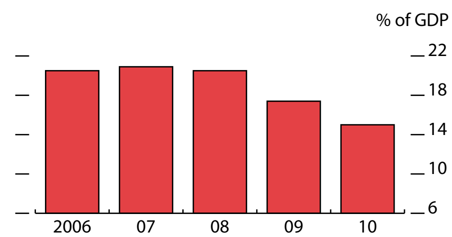
3.20.2 Fixed investment



Source: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk

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This chapter was written by Dawn Elizabeth Rehm of the Central and West Asia Department, ADB, Manila; and Farzana Noshab of the Pakistan Resident Mission, ADB, Islamabad.

share of GDP from 20.5% in FY2006 to 15.0% in FY2010 will crimp future growth prospects (Figure 3.20.2). Private savings have similarly declined, owing in part to the failure of key asset rates to keep pace with inflation, leading to either negligible or negative real returns.

Pakistan's fiscal balance deteriorated in FY2010, reflecting delays in putting through planned policy measures to improve revenue performance and limit the burden on the deficit of losses at state-owned enterprises (SOEs) and of energy-related subsidies. It widened from 5.3% of GDP in FY2009 to 6.3% in FY2010 (Figure 3.20.3), well in excess of the (revised) target of 5.1%. Revenue targets in the FY2010 budget, too, were missed and Federal Board of Revenue (FBR) tax receipts continued to decline as a share of GDP, reaching a 30-year low of 9.0% in FY2010.

Pakistan's current budget expenditure is relatively rigid, and it is difficult to offset overruns in one category with reductions in another. Inflexible current expenditure (such as security, interest, and pensions) alone absorbed revenue of 7.4% of GDP in FY2010, or about 82% of FBR tax receipts. Subsidies amounted to another 1.7% of GDP.

The government sharply curtailed the federal public sector development program (PSDP) to 3.5% of GDP to ease deficit pressure. Federal government borrowing from the State Bank of Pakistan (SBP), the central bank, as well as from commercial banks rose to PRs339.7 billion (2.3% of GDP), reflecting a widening deficit and lower external financing. Escalating losses from SOEs reached an estimated 1.7% of GDP for FY2010, adding to pressures.

Inflation fell to 11.7% in FY2010 from 20.8% in FY2009 (Figure 3.20.4). As it moderated, the SBP lowered the policy rate in steps from 14% to 12.5%. Broad money expanded by 12.5%, much faster than the 9.6% of the previous year.

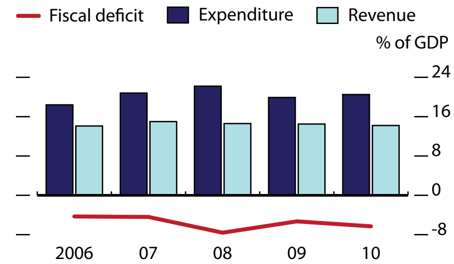
Developments in the external balances were mixed (Figure 3.20.5): the current account deficit narrowed, as imports declined by 1.7% with weaknesses in key industries (such as steel and oil refining) and a slump in investment; exports expanded by a modest 2.9% on higher exports of textiles, rice, and pharmaceuticals. Improvements in the service and income accounts contributed.

Yet financing the current account deficit became more difficult over the year: the capital and financial accounts fell by almost 13.4%, after a 26.2% decrease the year before. Foreign direct investment flows continued their downward path in response to infrastructure and security concerns, with communications, transport, and power accounting for much of the decline.

Gross reserves improved, benefiting from International Monetary Fund (IMF) releases under a stand-by arrangement, rising to $16.8 billion by end-FY2010. The nominal exchange rate depreciated by 6.3%, but inflation—high relative to trading partners'—lifted the real exchange rate by 1.0%.

Pakistan's public debt (excluding guarantees) as a share of GDP continued to climb in FY2010 (Figure 3.20.6). Government domestic debt amounted to 37.0% of GDP, including commodity debt and liabilities of SOEs. External debt rose to 31.9% of GDP, including 0.6% of GDP in external liabilities of SOEs. Interest payments due on domestic debt represent a heavy burden, accounting for 3.9% of GDP in FY2010, or

3.20.3 Fiscal indicators



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10* and Fiscal Operations July to June 2009–10. http://www.finance.gov.pk

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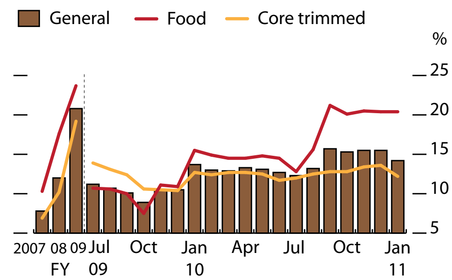
3.20.4 Year-on-year inflation



Note: Core trimmed inflation eliminates extreme outlying sample observations from the calculated average.

Sources: State Bank of Pakistan. *Annual Report 2009–2010* and Economic Data. http://www.sbp.org.pk (accessed 11 March 2011).

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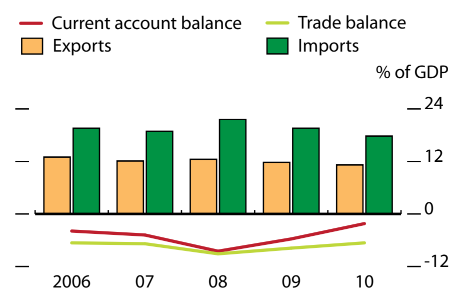
3.20.5 Current account indicators



Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 11 March 2011).

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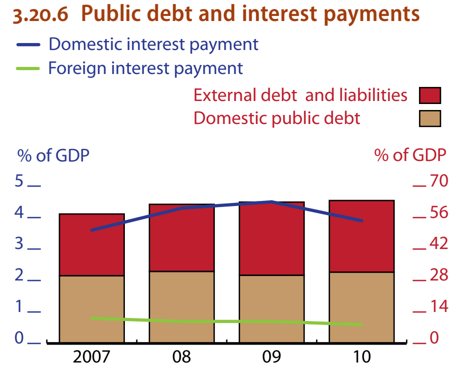
3.20.6 Public debt and interest payments



Sources: State Bank of Pakistan. *Annual Report 2009–2010* and *Statistical Bulletin March 2011*. http://www.sbp.org.pk.

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43% of FBR revenue. External debt amortization payments, excluding amounts owed to the IMF, are relatively stable for FY2010–FY2013 at about $3.3 billion. Amounts due for FY2012 and beyond will be raised substantially by repayment obligations to the IMF.

Government borrowing in the form of advances for commodity operations rose sharply in FY2009, in response to the bumper crop and increases in government-set procurement prices for wheat. With domestic prices higher than international prices, excess inventory was not sold. As this inventory looked as if it would not be sold nor loans repaid, banks' lending rates for government commodity operations rose, to exceed those for the private sector.

Prospects

Severe floods in July–August 2010 have affected FY2011's prospects. Damage was less severe than initially feared, but agriculture and communications were hit hard. Total damage is put at more than $10 billion, half in agriculture. For other areas, notably power and transport, damage was mild but widespread.

Information for the first 6 months of FY2011 points to a 1.7% contraction of large-scale manufacturing centered on textiles, food processing, and petroleum products, bringing the large-scale manufacturing index for September 2010 to its lowest since July 2007 (Figure 3.20.7).

With growth prospects reduced to 2.5% for FY2011 (Figure 3.20.8), average growth for FY2008–FY2011 is seen falling to 2.9%. Persistent energy shortages and security issues are expected to hold growth to 3.7% for FY2012, providing scant improvement on recent trends.

Inflation accelerated after the floods, to 15.7% in September, reflecting actual and expected shortages. It remained above 15% through December, falling to 14.2% in January owing to a government-freeze on oil and electricity prices. It is expected to stay high through FY2011, for an average annual 16.0%, and is then expected to recede in FY2012 to 13.0% (moderation in international food prices is likely to be at least partly offset by electricity price rises).

Pakistan began FY2011 with a budget that was based on policy measures that proved difficult to carry out. Revenue targets called for 26% growth of tax receipts, well over the 5-year average of 14%. Meeting them would have been hard even if a reformed General Sales Tax had come into effect. A reformed tax was initially scheduled for July 2010, but the process remains politically contentious, and any changes to the tax will have a limited effect on FY2011 receipts.

This tardiness, combined with the impact of the floods and wide tax exemptions for those in flood-affected areas, held FBR tax revenue growth to 10.9% in the first 7 months of FY2011, making a further decline in the tax-to-GDP ratio likely (Figure 3.20.9). (Total fiscal resources have also been affected by declines in nontax revenue.)

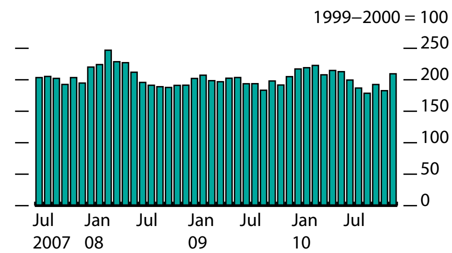
Current expenditure was under pressure due to a 50% wage increase for government workers, exacerbated by government failure to budget adequately for subsidies needed to cover the gap between notified and cost-recovery electricity tariffs. An annual budget allocation of

3.20.1 Selected economic indicators (%)

	2011	2012
GDP growth	2.5	3.7
Inflation	16.0	13.0
Current account balance (share of GDP)	-1.7	-2.3

Source: ADB estimates.

3.20.7 Large scale manufacturing index



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk; Federal Bureau of Statistics. http://www.statpak.gov.pk (accessed 11 March 2011).

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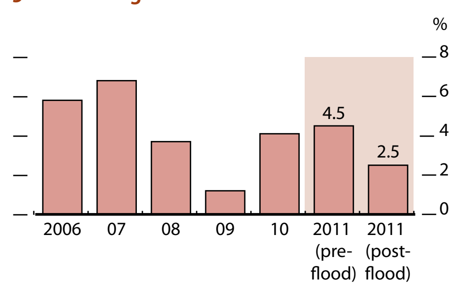
3.20.8 GDP growth



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk; ADB estimates.

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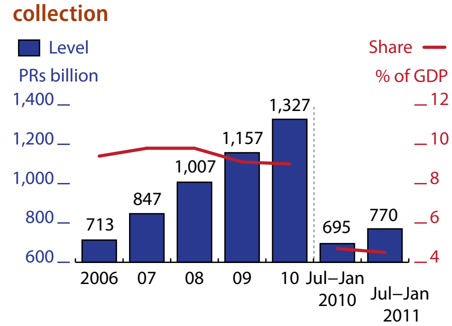
3.20.9 Federal Board of Revenue tax collection



Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2011).

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PRs30 billion to cover the tariff differential turned out well short of expected cost, and because of lack of policy measures total energy-related subsidies are expected to reach PRs200 billion. Part of this gap was to be covered by 2% monthly increases in electricity tariffs to bring them into line with cost recovery. Energy-related circular debt (due to payment arrears in the sector), which stood at PRs446 billion at end-FY2010, is expected to surge by end-FY2011.

For a third year, overruns on recurrent spending were met with a compression of the federal PSDP (Figure 3.20.10). For the first half of FY2011, only PRs66 billion was made available for PSDP activities, less than 25% of the PRs280 billion earmarked in the FY2011 federal budget, with spending limited to key projects and priority development programs. The federal PSDP for FY2011 faced a further cut of PRs100 billion on a lack of resources. The government is giving priority to completing projects. The remainder of the PSDP (PRs373 billion) in the combined provincial budgets is also under substantial pressure from resource constraints.

With a fiscal deficit at 2.9% of GDP in the first half of FY2011, the annual fiscal target was also revised to 5.5% under the weight of higher international food and energy prices, escalating subsidies, and subdued revenue performance.

With lower foreign funding, deficit financing is expected to rely heavily on the domestic banking system. After easing in FY2010, government borrowing from that source has surged in FY2011, reaching PRs379 billion by 12 February, compared with PRs330.4 billion for FY2010 as a whole (Figure 3.20.11). Of this, about 34% reflected borrowing from the SBP, consistent with commitments from the government in late January to roll back borrowing from the SBP to September 2010 levels.

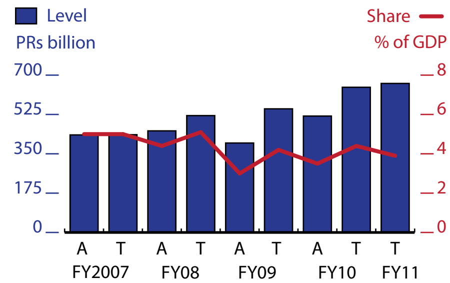
Credit to the private sector picked up but remained on the low side for various reasons. Banks expressed a preference for low-risk lending to government to offset flood-related increases in nonperforming loans, while weak postflood economic activity and rising borrowing costs held back demand for borrowing.

The pace of government borrowing from the banking system has supported a rapid expansion of broad money and reserve money: broad money growth for FY2011 through 26 February 2011 was much higher (7.7%) than in the same period of FY2010 (5.7%); the equivalent figures for reserve money were 14.9.% and 10.6%.

In response to the increase in inflation and growing evidence of its likely persistence, the SBP increased the policy rate in three successive 50 basis point increments from August 2010 to end-November 2010, bringing the rate back to 14.0% and reversing the cuts of FY2010 (Figure 3.20.12). In January 2011, the SBP left the policy rate unchanged, partly on the basis of commitments from the government to limit borrowing from the central bank.

Fiscal prospects for FY2012 are likely to improve as the political environment eases sufficiently to implement the revenue-enhancing and fiscal-management initiatives. Progress is expected in implementing reforms for the energy sector consistent with a move toward financial viability with a phased elimination of subsidy requirements, leaving enhanced fiscal space for development programs.

3.20.10 Public sector development program



A = Actual; T = Target.

Source: Ministry of Finance. *Fiscal Operations*. Various issues. http://www.finance.gov.pk

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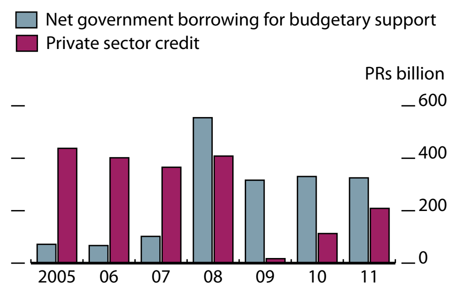
3.20.11 Budgetary and private sector credit



Note: 2011 data cover the period July 2010 to February 2011.

Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2011).

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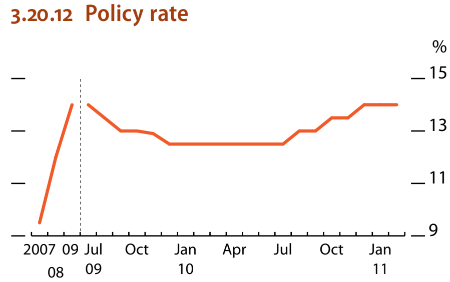
3.20.12 Policy rate



Source: State Bank of Pakistan. *Annual Report 2009–2010*. http://www.sbp.org.pk

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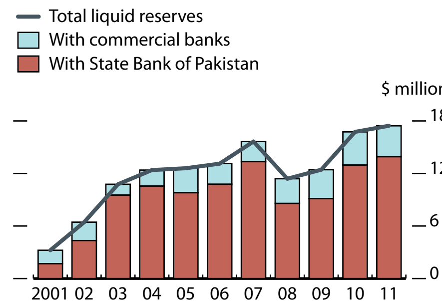
The extensive pickup of Treasury bills bought by the SBP through December 2010 reflected government reluctance to allow auction cutoff rates to rise enough for commercial banks to participate. Without a sufficient increase in 1-year bill rates, most purchases have shifted to shorter maturities of 3 and 6 months. In recent auctions, most banks' bids for bills with a maturity longer than 6 months have not been high enough to be accepted. But with an average maturity falling to 1.5 years, the possibility of roll-over risk and disorder in the auction market rises. The likely outcome is that, in time, the government will have to pay higher interest rates to fund its borrowing requirements.

Pakistan's external reserves reached a record high of $17.4 billion in early February 2011 (Figure 3.20.13), amounting to more than 5 months of imports of goods and services. This buildup essentially reflects IMF releases of $7.1 billion under the stand-by arrangement, an additional $450 million in emergency support in September 2010, and support from the Coalition Support Fund ($633 million) at end-December 2010. The central bank's holdings of liquid foreign exchange reserves ended FY2010 at $13.9 billion.

While import growth remains modest, a significant expansion of exports during the first 7 months of FY2011 moved the current account deficit into near balance, at 0.5% of GDP, but it is expected to widen to 1.7% for full-year FY2011, reflecting higher international food and commodity prices. For the first 7 months of FY2011, exports of textiles and rice showed strong growth in value terms, mainly on higher world prices. Remittances increased further, broadly in line with inflation, but non-debt-creating inflows continued to decline, with private FDI inflows about 16% below the same period of the previous year (Figure 3.20.14).

The current account deficit is expected to edge upward in FY2012 to 2.3% of GDP as projected declines in global food and commodity prices are more than offset by the impact of improved growth and increased demand for imports, including for postflood reconstruction.

3.20.13 Foreign exchange reserves



Note: Data for 2011 are as of 12 February.
Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2011).
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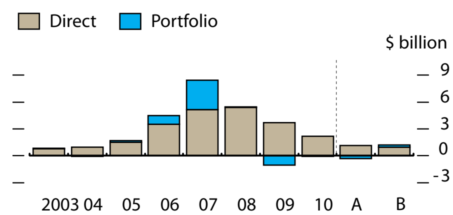
3.20.14 Foreign direct and portfolio investment, net inflows



A = July 2009–Jan 2010; B = July 2010–Jan 2011.
Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2011).
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Development challenges

The government recognizes that current subsidy requirements and support for SOEs are incompatible with creating the fiscal space needed to support investment in infrastructure and technology for a diversified and higher-value-added export base. The current pattern of lower imports, lower development spending, and exploding unproductive current outlays undermines domestic and external confidence in the economy's prospects and deters investment. Pakistan therefore needs to develop a systematically transparent revenue policy, and operate it effectively.

Elsewhere, energy shortfalls are lowering real growth by at least 2 percentage points annually. While the federal government increased electricity tariffs by 37% in FY2010, its decision not to push through with incremental monthly step-ups represents a reversal of its efforts to reach cost recovery. Again, it will be critical to design and implement policies that bring the sector to financial viability.

Sri Lanka

The economy bounced back strongly in 2010, reflecting post–civil war optimism and the global recovery. The outlook, too, is positive for healthy growth provided the fiscal consolidation process meets targets and the burgeoning inflation pressures are addressed. The medium term presents a need to greatly lift private investment, if the country is to reap the full rewards of the peace dividend.

Economic performance

The economy rebounded in 2010, with GDP growth estimated at 7.6%, after 3.5% in 2009 (Figure 3.21.1). Continued benefits from the end of the long-running civil conflict in 2009, such as improved business and tourist confidence plus more land available to agriculture, as well as the global return to growth, underpinned the strong performance. The overall optimism was reflected in the stock market's doubling.

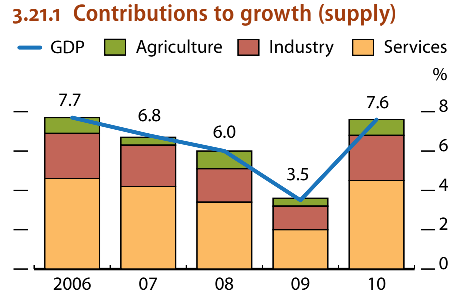
With the revival of paddy and fisheries production in the former conflict areas of Northern and Eastern provinces, agriculture grew at 6.5% in 2010. Good weather and fertilizer support by the government helped. With the improved domestic business climate, the upturn in domestic and external demand, and gradually improving infrastructure, industry grew by 8.0%.

Services, which account for nearly 60% of GDP, recorded growth of 7.6%. This was mainly due to the expansion of wholesale and retail trade, revival in tourism—which contributed to robust performance in hotels and restaurants—and the impressive performance of the banking, insurance, and real estate subsector. Tourist arrivals leaped by 46% to 654,477 in 2010, the highest number on record.

Annual average inflation as measured by the Colombo Consumer Price Index reached 5.9% in 2010, up from a 25-year low of 3.4% in 2009. Import duty reductions and subsidies that maintained stable fuel prices partly reined in rising global commodity prices' impact on domestic inflation. Nevertheless, overall inflation increased steadily from midyear to reach 7.8% in February 2011, with the rise due to escalating food prices that were 13% higher than a year earlier (Figure 3.21.2). Core inflation was on a downward trend throughout 2010 that continued in the first 2 months of 2011.

Commercial banks' average weighted prime lending rate continued to decline gradually in 2010 to 9.3% by year-end (Figure 3.21.3). The central bank reduced the reverse repurchase rate, the main policy rate, twice (and again in January 2011 to 8.5%). As interest rates edged down, growth in credit to the private sector came back strongly after 2009's shrinkage,

3.21.1 Contributions to growth (supply)



Sources: Central Bank of Sri Lanka. *Annual Report 2009*. http://www.cbsl.gov.lk; ADB estimates.

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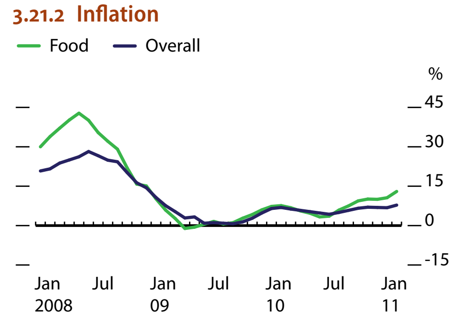
3.21.2 Inflation



Source: Department of Census and Statistics of Sri Lanka. http://www.statistics.gov.lk (accessed 2 March 2011).

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

reflecting commercial banks' improved lending appetites. Credit to the private sector increased by 25.1%, and broad money by 15.8%.

Per plan, the government tightened the budget deficit to 8.0% in 2010 from 9.9% in 2009 (Figure 3.21.4). It took minor steps to expand the revenue base, preferring to focus on simplifying the tax system, including reducing customs duty bands from five to four, removing the import duty surcharge, revising taxes relating to imports of motor vehicles and selected electronic items, and revising cess rates. Domestic revenue as a share of GDP at 14.6% was only marginally above 2009's. Grants added 0.4% of GDP to budget revenue.

The deficit narrowed therefore through current expenditure being cut by 1.5 percentage points as a share of GDP. All major categories of current expenditure saw a reduction as a share of GDP, including salaries and wages, interest payments, and transfers and subsidies. As a share of GDP, public investment was lower than in 2009, at 6.5%. Total expenditure was 23% of GDP in 2010.

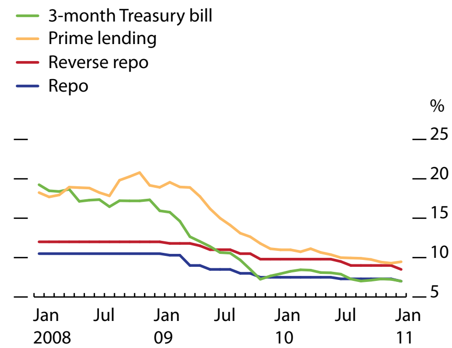
The ratio of government debt to GDP fell to an estimated 84% at end-2010 from 86% a year earlier but the total stock of government debt increased by 11%. While the debt ratio has fallen in recent years, the structure of debt has adversely changed, as the mix shifted from concessional external borrowing to higher-cost domestic and nonconcessional external borrowing. By August 2010, the share of concessional debt had declined to 68% from 72.2% at end-2009. In September 2010, the government issued its third international sovereign bond offering of $1 billion, after issues in 2007 and 2009. This issue was oversubscribed six times, with a yield substantially lower than the two previous issues.

After a 12.7% fall in 2009, exports recovered to expand by 17.3% in 2010. Industrial exports accounted for 74% of export earnings (of which more than half came from textiles and clothing) and agricultural exports 25%. Exports to major regions increased even though the European Union withdrew concessions under its Generalized System of Preferences Plus in August 2010. As the economy recovered in 2010 there was a marked increase in imports (about 32%), though this upsurge in large part reflected higher global prices, especially of oil. The steeper rise in imports than exports pushed out the trade deficit to 10.5% of GDP, from 7.5% a year earlier.

The strong resurgence in tourism as well as freight- and port-related activities brought an upturn in the services sector surplus. Growth momentum in remittances continued, reaching 24%. These items helped to counterbalance the large trade deficit to hold the current account deficit to 3.8% of GDP (Figure 3.21.5). Supported by healthy capital flows, the balance of payments recorded an estimated overall surplus of about 1.8% of GDP in 2010. Foreign direct investment strengthened sharply, to an estimated $500 million from $384 million in 2009, though at only about 1% of GDP it is very low for an economy of Sri Lanka's size and development level.

Investor sentiment was strengthened by the simultaneous approval of the third and fourth tranches of the International Monetary Fund (IMF) stand-by arrangement in June, and the fifth tranche in September, 2010. Both Standard and Poor's and Moody's raised the country's outlook to

3.21.3 Interest rates



Source: Central Bank of Sri Lanka. http://www.cbsl.lk (accessed 2 February 2011).

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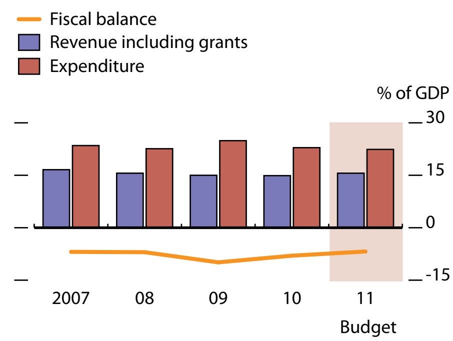
3.21.4 Fiscal indicators



Sources: Central Bank of Sri Lanka. *Annual Report 2009*. http://www.cbsl.lk; Ministry of Finance and Planning and the Treasury of Sri Lanka. *Budget Speech 2011*. http://www.treasury.gov.lk

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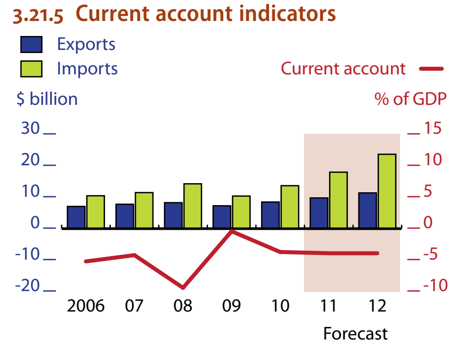
3.21.5 Current account indicators



Sources: Central Bank of Sri Lanka. *Recent Economic Developments Highlights of 2010 and Prospects for 2011*. http://www.cbsl.gov.lk; ADB estimates.

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stable, and Fitch to positive. Supported by the success of the bond issue and the release of IMF funding tranches, gross official reserves reached $6.6 billion, covering 5.9 months of imports (Figure 3.21.6).

The Sri Lanka rupee climbed gradually against the US dollar by about 3% to reach SLRs111.1 by end-2010 (Figure 3.21.7). The real effective rate appreciated by about 5% because of higher inflation than in trade partners. The central bank intervened to buy foreign currency, though this move created excess rupee liquidity in the economy, leading to inflation concerns.

Economic prospects

After last year's rebound, the economy is expected to show continued high growth of 8.0% in 2011, supported by some strengthening in external demand, and maintain growth at that level in 2012. Sustaining such performance will require fiscal consolidation, state enterprise and finance sector reforms, as well as flexible exchange rate management.

Services and industry will lead growth in 2011; agriculture is likely to be hampered by heavy rains and consequent flooding that affected several provinces in January–February 2011. Continued and planned infrastructure- and tourism-related building will support construction growth, while services, especially hotels and restaurants, will perform well, catering to the likely prolongation of the tourist boom.

Rising global food and oil prices and a shortfall in domestic supply of agricultural produce due to the flooding will stoke inflation, but only up to around 8%. In January 2011, the government reduced customs duty on gasoline from SLRs15 a liter to SLRs5 to avoid passing through global price rises. As with similar tariff-lowering steps on some imported food items, the fiscal implications are unclear. A recent hike in electricity prices will also contribute to upward price pressures this year.

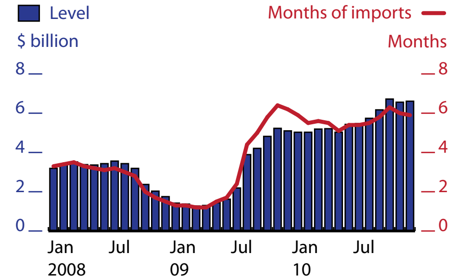
In a surprise move, the central bank cut policy rates in January even though inflation was on an upward trend, reasoning that the prevailing economic conditions provided the space for monetary relaxation to facilitate greater private investment without creating inflation pressures. With the economy now on a higher growth trajectory and inflation pressures rising, however, monetary tightening may well be needed later in the year.

The budget deficit is expected to come down to 6.8% of GDP from 8.0% in 2010, split equally between a 0.6% increase in revenue and a 0.6% cut in expenditure. Revenue buoyancy is likely, stemming from budget measures to simplify the tax system and move from tax concessions as the principal tool for attracting investment to increased economic activity.

Expenditure is forecast to rise moderately in nominal terms as the government is looking to cap public investments at around the 2010 level of 6%–7% of GDP. A sharp one-third increase in private investment is seen driving growth higher.

The budgeted fiscal consolidation is prudent, but meeting its target will require further measures as the costs of the humanitarian and reconstruction expenses related to the flooding in 2011 and the reduction in customs duty on gasoline were not provided for in the budget adopted in 2010.

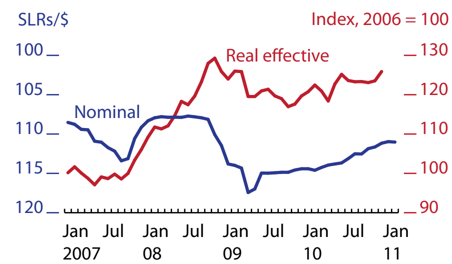
3.21.6 Gross official reserves



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

Click here for figure data

3.21.7 Exchange rates



Source: Central Bank of Sri Lanka. http://www.cbsl.lk (accessed 2 March 2011).

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3.21.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.0	8.0
Inflation	8.0	7.5
Current account balance (share of GDP)	-4.0	-4.0

Source: ADB estimates.

The government expects to move to a 5% of GDP deficit target in 2012. To achieve this it would be necessary to look closely at closing loopholes in the tax system and to improve efficiency in tax collection, together with further steps to broaden the tax base. Moreover, with infrastructure development a compelling priority, expenditure rationalization would have to focus rigorously on recurrent expenditure.

Export performance will depend on the recovery in Sri Lanka's major markets and is likely to grow by, say, 16% in 2011 and 2012. Rising global prices, especially of food items and petroleum, as well as high domestic demand, are expected to push up imports by around one-third in 2011 and 2012. Higher remittances and net services receipts are expected to hold the current account deficit to some 4% in both years.

FDI is projected to increase, supported by policy measures reinforced in the 2011 budget, including streamlining the role of the Board of Investment and ensuring that incentives to unproductive investments are canceled. The government wants FDI to hit about 3% of GDP this decade. The reserve position is likely to remain strong, supported by capital flows and the IMF program.

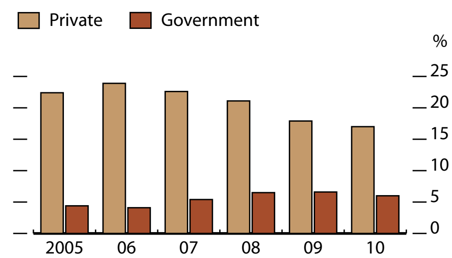
Development challenges

Investment is too low to achieve national development goals, and private investment in particular needs to be scaled up substantially (Figure 3.21.8). But several areas need to improve to secure an investment climate conducive to large-scale private investments. The 10-year development plan, the Mahinda Chintana, emphasizes the need to improve the business environment more widely. The World Bank's *Doing Business 2011* report ranks Sri Lanka at 102 out of 183 economies, suggesting the need to eliminate red tape. It also includes strengthening institutions, building human resources capacity, and simplifying procedures.

The finance sector requires development, as part of the thrust toward macro stability and hence greater investment. Improvements are needed in the legal framework for financial services and commercial transactions, and more generally in strengthening and enforcing prudential norms. The challenge for Sri Lanka will be enforcing different institutional and regulatory policy reforms in ways that are effective but without excessive bureaucracy.

It is also important to encourage both competition and consolidation in various parts of the finance sector to achieve efficiency and economies of scale. The capital markets are underdeveloped. Developing the corporate bond market is important to diversify funding sources in order to reduce reliance on banks and the equity market.

3.21.8 Fixed investment



Sources: Central Bank of Sri Lanka. *Annual Report 2009*. http://www.cbsl.lk; ADB estimates.

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