SAARCFINANCE
Governors' Symposium
"South Asia's Recent Growth and Future Prospects"

August 2008

Central Bank of Sri Lanka

Papers in this volume were prepared for the SAARCFINANCE Governors' Symposium on "South Asia's Recent Growth and Future Prospects" held on 21 August 2008 at the Central Bank of Sri Lanka, John Exter International Conference Hall in Colombo. The views expressed in the country papers are those of the respective SAARCFINANCE Central Banks/Monetary Authorities. Individual papers may be reproduced or translated with the authorization of the respective SAARCFINANCE Central Banks/Monetary Authorities concerned. These papers are also accessible at CBSL website (http://www.cbsl.gov.lk).

ISBN 978-955-575-178-0

Printed at the Central Bank Printing Press, Sri Lanka

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Foreword

This country paper volume contains the position paper and eight country papers presented at the SAARCFINANCE Governors' Symposium on "South Asia's Recent Growth and Future Prospects".

Majority of SAARC countries achieved an unprecedented growth during the past few years. This conference will provide a platform for the member countries of SAARC to share experiences of growth amidst many challenges in the form of higher international oil and commodity prices and higher capital flows. In this context, it will be valuable for all member countries to make use of this opportunity to share experiences with one another and initiate dialogue for increased cooperation among all member countries.

The success of the SAARCFINANCE Governors' Symposium is owed to many, first to SAARCFINANCE member Central Banks/ Monetary Authorities and their Governors/ Heads of Institutions, whose collaboration and continued support enabled the successful conclusion of the Governors' Symposium. I would also like to thank Mr. Ajith Nivard Cabraal, Governor and Mr. W A Wijewardene, Deputy Governor of the Central Bank of Sri Lanka and the Senior Management for their guidance in making the Governors' Symposium a success. A note of thanks also to my colleagues from SAARCFINANCE Central Banks/Monetary Authorities, who prepared, participated and presented their country papers at the Symposium. Finally, special thanks to my own staff in the Economic Research Department and the Organizing Committee of the Central Bank of Sri Lanka headed by Mr. Asoka Handagama, Director of Communications Department, who worked tirelessly on the organization of the Symposium and the preparation of this country paper volume.

Dr. P Nandalal Weerasinghe

Chief Economist & Director of Economic Research

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Opening Remarks

Excerpts from the Keynote Address by Mr. Ajith Nivard Cabraal, Governor, Central Bank of Sri Lanka delivered at the SAARCFINANCE Governors' Symposium on "South Asia's Recent Growth and Future Prospects"

The Governor extended a warm welcome to all fellow Governors, Excellencies and delegates and wished them a pleasant stay in Sri Lanka.

The Governor informed that the decision to host the SAARCFINANCE Symposium was made in Washington DC in April 2008. At that Symposium, the Governor of the Reserve Bank of India, Mr. Y V Reddy suggested to look at the growth in the Asian region and find ways and means of duplicating and replicating the success stories while avoiding the pitfalls that have been experienced by SAARC countries. He further stated that there will be discussions, position papers and experiences of SAARC countries presented at this forum that will help participants from member countries to understand the growth momentum among countries in the SAARC region, thereby ensuring increased cooperation within the region.

The South Asian region was known to be a rather quiet region in terms of economic growth. Nevertheless, during the last few years a new growth momentum has endeared the region to the international community. This was confirmed by the fact that during the recent SAARC Heads of State Summit in Colombo, there were about nine observers from non-SAARC countries showing a keen interest to know and to learn how the region was poised to move forward into the future.

The Governor noted that countries in the SAARC region are faced with challenges which are similar. All countries are grappling with the ill effects of terrorism. Poverty is still at unacceptable levels, although reducing. All countries are also faced with inflation, where painful decisions have to be made to tackle it. Negative publicity, the lack of infrastructure facilities, high energy and commodity prices, the economic slow downs in the industrialized economies are further negative aspects that have to be dealt with. Though SAARC economies are growing fast, the slow down in industrialized nations will have an impact on the region. Thus, there is a lot to learn from each other's experiences.

The Governor was also of the view that a fresh new trend is emerging in countries in the region, i.e., countries are taking ownership for the destiny of their own countries and are today the architects of the economic progress as never before. In the past, multilateral agencies had a great say in these economies. Today, there is a refreshing change among the countries in the region, and policies that affect the national economies are being taken independently of the multilateral agencies. This would also mean that SAARC countries would now not be able to blame multilateral agencies for their drawbacks, if any, as done in the past.

For example, when tracking Sri Lanka's economy, it can be seen that the average exchange rate was Rs. 8.87 to the US dollar in 1977 and at the end of 2006 it was Rs. 103.96. In thirty years it had depreciated 11.7 times. While of course, we can say that this was because of the advice of multilateral agencies, we have to realize that the results are finally the responsibility of our country. If these figures are extrapolated for the next thirty years, where will the exchange rate end up? Thus, it is important to reflect upon such issues and it is also time to look at new models to suit the needs of the individual countries in the region.

The Governor asserted, "Our destiny is ours, our future prospects are based on what we do today. To outsiders, it may be a case study, a technical assistance, a consultancy service, or an advisory assignment. But for us, it is our future, and the future of our children. Therefore, our policies must have the long-term benefits of the country at heart. For us, it is a process to build a better future for the country and our nation."

The Governor maintained that in today's globalised economic environment, competing and conflicting macroeconomic fundamentals have to be balanced. This is a difficult task. It's a balancing act, like that of a juggler. All issues will have to be addressed immediately. All issues have to be tackled without ignoring any of them.

Developed countries, when they increased their per capita incomes from about US dollars one thousand to three thousand, didn't have to contend with many of the conditions that this region is currently confronted with. They did not even subscribe to copyright laws or anti-money laundering laws. Those countries also did not have to adhere to labour laws, pollution laws and human rights laws. But the South Asian region is moving from a per capita of US dollars one thousand to three thousand, in a very responsible and sustainable manner while adhering to and respecting all these governance laws.

In his concluding remarks, the Governor noted, "We are creating the future for our own societies and we need to initiate policies to accomplish our goals. The difficult part is implementing policies to achieve the goals. Talking about policies is easy, than to make it happen. We have to have the strength and the vision to implement these strategies to achieve all the prospects we want to realize."

Position Paper :

South Asia's Recent Growth and Future Prospects

By

Economic Research Department

Central Bank of Sri Lanka

1. Overview and Regional Perspective

The South Asian nations have progressively liberalized their economies in recent years in an effort to integrate with the world economy. They have also taken steps to increase regional economic integration under the aegis of the South Asian Association for Regional Cooperation (SAARC). Even though the South Asian economies have grown at a healthy pace during the past decade, still as a region lag behind in living standards to its closest regional grouping, the Association of South East Asian Nations (ASEAN). It has been reported that the South Asian region house more than 1/5 of the world's population and closer to 1/6 of the world's arable land, but contributes only about 5.8 per cent of Purchasing Power Parity (PPP) based World Output (GDP) and account for less than 3 per cent of world goods trade and foreign direct investment[1]. Hence, the South Asia remains a region with many opportunities to explore and a huge market to penetrate.

South Asia's noteworthy economic growth was achieved amidst many obstacles such as conflict, inequality of development and high fiscal deficits. South Asia's impressive economic growth helped partly to alleviate poverty in the past decade, and if this growth accelerates to 10 per cent a year, the region could expect to achieve single-digit poverty rates by 2015. A closer look at the economies in the region suggests that much remains to be done to achieve these accelerated growth rates and thereby bringing higher living standards to its people. Despite impressive economic growth, South Asia still faces several challenges.

First, economic growth in the past decade has resulted in growing income inequality and wide regional disparity. The regional disparity still remains due to lack of integration between prosperous regions and lagging regions.

Second, most South Asian countries are running large fiscal deficits. Therefore, due to lack of fiscal space, South Asian governments' ability to face unexpected external shocks are limited.

Third, a comparison with East Asia - a region that has sustained 7-10 per cent growth rates shows that South Asia's export orientation, inflows of foreign direct investment, workers' skill levels, infrastructure and ease of doing business are also substantially less advanced than East Asia's. South Asia's savings, investment and productivity are also lower than its peers in East Asia.

These challenges suggest a set of policy choices for South Asian countries aimed at increasing investment and productivity, and the quality of labour, while addressing the problem of combining lagging regions for the growth centres of many South Asian countries. The position paper proposes to discuss salient areas of importance in analyzing the recent economic advancement of South Asia and its challenges and prospects.

2. Economic Growth - Contributors and Outcome

The economies in South Asia reported impressive growth recording an average 8.9 per cent growth when the world economy grew by about 5 per cent in 2007. For the period 2002-2006, the economies in South Asia reported healthy growth of approximately 7 per cent (Table 1). The Gross Domestic Product (GDP) of every country in the region grew at around 6 per cent or above in 2007, except for Nepal which was going through the pace of transformation into a republic.

India turned in the highest growth rate of 9.2 per cent among the large economies continuing its already built influence in the world economy, and Bhutan grew at 22.4 per cent, fastest among the small economies in a background of rapid expansion and growth of its hydro power generation and catering to the regional power demand. As a region, the South Asia's growth momentum was led by the services sector, but industry sector growth accelerated in regional big economies India, Pakistan, Bangladesh and Sri Lanka, reinforcing the sustainability of high growth rates into the future. The region also witnessed high levels of consumption and investment, credit expansion, and strong workers' remittances as a major share of migrant employees from South Asia work in the booming West and Central Asian countries. The above trend in world economic expansion, although some deceleration was noted especially after the second half of 2007 due to financial

1/ "Trade Pattern of SAARC Countries: Recent Trends" by Rajeev Jain & J.B. Singh of the Reserve Bank of India (RBI).

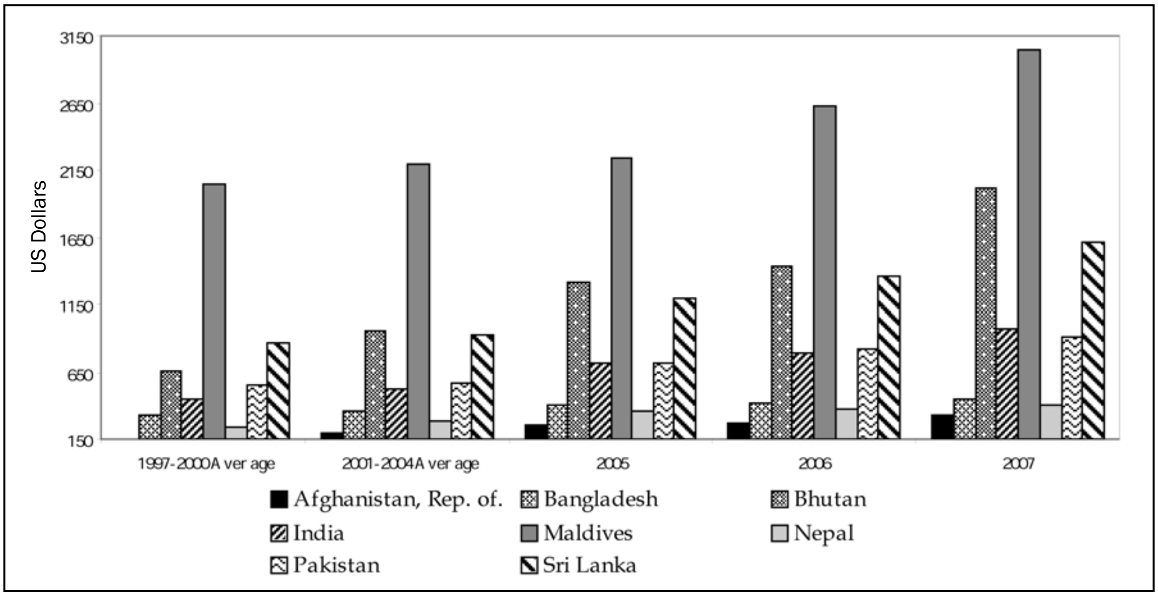
Table 1: Gross Domestic Product (Constant Prices) Annual (Per Cent) Change 1997-2007

Country	1997-2001 Average	2002-2006 Average	2007
Afghanistan, Rep. of.	n/a	11.7	12.4
Bangladesh	5.2	5.9	5.6
Bhutan	7.0	8.5	22.4
India	5.4	7.6	9.2
Maldives	7.1	7.8	6.6
Nepal	4.9	2.9	2.5
Pakistan	2.7	6.0	6.4
Sri Lanka	4.0	5.8	6.3

Sources: World Economic Outlook Database and IMF

stress in North America and Western Europe, kept external demand strong fostering export growth as the majority of South Asian countries' export base is intermediary goods and services except in the case of India. Also, the commodity exports from South Asia especially the agricultural commodities fetched higher income due to increasing commodity prices in the international markets. Another common aspect of the region is the improved business climate which attracted increased domestic private investment and foreign direct and portfolio investment, both reaching the highest historical levels in the large economies. As a result, all the countries in the region reported increase in domestic demand. Also, the income levels of countries in the region continue to increase with Maldives, Bhutan and Sri Lanka taking the lead (Figure 1). The two big economies in the region, India and Pakistan, too reported increasing per capita income, but at somewhat stagnant pace compared to its smaller counterparts.

Figure 1: GDP Per Capita (US Dollars)

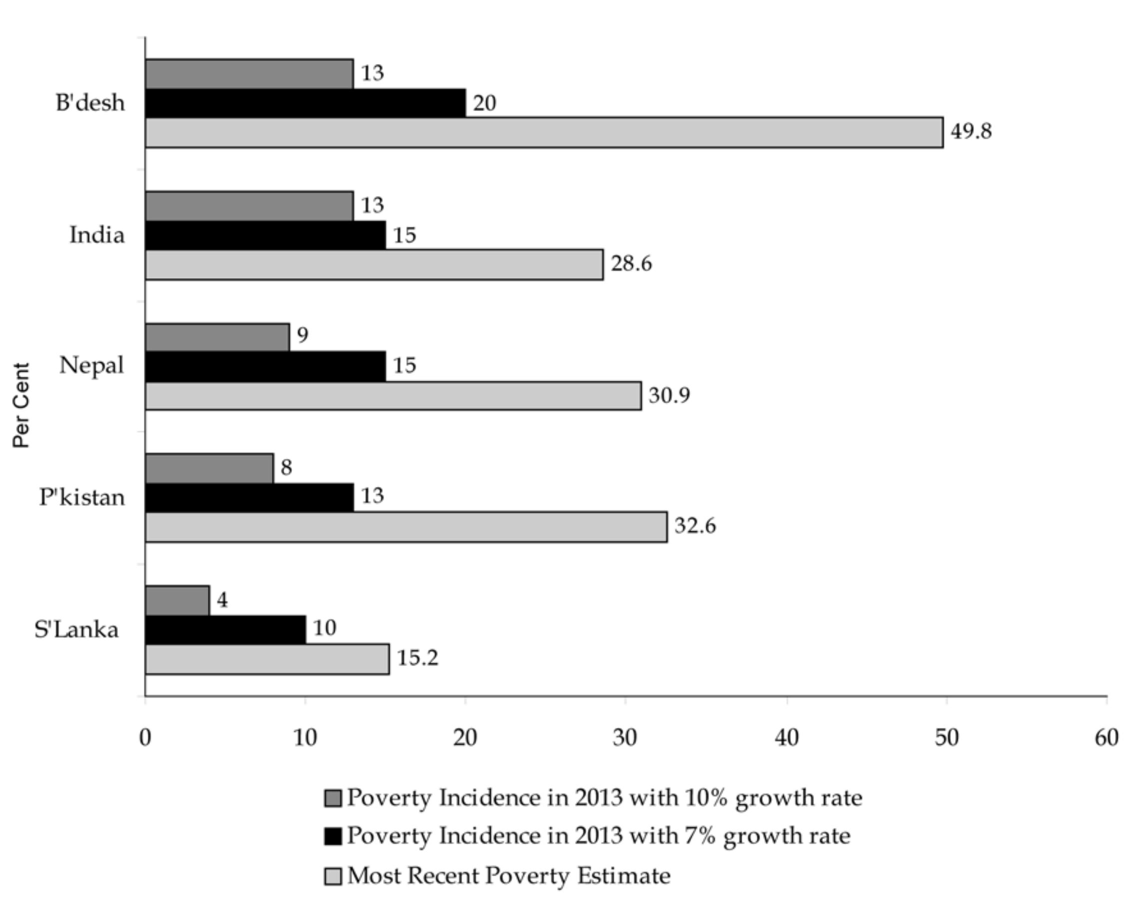


Sources: World Economic Outlook Database, IMF and CBSL

3. Poverty

Despite recent growth and poverty reduction, South Asia still has nearly 380 million poor people. Poverty is not just endemic, but increasingly concentrated in particular, lagging regions whose growth rates are substantially lower than the better-off regions. If these growth trends together with accelerating per capita income are sustained, South Asia will see a substantial reduction in poverty, from the current range of 15 per cent in Sri Lanka, 27 per cent in India and closer to 50 per cent in Bangladesh to a much lower range of 4 to 13 per cent by 2013. Poverty in Pakistan is likely to fall dramatically from the current 32.6 per cent to 8 per cent because of its high elasticity of poverty reduction with respect to income[2].

Figure 2: Poverty Incidence



Sources: World Development Indicators 2008, Annual Report CBSL, Economic Growth In South Asia: Promising, Un-equalizing, Sustainable? The World Bank, 2006.

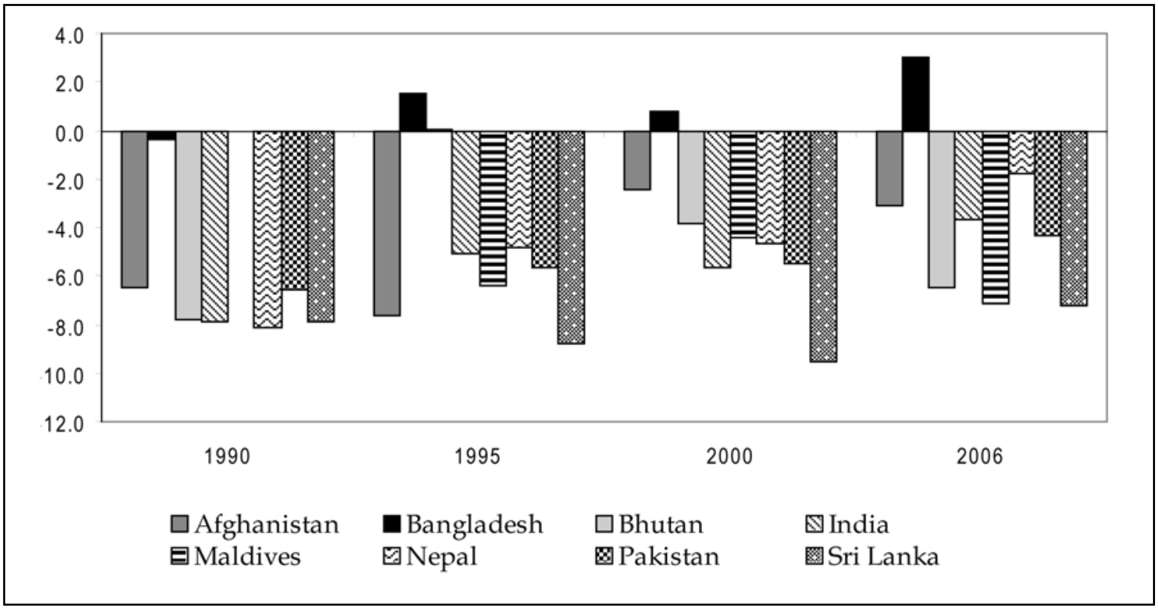
2/ Economic Growth In South Asia: Promising, Un-equalizing, Sustainable? The World Bank, 2006.

4. Inflation

The challenges of the region in recent years mainly centred around fighting inflation. The recent sharp increase in world oil and commodity prices and demand driven pressures in domestic economies led to an increase in the region's inflation rate to around 9 per cent in 2007. Inflation picked up among all the countries in the region and Sri Lanka remains a country with inherent attribute of comparatively higher inflation (Figure 4). The increase in inflation in many countries in the region bring challenges in the form of destabilising macroeconomic variables, including GDP growth. Higher oil import bills that most economies in the region absorb through subsidies could further swell their fiscal deficits. Since most countries in the region are running high fiscal deficits, their ability to use fiscal policy as an instrument to stimulate the economy or curtail cost of living is constrained.

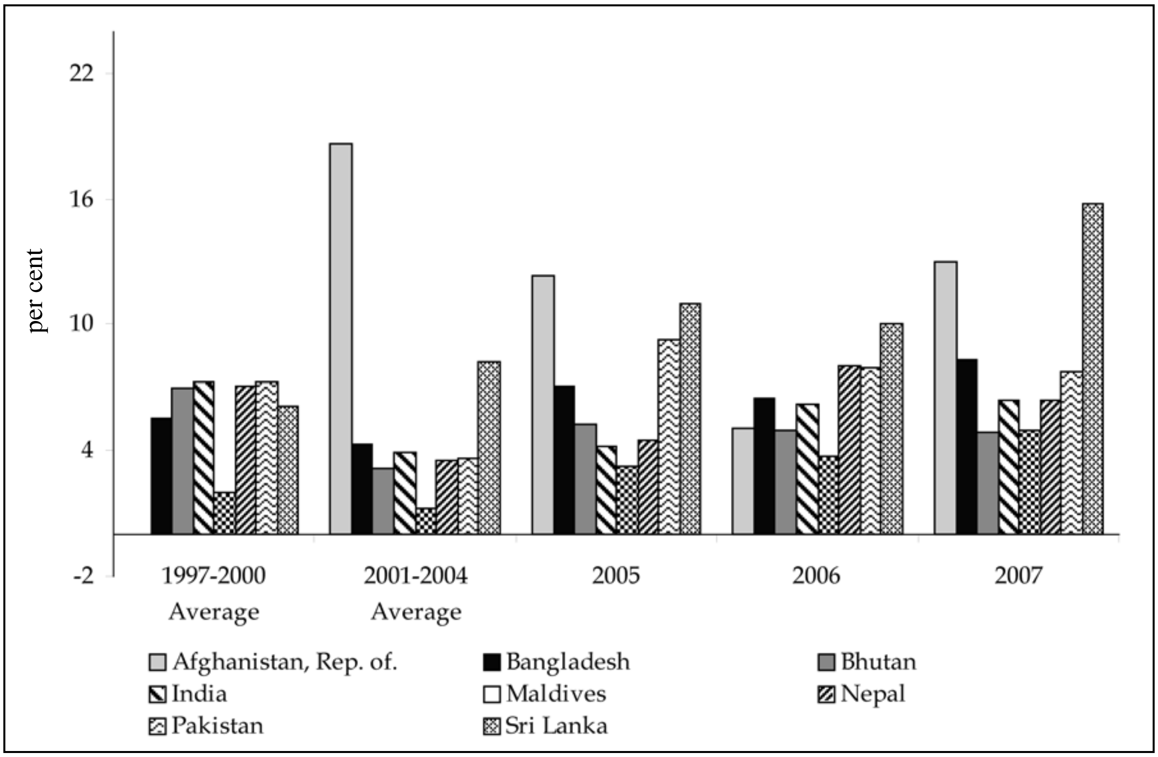
From another perspective, price volatility poses political dangers. South Asia still has a reasonable share of their population in poverty and thus they spend a relatively high proportion of their income - up to 80 per cent - on food. Rising food prices are thus effectively a regressive tax. If the past is any guide, price volatilities of South Asian staples like rice and wheat could result in political instability in the region.

Figure 3: Fiscal Balance - Per Cent of GDP



Sources: World Economic Outlook Database, IMF and CBSL

Figure 4: Consumer Prices (Per Cent Change)



Sources: World Economic Outlook Database, IMF and CBSL

5. Current Account Balance and Saving-Investment Gap

Inherently, all South Asian countries appear to experience current account deficits (Table 2). Among the countries, Maldives reportedly experience a higher current account deficit, despite a net surplus in services trade, mainly generated from the tourism industry. In Maldives, tourism earnings cushioned its trade deficit before the tsunami in 2004, but since then the tourism earnings were able only partly to finance the trade deficit as larger services payments and the expansion in imports took roots with the increasing growth. By 2007, the current account deficit in Maldives widened to 45 per cent of GDP. In the case of Afghanistan, the current account balance is expected to have recorded a deficit close to 1 per cent of GDP and financed by foreign direct investments (FDI), worker remittances and public sector concessional financing.

In India, Pakistan and Sri Lanka, the current account deficit appears to be correlated to the higher oil import and commodity import expenditure bills, and continuous expansion in economic activities by both private and public sectors including infrastructure development related imports, despite moderate growth in the export sector. Often, these economies financed their current account deficit by continued strong receipts of foreign direct investments, portfolio investments and inflows to the government. Both Pakistan and Sri Lanka also benefited from public sector financing to cushion their current account balances. In the case of India, higher surplus from exports of services such as software and business services also contributed to ease the current account deficit.

Two countries in South Asia, which appear to be maintaining either surplus or a balance in current account, are Bangladesh and Nepal. The current account surplus in both these countries have declined to around 0.5 per cent of GDP in 2007. The widening trade deficit and slower remittance inflows are blamed for declining surpluses in both these countries. The current account improved markedly in Bhutan and reported a surplus of 8.8 per cent of GDP in 2007. The surplus in Bhutan is mainly attributable to growth in exports of hydro electricity through the Tala hydropower project to India, partial reductions in imports and the larger net transfers.

Table 2: Current Account Balance - Per Cent of GDP

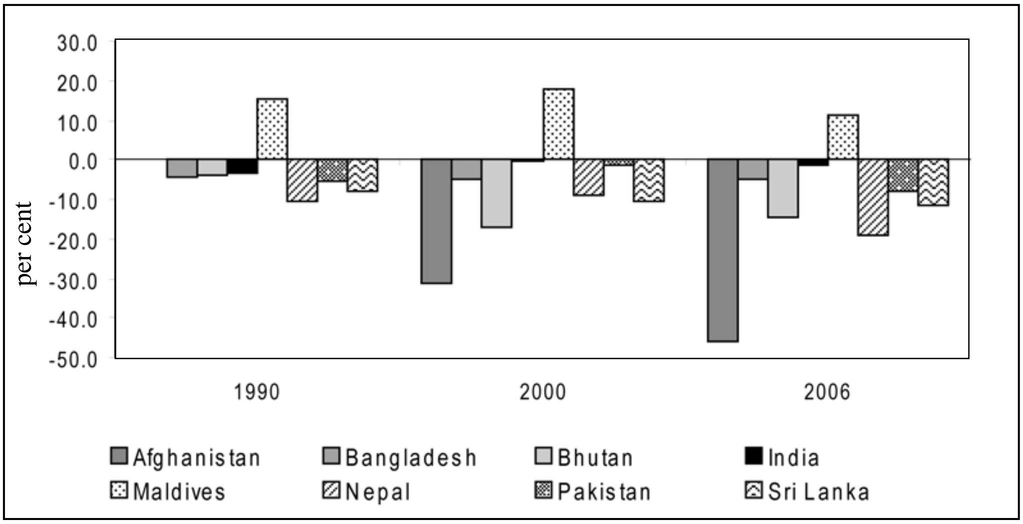
Country	1997-2000 Average	2001-2004 Average	2005	2006	2007
Afghanistan, Rep. of.	n/a	-6.3	-2.8	-6.3	-0.8
Bangladesh	-1.2	0.0	0.0	1.2	0.5
Bhutan	2.0	-11.2	-26.1	-3.1	8.8
India	-1.0	0.8	-1.3	-1.1	-1.8
Maldives	-8.0	-9.0	-35.8	-40.7	-45.0
Nepal	1.2	3.2	2.0	2.2	0.6
Pakistan	-2.5	2.8	-1.4	-3.9	-4.9
Sri Lanka	-3.5	-1.5	-2.8	-5.0	-4.6

Sources: World Economic Outlook Database and IMF

Across South Asia, the savings continue to be lower than its investments, leading the majority of South Asian countries to seek external finances. The external finances have also played a complementary role in policy reforms in South Asia. High savings-investment gap are mirror images of current account balances which highlight the importance of promoting domestic savings as well as attractring foreign savings to fill the resources gap.

An important source of external finance across the region is the substantial and rising inflow of capital by non-resident nationals in the form of remittances (repatriation of savings) that increases the pool of capital and stimulates demand to spur economic growth. Remittances by South Asian nationals working abroad totalled $22 billion in 2004-5, and account for the region's stability in balance of payments. By comparison, remittance earnings in sub-Saharan Africa totalled $6 billion. Remittances are a far more important source of external financing in South Asia than in East Asia, where external financing is primarily in the form of foreign direct investment.

Figure 5: Saving Invest Gap - Per Cent of GDP



Sources: World Economic Outlook Database, IMF and CBSL

6. Prospects of Further Growth and Stability in South Asia

World economy is expected to recover moderately from the economic slow down in North America and Western Europe in 2008. Also, the continuous increase in crude oil and commodity prices are not expected to continue but expected to remain at higher levels compared to 2007 prices. Most of the economies in South Asia have taken prudent measures to address increasing international prices and thus South Asia's prospects remain buoyant. The buoyant economic expectations are mainly due to strong domestic demand and investment and its efforts in further liberalizing their economic activities. Also, the majority of countries in South Asia still expect their external sector to perform given their export base and continuous attraction of FDI and portfolio investments. Also, the already started and newly initiated infrastructure development projects in the region with external finances would support increasing import expenditure and thereby current account balances. As a region, South Asia is expected to grow by about 8 per cent in 2008. India is expected grow by about 8 per cent while Pakistan, Bangladesh and Sri Lanka are expected to grow around 6 - 7 per cent in 2008.

Prudent policy measures taken to address demand pressures in many South Asian economies and adjustment of pricing policies in line with international market prices since 2006 are likely to exert pressure on credit growth. Improving fiscal balances due to expected increases in tax revenues and lower subsidies to buffer high oil prices are also expected to help most of South Asia to address inflationary concerns.

From the current account perspective, South Asia's growth of imports is likely to remain high despite increasing exports to meet high regional growth demand. The trade deficits emanating from increasing import expenditure would be offset by growth in exports of services and workers' remittances, and high growth rates in the region will continue to attract large capital flows.

7. Challenges to Sustain Growth

Across South Asia, it has been noted that inflationary concerns take higher priority in recent policy dialogues and leaving authorities to choose between growth direction and fighting inflationary concerns. This itself is a challenge that all the countries in the region have to overcome. From another perspective, the global economic slowdown, partly restrain growth momentum of the region thereby further restraining the sustainability of the growth momentum. To sustain the accelerated growth momentum, South Asia may find the volatility in crude and commodity prices challenging. Although the international market prices of crude oil are expected to decelerate somewhat by the latter half of 2008 due to slowing demand in North America and Western Europe, robust growth in emerging market countries including India and political developments in the Middle East would continue to make crude oil prices volatile in international markets. Therefore, South Asia needs to develop an energy policy aimed at reducing demand, supporting the expansion of local energy supplies, and developing regional distribution networks that allow cost-effective transfers of power and gas among countries.

As highlighted in the Asian Development Outlook, growing global payments imbalances pose a risk to South Asia as a disruptive correction could abruptly check capital flows, increasing the cost of funds, and possibly deflating the ballooning asset prices not necessarily in South Asia, but in the emerging and developing world as a whole. To buffer such an eventuality, reforms of the region's financial systems including prudential supervisory measures must continue and share the experiences of each.

If the incomplete pass-through of oil prices and domestic demand pressures are not successfully checked by tightening monetary and fiscal policies, inflation and the current account deficits could rise. Therefore, policy authorities need to adhere to macroeconomic policies carefully to sustain economic growth and maintain price stability.

India accounts for 80 per cent of South Asia's GDP, and so its accelerated growth can benefit the region by policies to integrate regional economies. South Asia has not done well in integrating with the rest of the world and, although steps for regional integration have been taken, the region is still far behind the other regional arrangements. South Asia being the least integrated region in the world, it can benefit from more integration in trade in goods, services and investment. Although, the policy choices appear to be daunting, the dynamism and openness that characterizes South Asia today makes us optimistic that some, if not all, of these challenges can be met and the region will be substantially integrated with the rest of the world if every country makes a concerted effort.

Country Paper: Afghanistan

The Role of the Central Bank in Igniting Economic Growth in Afghanistan

1. Outline

Da Afghanistan Bank explaining the state of the economy during the civil strife stated that in 2002, Afghanistan emerged from over two decades of war and civil strife that devastated all economic institutions. There were three types of currency in circulation, before the fall of the Taliban Regime. There were no macroeconomic statistics such as GDP, CPI, BoP, External Debt etc. and Afghanistan was experiencing hyperinflation. The banking sector was primitive, with only seven state-owned banks and no private commercial banks. Further, there were no modern central banking activities, bank supervision or monetary policy.

2. Effects of the Conflict on Growth

A typical civil conflict reduces GDP by around 15 per cent and human, physical and social capital is destroyed. Private businesses shift capital abroad, while households revert to subsistence activities. Recent research has shown that there is a high-risk of further violent conflict at the end of a civil war i.e., 39 per cent risk that peace will collapse within the first five years and 32 per cent risk that it will collapse in the next five years (Paul Collier, 2007). Economic growth is the key priority for countries emerging from conflict. High economic growth is most effective in reducing the risks of returning to violent conflict (Bigombe, 2005) as it reduces conflict risk, raises household income and diversifies the economy.

3. Economic Growth

The post-conflict Afghanistan has witnessed a high but volatile growth in GDP. Although agriculture was the fastest growing sector, its share as a percentage of GDP has declined in recent times. In that same period of five years, the services and the industry sector has contributed more towards the growth in GDP. Private sector investments and savings were very low. Headline inflation has surged from single to double digits increasing up to 35.8 per cent. The acceleration in inflation is attributed to the rising food and energy prices. The nominal exchange rate which is a managed floating exchange rate has remained fairly stable since March 2007.

4. Financial Sector Reforms

Afghanistan's banking sector has grown rapidly, increasing from only 3 state-owned banks in 2002 to 16 licensed banks by 2007. The asset base has increased up to $ 1.6 billion by 2008 which was $ 262 mn in 2004. However, the interest rates have remained negative in real terms. The financial sector is considered to be shallow in terms of the money/GDP ratio and the bank deposits/GDP ratio.

5. Economic Policies

The general consensus is that pro-growth economic policies provide effective property rights protection and contract enforcement, maintain macroeconomic stability, integrate into the world economy, provide effective prudential regulation of financial intermediaries and ensure an appropriate environment for productive diversification and innovation. Thus, central banks are expected to act as the key drivers of pro-growth economic policies, by supporting an efficient payments system, contributing to financial stability through sound prudential regulations, supporting private sector development and utilizing its ultimate ability to control inflation in the long-term through the conduct of monetary policy.

However, central banks face the challenge of translating general principles into a concrete policy agenda, as they do not map directly into specific policies. Hausmann, Rodrik and Velasco (2006) highlighted that increased growth does not require a long list of reforms, but that growth accelerations occur when binding constraints on growth are removed. Hence, they have proposed a growth diagnostics approach to formulating growth strategies.

6. Growth Diagnostic Approach to Economic Growth

The key to the growth diagnostics approach is to deal with one aspect at a time. The first step is to identify the binding constraint (the market or government failure) which is the most important bottleneck to growth. The underlying principle is that elimination of a few key constraints will have a larger impact on growth than the traditional approach of attempting to undertake a long list of reforms. Hence, the growth diagnostics approach requires a thorough empirical analysis of macroeconomic variables. The second step is the policy design in which you decide how best to alleviate the relevant constraints. The final step is to institutionalise the diagnostic/policy design process in view of the fact that the nature of binding constraints will change over time. The Da Afghanistan Bank has followed these three steps in identifying and designing policy for developing its economy.

7. Identification of Binding Constraints

Da Afganistan Bank has completed the first step in the growth diagnostic approach. The main obstacles to Afghanistan's economic growth has been identified and a number of constraints have been removed which has helped the economy move forward. The economy is stuck in an informality trap. Small businesses and agriculture are unable to obtain credit to increase their productivity, as they are in the informal sector. Although large businesses can obtain bank credit, they are targets for high taxes, burdensome regulations and red tape that put them at a competitive disadvantage. As a result, the banking sector lends to a few businesses in urban areas, mainly for trade finance. Hence, it is a stunted private sector, which does not create enough employment and which in turn fuels insecurity.

Another major obstacle to high growth in Afghanistan is the shortage of capital and productive capacity. Therefore, the key policy issue for the central bank is how to induce the private sector to increase investment. The central bank's activities should be geared towards enhancing returns to private investment so as to generate a virtuous cycle of profits, investment and employment.

8. Alleviation of Constraints

After these obstacles have been identified, the Da Afghanistan Bank designed policies to overcome these obstacles under the second step of the Growth Diagnostic Approach. The first five years of central bank reforms included: A new Central Bank law that mandated an independent central bank with price stability and building a robust financial sector; a new single currency unifying the 3 separate currencies circulating at the same time; flexible exchange rate and market determined interest rates; strong prudential regulations and enforcement; and a monetary programme based on a consistent macroeconomic framework for conduct of monetary policy.

As a consequence of all these policies economic growth has been re-ignited since 2002.However, it has been highly volatile. Structural transformation is taking place with the share of agriculture declining and services and industry increasing. Inflation reached single digits but accelerated in 2008 due to global shocks. Further, domestic savings are low, real interest rates are negative and the illicit (opium) sector is large at 30 per cent of GDP. The financial sector is considered to be shallow.

9. Institutionalisation of Policy Design

The changes in the nature of binding constraints need to be identified over time, as growth will slow down if the diagnostic process is not ongoing. Sustaining high growth requires ongoing institutional reform in the central bank to maintain productive dynamism and increase resilience of the economy to external shocks. Under the third step of the Growth Diagnostic Approach which is the institutionalization of the policy design process, Da Afghanistan Bank's reforms will include the establishment of a credit information bureau and a deposit insurance scheme; introduction of mortgage, leasing and agency laws and a collateral registry; Islamic banking; mobile banking and strengthening the Afghanistan Bankers Association; and open market operations. All these reforms are expected to take place within the next five years.

Da Afghanistan Bank aims to be a learning organization, regularly reviewing its strategic plan and monitoring and evaluating its performance to tackle new constraints.

In summary, it was noted that the Da Afghanistan Bank had played a key role in igniting economic growth after 20 years of conflict. But new challenges have emerged. Afghanistan mobilizes too little domestic savings to finance investment required for high growth. Access to finance is limited which constraints financing of growth-enhancing investments. The deeper the financial system the more access businesses and individuals have to varied financial services and the better equipped it is to mobilize resources. Therefore, the bank's reforms over the next five years will be targeted to deepen the financial system while striving to maintain low inflation and macroeconomic stability in a turbulent world environment.

10. Discussion

In response to a query on how Afghanistan was dealing with very high inflation, it was stated that Afghanistan was following a contractionary monetary policy and had placed a ceiling on the currency in circulation. Since it was a net importing country, especially food items, it was planning to create a strategic reserve of food, in order to mitigate the impact of a potential increase in inflation during 2008.

Another query was raised as to whether the Da Afghanistan Bank was taking a lead role in developing and deepening its financial markets, in view of the country's large savings base. Mr. Alamyaar commented that bank supervision had been enhanced with a view to increasing financial deepening, as banks played a key role in lending. Further, micro finance institutions were also flourishing. However, he mentioned that the foreign reserves were maintained for specific purposes such as external obligations and to meet import needs.

Since opium accounted for a significant portion of Afghanistan's GDP growth, it was questioned as to what measures the government proposed to take to address this issue. Mr. Alamyaar responded by stating that a strategy of gradual elimination of opium production was being followed, as total elimination was not immediately possible. He also stated that finding alternative livelihood in place of opium was a huge challenge in view of the fact that it accounted for 1/3rd of the economy. Utilizing opium for beneficial purposes such as the manufacture of drugs was a possible alternative but was considered to be difficult.

The Indian delegate commented that operational independence of the central bank was a common problem faced within the SAARC region and questioned as to how the Da Afghanistan Bank was dealing with this aspect. In response it was stated that in terms of a new constitution, the Bank was prevented from financing the government's fiscal deficit and was expected to be totally independent within a period of 5 years.

Country Paper: Bangladesh

Recent Growth and Future Prospects*

* This paper has been prepared jointly by Mr. Md. Kabir Ahmed Chowdhury, General Manager and Mr. Julhas Uddin, Joint Director, Research Department, Bangladesh Bank under the guidance of Mr. Habibullah Bahar, Economic Adviser, Bangladesh Bank.

1. Introduction

In spite of increased frequency and severity of natural calamities, the Bangladesh economy has been experiencing an astounding growth particularly since 1990. From a mainly agrarian base, the Bangladesh economy has undergone a rapid structural transformation towards manufacturing and services. The contribution of the agriculture sector to GDP has dwindled from about 50 per cent in FY1973 to around 25 per cent in FY 2002 and further to only around 21 per cent in FY 2008. There has been a remarkable progress in health and education sectors. The extent of self-reliance and self-sufficiency of the economy has improved impressively in the recent years. A substantial progress has been made in Bangladesh in mass literacy, public health, population growth control, and self-employment support for the rural people. Due to implementation of the Financial Sector Reform Programme (FSRP) in the early nineties, the overall policy structure and standards of financial services of the country's banking and financial sectors have improved remarkably in the recent years. However, this paper mainly focuses on recent growth momentum and future prospects of the Bangladesh economy.

2. Review of Growth Performance

Bangladesh's real per-capita Gross Domestic Product (GDP) has become more than doubled since 1975. Until 1989, GDP per-capita grew at a positive but mediocre average yearly rate of 1.2 per cent. In the second phase, the period since 1990, GDP per-capita moved up at average 3.3[1] per cent due to introduction of reforms in the area of macro stabilization. Due to accelerated income growth in the last decade and a half, Bangladesh's poverty rate sharply declined to 40 per cent in 2005 from an estimated 70 per cent in 1971. The Bangladesh economy has experienced at or above six per cent growth for the last five consecutive years. An accelerated growth in exports supported by private sector led growth strategy and a handsome amount of workers' remittances have played an important role in accelerating recent growth performance of the economy. The following sections of the paper will highlight growth of GDP and contribution of major sectors, major drivers of recent economic growth, reform measures undertaken in the financial system, and major problems experienced in the economy for macroeconomic management. On the basis of overall observations some concluding remarks/summary of policy recommendations are given at the end of the paper.

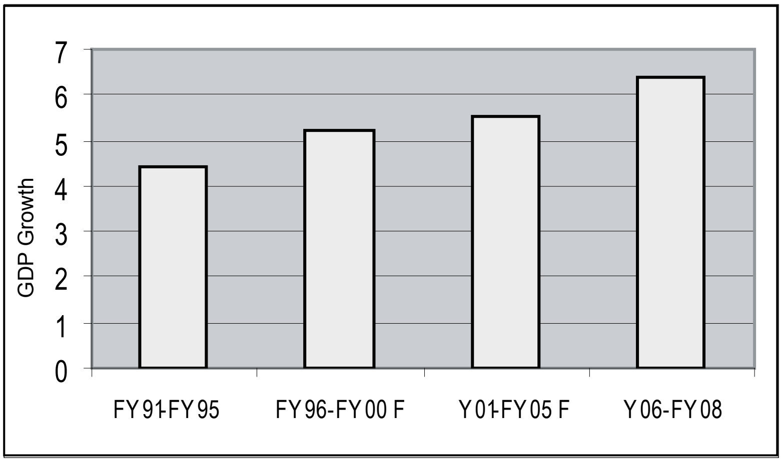
3. Growth of GDP and Major Sectors

An impressive feature of the growth process in Bangladesh has been its remarkable and improving stability. Growth has also been broad-based, although the sectoral composition is shifting away from agriculture, as is common for developing economies in periods of sustained high growth. The Bangladesh economy entered into a moderately high growth phase in the 1990s and remained sustainable over the past fifteen years or more. An average annual growth of real GDP during the five-year period FY 1991-FY 1995 was 4.4 per cent which accelerated to 5.2 per cent during FY 1996-FY 2000. Average growth of real GDP further accelerated to 5.5 per cent during FY 2001-FY 2005. In spite of political crises that originated due mainly from the confrontational political culture and devastations of the last year's floods and cyclone, Sidr, Bangladesh economy maintained its high growth path. During the last three-year period of FY 2006-FY 2008 average annual real GDP growth of Bangladesh economy remained at around 6.5 per cent and for the last five consecutive years GDP growth rate remained sustainable at or above six per cent.

Sectoral break-ups of real GDP growth showed that growth of the services sector, the major contributor to the GDP has exhibited a consistent up-trend from an annual average of 4.1 per cent during five-year period FY 1991-FY 1995 and 4.8 per cent during the FY 1996-FY 2000 to 5.7 per cent during the FY 2001-FY 2005. Up-trend in the growth of the services sector remained consistent till FY 2008 when annual growth was 6.7 per cent. The industry sector showed a robust growth particularly in the recent years. The recent high growth

1/ It was more than double that of the median country worldwide and three times that of the median Low-income Country (LIC). For elaboration of this, see Bangladesh: Strategy for Sustained Growth, June 2007.

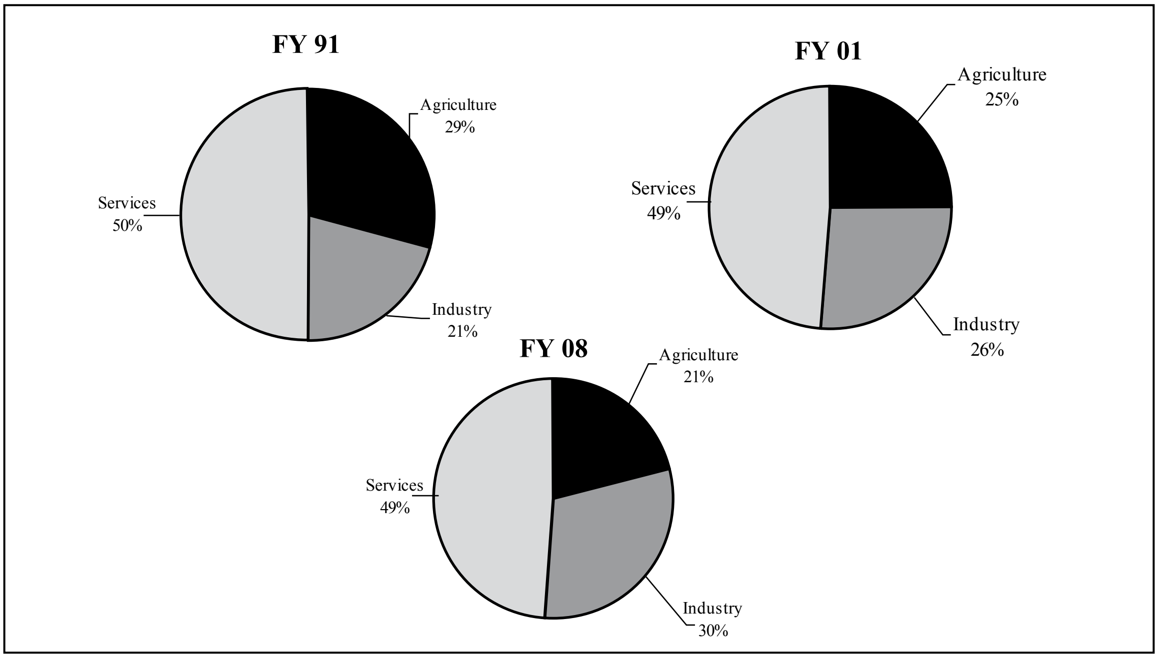
Figure 1: Real GDP Growth



in the industry sector has mainly been supported by a continued improved performance in the manufacturing sub-sector, facilitated by strong and sustained growth in export-oriented manufacturing activity and expansion in domestic demand. Growth in the mining and quarrying sub-sector has also supported the recent robust growth in the industry sector. A review on growth of GDP showed that during five-year period FY 1991-FY 1995, the industry sector grew on an average annually at 6.4 per cent which decelerated a bit to 5.6 per cent during FY 1996-FY 2000 but again accelerated to 7.5 per cent during FY 2001-FY 2005. Growth in the industry sector further accelerated and reached almost a double digit figure in FY 2006. After this picking up, due to the anti-corruption drive of the present Caretaker Government and the political uncertainty that prevailed in the last part of the previous government, growth in the industry sector was hampered and its high growth momentum faced a little set-back during FY 2007-FY 2008. Notwithstanding this set-back, the industry sector recorded an average growth of 8.3 per cent during the last three fiscal years. Growth in the agriculture sector averaged 1.6 per cent during FY 1991- FY 1995 which rose to an average of 4.9 per cent during FY 1996-FY 2000. Average growth in the agriculture sector decelerated to 2.5 per cent during FY 2001-FY 2005. The growth in the agriculture sector stood at 4.9 per cent in FY 2006 but again decelerated to 4.6 per cent in FY 2007 and rose to 5.6 per cent in FY 2008. In fact, agriculture sector growth has really been sporadic in Bangladesh due mainly to an uneven behaviour of natural calamities.

Looking at the long-term trend of sectoral shares, it has been observed that since the FY 1991 there has been a remarkable shift of sectoral composition of GDP away from agriculture towards industry in Bangladesh (Figure 2). The average share of agriculture in GDP during the five-year period FY 1991-FY 1995, was 27.9 per cent which came down to 25.6 per cent during FY 1996-FY 2000 and 23.6 per cent during FY 2001-FY 2005. Latest available data indicates that the average share of the agriculture sector in GDP stood at 21.3 per cent in FY 2006-FY 2008. During the aforesaid periods the share of industry sector in GDP has risen steadily while the services sector maintained its lion's share almost at the same rate of nearly 49 per cent. During FY 1991-FY 1995, average share of the industry sector in GDP was 22.5 per cent which increased to 25.4 per cent and 27.2 per cent during FY 1996-FY 2000 and FY 2001-FY 2005 respectively. Contribution of the services sector to GDP remarkably increased during the seventies and eighties in Bangladesh while since FY 1991, this sector has maintained its lion's share in GDP somewhere around 49 per cent with maintaining reasonably high growth rates. Details of growth and sectoral share have been given in Annex-I.

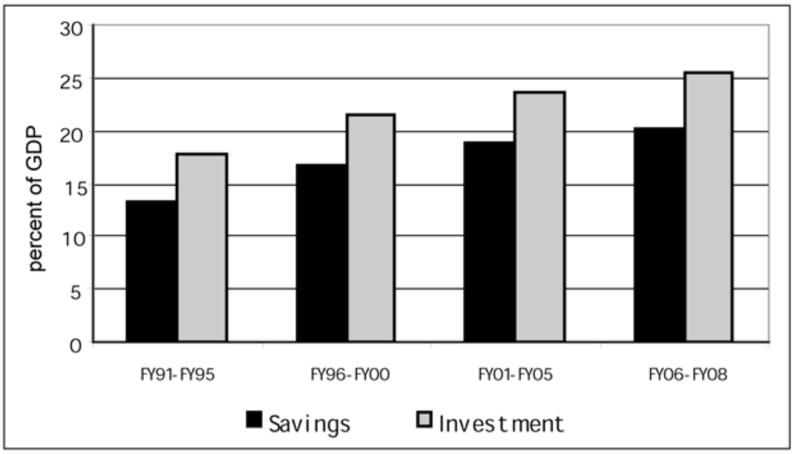
Figure 2: Broad Sectoral Share of GDP



4. Major Drivers of Recent Economic Growth

Accumulation of physical capital and labour has been instrumental in the recent growth acceleration in Bangladesh. Capital accumulation has been led by private investment and financed mainly by gross domestic savings. Available data indicate that the gross domestic savings as well as gross national savings and gross investment particularly in the private sector, have been steadily increasing in Bangladesh since FY 1991. Gross domestic savings as a percentage of GDP picked up from an average of 13.4 per cent during FY 1991-FY 1995 to 16.7 per cent during FY 1996-FY 2000. Gross domestic savings as a percentage of GDP further picked up at an average of 18.9 per cent during FY 2001-FY 2005 which remained above 20 per cent for the last three fiscal years. Gross national savings which was an average 19 per cent of GDP during FY 1991-FY 1995 has also been increasing and stood at 29.2 per cent of GDP in FY 2008.

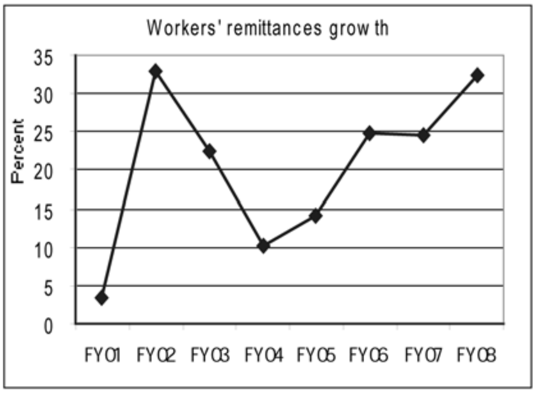
Figure 3: Domestic Savings and Investment



It has been noticed that since FY 1991, although investment in the public sector remarkably declined, gross investment increased from an average of 17.9 per cent of GDP during FY 1991-FY 1996 to 24.2 per cent in FY 2008 due to increase of investment in the private sector. Relaxation of several restrictions on private investment in the Industrial Policies of 1991 and 1992 and the opening up of telecommunications, power generation, and domestic air transport to the private sector are the main stimulus toward accelerated growth in private sector investment in Bangladesh. Moreover, according to the World Bank data, increased total factor productivity (TFP) growth has also contributed to the growth acceleration since 1990 in Bangladesh[2].

Recent accelerated economic growth has also been aided by increased inflow of workers' remittances from abroad and an inspiring growth in exports. It has been observed that during the five-year period FY 1991-FY 1995 average export earnings were only around 7.1 per cent of GDP which picked up at 11.1 per cent during FY 1996-FY 2000. Growth in export earnings has increased substantially in the recent years and in FY2007 it became 17.8 per cent of GDP. Growth in workers' remittances from non-resident Bangladesh nationals has also increased tremendously in the recent years. During the five-year period of FY 1991-FY1995, the amount was only 2.9 per cent of GDP which increased to 8.8 per cent of GDP in FY 2007 (for details please see Annex-II). Bangladesh's export performances are mostly dominated by the ready-made garment (RMG) sector with female workers contributing about 90 per cent of the sector's total employment. Most importantly, an increased female participation in the total labour force has helped to boost up not only exports but also overall productivity of the economy.

Figure 4: Export, Import & Workers' Remittances Growth



Foreign direct investment (FDI) is considered as an effective driver of achieving a high economic growth in any developing country. It enables a capital-poor country to build up physical capital, create employment opportunity, develop productive capacity, enhance skills of local labour through transfer of technology and managerial know-how, and help to integrate the domestic economy with the global economy. It has been observed that Bangladesh received a good amount[3] of FDI during FY 1998-FY 2007. During this period, the aggregate FDI inflows to Bangladesh were USD 5,510 million (Table-1). It is notable that since 1998 there has been a positive net inflow of FDI in Bangladesh. Several underlying factors may have contributed to this FDI net inflow including trading and exchange liberalization, convertibility on current account, liberalization of the investment regime, opening up of infrastructure and services to the private sector-both domestic and foreign etc.

2/ For details please see the World Bank Report on Bangladesh: Strategy for Sustained Growth, June 2007.

3/ It would be relevant to mention that although FDI as a share of GDP is very low, over the last decade it varied between a high of 1.4 per cent in FY 1998 and a low of 0.5 per cent in FY 2004. As a ratio of gross investment, FDI just varied between a low of 1.2 per cent in FY 2004 and a high of 3.2 per cent in FY 1998.

Table 1: FDI Inflows and Associated Outward Remittances, 1998-2007

(Million US dollars)

	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	Total
Total FDI inflows	603	594	383	564	394	379	284	804	745	760	**5,510**
Equity	349	396	153	372	230	164	111	361	447	403	**2,986**
Reinvested earnings	181	121	81	81	85	165	161	294	199	266	**1,634**
Intra-company loans	73	77	149	111	79	50	12	149	99	91	**890**
Outward remittances											
Dividend/profit repatriation	40	83	149	175	195	355	228	418	396	569	**2,718**
Investment liquidation	0.1	2.9	0.5	0.5	2.6	2.2	10.5	3.3	3.5	4.5	**30.6**

Source: Statistics Department, Bangladesh Bank

During the ten-year period of FY 1998-FY 2007 there were three broad sectors of FDI inflows: infrastructure (46 per cent of total share), manufacturing (27 per cent of total share), and services (27 per cent of total share). In the infrastructure sector, gas and oil sub-sector was the highest recipient of FDI amounting to USD 1,241 million (22.5 per cent of total FDI inflows). There was a high growth in FDI inflow to the telecommunication sector in FY 2005 which continued till FY 2007. In the manufacturing group, the most significant recipient was the textiles sector amounting to USD 903 million (16.4 per cent of total FDI) out of USD 1,374 million to the group. The third group is the services sector where FDI inflows amounted to USD 1,349 million during the period, out of which trade and commerce was the highest recipient with USD 909 million (16.5 per cent of total FDI inflows).

Table 2: Sector-wise Distribution of FDI Inflows, 1998-2007

(Million US dollars)

Sector	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	Total
Infrastructure	238	249	106	319	197	120	131	461	478	488	**2,287**
Gas and Oil	231	124	50	139	75	23	61	169	182	187	**1,241**
Power	0	101	56	175	101	35	26	30	28	29	**581**
Telecommunications	7	24	0	5	21	62	44	262	268	272	**965**
Manufacturing	145	150	163	134	123	160	64	219	107	109	**1,374**
Textiles	117	129	144	113	67	77	32	75	74	75	**903**
Fertilizer	2	0	0	4	25	5	23	51	16	16	**142**
Cement	3	2	5	13	28	77	6	87	16	16	**253**
Chemicals & Pharma	23	19	14	4	3	1	3	6	1	2	**76**
Services	220	195	114	111	74	99	89	124	160	163	**1,349**
Trade & Commerce	173	116	44	35	48	49	55	102	142	145	**909**
Other Services	47	79	70	76	26	50	34	22	18	18	**440**
Total	**603**	**594**	**383**	**564**	**394**	**379**	**284**	**804**	**745**	**760**	**5,510**

Note: Pharma = Pharmaceuticals

Source: Statistics Department, Bangladesh

5. Major Economic Reform Measures Undertaken in Bangladesh

Bangladesh's growth process is essentially supported by broad-based market oriented reforms and macro stabilization measures. The reform measures started in the early part of the eighties when the country turned back to the privatization policy from its previously run nationalization policy. During the eighties, some nationalized banks were privatized and some new banks were also allowed to run in the private sector. However, reform and macro stabilization measures actually started in a comprehensive way since the early nineties with the introduction of the financial sector reform programme (FSRP). Under the FSRP various steps were undertaken which included liberalization of interest rate structure, i.e., flexibly managed or fully market-determined interest rates for both deposits and lending; reduced reliance on public credit programmes and interest rate subsidies; and promotion of competition among financial institutions by authorizing the entry of new institutions, deregulation of foreign exchange market, strengthening the legal framework in the financial sector, development of the capital market, computerization in the banking sector etc.

During the early 1990s various macro stabilization measures were also undertaken in the fiscal sector which included reform in the tax structure and broadening the tax base of the economy by introducing a value added tax (VAT) system. Due to adoption of improved macroeconomic stabilization measures, CPI inflation fell from an average rate of 10 per cent during 1985-1990 to 4 per cent during 1991-94, while the current account deficit as a share of GDP fell from 7 per cent to 2.7 per cent and fiscal deficit from 7.6 per cent to 6.2 per cent[4]. The country's export performances responded to the easing of trade and exchange restrictions. Preferential arrangements for garment exporters to avail of the special access to developed countries' markets offered by the Multi-Fibre Arrangement (MFA) quota system helped to boost-up overall export performances. Abolition of "Secondary Exchange Rate" to unify the exchange rate system and withdrawal of most exchange controls on current account also helped to accelerate export growth. As a result, after stagnating at about 5-6 per cent of GDP between FY1985-1990, exports to GDP ratio increased to 11 per cent by 1995.[5] In order to create a deeper and more efficient financial system, since 2001 Bangladesh has embarked on bold banking reforms, most prominently by de-emphasizing the role of the NCBs, strengthening competitive pressures, loosening government control, and tightening prudential regulations and regulatory quality. Key measures on the latter include raising the capital adequacy ratio to international standards, tightening of loan classification, issuance of risk guidelines, and improvements in corporate governance of banks. Very recently, three Nationalized Commercial Banks (NCBs) have been made public limited companies and the government has an intention of selling shares of these NCBs in the coming years. After experiencing a big stock market collapse in the mid-nineties, the country's capital market has gone through a massive restructuring and reorganization. The Central Depository Bangladesh Limited (CDBL) was incorporated as a public limited company on 20 August 2000 to operate and maintain the Central Depository System (CDS) of electronic book entry, including recording and maintaining securities accounts and registering transfer of securities; changing the ownership without any physical movement or endorsement of certificates and execution of transfer instruments, as well as various other investor services including facilitation of secondary market trading of treasury bills and bonds. Very recently, efforts have been taken to improve investors' confidence through improving corporate governance and financial discloser practices of the companies listed in the country's two stock exchanges, i.e., The Dhaka Stock Exchange (DSE) and the Chittagong Stock Exchange (CSE).

These measures have attracted strong investor interest in the new capital issues of banks and financial institutions in particular. All major indicators of the equity market in Bangladesh are now showing signs of gradual improvement reflecting some gains of investors' confidence in the capital market. As of 30th June 2008, there were 285 companies (including mutual funds) listed on the DSE with a bigger market capitalization of Taka 931.03 billion compared to Taka 11.49 billion in FY 1990.

4/ Bangladesh: Recent Economic Developments and Priority Reform Agenda for Rapid Growth, World Bank 1995.

5/ According to latest available data, exports to GDP ratio has increased to 17.8 per cent in FY 2007.

6. Major Problems Experienced

Bangladesh's recent impressive growth and development records have been recognized and admired widely by the international community including the World Bank. Notwithstanding good growth record in the recent years, the Bangladesh economy has experienced some chronic problems and challenges which impeded realization of its full growth potential. Confrontational politics and poor governance issues are a big concern for rapid growth in Bangladesh. The country has experienced a unique time in the recent past when a state of emergency was declared by the present Caretaker Government (CTG). A wide ranging anti-corruption drive by the CTG gave rise to confusion and uncertainties which affected investment and business environment with consequent negative implications for domestic and foreign investments. Moreover, three consecutive natural disasters-two floods and cyclone Sidr, inflicted severe burden on macroeconomic management in FY2008, the recently past fiscal year. As a result, macroeconomic performance of the Bangladesh economy was marked by: (1) acceleration of the inflationary pressure; (2) lower level of ADP implementation underpinned by cost escalation of projects and weak implementation capacity of government machinery; (3) higher public expenditure owing to flood and cyclone rehabilitation related efforts; (4) rising demand for subsidy in the wake of higher import prices; and (5) pressure on balance of payments arising from higher trade deficit driven by higher import expenditure particularly for food and fuel imports, and relatively low pace of export growth. Frequent power shortages, high cost of construction materials, uncertainties afflicting investment in industry and real estate in the context of the ongoing anti-graft drive, had adverse impact on the investment environment.

Although performance in the banking sector has responded well to the reform measures and over the last few years market shares of the state-owned banks have declined substantially, while market share of the private commercial banks (PCBs) and foreign commercial banks (FCBs) have increased[6] remarkably, non-performing loan (NPL) ratio till remained significantly high in state-owned commercial banks (SOCBs) and in specialized banks (SBs).

Table 3: Ratio of Gross NPL to Total Loans for all types of banks during 2000-2007

Bank types	Ratio of gross NPL to total loans							
	2000	2001	2002	2003	2004	2005	2006	2007
SOCBs	38.6	37.0	33.7	29.0	25.3	21.4	22.9	29.9
SBs	62.6	61.8	56.1	47.4	42.9	34.9	33.7	28.6
PCBs	22.0	17.0	16.4	12.4	8.5	5.6	5.5	5.0
FCBs	3.4	3.3	2.6	2.7	1.5	1.3	0.8	1.4
Overall	**34.9**	**31.5**	**28.0**	**22.1**	**17.6**	**13.6**	**13.2**	**13.2**

Source: Bangladesh Bank Annual Report, various issues

Bangladesh entered into a floating exchange rate regime effective from May 31, 2003. Its transition to a floating exchange rate regime was exceptionally smooth. But in the recent years, the foreign exchange market in Bangladesh witnessed some unusual pressure on the Taka-Dollar exchange rate resulting from a relatively faster growth in import bills than that of combined export earnings and workers' remittance flows due mainly to an unusual price hike in fuel oil and food items. Local currency (Taka) has depreciated remarkably against the US Dollar in the recent years, particularly in FY2006 although this pressure has been reduced in the recent months by a record high inflow of workers' remittances.

6/ The share of the state-owned commercial banks in the total assets fell from 54 per cent in 1998 to 37 per cent in 2005, while PCBs and FCBs increased their share to over one-half by 2004.

Table 4: Period Average Taka-US Dollar Exchange Rates, FY00-08

Year	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08
Taka/ US$	50.31	53.96	57.43	57.90	58.94	61.39	67.08	69.03	68.60

Source: Monthly Economic Trends, Bangladesh Bank

A major emerging concern which had an adverse impact on the balance of trade in the recent years had been Bangladesh's deteriorating terms of trade. At a time when commodity prices have seen unprecedented rise in the global market, with consequent high burden for Bangladesh on account of import payments, Bangladesh's export prices have experienced a continuing fall. The Center for Policy Dialogue (CPD), a leading private research institution in Bangladesh, in their recently published "Interim Review of Macroeconomic Performance of Bangladesh Economy in FY2007-08" has indicated that if the price level of 2000 is taken as base (100), Bangladesh's terms of trade had declined to 85 by 2007. The decline in the average prices per unit of major exportables has continued in FY2008 and onwards.

7. Challenges to Price Stability

It is well recognized that a successful and sustained macroeconomic stabilization policy (lower inflation and smaller internal-external imbalances), played an important part in nurturing the good growth in Bangladesh. Since the early 1990s to till FY 2007, inflation has not touched the two-digit mark, broadly reflecting responsible monetary and fiscal policies. But this record is now threatened by an unusual hike in the general price level. Available data show that inflation on 12-month average basis stood at 9.87 per cent in FY2008 which is significantly higher than that of the previous year (Table-5). In fact, a high general price level experienced in FY 2008 originated from both domestic and global factors. In the domestic arena, increase in food inflation has been due to lower food production as a result of two consecutive floods and a cyclone Sidr. Internationally, prices of non-food items such as soybean and fuel oil have increased at a fast pace breaking all past records.

Table 5: Trends in General Inflation during FY90-FY08

Inflation	Average during FY90-FY95	Average during FY96-FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08*
12-Month average	4.0	5.6	1.94	2.79	4.38	5.83	6.48	7.16	7.20	9.87
Point-to-point	-	-	1.66	3.58	5.03	5.64	7.35	7.54	9.20	7.44

* Up to May 2008.

Source: Bangladesh Bureau of Statistics.

Recent inflationary pressure has had an adverse impact on the consumers through reduction of their purchasing power and income erosion. High inflation, particularly high food inflation, has affected the poor and people in the fixed income group more than others.

The government has undertaken several fiscal and monetary measures to tackle the price hike and contain inflation. Sales of essential food items through the open market system (OMS) and expansion of social safety net programmes such as vulnerable group development (VGD) were some of the fiscal measures. The government has also pursued a proactive policy for distribution of fertilizer and agricultural inputs to increase food production. As a result, the country has experienced a bumper boro (paddy) production towards the end of the last fiscal year that ended in June 2008. Surprisingly, prices of essential items are still soaring in the recent months. In fact, economists are considering the recent price hike not as a short-term problem but as a structural one. Given the fact that in the context of the present global economic scenario commodity prices will not decline dramatically in the immediate future, Bangladesh, as many other developing countries, may not be able to get back to a comfortable situation with a tolerable inflation within a short span of time.

8. Risks to Growth Momentum

In spite of a world-wide recent unusual price hike and a recessionary condition in the world's leading economies and an unfavourable domestic environment created from natural disasters and political uncertainties, the Bangladesh economy maintained over six per cent growth for the last five consecutive fiscal years till June 2008. But it is noteworthy that since the Bangladesh economy is now increasingly globally integrated, the recent financial turmoil which spread from the US sub-prime mortgage market in the middle of the last year may create a downside risk to future growth performance of the developing countries like Bangladesh. Bangladesh's export markets are highly concentrated with the developed countries of the world and any adverse effect in the developed countries may have reciprocal impact on the Bangladesh economy. Unfortunately, slower growth projections for major export destinations of Bangladesh, particularly the stagflation in the US and also the Euro zone countries, and the high global inflationary trends, may adversely influence the overall growth performance of the Bangladesh economy in the coming months.

Table 6: Projections of Real GDP Growth of Selected Countries

Countries/Zones	2007	2008	2009
World	4.9	3.7	3.8
United States	2.2	0.5	0.6
Japan	2.1	1.4	1.5
European Union (EU)	3.1	1.8	1.7
China	11.4	9.3	9.5
India	9.2	7.9	8.0
Singapore	7.7	4.0	4.5
Hong Kong	6.3	4.3	4.8

Sources: World Economic Outlook, April 2008 and IMF

It is evident from Table 6 that growth projections for the US and the EU, the major export destinations of Bangladesh, for 2008 were low at 0.5 per cent (down from 2.2 per cent in 2007) and 1.8 per cent (down from 3.1 per cent in 2007) respectively which are more or less projected to be almost same in 2009. Growth rates for India and China, two major import sources of Bangladesh, were also projected to be downward from the existing levels. Sluggish growth in the major trading partner countries may adversely affect the overall growth performance in the Bangladesh economy. Presently deteriorating terms of trade may further deteriorate and foreign investments (both direct and portfolio) may sharply decline in the coming months. Slower growth of the major economies could also dampen initiatives such as aid for trade and also undermine the prospects of LDC-friendly initiatives in the WTO and the initiative to provide zero-tariff access to LDC products in the US markets.

Stabilizing the inflation rate is a major challenge for the policy makers because a low and stable rate of inflation is critically important for accelerated growth and poverty reduction. Another major challenge will be to address the growing fiscal deficit which is increasing at a faster rate in the recent months due to government's high borrowing from the domestic sources particularly from the banking sector.

Some internal factors such as political uncertainty, infrastructural constraints and Bangladesh's vulnerability to natural disasters may also pose a big risk to its existing growth momentum. As the country is now passing through a state of emergency ruled by the Caretaker Government (CTG) and the CTG has announced a road map to hold general elections by the end of December 2008, any big deviation or failing to organize a long desired free-fair and impartial elections can create huge uncertainty on the future growth prospects of the Bangladesh economy. Weak infrastructure, including serious power shortages and transportation bottlenecks, is also a big concern for maintaining high growth momentum in Bangladesh.

9. Medium Term Growth Prospects

Despite some challenges both in domestic and international arena, the near and medium term growth prospects in Bangladesh are likely to be favourable. In the recently declared budget for FY2009, real GDP growth has been projected to grow by 6.5 per cent and in the Poverty Reduction Strategy Paper (PRSP) it has been expected to be maintained at or above 7.0 per cent till FY2011. To support the pro-poor growth target envisaged in the medium term macroeconomic framework (MTMF) of PRSP, the gross domestic investment is projected to increase gradually from the existing amount of around 24 per cent (Annex-II) to around 27 per cent in FY 2011 through mobilization of internal and foreign resources. Exports are projected to grow by 16.0 + per cent each year during FY 2009 to FY 2011. The gross official foreign exchange reserves are projected to be USD 6,500 million by FY 2011.

The outlook envisaged in the MTMF, however, faces several near and medium term down-side risks and uncertainties originating from (i) the rising inflationary pressures, (ii) the sustained high global oil prices, (iii) infrastructure constraints (especially power and gas shortages and transportation bottlenecks), (iv) probable adverse effects in the RMG sub-sector from 2008 onwards due to the expiry of restrictions imposed on China by the US, (v) restoring business confidence for strengthening private sector investment activities, and (vi) the political developments and outcome of the next general election scheduled to be held by December 2008.

Regarding the growth prospects, the World Bank in its recently published report "Bangladesh: Strategy for Sustained Growth" has stated that "Bangladesh, with per-capita gross national income (GNI) of $476 in 2005, could become a middle-income country-defined by the International Development Association (IDA) as one with per-capita gross national income (GNI) of $875- by 2023, if the average per-capita GDP growth holds at the 3.5 per cent level of the last 10 years (assuming GNI growth equals GDP growth). Or, Bangladesh could become an MIC within a decade (by 2016) if it raised per-capita growth to 6 per cent, implying GDP growth at a challenging but not impossible 7.5 per cent".

Recently, PricewaterhouseCoopers in their report "The World in 2050: A Broader Look at Emerging Market Growth Prospects" identified 13 emerging economies (Argentina, Bangladesh, Egypt, Iran, Malaysia, Nigeria, Pakistan, Philippines, Poland, Saudi Arabia, South Africa, Thailand and Vietnam) as having the potential to grow significantly faster than the Organization for Economic Cooperation and Development (OECD) countries. The said report projected real annual GDP growth rates for Bangladesh during 2007-2050 at 7 per cent in dollar terms.

Finally, as the global centre of economic activity is now shifting to India, China and other large economies, Bangladesh must make all efforts to capitalize on its comparative advantages to benefit from this global paradigm shift.

10. Concluding Remarks/Summary of Policy Recommendations

Available data indicate that the Bangladesh economy exhibited an excellent growth record during the last fifteen years or more. Bangladesh's growth performance has been appreciated by the world community. The World Bank in its recently published report on 'Bangladesh: Strategy for Sustained Growth' has mentioned, "Desperately poor when it won its independence in 1971, over-populated, and reeling from overwhelming war damage to its institutional and physical capital, Bangladesh looked to become, as Henry Kissinger forecast, "an international basket case." Thirty some years later, doubts and doubters have been disproven. Life expectancy in Bangladesh has risen from 50 to 64 years. Population growth rates of 3 per cent a year have been halved. Unemployment that ran at 25-30 per cent has shrunk to 4 per cent. Child mortality rates of 240 per 1,000 births have been cut by 70 per cent. Literacy has more than doubled, and Bangladesh is on track in meeting the Millennium Development Goal on gender parity, having already achieved the goal on primary and secondary schooling. The poverty rate has fallen by close to 20 percentage points since the early 1990s, benefiting from a sharp acceleration in per-capita GDP growth." In spite of such a good record, the Bangladesh economy is now facing some emerging challenges which need to be addressed on a priority basis. Key challenges and their probable solutions are summarized as follows:

1. Recent increase in exports, largely driven by the success of the RMG sector (about 75 per cent of total merchandise exports), has contributed to the recent acceleration of GDP growth in Bangladesh. This sector may face a big challenge in the coming years due to intensive competition mostly coming from China and some other apparel exporting countries like Vietnam. Therefore, the country's exports base needs to be broadened with the introduction of high value added export items. It may be mentioned that low domestic labour cost is the main source of comparative advantage for the RMG sector in Bangladesh. Recent unusual increase in food prices may induce to increase existing labour cost in the coming months. Hence, due attention is needed to maintain comparative advantage of our RMG sector and at the same time labour unrest should be

contained through proper negotiation with leaders of garment workers.

2. Inflation control and investment promotion appear to be the two major challenges in the coming months. There is no alternative but to increase productivity particularly in the agriculture sector for containing inflation. In fact, over the past the country's agriculture sector was undermined and as such the rest of the economy has outpaced the agriculture sector, resulting in a decline in the sector's share in GDP (though it is very natural in the high growth stage), from 30 per cent in 1990 to 21 per cent in FY2008. An extra attention has to be given for increasing agricultural productivity. Simultaneously, an increased financing in the country's Small and Medium Enterprise (SME) sector could be the best way to increase productivity and enhance investment in the economy.

3. The present Caretaker Government has made a notable progress in preparing for holding the next general election scheduled to be held by end December 2008. Business confidence is gradually restoring and growth in private sector credit including credit disbursed by the microfinance institutions has been increasing in the recent months. This indicates signs of recovery from the last year's floods and cyclone damages and restoring business confidence which was shaken by the anti-corruption drive of the Caretaker Government. Under such circumstances, a moderately accommodative monetary policy could be helpful in maintaining desired growth momentum in the economy.

4. Under the leadership of the present Caretaker Government, a bold step has been undertaken to curb previously widespread corruption and enhance good governance and it is now widely believed that Bangladesh can join a group of middle income countries (MIC) by the year 2020 or sometime sooner or later by maintaining its present growth momentum.

Annex I

Growth and Sectoral Share of GDP (at FY96 constant prices)

Sectors	FY91-FY95	FY96-FY00	FY01	FY02	FY03	FY04	FY05	FY01-FY05	FY06	FY07	FY08 p	FY06-FY08
1	2	3	3	4	5	6	7	8	9	10	11	12
Growth in percent												
i. Agriculture	**1.6**	**4.9**	**3.1**	**0.01**	**3.1**	**4.1**	**2.2**	**2.5**	**4.9**	**4.6**	**3.6**	**4.4**
a) Agriculture and forestry	0.3	3.9	5.5	-0.6	3.3	4.4	1.8	2.9	5.2	4.7	3.5	4.5
1. Crops and horticulture	-0.4	4.1	6.2	-2.4	2.9	4.3	0.2	2.2	5.0	4.4	3.4	4.3
2. Animal farming	2.4	2.6	2.8	4.7	4.5	5.0	7.2	4.8	6.2	5.5	2.4	4.7
3. Forest and related services	2.8	4.4	4.9	4.9	4.4	4.2	5.1	4.7	5.2	5.2	5.4	5.3
b) Fishing	7.9	8.6	-4.5	2.2	2.3	3.1	3.7	1.4	3.9	4.1	4.1	4.0
ii. Industry	**7.5**	**6.4**	**7.4**	**6.5**	**7.3**	**7.6**	**8.3**	**7.4**	**9.7**	**8.4**	**6.9**	**8.3**
a) Mining and quarrying	6.4	5.6	9.7	4.5	7.2	7.7	8.4	7.5	9.3	8.3	8.6	8.7
b) Manufacturing	8.2	5.6	6.7	5.5	6.7	7.1	8.2	6.8	10.8	9.7	7.4	9.3
i) Large and medium scale	8.4	5.5	6.5	4.6	6.6	7.0	8.3	6.6	11.4	9.7	7.2	9.5
ii) Small scale	7.7	5.9	7.0	7.7	7.2	7.5	7.9	7.5	9.2	9.7	7.9	8.9
c) Electricity, gas and water supply	6.5	4.4	7.4	7.6	8.0	9.1	8.9	8.2	7.7	2.1	4.9	4.9
d) Construction	6.3	8.8	8.6	8.6	8.1	8.3	8.3	8.4	8.3	7.0	5.9	7.1
iii. Services	**4.1**	**4.8**	**5.5**	**5.4**	**5.4**	**5.7**	**6.4**	**5.7**	**6.4**	**6.9**	**6.7**	**6.7**
a) Wholesale and retail trade	5.4	6.0	6.4	6.6	6.1	6.6	7.1	6.6	6.8	8.0	7.2	7.3
b) Hotel and restaurants	5.0	6.0	7.0	6.9	7.0	7.1	7.1	7.0	7.5	7.5	7.6	7.5
c) Transport, storage and communication	3.5	5.7	7.9	6.6	6.8	6.2	7.9	7.1	8.0	8.0	8.7	8.2
d) Financial intermediations	4.3	5.2	5.5	6.7	6.7	7.0	8.9	7.0	8.5	9.2	9.0	8.9
e) Real estate, renting and business activities	3.3	3.7	3.4	3.4	3.5	3.6	3.7	3.5	3.7	3.8	3.6	3.7
f) Public administration and defence	8.1	5.5	5.9	5.9	5.2	7.1	8.0	6.4	8.2	8.4	7.2	7.9
g) Education	6.1	6.2	7.1	7.6	7.6	7.7	7.9	7.6	9.1	9.0	7.9	8.6
h) Health and social work	3.9	4.1	4.9	5.3	5.6	6.2	7.4	5.9	7.8	7.6	7.5	7.6
i) Community, social and personal services	2.7	2.9	3.1	3.2	3.3	4.0	4.1	3.5	4.1	4.6	4.6	4.4
GDP (at FY96 constant market prices)	**4.4**	**5.2**	**5.3**	**4.4**	**5.3**	**6.3**	**6.0**	**5.5**	**6.6**	**6.4**	**6.2**	**6.4**
Sectoral share (percent of GDP)												
i. Agriculture	27.9	25.6	25.0	24.0	23.5	23.1	22.3	23.6	21.8	21.4	20.9	21.3
ii. Industry	22.5	25.4	26.2	26.7	27.2	27.7	28.3	27.2	29.1	29.4	29.6	29.4
iii. Services	49.7	49.0	48.8	49.3	49.3	49.2	49.4	49.2	49.1	49.2	49.5	49.3
GDP (at FY96 constant market prices)	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

p = provisional

Source: Bangladesh Bureau of Statistics

Annex II

Movements of the Major Macroeconomic Indicators

Indicators	FY91-FY95 (Average)	FY96-FY00 (Average)	FY01	FY02	FY03	FY04	FY05	FY01-FY05 (Average)	FY06	FY07	FY08	FY06-FY08 (Average)
1	2	3	4	5	6	7	8	9	10	11	11	13
as % of GDP												
1. Gross domestic savings	13.4	16.7	18.0	18.2	18.6	19.5	20.0	18.9	20.3	20.4	20.1	20.3
2. Gross national savings	19.0	21.6	22.4	23.4	24.9	25.4	25.8	24.4	27.7	28.7	29.2	28.5
3. Gross investment	17.9	21.6	23.1	23.1	23.4	24.0	24.5	23.6	24.7	24.5	24.2	24.5
Public	11.3	6.8	7.2	6.4	6.2	6.2	6.2	6.4	6.0	5.6	5.0	5.5
Private	6.7	14.7	15.8	16.8	17.2	17.8	18.3	17.2	18.7	18.7	19.2	18.9
4. Broad money	25.3	28.72	34.4	36.1	37.9	39	41.1	37.7	43.5	45.3		
	(13.60)	(12.14)	(16.60)	(13.10)	(15.60)	(13.80)	(16.80)	(15.18)	(19.50)	(17.00)		
5. Market capitalization (value of ordinary shares of companies listed with DSE)	-	3.6	2.8	2.4	2.4	4.3	5.7	3.5	4.9	8.8		
6. Overall budget deficit (excluding grants)	5.0	4.5	5.1	4.7	4.2	4.2	4.5	4.5	3.9	3.7	4.7#	4.0
7. Government debt outstanding	-	43.3	46.2	50.0	49.0	48.2	46.9	48.1	46.6	45.9		
Domestic debt		10.3	15.0	16.6	16.3	16.4	16.5	16.2	16.6	16.7		
External debt**		33.0	31.2	33.4	32.7	31.8	30.5	31.9	30.1	29.1		
8. Exports	7.1	11.1	13.8	12.5	12.5	13.3	14.2	13.3	16.8	17.8		
	(19.00)	(10.80)	(12.40)	(-8.4)	(9.50)	(15.90)	(14.00)	(8.70)	(21.50)	(15.80)		
9. Import	12.5	17.3	19.9	16.2	16.8	17.4	19.7	18	21.5	22.9		
	(10.40)	(7.70)	(11.40)	(-17.8)	(13.10)	(13.00)	(20.60)	(8.10)	(12.10)	(16.60)		
10. Trade balance (8-9)	-5.4	-6.2	-6.1	-3.7	-4.3	-4.1	-5.5	-4.7	-4.7	-5.1		
11. Workers' remittances	2.9	3.6	4.0	5.3	5.9	6.0	6.4	5.5	7.7	8.8		
	(9.60)	(10.50)	(-3.4)	(32.90)	(22.40)	(10.10)	(14.10)	(15.20)	(24.80)	(24.50)		
12. Current account balance	-2.2	-1.2	-1.7	0.3	0.3	0.3	-0.9	-0.3	1.3	1.4		
13. CPI inflation (annual average)*	5.6	5.8	1.9	2.8	4.4	5.8	6.5	4.3	7.2	7.2		
14. Foreign exchange reserve (million US $) (end June)	2,092	1,724	1,307	1,583	2,470	2,705	2,930	2,199	3,484	5,077	6,149	4,903.3

Figures in the bracket indicate percentage changes

* From FY 91 to FY 97, Base: FY 86=100 and from FY 98 to FY 08, Base: FY 96=100.

**Excluding IMF loan

Excluding BPC

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ii) Economic Trends, BB
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Country Paper: Bhutan

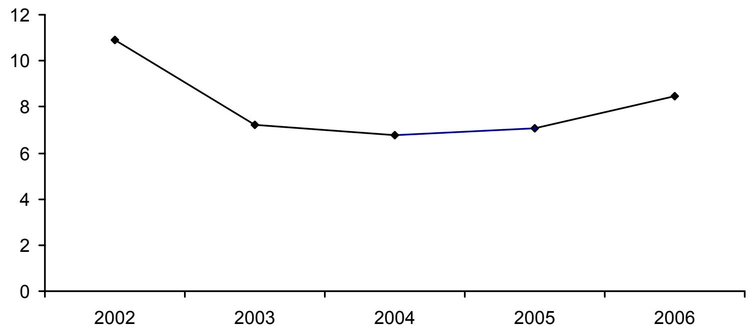
Review of Growth Performance in Bhutan

1. Domestic Economy

1.1 Real Sector

The real GDP growth increased to 8.5 per cent in 2006 as compared to 7.1 per cent in 2005. This was due to coming on stream of the Tala Hydropower Project. The tertiary sector was the main contributor to the growth in 2006 followed by secondary and lastly by the primary sector. Looking at individual sub-sector's contribution, the electricity sub-sector contributed the highest; followed by mining and quarrying; and financing, insurance and real estate. As for the share in the total GDP, the tertiary sector accounted for 42.4 per cent of the nominal GDP in 2006, followed by the secondary sector, which accounted for 34 per cent, and the primary sector accounted for the remaining 23.7 per cent.

Figure 1: Real GDP Growth (year-to-year)

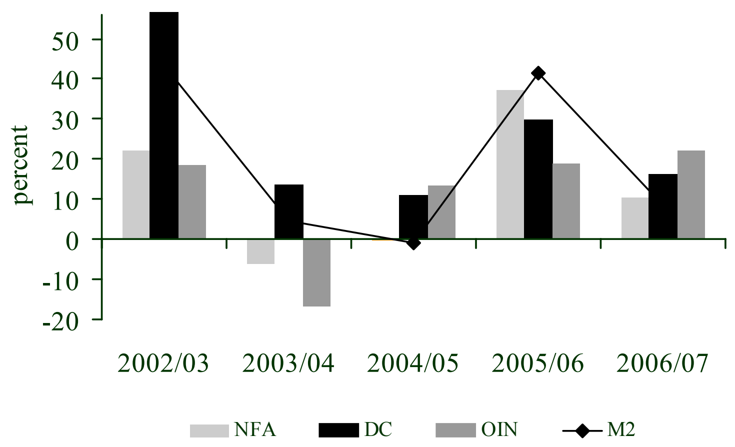


1.2 Monetary Sector

Monetary expansion in general was lower in 2006/07 compared to the previous year. The broad money supply (M2) grew at a much slower rate of 8.6 per cent, as compared to 26 per cent in 2005/06. Net Foreign Assets, which is a major counterpart of the M2, grew at a lower rate of about 11 per cent as compared to 37 per cent in the previous year.

Overall domestic credit by the commercial banks increased by 16 per cent in 2006/07.

Figure 2: Growth in M2 and its Counterparts (annual change)



The credit to the private sector grew at 35.5 per cent with major share of the credit going to the building and construction sector. Credit to the building and construction sector constituted almost 35 per cent of the total loan portfolio of the banks, followed by manufacturing at 20.3 per cent, trade and commerce at 14.2 per cent and service and tourism at 13.6 per cent, with the remaining allocated to other sectors.

In response to the rapid credit growth to the private sector, the RMA tightened its monetary policy by increasing the CRR and the volume of RMA Bills in September 2007. Further, provisioning requirements for loans in the most exposed sector have been increased on both substandard and doubtful loans. The capital adequacy ratio (CAR) was also increased from 8 per cent to 10 per cent to ensure the soundness of the financial institutions.

1.3 Prices

The excess liquidity in the financial system has not translated into inflationary pressures as monetary developments have a limited impact on prices in Bhutan. The inflation in Bhutan is influenced more by price developments in India, since about 70 per cent of the country's import is from India, and moreover, the Bhutanese currency Ngultrum is one-to-one pegged to the Indian Rupee.

Following the price developments in India (fuel and food), inflation in Bhutan increased to 8.85 per cent in the second quarter of 2008 as compared to 5.94 per cent in the same period last year. Reflecting the global food and fuel price increase, the increase in prices of the food items doubled to 10.99 per cent as compared to the same period last year.

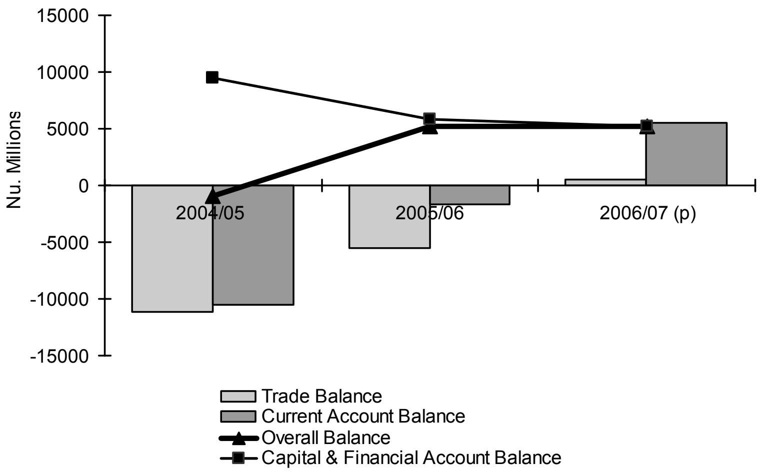
2. External Sector

Developments in Bhutan's external sector as indicated by the balance of payments statistics were characterized by highly increased merchandise exports and FDI-related inflows. The annual growth in exports (by 62.4 per cent compared to a 13.7 per cent growth in imports) resulted in an overall trade surplus of Nu.555 million in 2006/07. Hydropower, Bhutan's major export, accounted for 26.5 per cent of the total exports in 2006, largely because of additional sales from Tala while exports of Chukha hydro power also increased.

The current account improved from a deficit of 4.6 per cent of GDP in 2005/06 to a surplus of 12.2 per cent of GDP in 2006/07. In the services account, the export of transportation services grew by 46.7 per cent and travel services by 21.3 per cent. Convertible currency earnings from tourism continue to dominate accounting for 43.2 per cent of total services export. On the other hand, the import of construction services decreased by 38.4 per cent.

Inward remittances from non-resident Bhutanese based in COTI, and channelled through the banking system, increased from Nu.55.1 million in 2005/06 to Nu.70.4 million in 2006/07.

Figure 3: Bhutan - Overall BOP



In the capital and financial account, the completion of Tala has led to a decrease in related aid inflows and convertible currency loan disbursements have also fallen in 2006/07. However, FDI-related inflows increased substantially and as a result, the capital and financial account balance was a surplus of Nu.5,193.2 million. The overall balance was positive at Nu.5,184.4 million with a consequent increase in the country's gross international reserves by 25.1 per cent.

3. Fiscal Sector

With the extension of the 9th five-year plan by one more year, the revised total outlay for fiscal year (FY) 2006/07 increased to Nu.18,316.2 million from Nu.13,770.9 million in 2005/06. The total expenditure increased by 33 per cent whereas the total resource increased only by 24 per cent, resulting in higher budget deficit of Nu.1,646.7 million in 2006/07. Likewise, the budget deficit as a percentage of GDP increased from 0.3 per cent to 3.5 per cent.

4. Future Prospects

Table 1: Key Economic Indicators of Bhutan

Item	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07 (p)
GDP Growth and Prices (percent change)						
GDP at Constant (2000) Prices (a), (b)	6.8	10.9	7.2	6.8	7.1	8.5
Consumer Prices (c)	2.7	1.8	4.6	5.5	6.2	5.9
Wholesale Prices (India) (d)	1.7	5.7	5.6	5.2	4.6	5.4
Government Budget (in millions of Nu.) (e)						
Total Revenue & Grants	8826.7	7054.3	11113.9	10501.1	13452.2	16669.5
Of which: Foreign Grants	3748.5	2289.1	5567.4	4573.1	6124.7	6718.5
Total Expenditure and Net Lending	10052.1	9945.3	10534.1	12893.7	13770.9	18316.2
Current Balance	630.3	254.4	597.3	-42.6	955.1	1265.3
Overall Balance	-1225.4	-2891.9	579.8	-2392.6	-318.7	-1646.7
Money and Credit (percent change, end of period)						
Broad Money, M2	17.6	45.4	4.4	10.7	28.3	8.6
Credit to Private Sector	22.7	25.4	32.8	26.3	32.3	35.5
Interest Rates (end of period)						
One Year Deposits	8.0	7.0	6.0	4.5	4.5	4.5
Lending Rate	12-16	12-16	10-16	10-16	10-16	10-16
91-day RMA Bills	4.7	3.5	3.5	3.5	3.5	3.5
Balance of Payments (in millions of Nu.)						
Trade Balance	-4795.5	-4481.0	-4766.0	-11099.0	-5496.7	555.1
With India	-3088.3	-3911.3	-3820.7	-5601.2	-3176.7	1705.6
Current Account Balance	-3893.6	-6597.5	-5519.3	-11487.4	-1695.7	5177.0
(in percent of GDP)	-17.0	-25.8	-15.8	-32.4	-4.6	13.2
With India	-3837.0	-7316.2	-5793.7	-5253.9	-2348.6	3042.5
(in percent of GDP)	-18.7	-26.9	-19.4	-16.3	-6.4	8.1
Foreign Aid (Concessional Loans net)	2646.2	4527.5	4666.2	2939.4	3478.7	641.0
Of which: India	1863.2	3316.8	3258.6	1653.1	2324.6	-34.3
Errors and Omissions	-923.8	-1653.4	-2912.2	95.5	1059.2	-5485.8
Overall Balance	1242.7	2613.6	370.1	-985.6	5208.1	5184.4
(in percent of GDP)	5.4	9.9	1.4	-2.8	14.2	13.5
External Indicators (end of period)						
Gross Official Reserves in Millions of USD	335.5	375.3	383.3	366.5	478.6	599.0
(in months of merchandise imports)	16.9	21.2	17.6	9.3	13.6	13.2
External Debt (percent of GDP)	61.4	79.6	81.8	88.9	85.2	67.4
Debt Service Ratio (f)	4.5	6.8	6.2	11.4	7.5	4.2

Item	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07 (p)
Memorandum Items:						
Nominal GDP (in millions of Nu.) (a), (b)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Ngultrum per USD (fiscal year period average)	[illegible]	[illegible]	45.4	[illegible]	[illegible]	[illegible]
Money Supply, M2 (end of period)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Money Supply, M1 (end of period)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Counterparts						
Foreign Assets (Net)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Domestic Credit	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Claims on Private Sector	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Components						
Currency Outside Banks	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Demand Deposits	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Quasi-Money	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Reserve Money, M0, of which	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Banks' Deposits	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Money Multiplier (M2/M0)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Income Velocity (GDP/M2)	2.1	[illegible]	[illegible]	1.8	[illegible]	[illegible]
Population Growth Rate (a), (g), (h)	[illegible]	2.4	[illegible]	[illegible]	[illegible]	[illegible]
Unemployment Rate (a), (g), (h)	[illegible]	-	[illegible]	[illegible]	[illegible]	[illegible]

a) On a calendar year basis, e.g., the entry under 2006/07 is for 2006. - b) Source: National Accounts Statistics (2007), NSB - c) Data till 2003/04 are based on the old half-yearly average CPI of the NSB (1979 base year). This was replaced by a new quarterly CPI with a revised basket and Q1 of 2004 as the base. Rates of change (year-to-year) for the quarterly CPI are therefore not available prior to Q1 2004. The CPI reflected in this table is for the last quarter of the fiscal year. - d) Source: Reserve Bank of India, Wholesale Price Index of All Commodities, 1993-94 base. [illegible] - e) Data for 2006/07 are provisional estimates. - f) Debt service payments in percent of exports of goods and services. (g) Data for 2005 is from the Population & Housing Census of Bhutan 2005. (h) Source: Comparative Socio-Economic Indicators for Bhutan (June 2005), NSB; Labour Market Information Bulletin (2007) & Labour Force Survey (May 2007), MLHR

Although globally, fuel and food price increases have adversely affected the growth prospective of the various economies, Bhutan will face constraints for achieving the earlier projected growth. Bhutanese economy growth is hydropower driven and with the commencement of new projects such as Punatsangchu and Dagachu, the growth of the economy despite fuel and food crisis, is expected to be double digit. The inflation and external sector vulnerabilities particularly with India need very strict monetary and fiscal policy stance, which may also affect the growth to a certain extent. Overall, the prospects of future growth and development looks reasonably bright.

Country Paper: India

Trade Pattern of SAARC Countries: Recent Trends

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1. Macroeconomic Overview of SAARC Economies

The South Asian region (as defined by SAARC)[1] constitutes about 23 per cent of the world's population and has 15 per cent of the world's arable land, but only about 5.8 per cent of PPP based global gross domestic product (GDP) and account for less than 2.0 per cent of world goods trade, and less than 1.7 per cent of world foreign direct investment. The South Asian region is extraordinarily diverse in terms of country size, economic and social development, geography, political systems, languages, and cultures. Three of the eight countries under South Asian region, viz., Afghanistan, Nepal, and Bhutan, are landlocked and mountainous; while Sri Lanka is an island and the Maldives is an archipelago of low-lying coral islands in the central Indian Ocean.

The region translated itself from a position of slowest growing region during the 1960s and the 1970s to one of the fastest growing regions in the world since the 1980s. In terms of GDP growth, South Asia has performed robust growth over the years among the low income countries. As per the World Bank database, during the 1960s, GDP growth in the region was placed at 4.2 per cent as compared to 5.4 per cent the global level. Except during the 1970s, the GDP growth in South Asia was higher than those of the world output growth till 2006. The growth had been sustained at an average of about 5.4 per cent during 1980-2004 followed by marked jump to 8.7 per cent during 2005 and 2006 which sustained in 2007.

Reflecting growing savings, the gross capital formation of South Asian economies also more than doubled from 15.1 per cent during the 60s to 31.6 per cent during 2006 as against a decline from 23.1 per cent during the 60s to 21.7 per cent during 2005 at the world level. However, some economies of the region, viz., Afghanistan, Nepal, Bhutan and Bangladesh still depend on foreign savings/aid for financing their resource gaps.

As regards fiscal position of the South Asian region, at present, all countries have fiscal deficit. Some of the economies of the region are highly sensitive to external and natural shocks. For instance, the deteriorating fiscal balance (7.9 per cent of GDP in 2007) on account of reconstruction projects undertaken in the aftermath of tsunami in recent years was a major concern in **Maldives**. Similarly, it has been noted that fiscal position of **Bhutan** is quite sensitive to project-specific revenues and expenditure of the government. The budget deficit widened to 3.4 per cent of GDP in 2007. In **Pakistan**, despite overall improved revenue position, a sharp increase in current expenditures led by interest payments and continued expansion in development spending kept the fiscal deficit at 4.3 per cent of GDP. Continued modernization of revenue administration broadened the tax base in **Sri Lanka** which along with lower than expected expenditure, contributed to a further reduction of the fiscal deficit to an estimated 7.7 per cent of GDP in 2007. In **Bangladesh**, revenue collection slipped and total spending was contained by a reduction in outlays for the annual development programme which kept the fiscal deficit at 3.2 per cent of GDP. The budget deficit widened marginally to 2.0 per cent of GDP in **Nepal** during 2007 despite a significant increase in expenditures during the year. The fiscal position in **India**, both at centre and States, is undergoing consolidation in terms of targeted reduction in fiscal deficit indicators under the Fiscal Responsibility and Budget Management (FRBM) Act. As per the revised estimates, the gross fiscal deficit (GFD) and revenue deficit (RD) of central government for 2007-08 have been placed at 3.1 per cent and 1.4 per cent of GDP.

At present, all South Asian countries, except Nepal and Bangladesh have been incurring current account deficit (CAD). CAD is highest in Maldives despite a net surplus in services trade, most of which comes from tourism that had financed the trade deficit until 2004. Even though tourism earnings recovered to exceed the pre-tsunami level in 2007, larger services payments and the expansion in imports meant that net services covered only about 40 per cent of the trade deficit. The CAD in Maldives, therefore, widened further to 45.0 per cent of GDP in 2007. In Afghanistan, the CAD, excluding grants, is estimated to have grown to 72.6 per cent of GDP in FY2007, reflecting a trade deficit widened by higher than expected imports, which were associated with donor financed activities outside the core budget (including both security and development projects). Including grants, the current account balance is expected to have recorded a deficit of 1.4 per cent of GDP, financed by FDI and concessional loan disbursements. Strong growth in overseas workers' remittances

1/ SAARC includes Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka continues to provide a cushion to the external balance. Despite a higher trade deficit, the current account balance is projected to show a surplus of 0.7 per cent of GDP in FY 2008. The current account surplus in Bangladesh declined to 0.5 per cent of GDP in FY 2007 amid a widening trade deficit and slower remittance inflows. With capital inflows also slowing, the overall balance of payments surplus declined from 4.3 per cent of GDP in FY 2006 to 0.9 per cent of GDP in FY 2007. In Nepal, the current account surplus declined to 0.5 per cent of GDP in FY 2007 amid a widening trade deficit and slower remittance inflows. In Pakistan, the current deficit is under pressure because of a higher oil import bill and deteriorating income and services accounts, despite moderate growth in exports and continued strong receipts of workers' remittances. During 2007, CAD stood at 4.8 per cent in Pakistan. The trend of strong remittance growth In Sri Lanka since 2004 continued during 2007 to support the current account balance of payments. Remittances counterbalanced the continued high trade deficit, which fell slightly from the 2006 level, on account of lower import growth and a strong export performance (mainly garments). In 2007, the CAD amounted to 4.3 per cent of GDP in Sri Lanka. In India, although the trade deficit widened significantly during 2007-08, it was offset by a steady inflow of remittances and a higher surplus from exports of services such as software and business services, though their expansion in earnings was reduced from the rapid rates seen in previous years. During 2007-08, the widening of the trade deficit mainly led by imports resulted in a higher level of CAD which stood at US$ 17.4 billion or 1.5 per cent of GDP (US $ 9.8 billion or 1.1 per cent of GDP in 2006-07 (Table 1).

Despite a number of substantial reforms undertaken in South Asian economies in the recent period, it remained one of the poorest in terms of per capita income, besides being the most densely populated region. Furthermore, the region has significantly lagged behind in the field of infrastructure, social provisions and working of the institutional set-up. Only the Sri Lankan economy is exceptional. Sri Lanka is exceptional not only in South Asia, but in the developing world. It has achieved high literacy and low infant and adult mortality rates and continues to provide universal health and education coverage and in its commitment to gender equality and social development. Its current levels of human development indicators are comparable to those of high-income countries (Srinivasan, 2004).

Table 1: Macroeconomic Indicators of SAARC Economies: 2007

	AFG	BD	BT	IND	MD	NEP	PAK	SRL
Real GDP Growth, %	12.4	5.6	22.4	9.2	6.6	2.5	6.4	6.3
GDP Per capita (US$)	323	456	2012	978	3040	400	909	1506
GDP(PPP) % of world total	…	0.3	0.0	4.6	0.0	0.0	0.6	0.1
CPI Inflation, average, %	13.0	8.4	4.9	6.4	5.0	6.4	7.8	19.7
Fiscal Balance, % of GDP, FY Basis	..	3.2	3.4	3.1#	7.9	2.0	4.3	7.7
Merchandise Export, % Growth	3.3	15.8	64.5	18.1	2.8	4.3	4.4	12.5
Merchandise Import, % Growth	15.0	16.6	15.1	28.5	14.8	11.3	8.0	10.2
CAB (US $ Billion)	-0.1	0.3	0.1	-19.3	-0.5	0.1	-7.1	-1.4
CAB % of GDP	-0.8	0.5	8.8	-1.5#	-45.0	0.6	-4.9	-4.6
Debt Service ratio, % of exports*	1.6	4.0	5.1	4.8	4.5	9.3	13.8	12.7
Reserves (Excl. gold), US$ Billion, end period	2.1*	5.4	0.6	267.0	0.3	1.8*	14.0	3.5

* For end-2006 in gross terms.
\# For 2007-08.

Sources: World Economic Outlook, International Financial Statistics and Asian Development Outlook.

2. Recent Trade Performance of SAARC Region

The importance of trade as growth facilitator has been recognized in SAARC countries as well. It is evident from the growing trade openness of SAARC economies over the years. However, there are wide disparities within the SAARC region. For instance, Maldives is highly dependent on the external sector with 178 per cent trade openness ratio (Trade-GDP ratio) while Pakistan is the least open country in the SAARC region (Table 2). Saxena (2005) elaborates that India has a huge domestic market, hence trade forms a substantially smaller percentage of GDP, especially when compared with East Asian economies, that are small and essentially require trade for growth. The rest of the countries are fairly open to trade.

Table 2 : Trade Openness (Export and Import as % of GDP) in SAARC Countries

Country	1960	1970	1980	1990	2000	2006
Afghanistan	11.2	21.7	…	…	…	68.1
Bangladesh	19.3	20.8	23.4	19.7	33.2	44.2
Bhutan	…	…	50.4	56.7	76.2	76.8
India	11.8	7.8	15.6	15.7	27.4	48.8
Maldives	…	…	…	…	161.1	178.1
Nepal	…	13.2	30.3	32.2	55.7	45.3
Pakistan	…	22.4	36.6	38.9	28.1	38.6
Sri Lanka	62.4	54.1	87.0	68.2	88.6	74.8

Sources: World Development Indicators and World Bank

Despite growing trade-GDP ratio, the South Asian economies continued to remain least open relative to other groups of emerging and developing economies. The proportion of trade in GDP of the SAARC region increased markedly from 15.1 per cent during 1970s to 48.0 per cent in 2006. For East Asia and Pacific, however, it soared from 20.9 per cent during 1970s to as much as 87.5 per cent during 2006.

As regards the trend in the share of SAARC region in total world trade, it witnessed a persistent decline during the 1960s, 1970s and 1980s. However, there has been a gradual pickup in share in total world exports since 1990s but still lower than the level of share in 1950. During 2006, share of SAARC region in total world exports stood at 1.3 per cent (3.71 per cent in 1950) (Table 3 and Chart 1). Similarly, the share of SAARC region in total world imports declined but picked up in recent years (Table 4 and Chart 1)

Table 3: Share of SAARC Region in World Exports

Economy/Year	1950	1960	1970	1980	1990	2000	2006
Afghanistan	0.09	0.04	0.03	0.03	0.01	0.00	0.00
Bangladesh				0.04	0.05	0.10	0.10
Bhutan				0.001	0.002	0.002	0.003
India	1.85	1.02	0.64	0.42	0.52	0.66	1.00
Maldives	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Nepal	0.00	0.01	0.01	0.00	0.01	0.01	0.01
Pakistan*	1.23	0.55	0.29	0.13	0.16	0.14	0.14
Sri Lanka	0.53	0.30	0.11	0.05	0.05	0.08	0.06
SAARC	**3.71**	**1.92**	**1.08**	**0.68**	**0.80**	**1.00**	**1.30**

Note: Data for Pakistan during 1950, 1960 and 1970 includes erstwhile East Pakistan. Source: UNCTAD

Table 4: Share of SAARC Region in World Imports

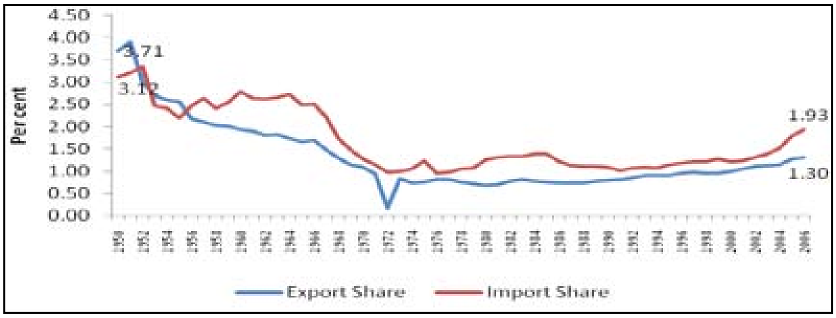
Economy/Year	1950	1960	1970	1980	1990	2000	2006
Afghanistan	0.09	0.06	0.03	0.04	0.03	0.02	0.02
Bangladesh	…	…	…	0.13	0.10	0.13	0.13
Bhutan	…	…	…	0.002	0.002	0.003	0.003
India	1.70	1.68	0.64	0.72	0.66	0.77	1.42
Maldives	0.01	0.00	0.00	0.00	0.00	0.01	0.01
Nepal	0.03	0.03	0.02	0.02	0.02	0.02	0.02
Pakistan	0.91	0.72	0.45	0.26	0.21	0.16	0.24
Sri Lanka	0.38	0.30	0.12	0.10	0.07	0.09	0.08
SAARC	**3.12**	**2.79**	**1.27**	**1.26**	**1.09**	**1.22**	**1.93**

Note: Data for Pakistan during 1950, 1960 and 1970 includes erstwhile East Pakistan. Source: UNCTAD

The trade analysis of the countries in the South Asian region shows that they witnessed a wide fluctuation in terms of export and import growth over time. During the 60s, the average annual growth of exports of goods and services for Pakistan was at 8.3 per cent followed by India at 5.4 per cent, Bangladesh at 2.6 per cent and Sri Lanka at 1.3 per cent. During the same period, import growth was maximum in Bangladesh among the South Asian countries followed by Pakistan. The export growth was further accelerated to 10.5 per cent for India in the 70s followed by Bangladesh at 7.9 per cent. There was also maximum import growth for India in the South Asian region in the 70s followed by Pakistan. In the 80s, Pakistan recorded export growth as high as 10.7 per cent followed by Sri Lanka at 6.3 per cent, Bangladesh at 6.1 per cent and India at 4.8 per cent. India witnessed maximum import growth at 7.6 per cent during the 80s within South Asian economies followed by Bangladesh at 7.0 per cent. India and Bangladesh recorded a robust export growth, respectively, at 12.0 per cent and 12.6 per cent in the 90s. In terms of import growth, India and Maldives had maximum import growth in the 90s among the South Asian countries. During 2000-06, the average export growth was as high as 17.1 per cent for Bhutan followed by India at 13.5 per cent. Similar trend was followed in import growth during 2000-06.

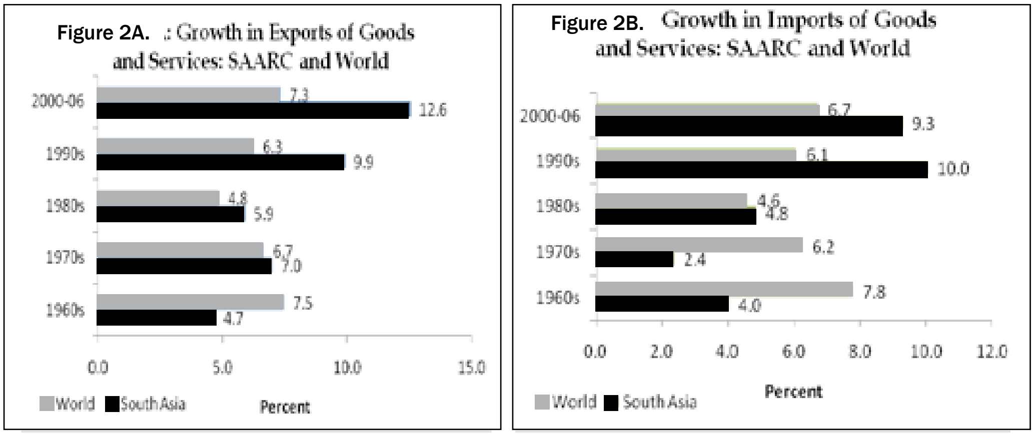
As far as direction of trade is concerned, share of exports from South Asia increased significantly to developing Asia (particularly China), Africa, Western Hemisphere and Middle-East while that to EU and UK declined over the years. In 2007, exports from South Asia have been to the extent of 27.4 per cent to developing Asia (7.2 per cent to China), followed by EU (23.9 per cent), USA (16.3 per cent), Middle-East (14.7 per cent) (Chart 3A). The direction of import in the region is mainly from developing Asia to the extent of 32.3 per cent (including China with 11.6 per cent), EU (16.6 per cent) and Middle East (9.8 per cent). However, import dependence on US, UK and EU seems to have declined over the recent years (Chart 3B).

Figure 1: Trend in Merchandise Export and Import Share of SAARC in World Totals



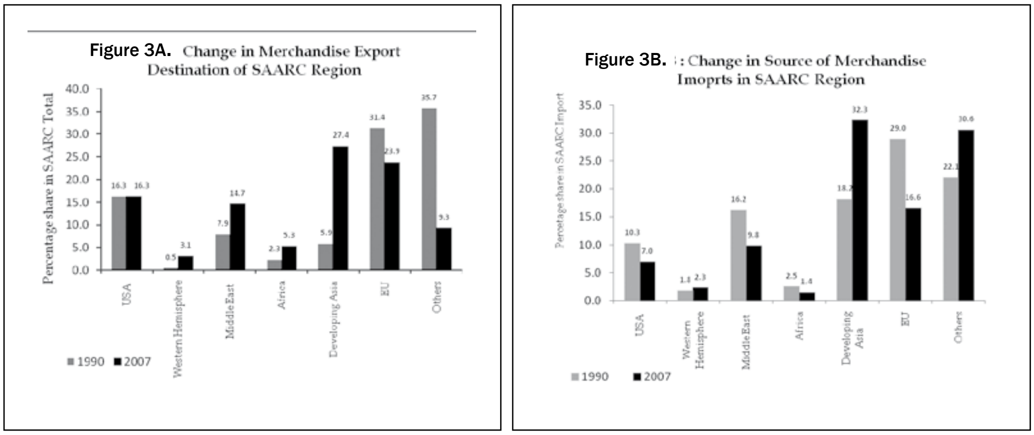
Source: World Development Indicator Database, World Bank.

Figure 2:



Source: World Development Indicator Database, World Bank.

Figure 3:



Source: Direction of Trade, IMF, June 2008.

Intra-regional Trade in South Asia

Intra-regional trade in South Asia is relatively low compared with other regions, such as ASEAN in Asia. The South Asian countries exchange goods principally with countries outside the region. SAARC had a slow start, but gained momentum with the launch of SAPTA in the mid-1990s. Since the implementation of SAFTA at the beginning of the new millennium, it has begun to perform robustly (Mohanty and Chaturvedi, 2006). Intra-regional trade as a ratio of South Asia's total foreign trade was only 5.7 per cent in 2006, compared with 24.9 per cent for ASEAN member countries (Table 5). For individual countries, the intra-regional trade ratio varies from a low of 3.0 per cent for India and 5.0 per cent for Pakistan to a high of 60.5 per cent for Nepal and 43.1 per cent for Afghanistan (Table 6). India's trade with SAARC region has expanded significantly in recent years. During 2000-01 and 2006-07, the overall exports from India to other SAARC countries increased by an annual average of 25 per cent underpinned by an average of 53 per cent with Pakistan followed by Nepal with an average of 34 per cent. During this period, export expansion with Bangladesh was lowest. Similarly, imports from SAARC countries to India increased by an annual average of 22 per cent. A significant increase was observed in imports from Pakistan and Sri Lanka during this period.

Despite growing trade with the SAARC region, the intra-SAARC trade continues to remain lowest among all the major regional groups (except Gulf Cooperation Council) formed so far. In 2006, intra-SAARC trade was merely 5.7 per cent while APEC countries had 69.4 per cent of total trade within the region (Table 5). Despite the formation of regional grouping, trade flows within the SAARC region are not much significant. This is perhaps on account of the disparities in the market size of SAARC economies unlike other regional groupings. For instance, Bhutan or Nepal cannot be the major export destinations for India and Pakistan. Thus, one cannot expect beyond a modest potential in the intra-SAARC trade, particularly of big SAARC countries with small SAARC economies. In stark contrast, the small economies of Bhutan and Nepal have maintained strong trade links with India. For instance, Nepal and Sri Lanka import around 46 and 16 per cent of their imports from India but these cover a negligible portion of Indian exports.

Table 5: Trend in Intra - Regional Group Trade

Regional Group/Year	1950	1960	1970	1980	1990	1995	2000	2006
MERCOSUR	6.1	7.6	9.4	11.6	8.9	20.3	20.0	13.5
NAFTA	35.5	30.4	36.0	33.6	41.4	46.2	55.7	53.8
ASEAN	2.8	12.7	22.4	17.4	18.9	24.5	23.0	24.9
ASEAN +3	16.1	21.9	25.8	29.0	26.8	34.9	33.7	34.0
GCC	…	…	4.6	3.0	8.0	6.8	4.8	4.8
SAARC	**11.6**	**5.0**	**3.2**	**4.8**	**3.2**	**4.4**	**4.2**	**5.7**
EU 25	47.9	51.8	61.0	61.8	67.4	66.4	67.2	66.7
Euro zone	36.1	41.2	53.7	51.9	55.5	52.6	50.8	49.7
APEC	44.2	47.0	57.9	57.9	68.3	71.7	73.1	69.4
CIS	…	…	…	…	…	28.6	20.0	16.5

Source: UNCTAD

Table 6: Intra-regional Trade Share of South Asia's Total Trade

(Per cent)

Country	1985	1990	1995	2000	2004	2007
Afghanistan	11.4	14.5	11.1	29.7	35.3	43.1
Bangladesh	4.7	6.0	12.8	7.9	10.5	9.4
Bhutan	-	-	-	-	-	
India	1.7	1.6	2.7	2.5	3.0	2.7
Maldives	12.5	12.7	14.3	22.2	19.8	12.2
Nepal	34.3	11.9	14.8	22.3	47.2	60.5
Pakistan	3.1	2.7	2.3	3.6	5.0	6.6
Sri Lanka	5.5	5.6	7.8	7.4	15.1	18.9

- Data not available.

Source: Regional Co-operation Strategy and Programme, South Asia (2006-2008), ADB

3. Trade Policy in SAARC Countries

The importance of international trade as an important engine for growth has been widely debated among the economists. However, trade as one of the essential ingredients in economic growth is overwhelmingly supported in the literature. Even the multilateral institutions such as the World Bank, International Monetary Fund, and the OECD propagate policy advice based on the presumption that openness generates predictable and positive consequences for growth. It has been found that more open and outward-oriented economies consistently outperform countries with restrictive trade and foreign investment policies. Thus, policies toward foreign trade are among the more important factors promoting economic growth and convergence in developing countries.

As far as the trade policy of SAARC countries is concerned, there is a lot of change in the approach. South Asia has made good progress in liberalizing trade regimes and slashing tariffs since the early 1990s when most of the countries started with reforms. The countries have also undertaken considerable industrial deregulation and other structural reforms. The governments and the private sector recognise that strong exports are critical for overall economic growth and poverty reduction, and export-led growth has become a key thrust in each country. Each country has been integrating with the global economy, as evidenced by the significant increases in the merchandise trade [(exports plus imports)/GDP] ratios. The following discussion in this section provides an overview of trade policy measures initiated in SAARC countries.

Trade is considered as a component of overall development policy of Bangladesh. Bangladesh has pursued prudent structural reforms in priority areas and trade liberalization with positive results on growth and foreign direct investment inflows. In recent years, Bangladesh has adopted an outward-oriented growth strategy which aims at reducing the anti-export bias prevalent in the economy and improve competitiveness while keeping in view medium-term imperatives and long-term development agenda. Bangladesh's trade policy objectives as per Import Policy Order 2003-2006 have been to keep pace with globalization and the gradual development of a free market economy under the WTO rules; facilitate imports of technology to expand use of modern technology; ease imports for export industries, in order to place them on a sound basis and, to this end, coordinate the import policy with the industrial policy, export policy and other development programmes; and make industrial raw materials more easily available to increase competition and efficiency. Calibrating trade policy reform to support small and medium-sized enterprises development is another priority (WTO, 2006). The objectives stated in the Export Policy 2003-2006, which stresses the need for product-based and sector-based development, include product diversification/expansion, capacity building of export-related institutions, and identification and appraisal of advantages for LDCs provided under WTO rules. Measures taken to promote exports in Bangladesh include income tax rebates, project loans at concessional interest, cash support, export credit on easy terms, and reduced interest rates, reduced costs for air cargo, and duty drawbacks. Annual sector-specific export targets (envisaging more than 10 per cent annual increase) are set for, inter alia, highest priority and special development sectors which include RMGs, knitwear, frozen food, leather, jute products, raw jute, chemicals, tea, agri-products, handicrafts, electronic goods, engineering products, petroleum products, computer software, specialized fabrics, textile fabrics, ceramic tableware, bicycles, and shoes.

Sri Lanka began economic liberalization in 1997 with a move away from socialism. Sri Lanka's export-oriented policies have seen a shift from a reliance on agricultural exports to an increasing emphasis on the services and manufacturing sectors. The service sector accounts for over 55 per cent of GDP. Manufacturing, the fastest growing sector, is dominated by the garment industry. The agriculture sector, though decreasing in importance to the economy, nevertheless accounts for around 18 per cent of national output and employs more than one third of the workforce. The public sector remains large, with the state continuing to dominate in the financial, utilities, health and education sectors.

In Pakistan, during the past four years, various initiatives have been announced as a part of the Trade Policy. These measures aimed at reducing cost of doing business and included long term financing of export oriented projects, relocation of industries, freight subsidy, sales tax facilitation for export sectors, incentives for priority export sectors, research and development (R&D), marketing and business facilitation, special export zones, garment skill development board, creation of TDAP, revamping of the trade bodies law and framing of rules, tariff rationalization initiative, Trade Competitiveness Institute of Pakistan, etc. A Rapid Export Growth Strategy (REGS) was also announced in 2005. The strategy aimed at i) trade diplomacy to increase market access; ii) diversification of export markets; iii) strengthening of trade promotion infrastructure; iv) skill development; and v) early provision of modern infrastructure.

In India, the external sector has exhibited a marked transformation since the balance of payments crisis in 1991. The crisis was overcome by a series of stringent measures with an overriding objective to honour all external obligations without resorting to rescheduling of any external payment obligation. While successfully dealing with the crisis through an adjustment programme, it was decided to launch simultaneously a comprehensive programme of structural reforms in which the external sector was accorded a special emphasis. The policy measures undertaken aimed at making domestic industry cost-efficient by enhancing efficiency in resource use under international competition, which was expected to derive a better export performance in the long-run. The major trade policy changes in the post-1991 period included simplification of procedures, removal of quantitative restrictions, and substantial reduction in the tariff rates. Furthermore, the reach of the export incentives was broadened, extending the benefits of various export-promotion schemes to a large number of non-traditional and non-manufactured exports. Following the announcements in the Export-Import (EXIM) policies, various changes were effected such as the removal of quantitative restrictions, strengthening the export production base, removal of procedural bottlenecks, technological upgradation and improvement of product quality. Various steps were also taken to promote exports through multilateral and bilateral initiatives, including identification of thrust areas and focus regions. The policy stance also marked a move away from the provision of direct export subsidy to indirect promotional measures. India also took several policy initiatives at the multilateral levels for tariffication of the non-tariff barriers.

As per India's commitment to the World Trade Organisation (WTO), India agreed to the phased removal of all balance-of-payments (BoP) related quantitative restrictions by end-March 2001 (RBI, 2002). The tariff rates have undergone considerable rationalisation during the 1990s. Prior to the 1990s, the maximum import duty rates on certain items were over 300 per cent. The peak rate of import duty on non-agricultural imports was gradually reduced from as high as 150 per cent in 1991-92 to the present level of 10 per cent (subject to certain exceptions). In 2004, India's first ever integrated Foreign Trade Policy for 2004-09 was announced by the Ministry of Commerce and Industry. The policy aimed at doubling India's percentage share in global merchandise trade within 5 years and to use trade expansion as an effective instrument of economic growth and employment generation. The present trade policy of India envisages achieving a share of 5 per cent in world trade in both goods and services by the year 2020. Policy announced in April 2008 provides that with a view to achieve the desired share in global trade and expanding employment opportunities, especially in semi-urban and rural areas, certain special focus initiatives have been identified for agriculture, handlooms, handicraft, gems & jewellery, leather, marine, electronics and IT hardware manufacturing industries and sports goods and toys sectors. As per the policy, the Government of India shall make concerted efforts to promote exports in these sectors by specific sectoral strategies that shall be notified from time to time (GoI, 2008).

In Maldives, the export and import law of 1979 was changed in 2000. It formally adopted the Harmonized System (HS). At the same time, tariff rates were changed up or down. Trade and economic liberalization is considered to be means of promoting private-sector investment and development in Maldives. However, trade liberalization, such as tariff reductions, is not specifically included in the current development plan. Relatively high tariffs are maintained, mainly for revenue reasons. These account for about two-thirds of tax receipts in Maldives. Nevertheless, the Government is committed to further outward orientation of the economy to improve trade and economic performance, and to diversify the economy away from fishing and tourism. The Maldives provides at least MFN treatment to all WTO Members and is eligible for "special and differential treatment" under WTO Agreements. The export regime in Maldives is relatively open; export controls (on timber), taxes (on ambergris), and regulations are minimal, although some foreign investment royalties apply only to exports.

The basic objective of Nepalese trade policy 1992 was (i) to enhance the contributions of the trade sector to the national economy by promoting internal and international trade with the increased participation of the private sector through the creation of an open and liberal atmosphere, (ii) to diversify trade by identifying, developing and producing new exportable products through the promotion of backward linkages for making export trade competitive and sustainable, (iii) to expand trade on a sustained basis through gradual reduction in trade imbalances, and (iv) to co-ordinate trade with other sectors by expanding employment-oriented trade. Compared to other SAARC countries, Nepal was a late comer to join the WTO in April 2004. The most notable ingredients of Nepal's accession package are: (i) agreement to bind other duties and charges at zero and phase them out within 10 years; (ii) agreement to bind average tariff at 42 per cent for the agricultural products and 24 per cent for all other products; and (iii) agreement to allow up to 80 per cent foreign equity participation in 70 services sub-sectors spanning distribution, retail and wholesale services and audio-visual. Second, the rescinding of Multi-Fibre Arrangement quotas at the end of 2004 has dramatically changed prospects for Nepal's garment industry that accounted for a significant portion of total exports.

In Afghanistan, improving trade policy and customs administration has consistently been a high priority for policy agenda. In late 2001, Afghanistan inherited a highly differentiated import tariff regime (including 25 tariff bands with a maximum rate of 150 per cent and a simple average rate of 43 per cent). However, there has been a major rationalization of the tariff structure, introducing use of the market exchange rate in calculating import duties and reducing the number of different tariff rates to six (maximum 16 per cent) with a relatively low level of dispersion. The simple average tariff rate correspondingly declined to 5.3 per cent, making for one of the lowest and least differentiated tariff structures in the region. Afghanistan has embarked on a major programme to strengthen and reform the Customs administration, with support from the World Bank and other external partners. The country has been pursuing trade and transit agreements at bilateral level with regional countries, and at the multilateral level it has recently initiated the WTO accession process (World Bank, 2004). Afghanistan maintains import bans on only a few products (largely for religious reasons) and imposes no seasonal restrictions, quotas, or other non-tariff barriers. Das (2008) views that trade reforms have helped to erode the most egregious forms of anti-export bias from which these economies suffered in the past.

Overall, import barriers have shrunk dramatically throughout the region, although tariffs are now the principal means by which the South Asian countries protect their domestic industries. Sri Lanka embarked on trade liberalization and reduced tariffs substantially in the late 1970s, and presently has the lowest average tariffs in the region. During the 1990s, the other four major South Asian countries have also steadily reduced their tariffs levels. Apart from reducing the tariff levels, reforms in South Asia have also reduced the complexity of customs duties by reducing the number of "tariff slabs" i.e., the number of generally applied Customs duties rates. Overall, the South Asian countries have made considerable progress in simplifying their trade regimes and making them more transparent, especially through the elimination of most quantitative restrictions and the reduction and simplification of Customs schedules. The average tariff profile of SAARC countries as at end-2006 is shown in Table 7. Available data show that Sri Lanka has the lowest average tariff rates in the region.

Table 7: Tariffs Rates: Non-Agriculture Products

	Av. MFN Applied	Av. Final Bound	Trade Weighted Av.	No. of MFN Applied Tariff Lines
Afghanistan	5.7	…	…	5376
Bangladesh	14.9	33.8	…	6637
Bhutan	19.2	…	…	5254
India (2005)	16.4	34.9	12.3	11693
Maldives	20.5	35.1	21.5	8995
Nepal	13.7	23.7	…	5347
Pakistan	14.0	54.6	12.8	6336
Sri Lanka	9.2	19.6	5.9	6411

Source: Compiled from WTO 2006 Tariff Profiles, 2007.

… Not Available.

Note: Applied duties that are actually charged on imports. These can be below the bound rates. Bound rates are commitment not to increase a rate of duty beyond an agreed level without compensating the affected party. Tariff Line is a product, as defined by a system of code numbers for tariffs.

A World Bank study (2004) highlighted that one broad area that has facilitated trade policy reforms in the SAARC region is the move towards more market-based exchange-rate regimes. India, Pakistan, and Sri Lanka now maintain floating exchange rates; Bangladesh, which had a moderately flexible exchange rate system after 1991, floated its currency as of May 2003. However, Maldives's currency is pegged to the US dollar, and periodically devalued while Nepal's and Bhutan's currencies are pegged to the Indian rupee. The study further revealed that flexibly managed exchange rates have been important supports for the trade liberalizations in the South Asian region, by offsetting or partially offsetting the effects of removal of quantitative restrictions and tariff reductions on import competition for domestic industries. Because of their fixed exchange rates with the Indian Rupee, for Nepal and Bhutan, these effects have been partial and indirect and have not affected their trade with India. More generally, unlike the other South Asian countries, they are not able to use the exchange rate as a means of adjusting to terms-of-trade and more general macro-economic changes.

4. Trade Basket of SAARC Countries

In comparison to other regions, South Asia's exports include an unusually large share of labour-intensive manufactures. India enjoys the best position in the region in terms of a relatively diversified export structure with its top 20 commodity groups accounting for only 43 per cent of exports. However, the composition of exports in different SAARC member countries has undergone significant changes in the recent past. An encouraging feature is that their manufacturing output has been steadily increasing. Using United Nation's COMTRADE data[2] for the year 2004 for Bangladesh, India, Maldives, Pakistan and Sri Lanka, the calculated Hirschman-Herfindahl Index (HHI)[3] shows that among the SAARC countries, export basket is highly diversified for India followed by Pakistan (Table 8). Looking at the top 20 export items (6 digit level) of each country, it can be observed that top 20 commodities (from 16 different 2-digit industry groups) account for 43.1 per cent of total value of export from India, while concentration is highest in Bangladesh where top 20 items (from 5 different 2-digit industry groups) account for about 67 per cent of total exports. Likewise, top 20 items (from 11 different 2-digit industry groups) in the import basket of India account for 58 per cent of total value of Indian imports followed by Pakistan (Table 9).

2/ Commodity-wise 6-digit comparable data were available for majority of the SAARC countries only till 2004. It is quite possible that commodity ranking may have undergone some change in post- 2004 period for SAARC countries.

3/ The Herfindahl index equals the sum of squared share of each commodity in total export of the respective country and hence, has a maximum of 1 when the country is completely focused on one sector, and lower values of the index indicate more diversification.

Table 8: Herfindhal Index of Exports of Major SAARC Countries

Country	2-Digit Commodity Group*	6-digit level Commodity
Bangladesh	0.29	0.05
India	0.06	0.03
Maldives	0.25	0.24
Pakistan	0.12	0.02
Sri Lanka	0.16	0.02

Note: HHI varies between 0 and 1. A value closer to one indicates least diversification.
*: HHI index has been calculated for HS 1992 COMTRADE Data for 99 commodity groups.

Table 9: Share of top 20 Export Items (6 digit level) in Major SAARC Countries

	Export (%)	No. of 2 digit groups*	Import (%)	No. of 2 digit groups*
Bangladesh	66.6	5	28.2	12
India	43.1	16	58.3	11
Maldives	97.6	15	32.4	14
Pakistan	50.4	14	46.3	16
Sri Lanka	45.0	7	35.7	12

*No. of 2 digit Industry groups that top 20 export/import items belong to.

An analysis of exports based on six digit commodity data aggregated to 99 broad industry groups shows that all SAARC countries have quite a similar export basket. For instance, the rank correlation between India and Pakistan is highest at 0.60. Correlation matrix shows that all the correlation coefficients are statistically significant at 5 per cent (Table 10). Export and import composition of SAARC countries also shows that India and Pakistan's exports are notably complementary to the imports of some South Asian economies, particularly those of Bangladesh and Sri Lanka. Other economies, however, demonstrate efficiency in only a small number of export areas, most of which are not complementary to India's imports (or those of any other country).

South Asian export markets compete in a narrow range of products, particularly in textiles, apparel, and other light manufactured goods. While in the case of Bangladesh, 18 out of the top 20 export items (6 digit level commodities) belong to textile/jute textile sector, in the case of India, all the top 20 export items belong to different sectors. As per the COMTRADE data (2004), the top five exported items from India were 'diamonds', 'Oils petroleum, bituminous, distillates, except crude', 'jewellery', 'iron ore', 'rice'. Like Bangladesh, most of the top 20 exporting items from Pakistan were from the textile sector. Table 11 shows that major SAARC countries are competing with each other in 15 out of top 20 export items. It can be observed that India, Bangladesh, Pakistan and Sri Lanka compete in almost all textile items with other SAARC Countries, the sector in which they have strong comparative advantage (discussion in the section IV). Similarly India competes with Pakistan, Bangladesh and Sri Lanka in rice in semi-wholly-milled form. Similarly, in the category of diamonds, India and Sri Lanka compete with each other. These facts confirm the high rank correlation found for the export baskets of SAARC countries (Table 11 and Annex I).

Table 10: Rank Correlation Matrix of Export Baskets of Major SAARC Countries

(99 Commodity HS 1992 Groups)					
	BD	**IND**	**MAL**	**PAK**	**SRL**
BD	1.00	0.49	0.32	0.53	0.55
IND		1.00	0.36	0.60	0.57
MAL			1.00	0.34	0.45
PAK				1.00	0.49
SRL					1.00
t Statistics of Correlation					
	BD	**IND**	**MAL**	**PAK**	**SRL**
BD		5.58	3.83	6.17	6.44
IND			3.84	7.44	6.92
MAL				3.60	5.02
PAK					5.57

Note: Critical t value at 5% level of significance is 1.67 (N=99, d.f. = 97)

Table 11: Common Exporting Items of SAARC Countries

S. No.	6 digit	Item	Top 20	Other than Top 20
	1	2	3	4
1	030613	Shrimps and prawns, frozen	BD, IND	PAK, SL
2	100630	Rice, semi-milled or wholly milled	IND, PAK	BD, SL
3	271000	Oils petroleum, bituminous, distillates, except crude	IND, MD, PAK	BD, SL
4	610510	Men's, boys shirts, of cotton, knit	BD, PAK, SL	IND
5	610910	T-shirts, singlets and other vests, of cotton, knit	BD, IND, SL	IND, PAK
6	610990	T-shirts, singlets etc. of material nes, knit	BD, SL	IND, PAK
7	611020	Pullovers, cardigans etc. of cotton, knit	BD, SL	IND, PAK
8	620342	Men's, boys trousers & shorts, of cotton, not knit	BD, MD, PAK, SL	IND
9	620343	Men's, boys trousers shorts, synthetic fibre, not knit	BD, SL	IND, PAK
10	620462	Women's, girls trousers & shorts, of cotton, not knit	BD, MD, SL	IND, PAK
11	620520	Men's, boys shirts, of cotton, not knit	BD, IND, SL	PAK
12	620630	Women's, girls blouses & shirts, of cotton, not knit	BD, IND, SL	PAK
13	620690	Women's, girls blouses & shirts, material nes, not knit	BD, SRL	IND, PAK
14	710239	Diamonds (jewellery) worked but not mounted or set	IND, SR	…
15	880330	Aircraft parts nes	MD, SR	IND, PAK, BD

Note: Col. 4 shows that these countries export these items but do not figure among their respective top 20 commodity items.

Source: Compiled from UN Database

Analysis based on 6-digit commodity level import data aggregated to 2-digit industry group shows that import basket of SAARC countries are also quite similar in terms of composition as bilateral rank correlations are positive and statistically significant (Table 12). However, India's import basket is comparatively less diversified than other SAARC countries (Table 13).

Table 12: Rank Correlation Matrix of Import Baskets of Major SAARC Countries

(99 Commodity HS 1992 Groups)					
	BD	**IND**	**MAL**	**PAK**	**SRL**
BD	1.00	0.63	0.59	0.67	0.76
IND		1.00	0.41	0.78	0.56
MAL			1.00	0.49	0.66
PAK				1.00	0.60
SRL					1.00
t Statistics of Correlation					
	BD	**IND**	**MAL**	**PAK**	**SRL**
BD		8.03	7.13	8.98	12.9
IND			4.46	11.42	6.70
MAL				5.59	8.60
PAK					7.39

Note: Critical t value at 5% level of significance is 1.67 (N=99, d.f. = 97).

Table 13: Herfindhal Index of Imports of Major SAARC Countries

Country	2-Digit Commodity Group*	6-Digit Level Commodity
Bangladesh	0.06	0.02
India	0.13	0.07
Maldives	0.06	0.02
Pakistan	0.09	0.06
Sri Lanka	0.05	0.01

Note: HHI varies between 0 and 1.
*: HHI index has been calculated for 99 HS 1992 COMTRADE Data.

5. Trade Comparative Advantage of SAARC Countries

The large scale trade liberalization and domestic reform in most of the SAARC countries in recent years have led to an increasingly competitive international environment. Thus, it is timely to examine the extent to which SAARC countries have become more specialised in various sectors. Specifically, through analysing trade data for six SAARC countries, viz., Bangladesh, India, Maldives, Pakistan, Nepal and Sri Lanka and the rest of the world by commodity type, it is possible to reveal in which sectors and products their comparative advantage lies. Several indicators can be used to analyze competitive and comparative advantage.

In the present paper, Revealed Comparative Advantage (RCA) index and the Relative Trade Advantage (RTA) Index have been used to describe the tendency for countries to specialise and export those goods and services that they produce at a lower relative cost compared with other countries. However, before analysing the results, it is pertinent to briefly discuss the methodology to calculate these indices.

(a) Revealed Comparative Advantage (RCA)

The Revealed Comparative Advantage Index is the most frequently employed measurement of trade specialization. This index was first proposed by Balassa (1965) and defined as:

$RCAi = (Xi, j/\sum Xj) / (Xi, World/\sum XWorld)$

Where:

RCAi = revealed comparative advantage for good i.

Xi,j = exports of good i by country j

∑Xj = total exports by country j

Xi,World = world exports of good i

∑XWorld = total world exports

If RCAi > 1, then country j has a comparative advantage in good i. If RCAi < 1, then country j has a comparative disadvantage in good i.

RCA is based on observed trade patterns. The RCA measures a country's exports of a commodity relative to its total exports and to the corresponding export performance of a set of countries. This index takes values between 0 and +1. A value of index greater than 1 denotes a product in which a country is relatively more specialized. On the contrary, a value less than 1 characterizes that country j is accepted as not specialized in product i.

(b) The Relative Trade Advantage Index (RTA)

The Relative Trade Advantage Index (RTA) which was first used by Scott and Vollrath (1992) shows the net trade advantage/disadvantage. This index is computed as the difference between the Relative Export Advantage (RXA) and the Relative Import Penetration Index (RMP). Considering both exports and imports, the RTA is a more comprehensive measure of competitiveness, and expressed as:

RTAij = RXAij – RMPij

The competitive advantage revealed by this indicator is implicitly weighted by the importance of the relative export and the relative import advantages. It can be greater or less than zero. A positive value expresses a situation of net competitive advantage, and a negative one shows a competitive disadvantage.

An inter-temporal analysis of SITC data for 1995 and 2006 based on the Balassa index of RCA shows that in 1995, SAARC countries, as a whole, had comparative advantage only in a few SITC broad industry groups. In 1995, India had comparative advantage in five trade sectors. However, India has developed comparative advantage in 10 sectors over the years. In contrast, Pakistan and Bangladesh have lost their comparative advantage in some sectors over the same period. Pakistan had RCA index of more than 1 in agricultural raw material in 1995 but it witnessed a decline in RCA to 0.8 in 2006. Similarly, Bangladesh has lost its comparative advantage in food items and agricultural raw material as respective RCA indices turned from above one to below one. Nepal has developed comparative advantage in a number of sectors like food items, ores and metals, non-ferrous metals, chemical products and iron and steel as the respective RCA indices turned more than 1 in 2006 (Tables 14 and 15) .

None of the countries has comparative advantage in capital intensive and high value added products. For instance, no SAARC country has RCA greater than 1 in machinery and transport equipment. In contrast, all SAARC countries, except Maldives, have strong comparative advantage in the industry group of textile fibres, yarn, fabrics and clothing. In the overall manufactured goods sector, Bangladesh and Pakistan have comparative advantage with RCA index of 1.29 and 1.14 respectively, followed by Nepal and Sri Lanka with RCA index of 1.01 each. Out of 12 broad SITC Groups as classified by UNCTAD (though not mutually exclusive), India has comparative advantage in highest number of sectors while Pakistan, Sri Lanka and Bangladesh have only 4, 3 and 7 sectors respectively. However, India does not seem to have comparative advantage in the manufacturing goods sector. India has improved her comparative advantage substantially in 'iron and steel', 'chemical products', 'non-ferrous metals', 'ores and metal' and 'agriculture raw material'.

Table 14: Revealed Comparative Advantage of Major SAARC Countries : 1995

Broad SITC Groups /Countries	BD	IND	MALD	NEP	PAK	SRL
Primary commodities, including fuels (SITC 0+1+2+3+4+68)	0.63	1.16	3.45	0.42	0.77	1.11
All food items (SITC 0+1+22+4)	1.16	2.08	8.22	0.87	1.31	2.08
Agricultural raw materials (SITC 2 - 22 - 27 - 28)	1.00	0.49	0.28	0.42	1.46	1.62
Ores and metal (SITC 27 + 28 + 68)	0.00	1.10	0.06	0.04	0.05	0.22
Non-ferrous metals (SITC 68)	0.00	0.25	0.00	0.00	0.00	0.01
Fuels (SITC 3)	0.06	0.24	…	0.00	0.14	0.06
Manufactured goods (SITC 5 to 8 less 68)	1.13	0.97	0.34	1.11	1.10	1.00
Chemical products (SITC 5)	0.32	0.86	0.00	0.13	0.07	0.10
Machinery and transport equipment (SITC 7)	0.04	0.19	0.00	0.00	0.01	0.09
Other manufactured goods (SITC 6 + 8 less 68)	3.00	2.14	0.94	3.06	3.04	2.63
Iron and steel (SITC 67)	0.00	0.96	0.00	0.96	0.00	0.03
Textile fibres, yarn, fabrics and clothing (SITC 26 + 65 + 84)	10.39	3.85	3.61	11.08	10.69	7.61

Table 15: Revealed Comparative Advantage of Major SAARC Countries : 2006

Broad SITC Groups /Countries	BD	IND	MALD	NEP	PAK	SRL
Primary commodities, including fuels (SITC 0+1+2+3+4+68)	0.29	1.34	3.94	1.09	0.74	1.07
All food items (SITC 0+1+22+4)	0.84	1.36	15.69	3.20	1.88	3.42
Agricultural raw materials (SITC 2 - 22 - 27 - 28)	0.86	1.30	0.00	0.76	0.80	1.38
Ores and metal (SITC 27 + 28 + 68)	0.06	1.97	0.23	1.46	0.13	0.80
Non-ferrous metals (SITC 68)	0.02	1.31	0.00	1.07	0.03	1.08
Fuels (SITC 3)	0.03	1.13	2.08	0.00	0.38	0.01
Manufactured goods (SITC 5 to 8 less 68)	1.29	0.91	0.01	1.01	1.14	1.01
Chemical products (SITC 5)	0.12	1.09	0.00	1.44	0.24	0.12
Machinery and transport equipment (SITC 7)	0.03	0.29	0.01	0.05	0.05	0.14
Other manufactured goods (SITC 6 + 8 less 68)	4.20	1.98	0.00	2.57	3.58	3.05
Iron and steel (SITC 67)	0.08	1.78	0.00	2.10	0.09	0.02
Textile fibres, yarn, fabrics and clothing (SITC 26 + 65 + 84)	17.84	3.25	0.00	7.52	13.96	10.60

The analysis of competitiveness indicators, based on the index of relative trade advantages (RTA) which represents the difference between the index of relative export advantages (RXA) and the index of relative import advantages (RMP) shows that out of 12 broad industry groups, India enjoys relative trade advantage in 9 industry groups while Bangladesh enjoys only in textile items and manufactured goods (which are not entirely mutually exclusive). Pakistan has relative trade advantage in textile, food items, manufactured goods and other manufactured goods (Tables 16, 17 and18). One thing comes out clearly that SAARC countries seem to compete with each other in the textile sector as most of them have relative trade advantage in this sector.

Table 16: Relative Trade Advantage Index of Major SAARC Countries : 1995

Broad SITC Groups /Countries	BD	IND	MALD	NEP	PAK	SRL
Primary commodities, including fuels (SITC 0+1+2+3+4+68)	-0.70	-0.52	**1.75**	-0.63	-1.03	**0.24**
All food items (SITC 0+1+22+4)	-0.75	**1.62**	**5.56**	-0.22	-0.64	**0.44**
Agricultural raw materials (SITC 2 - 22 - 27 - 28)	-0.14	-0.86	-0.43	-0.37	-0.39	**1.06**
Ores and metal (SITC 27 + 28 + 68)	-0.62	-0.76	-0.44	-0.68	-0.66	-0.18
Non-ferrous metals (SITC 68)	-0.67	-1.30	-0.13	-1.00	-0.63	-0.38
Fuels (SITC 3)	-0.96	-2.96	…	-1.27	-2.02	-0.24
Manufactured goods (SITC 5 to 8 less 68)	**0.19**	**0.26**	-0.48	0.61	**0.33**	-0.04
Chemical products (SITC 5)	-0.71	-0.69	-0.59	-0.74	-1.64	-0.83
Machinery and transport equipment (SITC 7)	-0.35	-0.35	-0.71	-0.40	-0.77	-0.58
Other manufactured goods (SITC 6 + 8 less 68)	1.33	1.51	-0.13	2.56	2.63	1.02
Iron and steel (SITC 67)	-1.34	-0.27	-1.04	0.58	-1.19	-0.82
Textile fibres, yarn, fabrics and clothing (SITC 26 + 65 + 84)	**5.79**	**3.54**	**2.57**	**9.86**	**9.96**	**4.23**

Note: Industry groups are not entirely mutually exclusive.

Table 17: Relative Trade Advantage Index of Major SAARC Countries : 2006

Broad SITC Groups/Countries	BD	IND	MALD	NEP	PAK	SRL
Primary commodities, including fuels (SITC 0+1+2+3+4+68)	-0.99	-0.32	2.41	-0.69	-0.85	-0.07
All food items (SITC 0+1+22+4)	-1.53	0.86	13.13	0.77	0.24	1.45
Agricultural raw materials (SITC 2 - 22 - 27 - 28)	-1.74	0.24	-2.13	-0.45	-1.47	0.65
Ores and metal (SITC 27 + 28 + 68)	-0.57	0.53	-0.28	1.05	-0.56	0.06
Non-ferrous metals (SITC 68)	-0.57	0.69	-0.13	0.77	-0.52	0.42
Fuels (SITC 3)	-0.84	-1.17	0.74	-1.99	-1.38	-0.94
Manufactured goods (SITC 5 to 8 less 68)	0.37	0.25	-0.84	0.29	0.34	0.03
Chemical products (SITC 5)	-0.83	0.25	-0.51	0.33	-1.02	-0.78
Machinery and transport equipment (SITC 7)	-0.60	-0.32	-0.75	-0.42	-0.76	-0.42
Other manufactured goods (SITC 6 + 8 less 68)	2.82	1.37	-1.15	1.61	3.01	1.33
Iron and steel (SITC 67)	-0.93	0.69	-1.02	1.24	-1.29	-1.07
Textile fibres, yarn, fabrics and clothing (SITC 26 + 65 + 84)	13.11	3.03	-0.56	6.05	13.24	6.01

Note: Groups are not entirely mutually exclusive. RTA greater than zero indicates net competitive advantage (i.e., after taking into account import intensity of country in the group).

Table 18: Net Revealed Comparative Advantage of Major SAARC Countries: 2006

Broad SITC Groups /Countries	BD	IND	MALD	NEP	PAK	SRL
Primary commodities, including fuels (SITC 0+1+2+3+4+68)						
All food items (SITC 0+1+22+4)		□	□	□	□	□
Agricultural raw materials (SITC 2 - 22 - 27 - 28)		□	□			□
Ores and metal (SITC 27 + 28 + 68)		□		□		□
Non-ferrous metals (SITC 68)		□		□		□
Fuels (SITC 3)			□			
Manufactured goods (SITC 5 to 8 less 68)	□	□		□	□	□
Chemical products (SITC 5)		□		□		
Machinery and transport equipment (SITC 7)						
Other manufactured goods (SITC 6 + 8 less 68)	□	□		□	□	□
Iron and steel (SITC 67)		□		□		
Textile fibres, yarn, fabrics and clothing (SITC 26 + 65 + 84)	□	□		□	□	□

Note: Groups are not entirely mutually exclusive.

As far as the global competitiveness index compiled by the World Economic Forum is concered, all SAARC countries, except India and Sri Lanka, are placed among the bottom 50 countries. As the indicators show the main reasons seem to be lack of quality infrastructure, technological readiness, strong institutional mechanism, etc. While India is relatively better than other SAARC countries in respect of all competitiveness indicators, still a lot needs to be done in respect of labour market efficiency and technological advancements. However, the SAARC region is placed better in terms of potential market size. India is placed third, followed by Sri Lanka with 28th place and Pakistan with 36th place (Table 19).

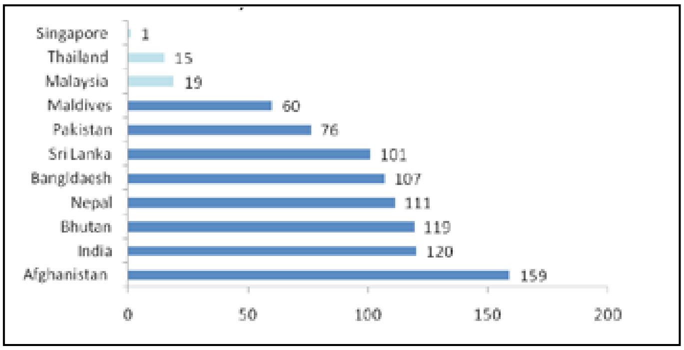
Table 19 : Rank of SAARC Countries based on Indicators of Competitiveness (2007-08)

Country/Competiveness Indicators	IND	SR	PAK	BD	NEP	Total No. of Countries
Global Competitiveness Index	**48**	**70**	**92**	**107**	**114**	**131**
Institutions	48	70	92	107	114	131
Infrastructure	67	72	73	120	128	131
Macrostability	85	87	101	108	125	131
Goods Market Efficiency	36	53	82	93	102	131
Labour Market Efficiency	96	113	118	76	122	131
Financial Market Sophistication	37	63	65	75	107	131
Market Size	3	28	36	58	85	131
Technological Readiness	62	88	89	125	115	131
Business Competitiveness Index	31	52	79	118	120	131
Sophist. of comp. opera. and strat.	27	44	88	117	118	131
Quality of the business environment	33	54	76	118	119	131

Source: World Economic Forum

Interestingly, World Bank Report on Doing Business 2008 highlights that South Asia picked up the pace of regulatory reform over the past year to become the second-fastest reforming region in the world, on par with the speed of reform in the countries of the OECD. The pickup in reform was led by India, which rose 12 places on the ease of doing business and made the reform of business regulation a policy objective. India was the top reformer worldwide in trading across borders. Bhutan and Sri Lanka are the other top reformers in South Asia this year. Bhutan introduced the country's first fundamental labour protections. Sri Lanka made it easier to start a business and to trade across borders. Notwithstanding the ongoing positive developments on reform fronts as highlighted in the Doing Business Report, SAARC economies including India are still far below the advanced and emerging economies in terms of ranking in ease of doing business (Chart 4).

Figure 4: Rank in Ease of Doing Business in SAARC/Non-SAARC Countries



6. Some Trade Related Issues

It is generally perceived that trade integration plays an important role in transmitting disturbances and influencing business cycle co-movements. However, in the case of SAARC region, it is found that despite a negligible share of intra-SAARC trade in total SAARC trade, the major economies of the region are significantly synchronized with each other. Using real GDP data of SAARC countries for the period 1960-2006, it is found that cyclical real GDP behaviour in India, Pakistan, Bangladesh and Sri Lanka exhibits significant convergence. Since the bilateral trade intensity between these countries is still low, the real GDP cyclical convergence could be perhaps on account of common external shocks and largely similar output structure. Furthermore, amplitude of cyclical behaviour of India, Pakistan and Sri Lanka is also found to be largely the same (Table 20).

Table 20: Bilateral Correlations of Cyclical Behaviour of Real GDP in SAARC Countries (1960-2006)

	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
Bangladesh	1.00	0.09	0.57*	0.29	-0.01	0.57*	0.47*
Bhutan		1.00	-0.25	-0.15	-0.62	0.02	-0.46
India			1.00	0.26	-0.17	0.87*	0.74
Maldives				1.00	-0.10	0.00	0.45*
Nepal					1.00	-0.27	-0.07
Pakistan						1.00	0.58*
Sri Lanka							1.00
Amplitude of Cycles	0.01	0.02	0.02	0.04	0.01	0.02	0.02

Note: (i) Calculations for Bhutan and Maldives were based on data available from 1980 and 1995 respectively.
(ii) * indicates statistical significant of positive bilateral correlations at 1 per cent.

The key criteria in the optimal currency area literature are that countries should join a currency union if they have closer international trade links and more symmetric business cycles. Since as found above, the SAARC region meets the second criteria but not the first one. Therefore, on order to envisage the introduction of a common currency in South Asia which at best is likely only in the long run, it is necessary that trade links in the SAARC area are strengthened. Providing an optimistic view, Rahman, Shadat and Das (2006) argue that potential high economic growth of South Asian countries (particularly for India, Bangladesh and Sri Lanka) may boost their trade flows.

The best way to co-operate and collectively benefit is to establish tradability of some key resources that our region is richly endowed with, and to complement one other in economic development. Only then would South Asian economic co-operation lead to significant trade creating and growth generating impact. For instance, Bhutan has huge hydro power potential, which could find optimum utilization by facilitating technological assistance by big neighbouring economies. Major SAARC economies like India, Pakistan, Bangladesh and Sri Lanka can provide a large and virtually inexhaustible market for many of these resources. There are other tradable items which can be traded between SAARC countries with least transport costs, etc. Moreover, two major SAARC countries, viz., India and Pakistan have been co-operating with each other over the last few years to overcoming their shortages of agricultural products. For instance, Pakistan supplied chickpeas, pulses, grains and sugar when these were short in supply in India. India supplied onions, potatoes, pulses and other food items to Pakistan. Now Pakistan has started to export cement to India taking advantage of the duty reduction announced by the Indian government. Despite all these developments, extra-ordinary issues still cloud over the potential of economic cooperation in the SAARC region. In the absence of redressal of trade issues, informal trade is also reportedly taking place in region, particularly between India and Pakistan which is estimated to the extent of US$ 2 billion. Much of this informal trade takes place via third countries like Dubai, CIS countries and Afghanistan (Taneja, 2006). Pohit and Taneja (2000) and Taneja et al. (2002) argue that informal trading is takes place due to trade and domestic policy distortions. As and when such distortions are corrected informal trade would shift to the formal channel.

As seen above, share of SAARC trade in world trade is abysmally low in comparison to other regional groups. Even Intra-SAARC is growing at a very modest pace and remains substantially lower than that of other regional groups. The main reason for this could be the vast disparity of size of economies. World Bank highlights that the reasons for this low level of trade include protectionist trade regimes, which discriminated against trade among larger neighbours; continued conflict between India and Pakistan; and transport and trade facilitation constraints. Chaturvedi (2007) also argues that the intra-regional trade has remained far below potential as not enough trade facilitation measures are being taken. Baysan, Panagariya and Pitigala (2006) argue that despite some bilateral FTAs existing even before, SAFTA outright excluded many of the major sectors in which countries have comparative advantage and imposed tariff quotas on many other sectors. Apart from these, strict 'rules of origin' further handicapped the potential expansion of intra-regional trade on preferential basis in products that had large potential of trade. It is important to note that the follow-up agreements on concessions, dispute settlement, negotiation of a Rules of Origin Agreement would be important factors in determining SAFTA being either a trade creating or a trade diverting RTA. Secretary General SAARC puts the cost of opportunity lost due to non-cooperation among the South Asian nations at US$ 8 billion a year.

Economic cooperation was always high on the SAARC agenda and formal attempt has been through SAFTA becoming effective in 2004. SAFTA came into effect with the aim of reducing tariffs for intra-regional trade among seven SAARC members. Pakistan and India have to complete implementation by 2012, followed by Sri Lanka in 2013 and Bhutan, Bangladesh, Maldives and Nepal by 2015. The SAFTA agreements suggest provisions regarding paperless trading, electronic means of reporting and identification of low risk, high risk goods, harmonization in standards, technical assistance and customs cooperation at the SAARC level. However, there are certain issues that still remain to be addressed by the country authorities. For instance, Chaturvedi (2007) argues that although SAFTA has some provisions for ensuring trade facilitation in the region, at the same time it misses out on several important provisions. He highlights the additional measures other than in SAFTA which need to be initiated. These issues relate to containerization of regional trade and movement of transit goods, security related concerns, infrastructure at the land customs stations and border agency coordination. In addition to these problems, the issue that Baysan et al. (2006) emphasise is that prima facie the economic case for SAFTA becomes weak because of high level of protection among the SAARC countries. If the country participating in a regional arrangement were itself open, it would not suffer from trade diversion even if it were tiny as its union partners have to compete with outside trade partners on equal footing.

It is important to note that India has recently become more proactive in updating arrangements with five least developed countries (LDCs) of SAARC (Bangladesh, Bhutan, Nepal, Maldives, Afghanistan). There is a form of non-reciprocity for LDCs. India has accorded special and favourable treatment for LDCs. These preferences are non-reciprocal and unconditional to make the tariff concessions deeper and wider in coverage. As Table 21 shows, effective preferential agreement coverage rate on products for all SAARC economies has increased from 0.89 per cent in 1992 to 15.29 per cent which is even higher for LDCs.

Table 21 : India's Preferential Tariff to SAARC/SAFTA Countries and LDCs

	Year	No. of Duty Free Lines	Effective Preferential Agreement Coverage Rate %
SAARC Preferential Tariff	1992	0	0.89
SAARC Preferential Tariff (LDC)		12	1.35
SAARC Preferential Tariff	1997	0	0.87
SAARC Preferential Tariff (LDC)		13	1.37
SAARC Preferential Tariff	1999	12	2.17
SAARC Preferential Tariff (LDC)		13	1.34
SAARC Preferential Tariff	2005	0	15.29
SAARC Preferential Tariff (LDC)		291	39.63

Source: UNCTAD-JETRO Report, 2008.

Analysing the empirical literature on the possible gains from SAFTA and given the present circumstances, Das (2008) reveals that South Asia, on the whole, stands to gain more from unilateral non-discriminatory liberalization and multilateral liberalization than from the formation of SAFTA. None of the empirical studies predicted robust welfare gains from the formation of a free trade agreement in South Asia. Such apprehensions point towards the economic as well as political issues that need to be persuasively addressed to make SAFTA more fruitful to the region. It is quite possible that as SAARC economies grow and economic complementarities begin to develop, the countries of South Asia, particularly the larger ones, may find that SAFTA can offer a potentially significant contribution to their progress.

A recent World Bank Study by Wilson and Otsuki (2006) finds that if the countries of South Asia raise their capacity halfway to East Asia's average, the intra-SAARC trade would rise by an estimated US$ 2.6 billion. This is approximately 60 per cent of the total intra-regional trade in South Asia. The category of trade facilitation that will produce the greatest gains is service-sector infrastructure, followed by efficiency in air and maritime ports. South Asia also has a stake in the success of efforts to promote capacity building outside its borders. If South Asia and the rest of the world raised their levels of trade facilitation halfway to the East Asian average, the gains to the region would be an estimated US$36 billion. Out of these gains, about 87 per cent of the total gains to South Asia would be generated from South Asia's own efforts (leaving the rest of the world unchanged).

In addition to implementing capacity building in trade facilitation, successful economic cooperation requires reducing barriers to foreign direct investment, further lowering tariff rates of protection, and eliminating other non-tariff barriers that slow productivity and hamper private sector growth. Macroeconomic policy stability of the region is also an important factor for the region's trade with the rest of world. In fact, the SAARC countries should strengthen coordinated mechanism under SAFTA so that it could be used as a stepping stone towards greater integration into the world economy and the WTO, as well as a laboratory for understanding the WTO's complexities. At present, certain disputes concerning SAARC countries are pending at the WTO (Table 22). SAFTA could be used as an appropriate forum not only to address intra-regional trade disputes but also for taking a collective stand on WTO related issues.

Table 22: Disputes Pending at the WTO

	As Complainant	As Respondent	As Third Party
Bangladesh	1 (1)	0 (0)	1 (1)
India	17 (0)	19 (1)	51 (1)
Maldives	…	…	…
Nepal	…	…	…
Pakistan	3	2	9 (4)
Sri Lanka	1 (0)	0	3 (2)

Note: Figures in brackets indicate the number of disputes in which other SAARC Country is involved. Source: WTO.

At present, the cost of trading across borders in South Asia is one of the highest in the world as the economies of the region have maintained a higher level of protection within the region than with the rest of the world. In fact, a study by Baysan, Panagariya and Pitigala (2006) warned that the region should avoid substituting intra-regional trade liberalisation for extra-regional liberalisation. They suggested that if countries in the region bring down the customs duties to 5 per cent, the impact of trade diversion will be considerably reduced. Procedural formalities in the region are still relatively cumbersome. It takes on average more than 33 days to export from South Asia compared to 12 days from OECD countries and more than 46 days to import into South Asia compared to 14 days for OECD. However, there are vast opportunities in the region to grow intra-SAARC trade if appropriate regional agreements on roads, rail, air, and shipping are put in place enabling seamless movement. Furthermore, since the countries of the South Asian region are net energy importers, to meet the growing energy requirements, energy trade between these countries is essential. But South Asia's current cross-border energy trade is limited to Bhutan, India and Nepal. Dhungel (2008) suggests that more energy trade projects between India, Pakistan and Bangladesh can help in contributing to integrate regional economies. There should be an effective mechanism that allows exporters in one country to obtain unique, less costly, or better quality inputs from suppliers in neighbouring countries and acquire global competitiveness.

7. Summing Up

To sum up, the growth of intra-regional trade has remained subdued due to considerations other than economic issues. In ensuring stability and growth in intra-regional trade, the Indo-Pak bilateral relationship plays a very crucial role. Apart from this, SAARC countries need to put in place adequate physical infrastructure in place which hampers their global competitiveness even in those sectors where they have revealed comparative advantages. Although major SAARC countries are better synchronized in terms of their GDP cycles, trade integration continues to be low due to high level of protectionism existing among the SAARC countries than the rest of world. In this context, successful outcome of SAFTA could play an important role in strengthening trade ties within the region. It is, however, to be expected that with further dismantling of tariff barriers under the SAFTA, a large part of the informal trade may come under purview of formal trade. This along with favourable Rules of Origin could raise intra-regional trade in the SARRC region. SAARC countries will need to take concrete steps for harmonization of customs and other procedures, mutual recognition of certificates and standards and trade facilitation measures. Trade policy of SAARC countries, therefore, needs to ensure that SAFTA ensures trade creation rather than trade diversion from the region as many researchers apprehend.

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Annex I : Top 20 Export Items of SAARC Countries (6-digit HS 1992 Classification)

	6 Digit Code	Bangladesh
1	610910	T-shirts, singlets and other vests, of cotton, knit
2	620342	Men's, boys trousers & shorts, of cotton, not knit
3	611090	Pullovers, cardigans etc. of material nes knit
4	620520	Men's, boys shirts, of cotton, not knit
5	30613	Shrimps and prawns, frozen
6	620590	Men's, boys shirts, of material nes, not knit
7	620462	Women's, girls trousers & shorts, of cotton, not knit
8	611020	Pullovers, cardigans etc. of cotton, knit
9	610510	Men's, boys shirts, of cotton, knit
10	620349	Men's, boys trousers & shorts, material nes, not knit
11	410439	Bovine and equine leather, nes
12	530710	Yarn of jute or textile bast fibres nes, single
13	620690	Women's, girls blouses & shirts, material nes, not knit
14	611030	Pullovers, cardigans etc of manmade fibres, knit
15	620333	Men's, boys jackets, blazers, synthetic fibre, not knit
16	620343	Men's, boys trousers shorts, synthetic fibre, not knit
17	620630	Women's, girls blouses & shirts, of cotton, not knit
18	620469	Women's, girls trousers, shorts, material nes, not knit
19	530310	Jute and other textile bast fibres, raw or retted
20	610990	T-shirts, singlets etc., of material nes., knit
		India
1	710239	Diamonds (jewellery) worked but not mounted or set
2	271000	Oils petroleum, bituminous, distillates, except crude
3	711319	Jewellery and parts of precious metal except silver
4	260111	Iron ore, concentrate, not iron pyrites, unagglomerate
5	100630	Rice, semi-milled or wholly milled
6	294200	Organic compounds, nes
7	721049	Flat rolled iron or non-alloy steel, coated with zinc, width >600mm, nes
8	300490	Medicaments nes, in dosage
9	999999	Commodities not specified according to kind
10	610910	T-shirts, singlets and other vests, of cotton, knit
11	620630	Women's, girls blouses & shirts, of cotton, not knit
12	30613	Shrimps and prawns, frozen
13	620520	Men's, boys shirts, of cotton, not knit
14	711719	Imitation jewellery nes of base metal including plate
15	630492	Furnishing articles nes, of cotton, not knit, crochet
16	230400	Soya-bean oil-cake and other solid residues
17	80130	Cashew nuts, fresh or dried
18	630790	Made up articles (textile) nes, textile dress pattern
19	870899	Motor vehicle parts nes
20	390210	Polypropylene in primary forms
		Maldives
1	271000	Oils petroleum, bituminous, distillates, except crude
2	610821	Women's, girls briefs or panties, of cotton, knit
3	160414	Tuna, skipjack, bonito, prepared/preserved, not mince
4	490700	Documents of title (bonds etc.), unused stamps etc.
5	620462	Women's, girls trousers & shorts, of cotton, not knit
6	610829	Women's, girls briefs or panties, material nes, knit
7	880330	Aircraft parts nes
8	230120	Flour or meal, pellet, fish, etc., for animal feed
9	620342	Men's, boys trousers & shorts, of cotton, not knit
10	220890	Alcoholic liqueurs nes
11	840710	Aircraft engines, spark-ignition
12	845229	Sewing machines, other than book-sewing machines, nes
13	720429	Waste or scrap, of alloy steel, other than stainless
14	220830	Whiskies
15	847420	Machines to crush or grind stone, ores and minerals
16	490110	Brochures, leaflets and similar, in single sheets

17	740400	Copper/copper alloy waste or scrap
18	560490	Textile yarn/strip, rubber, plastic impregnated/coate
19	240220	Cigarettes containing tobacco
20	901590	Parts and accessories for surveying etc. instruments
		Pakistan
1	630231	Bed linen, of cotton, nes
2	100630	Rice, semi-milled or wholly milled
3	520512	Cotton yarn >85% single uncombed 714-232 dtex,not ret
4	630260	Toilet or kitchen linen, of cotton terry towelling
5	610510	Men's, boys shirts, of cotton, knit
6	520819	Woven cotton nes, >85% <200g/m2, unbleached
7	620342	Men's, boys trousers & shorts, of cotton, not knit
8	271000	Oils petroleum, bituminous, distillates, except crude
9	420310	Articles of apparel of leather or composition leather
10	521051	Plain weave cotton, <85% +manmade fibre, <200g print
11	570110	Carpets of wool or fine animal hair, knotted
12	890510	Dredgers
13	521213	Woven cotton fabric, > 200g/m2, dyed, nes
14	520522	Cotton yarn >85% single combed 714-232 dtex,not retail
15	950662	Inflatable balls
16	630210	Bed linen, of textile knit or crochet materials
17	940490	Articles of bedding nes
18	611490	Garments nes, of materials nes, knit
19	610590	Men's, boys shirts, of materials nes, knit
20	901890	Instruments, appliances for medical, etc. science, nes.
		Sri Lanka
1	90240	Tea, black (fermented or partly) in packages > 3 kg
2	90230	Tea, black (fermented or partly) in packages < 3 kg
3	621210	Brassieres and parts thereof
4	620342	Men's, boys trousers & shorts, of cotton, not knit
5	610910	T-shirts, singlets and other vests, of cotton, knit
6	620462	Women's, girls trousers & shorts, of cotton, not knit
7	620469	Women's, girls trousers, shorts, material nes, not knit
8	880330	Aircraft parts nes
9	620520	Men's, boys shirts, of cotton, not knit
10	401290	Solid or cushioned tyres, interchangeable treads
11	710391	Rubies, sapphires and emeralds worked but not set
12	740319	Refined copper products, unwrought, nes
13	611020	Pullovers, cardigans etc. of cotton, knit
14	610510	Men's, boys shirts, of cotton, knit
15	710239	Diamonds (jewellery) worked but not mounted or set
16	620630	Women's, girls blouses & shirts, of cotton, not knit
17	611610	Gloves impregnated or coated with plastic,rubber, knit
18	620343	Men's, boys trousers shorts, synthetic fibre, not knit
19	610990	T-shirts, singlets etc., of material nes, knit
20	620690	Women's, girls blouses & shirts, material nes, not knit

Source: Compiled from the UNCTAD COMTRADE Database.

Country Paper: Maldives

Review of Growth Performance of the Maldivian Economy

1. Growth of GDP and Major Sectors

The Maldivian economy recorded a solid performance over the past 30 years, registering an average growth of 7 per cent per annum. This is a considerably higher growth rate when compared to other developing economies in the South East Asian region.

However, the Maldivian economy is highly vulnerable to external shocks; including rising international commodity prices and natural disasters. As such, the economy has contracted by 4.6 per cent in 2005, due to the tsunami at the end of 2004, which affected the tourism industry causing considerable infrastructural damage and disruption in tourist arrivals. Tourism is the most significant sector of the Maldivian economy, holding the majority share of GDP. With strong recovery efforts made by the government and the private sector, the industry fully recovered by the end of 2006. Since then, the economy has performed well with a record growth rate of 19.1 per cent in 2006, with advancement and development in the tourism sector and construction sector underpinned mainly by recovery and reconstruction activities. During 2007, economic activity remained buoyant with tourism and construction being the key drivers of growth which resulted in a GDP growth of 6.6 per cent in real terms.

Table 1: Gross Domestic Product (GDP)

	2004	2005	2006	2007	2008	2009	2010	2011
		Est.	*Est**	*Est**	*Proj.**	*Proj.**	*Proj.**	*Proj.**
Real GDP (millions of rufiyaa)	8,313	7,927	9,445	10,161	11,137	12,327	13,441	14,555
(percent change)	9.5	(4.6)	19.1	7.6	9.6	10.7	9.0	8.3
Nominal GDP (millions of rufiyaa)	9,939	9,596	11,890	13,560	16,125	19,276	22,593	26,180
(percent change)	12.1	(3.4)	23.9	14.0	18.9	19.5	17.2	15.9
(per capita, rufiyaa)	34,333	32,668	39,634	44,477	52,088	61,282	70,662	81,879
Nominal GDP (millions of US$)	776	750	929	1,059	1,260	1,506	1,765	2,045
(per capita, US$)	2,682	2,552	3,096	3,475	4,069	4,788	5,520	6,397
Population	289,480	293,746	300,000	304,869	309,575	314,542	319,738	319,738
(percent change)	1.7	1.7	1.7	1.6	1.6	1.6	1.6	1.6
National CPI excl fish (June 2004=100) (%change)			3.9	5.4	7.0	7.0	7.0	7.0
Implicit GDP deflator (index 1995=100)	120	121	126	133	145	156	168	180
(percent change)	2	1	4	6	9	8	8	7

Source: Ministry of Planning and National Development

2. Major Economic Reforms Measures Undertaken

The 7th National Development Plan 2007-2010 sets out integrated investment programmes that will underpin economic growth in a sustainable manner economically, socially and environmentally. The major focus of these programmes were to diversify the national investment to sustain the economic development.

In this regard, tourism industry is being expanded to cater for the bed capacity shortage experienced by the industry and also to expand tourism related activities throughout the country. To this end, 35 new islands were leased out during 2006. In 2007, 5 islands were planned to be leased out as resorts, under the population and development consolidation programme, 10 new regional airports established, each with a 200-bed hotel and a 200-bed resort, and transit hotels established on the three existing regional airports. By the end of the year, most of these islands were leased out, with 3 of the new regional airports, and 1 island under the population and development consolidation programme deferred to 2008.

For decades, the Maldivian economy has depended heavily on the tourism industry. However, government has planned to change the national investment strategy. The government wishes to diversify the investment into different sectors of the economy in order to minimise the market risks associated with each sector, mainly caused by external shocks. For that purpose, the country's Foreign Direct Investment (FDI) policy has been developed to promote FDI, long-term strategic investments and large scale infrastructure development projects such as transshipment ports and airports to support long-term economic growth. As per the 7th NDP, government has proposed various strategic investments plans on infrastructure development. The new proposed investment under FDI includes:

- Development of transshipment port in the north and south region of the country.
- Development of regional airports.

Liberalization of the fisheries sector is another important economic reform measure that has been undertaken by the government. During this process, the most important step taken by the government was the liberalization of the fish processing and export sector. In 2000, the fish processing and export monopoly of the state owned fishing company MIFCO was withdrawn from the northernmost region or Zone 1 and the southern middle region, Zone 3, although MIFCO was allowed to continue its operations in Zones 2 and 4. The main objectives of this programme include ensuring the private sector's contribution in the economic diversification and providing them with the sufficient means to sustain.

Efforts have been made to increase the fisheries sector's contribution to government revenue. At present, government receives royalties from licensed foreign fishing vessels operating in the Exclusive Economic Zone (EEZ) and from local tuna exports. In addition, the government has undertaken a number of small and medium term investment projects for the development of the industry, which includes increasing the quality and scope of the facilities available for the tuna fleet; and to encourage investment in processing and transformation facilities which add value to the product. For further development of the primary sector, the government of Maldives has started issuing small investment facilities specially designed for SMEs which engage in the agriculture sector.

As an important step for the economic development process, the government of Maldives has taken a number of measures to strengthen the country's legislative and regulatory framework. As such, the existing constitution of the country is in the process of being revised and to enhance greater efficiency and transparency, some of the government agencies have already become independent as per the revised constitution.

The Maldives Monetary Authority which is now independent has taken important steps for the development of the financial sector of the country. The provision of financial services throughout the country is hindered by the high costs of providing such services as a result of the highly dispersed nature of the Maldivian population. As such, the Maldives Monetary Authority plans to introduce mobile phone banking service by the end of 2009. The main objective of the project is to assure that every citizen of the Maldives has access to financial service. In addition, the creation of a Financial Intelligence Unit (FIU), a Credit Information Bureau (CIB) and the introduction of Islamic financing are the key developments expected in financial sector.

3. Major Drivers of Recent Economic Growth

The tertiary sector, which covers all services, remained the largest segment of the economy contributing to more than 70 per cent of GDP. All services recorded growth of 8.6 per cent during 2007. Tourism is the dominant industry in the tertiary sector and contributed to about 28 per cent of GDP in 2007.

Construction is the major industry in secondary sector. During 2007, the construction sector continued to boom owing to the increase in developmental activities of the tourism sector as well as due to the ongoing tsunami reconstruction activities, capital projects by the government and the residential and property development by the private sector. The sector's contribution to the GDP increased to 6.0 per cent during 2007 from an average of 4.1 per cent in 2000-2006.

Primary sector is the least contributor to GDP contributing at an average of 9 per cent per annum. Fisheries industry is the main industry in the primary sector. Despite the overall high level of real sector activity in the economy, the year 2007 was not the best year for the fisheries sector. Fish landings declined considerably in 2007, with a 22 per cent contraction compared to 2006. Hence, contribution of the fisheries sector to GDP has declined from 6.3 per cent in 2006 to 4.5 per cent in 2007.

4. Major Problems Experienced

4.1 Challenges to Price Stability

During the year, domestic inflation which is measured by the annual percent change in the 12 month moving average of Consumer Price Index (CPI) rose from 2.7 per cent in 2006 to 6.8 per cent in 2007.

The development in CPI during the year was mainly contributed by higher prices of food, housing, health care and transportation. The increase in food prices reflects the rising global food prices while supply constraints in the housing sector led to marked increase in housing rent. So far, government policy has insulated the economy from the effects of volatile and rising energy prices. However, if world energy prices continue their bullish trend, government may be compelled to review its present policy and allow price increases to filter through to the domestic economy.

4.2 Risks to Growth Momentum

Narrow economic and resource base

Maldives is a small open economy with limited economic resources. Tourism and fisheries sector are the two main sectors in the Maldivian economy. The tourism sector accounts for approximately 26 – 30 per cent of the country's GDP, 30 per cent of total government revenue, and the main source of foreign exchange earnings for the country. The fisheries sector, contributing 4 – 6 per cent of GDP, accounts for a large proportion of employment, and 95 per cent of total domestic exports.

Given the narrow resource base of the country, and the over-dependence on two sectors, efforts have always been made to diversify the economy. Given that the population size is too small to stimulate domestic economic growth, the Maldives will exploit its strategic location and proximity to the South Asian markets to expand trade, port and logistics, and business and financial services.

US$ depreciation and inflation

The Maldivian Rufiyaa has been pegged to the US dollar over decades. Current exchange rate is at MRF12.85 per US dollar. However, the US economic downturn following the collapse of the sub-prime mortgage market has resulted in the US dollar depreciation against the major currencies in the world economy. Given the narrow resource base of the country, the economy is highly dependent on imports. The depreciation of the US$ hence increases the price of the imports into the country, as well as worsening the balance of payments position. Estimates show the current account deficit as a percentage of GDP to be 61 per cent in 2008. Further depreciation of the dollar will lead to a worsening of the current account deficit.

The effect of the dollar depreciation is worsened by increasing oil prices in the world market. The resultant increase in prices internationally leads to high imported inflation, with domestic inflation expected to increase further in 2008. In addition, the value of total imports also increased considerably due to the increasing prices of petroleum products, further exacerbating the current account situation.

Increasing external debt ratios

Government external debt as a percentage of GDP has increased considerably in the past decade or so. Debt to GDP ratio at 28 per cent at the end of 2000 is expected to increase to 40 per cent by the end of 2008. The debt situation of the country may worsen in the medium-term, given that the country is to graduate from the UN Least Developed Countries List in 2011. As a result, grants and concessional loan accessibility will diminish, and there may also be acceleration of past debt obligations, as a large number of multilateral creditors stipulate repayment terms to be modified to increase by 100 per cent the amount of each remaining maturity, in the case of graduation.

Graduation from UN LDC Status

Maldives graduated from UN LDC status in December 2004, just days before the tsunami disaster of 26th December 2004. As a result of the tsunami and the damage it caused, the decision to graduate was re-visited, with the new transitional period to run from 2007 till 2010 and graduation to take effect in 2011.

Graduation from LDC status poses challenges for the Maldives, in terms of loss of preferential access to markets, especially for fish exports, which contribute approximately 95 per cent to domestic exports.

5. Medium Term Growth Prospects

In the absence of devastating external shocks, the short to medium-term outlook for the domestic economy remains generally positive. Growth for 2008 is estimated at 9.6 per cent and growth in the medium-term also looks promising at 10.7, 9.0 and 8.3 per cent for 2009, 2010 and 2011, respectively. The underlying trend in tourism continues to strengthen whilst in the fisheries sector, tuna catch levels are expected to normalise before the end of the 3rd quarter of year 2008, as the El Nino climatic conditions dissipate. Against this backdrop, the medium-term growth is thus seemingly realisable.

However, many challenges remain to secure the credibility of the development of the economy and ensure its successful closure. As in 2007, the year closed with continued uncertainties with regard to the future evolution of energy prices amidst threats of world economic slowdown, following the international liquidity squeeze resulting from the collapse of the sub-prime mortgage market in the USA. Prospects are further clouded by the associated turmoil in the currency and equity markets as well as in the price volatility in commodity markets. Such risks only serve to completely expose the vulnerability of Maldives to the vagaries of international economic developments.

Country Paper: Nepal

Review of Growth Performance in Nepal

1. Introduction

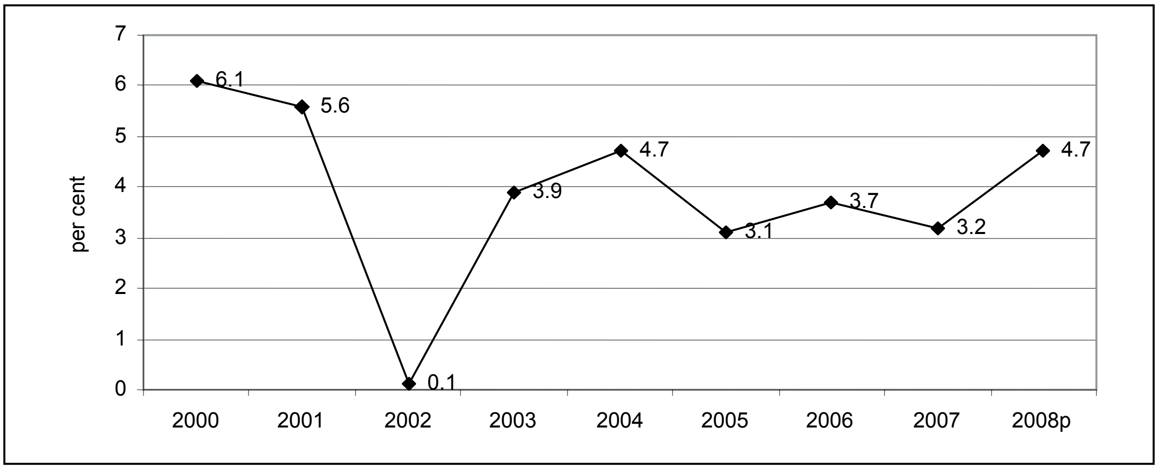
A decade long internal conflict ended following the successful peoples' movement in April 2006 that brought the rebels into mainstream politics. The first meeting of the Constituent Assembly (CA) declared Nepal as the Federal Democratic Republic state on May 28, 2008 and abolished the 240-year long monarchy. Now the challenge is to reorient the developmental agenda for sustainable economic growth and prosperity of the Nepali people.

2. Growth of GDP and Major Driving Sectors

The Nepalese economy underwent a structural change in the last decade. The share of the services sector in nominal GDP surged to 51.4 per cent in 2007/08 from 39.3 per cent in 1997/98. The contribution of agriculture sector to the nominal GDP declined to 32.6 per cent in 2007/08 from 38.8 per cent in 1997/98. Likewise, the share of industrial sector decreased from 21.9 per cent in 1997/98 to 16.0 per cent in 2007/08.

During the 1990s the Nepalese economy registered an annual average growth of 5.0 per cent, a bit higher than that of the potential growth of 4.5 per cent estimated on the basis of time trend. However, in 2001/02 the economic growth fell to 0.1 per cent due mainly to the negative performance of the five major sectors (manufacturing, hotels and restaurants, trade, real estate, and other social services) which constituted about 36.0 per cent share in GDP.

Figure 1: Real GDP Growth



The economic growth remained higher than expected in 2007/08. The growth in real GDP at producers' price is estimated at 4.7 per cent in 2007/08 compared to a growth of 3.2 per cent in 2006/07.

The growth is mainly driven by the improved performance of the agriculture sector in 2007/08. This sector grew by 5.7 per cent in the review year on the back of significant growth in paddy production. The agriculture sector had posted a marginal growth of 0.9 per cent a year ago. Similarly, an improved performance of financial intermediation, hotel and restaurants, wholesale and retail trades and transport, storage and communications sub-sectors accounted for a moderate growth of 5.6 per cent in the non-agriculture sector in 2007/08. The services sector grew by 6.9 per cent in 2007/08 compared to a growth of 4.2 per cent in the previous year.

The growth in the industrial sector decelerated to 1.8 per cent in 2007/08 from 4.0 per cent in 2006/07. The growth in manufacturing, construction and electricity, gas and water sub-sectors remained less than satisfactory in 2007/08. The growth rate of the manufacturing sector whose share in GDP is around 7.0 per cent averaged 0.6 per cent during the past seven years. Industrial unrest, supply constraints and non-completion of new electricity projects and the decline in the domestic production of construction materials are the major factors responsible for a slow growth in the industrial sector.

The growth rate of domestic demand soared to 15.0 per cent in 2007/08 from 4.1 per cent in 2001/02. Of the total domestic demand, the growth of private sector consumption comprising 64.0 per cent share in the total domestic demand went up to 9.42 per cent in 2007/08 from 6.42 per cent in 2001/02. Similarly, the private sector investment comprising 15.0 per cent share in the total domestic demand increased by 22.0 per cent in 2007/08 compared to that of 8.64 per cent in 2001/02.

The public sector investment increased substantially by 22.0 per cent in 2007/08 as against a decline of 3.0 per cent in 2001/02. The growth rate of external demand for the Nepalese goods and services, which had registered a negative growth of 5.0 per cent in 2001/02 further declined in the subsequent years and showed a negative growth of 27.0 per cent in 2007/08. The exports of ready-made garments decreased by 33.5 per cent in 2006/07 from the level of 2001/02, due mainly to the phasing out of quota available for the export of ready-made garments that constitutes about 30 per cent share in the total overseas exports of Nepal.

The growth rate of total consumption accelerated to 10.7 per cent in 2007/08 from 6.6 per cent in 2001/02. The ratio of total consumption to GDP remained almost unchanged at around 90.0 per cent during 2001/02 to 2007/08.

The gross domestic savings grew remarkably by 32.7 per cent to Rs. 94.12 billion in 2007/08 which had declined by 15.3 per cent to Rs. 43.6 billion in 2001/02. Likewise, the total investment also posed a significant growth of 28.9 per cent to Rs. 262.5 billion in 2007/08 which had decreased by 5.7 per cent to Rs. 93.02 billion in 2001/02. The investment to GDP ratio went up to 32.0 per cent in 2007/08 from 20.2 per cent in 2001/02.

The overall economic growth remained subdued for the last few years due mainly to the input supply disruptions, poor weather conditions, domestic political unrest and also weak external demand. However, the major macroeconomic fundamentals have remained satisfactory ensuring overall macroeconomic stability.

3. Economic Reforms

The liberalization of the Nepalese economy began since 1984 with the removal of the entry barrier to the private sector for opening up commercial banks. This allowed the private sector to establish commercial banks even in the foreign joint venture form. The interest rates were completely deregulated in 1989. Following the restoration of multi-party democracy in 1990, the process of economic reform was further accelerated. A number of economic reform measures consistent with a liberal and more open policy regime were undertaken to integrate the country with the global economy. Accordingly, quantitative restrictions on imports have been removed; customs duties have been rationalized and brought down substantially. On the foreign exchange front, Nepal has fully liberalized the current account transactions and, in the process, has obtained the IMF Article VIII status.

Nepal Rastra Bank (NRB), the central bank of Nepal, has withdrawn its senior officials from the board of commercial banks and abolished the provision of directed lending and operationlization of commercial bank branches in relatively less viable areas. Substantial policy changes have been made through the legislation of industrial, commercial, foreign investment and technology transfer Acts. In addition, a series of policy measures have been initiated to promote exports, strengthen financial and capital markets, foster private sector development, and strengthen public expenditure management. The most recent reform process initiated in Nepal is the Financial Sector Reform Project, which includes the restructuring of the two large commercial banks namely, Nepal Bank Limited and Rastriya Banijya Bank, reengineering of the central bank and the capacity building of the overall financial sector.

4. Problems Experienced

The dependence of Nepal's agriculture on monsoon and low productivity growth of this sector have often led to fluctuations in output growth. The agriculture sector alone contributes around 33 per cent to GDP and generates employment opportunity to about 66 per cent of the working population. Lack of modernization of agriculture, inadequate access to financial resources, especially to the small farmers, insufficient irrigation facilities, lack of research-based development programmes and modern technology, and irregular supply of quality agriculture inputs are the main constraints to agriculture output growth in Nepal.

For the past 10 years, and more intensively in the last couple of years, the industrial output has suffered due mainly to continued political instability in the country. Additionally, frequent strikes, power shortages, raw material supply disruptions, labour-management disputes, etc. vitiated the industrial environment in the country. Streamlining these issues is crucial for accelerating industrial growth.

With the end of the decade long insurgency, Nepal has now moved forward to durable peace and sustainable development. In this context, expediting the various development projects affected by the past conflict has become a challenge.

Poverty reduction has been the national priority since the inception of the development endeavours in Nepal. The proportion of people living below the poverty line has declined from 42.0 per cent in 1996/97 to 31.0 per cent in 2003/04. However, widespread poverty and inequality especially in the rural area still exists. It is thus a big challenge to initiate local development activities which would pave the way for creating self-employment opportunities and thereby reducing poverty and narrowing the income gap.

With the onset of financial sector liberalization in Nepal, there has been an increased financial deepening. The M2 to GDP ratio was 55.0 per cent in 2006/07, whereas this ratio remained at 30.5 per cent in 1990. However, the accessibility of financial services to the rural area is still limited.

In the context of the huge investment requirement for economic development, there is ample room for attracting investment, technical expertise and entrepreneurship, and modern technology from the Non-resident Nepalese (NRN) and other development partners.

With a small export base as well as low value exportables, Nepal's export is confined to a few countries and products. It is, thus, a crucial challenge to diversify the exports, both product-wise and country-wise, on a competitive and comparative advantage basis.

For the last couple of years, remittances have become a dominant source of foreign currency earnings in the country. There is still challenge ahead for channelling remittances through the formal sector. It is equally important to productively utilize the remittances so as to uplift the living standard of the people.

Despite the ample potentials, the country has not obtained the expected benefits from the tourism sector. Inadequate promotional measures including narrow range of advertisement, non-explorations of new tourism areas, poor conservation of environment, lack of quality service, fluid political and security situation are the main hindrances for the development of the tourism industry in Nepal.

Among others, inadequate infrastructural set up – especially in road-network, electricity supply, communication services, lack of skilled manpower, poor technical know-how, insufficient capital and weak governance also stand as the constraints to growth.

5. Challenges to Price Stability

The core objectives of monetary policy, enshrined in the NRB Act 2002, are to ensure domestic price stability, secure a reasonable level of surplus in BOP and maintain financial sector stability. The fixed exchange rate regime with Indian currency (IC) continues to be a nominal anchor of monetary policy.

A rapid rise in inflation has been a global phenomenon. As in the global level, food, energy and commodity prices have driven up the overall level of prices in Nepal. Fuel prices are not yet fully adjusted in Nepal. This poses risks to inflation outlook in Nepal.

6. Risks and Growth Prospects

The end of the decade long insurgency and gradual settlement of major political issues have raised expectations of higher economic growth. A higher economic growth is essential to lift the economy from the morass of rampant poverty and low level of equilibrium trap. Strong political commitment and stability are prerequisites to achieve the sustained and inclusive economic growth as stipulated in our plan documents.

Located between two economic giants, China and India, Nepal has enormous prospects of comparative advantages in hydropower and tourism. Going forward, Nepal hopes to benefit from its vast potential of untapped water resources as well as natural, cultural and ethnic diversity.

7. Conclusion

The economic growth of Nepal over the past years remained less than satisfactory. The growth for the current year has, however, indicated a better economic performance in the years to come on account of recent political changes striving towards long lasting peace.

Country Paper: Pakistan

The Long-Term Challenge to Inflation in Pakistan

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1. Introduction*

Pakistan in recent years has made some impressive strides towards economic stability. Real GDP growth rates have averaged around 6 per cent since 2002, stock market surges have broken all the previous records, there has been much more dynamism in the banking industry, capital flows led to record levels of foreign exchange reserves, and poverty witnessed a declining trend. However, what threatens this achievement since last year is the menace of rising inflation. And while there are few monetary policy prescriptions to deal with this rising danger in the short to medium term, this paper attempts to highlight the importance of political instability as the long-term challenge to inflation stabilization in Pakistan.

Although Pakistan does not have a history of runaway inflation, it has experienced some episodes of high inflation rates. In fifty-seven years from 1951 to 2007, the inflation remained in double-digit in fourteen years and some of those years coincide with oil price shocks. Taking the sample (1951-2007) average of 6.9 per cent as a benchmark of high inflation, then it was in twenty-six years that inflation was recorded more than this average; most notably from 1973 to 1982, 1991 to 1998, and more recently from 2005 to 2007.

Interestingly, it was only in the mid-1970s that the world, including Pakistan, was taken by the oil price surprise. The U.K. Brent at $ 12.21 per barrel peaked to $ 37.42 per barrel in 1980. It however fluctuated between $ 37.42 per barrel in 1980 and $ 37.66 per barrel in 2004. This indicates that there is perhaps more to high (above average) inflation rates of Pakistan in the aforementioned years than only oil price.

One possible explanation for this could be the destabilizing effects of political instability on inflation as it hampers policy formulation and its effectiveness such as efforts aimed at macroeconomic stabilization. Political instability does not provide much room for the implementation or continuation of consistent or coherent policies. This greatly undermines the competence of a government to manage the economy and diminishes its resilience to accommodate shocks that eventually results in macroeconomic disequilibrium such as inflation.

As Pakistan also had its share of political instability, this paper investigates its association with inflation in Pakistan. We make use of the predictions of Fiscal Theory of Price Level (FTPL) determination and Political Economy of Macroeconomic Policy (PEMP) literature to show the theoretical link between political instability and inflation and its relevance to Pakistan (Section 2). Making use of simple ocular econometrics, we analyze some of the measures of political instability with inflation variability to investigate the relevance of this relationship; and test its robustness by examining the association of oil price with inflation (Section 3). Some final remarks that emphasize on the need to undertake political reforms to attain macroeconomic stability conclude this paper (Section 4).

2. The Theoretical Link: How Political Instability Leads to Inflation?

To show the link between political instability and inflation, we use a combination of the predictions of the FTPL determination and the PEMP literature. Following Carlstrom and Fuerst (1999) and (2000), the FTPL posits that price level and hence inflation is a result of the budgetary policies of the fiscal authorities. This is argued in two versions of weak-form FTPL and strong-form FTPL.[1]

The weak version akin to the famous monetarists' dictum, "inflation is always and everywhere a monetary phenomenon," argues that inflation is produced by excessive money growth dictated by the fiscal authorities and not the central bank. Thus, the underlying assumption here is the dominance of fiscal authorities in money creation. Whereas, the incentive for money creation is the revenue generation by printing money; that is, through seignorage.

Sceptics however argue that seignorage in reality does not account for as much of an amount of revenue collection so as to validate the aforementioned fiscal dominance assumption. This critique paves the way for the possibility of the dual dominance of both the fiscal and monetary authorities and thus the strong-form

*/ The paper is based on a study by Khan and Saqib (2008). The views expressed in this paper are those of the author and not necessarily those of the State Bank of Pakistan or its staff.

1/See, also Christiano and Fitzgerald (2000) and Kocherlakota and Phelan (1999) for a detailed review of the FTPL.

FTPL. The strong-form argues that fiscal policy independently affects the price level and hence the inflation rate; independent of the changes in money growth and dependent on the changes in government debt or budget deficit.

To illustrate this point, let us assume the standard intertemporal fiscal budget balance of the type. Where, is the present value of the future budget surplus (if negative then deficit), is the seignorage as the function of money growth, is the value of government debt, and is the nominal price level. Now considering that there is constant money growth then the above budget equation would yield. This implies, in this partial equilibrium set-up, that for any future increase in budget surplus prices must fall down and for any future decrease in budget surplus (that is, increase in deficit) prices must rise to restore balance in the fiscal budget. Similarly, increase in the value of government debt would also raise price level and vice versa.

What would cause the budget deficit and government debt to increase or persist that actually leads to higher inflation rate in this set-up? Two predictions from PEMP literature are relevant in this context. The first is the concept of 'political instability and deficit bias' as modeled by Alesina and Tabellini (1990) and the other is known as the 'war of attrition' as modeled by Alesina and Drazen (1991).

The theory of 'political instability and deficit bias' argues that alternating governments are either uncertain of each other's preferences or they disagree over the composition of public spending that gives rise to excessively high budget deficits. Because it is in the interest of an incumbent policy maker to run high budget deficit so as to maximize the spending of its own preference and thereby limiting the spending of its successor's preference. This strategic interaction reflects adversely on society's intertemporal choices and results into suboptimal outcomes. Typically, the deficit bias is stronger the more unstable is the political system or the greater is the likelihood of a government change.

Yet another channel of persistence or increase in deficit is the phenomenon of 'war of attrition' between conflicting political groups. A typical example to explain this is an unsustainable budget deficit. Even though it would be efficient to close down the deficit, a political agreement over this is often not found. This delay in fiscal stabilization may last until it becomes extremely costly for everybody. The reason in this delay has to do with asymmetric information among key political figures; that is, who bears the cost of stabilization?[2] Thus, the higher the number of political parties in a legislative council the higher the likelihood of conflict, the harder to reach agreements and the more the persistence or increase in fiscal deficit.

While both the theories of 'war of attrition' and 'political instability and deficit bias' focus on budget deficit, the basic idea of these theories can nonetheless be applied to any other variable such as public investment or government debt. In the absence of any binding fiscal rule and given the aforementioned political economy predictions the public investments are bound to swell through increase in government debt thus leading to inflation.

More importantly, political instability undermines the effectiveness of a government in implementing consistent or coherent policies and weakens the state's hold on the management of the economy. The bureaucracy, on the other hand, greatly benefits from this situation and remains unaccountable to the state organs. All this provides an accommodating framework for the promotion of sub-optimal allocation of resources resulting in severe distortions. Apart from weakening the resilience of the economy in the case of exogenous shocks such as oil price, it also results in endogenous supply shocks such as food price hikes (for example, due to hoarding).

Relevance to Pakistan

Previous studies linking political instability to inflation have however reasoned otherwise; closer to the weak-form FTPL. Most notably, Cukierman et al. (1992) and more recently Aisen and Veiga (2006) argue that economies with political instability and weak institutions do not have efficient tax system that increases their reliance on seigniorage. Therefore, to meet the demand for public expenditures they end up printing

2/ A focused explanation of this phenomenon through a hypothetical example goes as follows. Consider a coalition government in office that comprises political parties A and B. The senior partner (party A) wishes to minimize a seemingly unsustainable budget deficit through the abandonment of generous pension-related expenditures. Party B, however, does not agree to this, as it is afraid to lose its substantial vote-bank that enjoys the privileges stemming from pension-related expenditures of the government. Thus, party A and party B is locked in a war of attrition and the delay in this stabilization may carry adverse economic consequences.

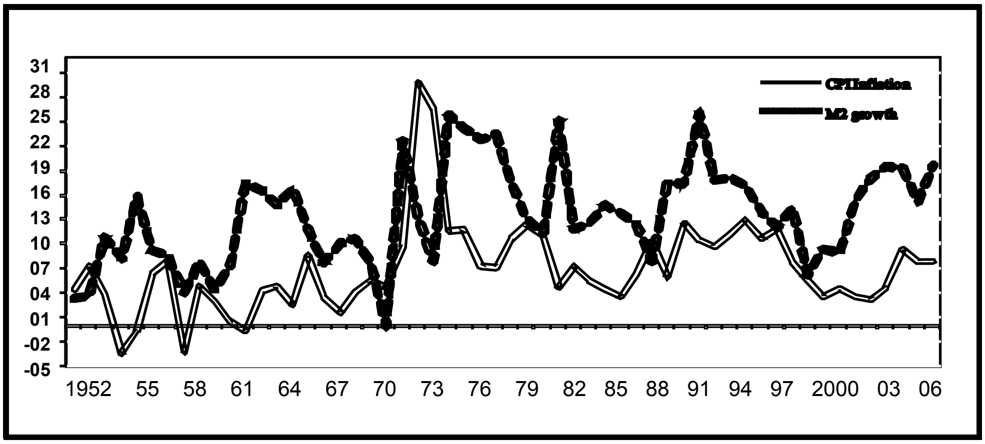
excessive money that eventually leads to inflation. We however argue that this line of reasoning might be true for very high (hyper) inflation countries but not for low or moderately high inflation countries.[3]

Our argument is based on two studies by Moroney (2002) and DeGrauwe and Polan (2005) that test the one-on-one relationship between money and inflation in multi-country investigations. The former study separates countries into 'high-money-growth and high-inflation' and 'low-money-growth and low-inflation' categories. The first category is characterized by money growth exceeding real GDP growth by at least 15 per cent and for the second category exceeding by less than 6 per cent. He finds that one-on-one relationship is strongly supported in the first category and does not carry the same support in the second category.

Similarly, the latter study confirms this result by separating countries into four categories characterized by annual average money (M1 and M2) growth rates of less than 15, 20, 30, and 100 per cent. The one-on-one relationship holds in the last two categories; the coefficients for less than 20 per cent category are 0.79 and 0.88 for M1 and M2; and for the first category the coefficients are 0.22 (M1) and 0.25 (M2).[4]

In Pakistan average annual inflation and money growth (M2 growth) remained at 6.99 per cent and 13.64 per cent during 1951-2007. M2 growth to real GDP growth over the same time has remained at 3.04 per cent. By Moroney and De Grauwe and Polan standards, Pakistan can be categorized into 'low-money-growth and low-inflation' countries. Also note that the correlation coefficient, as reflected in Figure 1, between CPI inflation and M2 growth during 1951-2007 has remained at 20.1 per cent. Therefore, the seigniorage factor as argued in the weak-form FTPL cannot be applied to a country like Pakistan; the combination of the predictions of the strong-form FTPL and PEMP literature are more relevant.

Figure 1: CPI Inflation and M2 Growth, 1952-2007



3. The Data and Analysis

We use annual time series data for the years 1951 to 2007. The variable on Inflation is the yearly growth rate of Consumer Price Index taken from the Federal Bureau of Statistics of Pakistan and the data on Oil price is the yearly growth rate of U.K. Brent (dollars per barrel) from International Financial Statistics of the International Monetary Fund.

For data on political instability, we use three different variables that indicate the political environment of Pakistan. First, we use Polity IV dataset of the Polity IV Project, Center for Global Policy, George Mason University and call it as Polity. In accordance with its lexicon meaning Polity does represent "a particular form or a system of government", its generators define it on the bases of regime legitimacy. Broadly, three

3/ For example, Aisen and Veiga (2006) in their empirical analysis define high inflation as a rate equal to or greater than 50 percent.

4/ See, Omer and Saqib (2008) for a similar argument.

norms concerning executive are identified: recruitment, constraints, and political competition. They are then given scale weights under Democratic and Autocratic regimes' characteristics. Interaction of these two then yields Polity that ranges from -10 (purely Autocratic) to +10 (purely Democratic). Increase in Polity then signifies a more democratic polity and decrease for a more autocratic one.

The second variable for political instability is the **Government crises** of the Cross National Time Series Data Archive. It accounts for the number of situations in a given year that threaten to undermine a current regime. Our third variable, **Cabinet changes**, is also from the Cross National Time Series Data Archive. It represents the number of changes in and of government. Specifically, it gives the number of times in a year a chief executive and/or 50 per cent of the cabinet is replaced with new minister(s). Increase in both the Government crises and Cabinet changes indicate increase in political instability.

With reference to Pakistan's experience, Polity actually never reaches to any of its extreme values of either +10 or -10. Table 1 gives the descriptive statistics of Polity for some select countries. As evident, for most politically stable and democratic countries, the mean, median, maximum, and minimum values are all +10 with 0 standard deviations. But, for Pakistan and Brazil this is not the case; it is suffice to assume a high degree of political regime switching as the standard deviations for both these countries stands at very high values of 6.07 and 6.54. Similarly, Pakistan records high values in both the Government crises and Cabinet changes. Followed only by Brazil and India, the standard deviation and mean values for Pakistan are at 0.85 and 0.60 for Government crises and 0.79 and 0.68 for Cabinet changes.

Table 1: Descriptive Statistics of Political Instability Variables for Select Countries

	U.S.A.[a/]	UK[a/]	Singapore[a/]	India[a/]	Pakistan[b/]	Brazil[a/]
Polity						
Mean	10	10	-1.10	8.57	1.31	1.39
Median	10	10	-2	9	1	5
Maximum	10	10	7	9	8	8
Minimum	10	10	-2	7	-7	-9
Std. Dev.	0	0	2.73	0.57	6.07	6.54
Government Crises						
Mean	0.04	0.26	0	0.47	0.60	0.46
Median	0	0	0	0	0	0
Maximum	1	3	0	2	3	3
Minimum	0	0	0	0	0	0
Std. Dev.	0.20	0.63	0	0.65	0.85	0.81
Cabinet Changes						
Mean	0.24	0.38	0.06	0.52	0.68	0.44
Median	0	0	0	1	1	0
Maximum	1	1	1	1	4	2
Minimum	0	0	0	0	0	0
Std. Dev.	0.43	0.49	0.24	0.50	0.79	0.54

a/ 1951-2002;

b/ 1951-2007.

Table 2: Polity and the Number of Government Crises and Cabinet Changes

	Polity	Government Crises	Cabinet Changes
1951-1957	4.1	10	5
1958-1972	-1.6	9	5
1973-1977	2.5	1	2
1978-1988	-5.3	0	9
1989-1999	7.2	10	12
2000-2007	-4.2	12	3

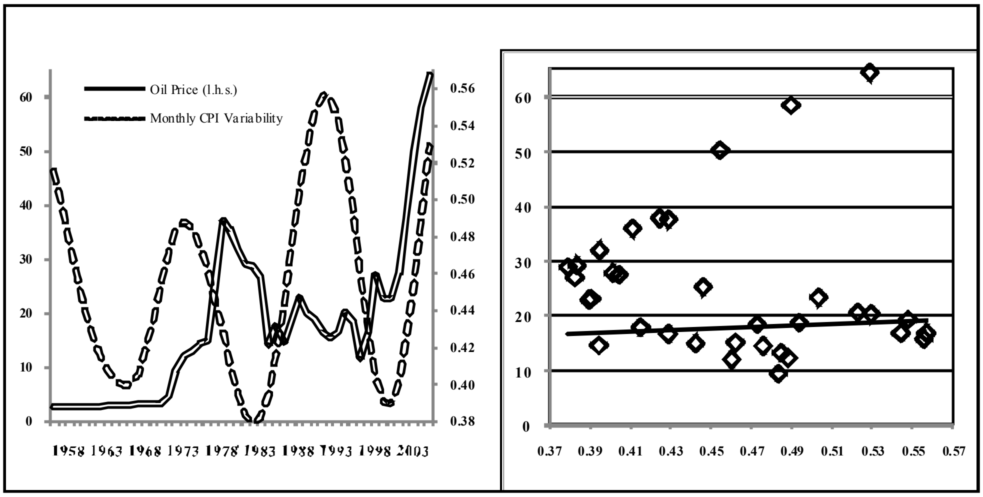
A noteworthy aspect of political instability in Pakistan is that Government crises and Cabinet changes are associated more with democratic regimes than the autocratic ones. As presented in Table 2, the Polity index with positive values, signifying the regimes with more democratic characteristics, shows more instability than the Polity with negative values.

The degree of political instability and uncertainty as in the aforementioned variables for Pakistan is greatly reflected in the frequent changes in the heads of state and prime ministers. In its 60 years history Pakistan has had a fairly large number of executive changes with 41 heads of state and prime ministers; notably, there have been 25 prime ministers to this date. Apart from this, there are two important points to note. First, a large majority of the Pakistani executives had rather short stints in the office. Second, the tenures of many did not end as a result of some routine change, such as elections. In fact, for a majority of them the exit has been unceremonious, such as dismissals.

A Simple Analysis

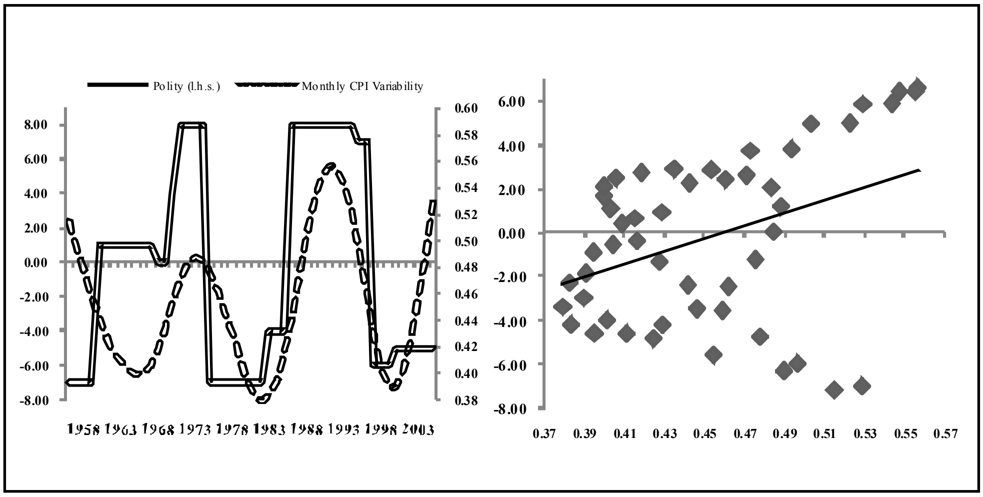
With some data at our hand, we now attempt to make some sense of it. Relying on simple analysis of ocular econometrics we establish a relationship between political instability and inflation in Pakistan. And to check the robustness of this relationship, we compete it with some other well-known 'nonmonetary' determinant of inflation in Pakistan such as oil price. Furthermore, to have a deeper understanding, we do not take CPI inflation but a proxy of it. In particular, we take the **Monthly CPI Variability** which is computed as the monthly CPI changes above average-CPI during each year.[5] In this way, we would have a better idea of significant price changes in a month instead of year-on-year CPI inflation averages.

Figure 2: Oil Price (U.K. Brent, $/barrel) and Monthly CPI Variability, 1958-2007



5/ Note that due to noise in the resultant series, we smoothed it using the H-P filter method; this gives a relatively clear picture of the underlying trend.

Figure 3: Polity and Monthly CPI Variability, 1958-2007



We analyze the Monthly CPI Variability with Polity and Oil Price in simple correlation analysis. Covering a period of about fifty years (1958-2007), Figures 2 and 3 summarize these relationships. Both the panels of Figure 2 show that the relationship between the two variables is rather insignificant. The correlation coefficient between oil price and monthly CPI variability is rather marginal at 4.55 per cent. This is evident in the nearly horizontal trend line in the right hand panel of Figure 2.

Analyzing Polity with monthly CPI variability however reveals another pattern. As shown in Figure 3, the trend line of the scatter plot between Polity and monthly CPI variability is upward sloping. The relationship is further confirmed in the correlation coefficient of a significant 52.60 per cent between these two variables. This signifies that the more democratic a regime is in Pakistan, the higher the variability in CPI. In other words, Government crises and Cabinet changes are associated with an upward CPI variability.

4. Final Remarks

Perhaps there are no two opinions on the benefits of achieving and maintaining low and stable inflation. Apart from eroding the purchasing power of an individual, high and persistent inflation causes uncertainty thus impeding saving and investment decisions hurting economic growth and development of a sound financial system. While these costs of inflation are rather well-known, controlling inflation in a country like Pakistan is essential in attaining macroeconomic stabilization to eventually address its ultimate objective of eliminating poverty. At the same time, low and stable inflation is a crucial societal insurance for the marginal segments of Pakistan.

Policy makers should therefore recognize the importance of a stable political environment for the implementation of consistent and coherent policies. Our analyses suggest that unless political reforms aimed at mitigating Government crises and Cabinet changes are not undertaken, inflation stabilization efforts by the technocrats would fail to yield long term price stability.

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Country Paper: Sri Lanka

Sri Lanka's Economic Growth, Performance and Future Prospects

Overview

Over the past decade, the Sri Lankan economy grew on average by 5.1 per cent and for the last three years it recorded a growth of well above 6.0 per cent for the first time since independence, demonstrating that Sri Lanka has now moved on to a higher growth path. The achievement of continuous growth during the period 1997 to 2007 amidst many challenges including inherent attributes in the form of relatively higher inflation of about 10 per cent, continous current account deficit of about 3 per cent of Gross Domestic Product (GDP), and a fiscal deficit of about 8.5 per cent of GDP leading to higher public debt of around 95 per cent demonstrated the resilience of Sri Lankan economy. It is noteworthy that the growth performance during last two decades was achieved amidst security related concerns.

The fruits of growth in Sri Lanka contributed to overall improvements in the macro economic variables leading to lowest ever recorded unemployment level of 6 per cent and the per capita income rose further to US dollars 1,617 by 2007. The achievements in the economic front in a challenging environment of increased counter terrorism measures and rising petroleum and commodity prices in international markets threatening the achievement of price stability and its spillovers into inherent deficiencies of higher current account and fiscal deficit and public debt have been recognized and measures to address these imbalances are in progress. The fiscal consolidation process pursued by the government moved in the right direction, both the fiscal deficit and public debt continued to improve in line with the trend observed in recent years. The external sector demonstrated its resilience to external shocks, with the balance of payments (BoP) recording surpluses in all years except for 2004 since the floatation of the exchange rate in 2001. As a result, the country's external reserves increased by more than 3 times since 2000, along with a greater stability in the exchange rate.

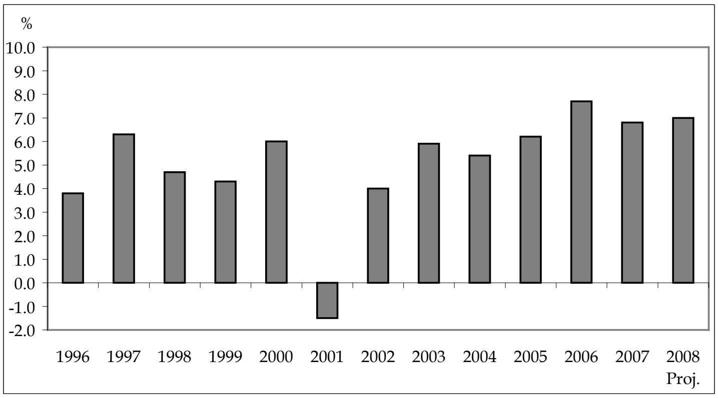
This paper discusses the overall performance of the economy on the basis of real, fiscal, external and monetary sector developments and discusses the challenges and prospects in the period ahead.

1. Review of the Performance of Major Sectors of the Sri Lankan Economy

1.1. Real Sector Performance

Since the major liberalization of the economy in 1977, Sri Lanka's economy achieved an average growth of around 5 per cent with a relatively higher inflation. The economic performance is commendable as it was achieved despite a number of external and domestic challenges. Apart from high international commodity prices including crude oil, increased competition for exports following the dismantling of the Multi-Fibre Arrangement (MFA), Tsunami devastation in December 2004 and 25 years of uncertain security situation required economic agents to adjust accordingly while the growth process was supported by reforms in the areas of finance and trade, deregulations, increased investments including foreign direct investments (FDI), and productivity and efficiency improvements. However, a negative growth of 1.5 per cent was recorded in 2001, attributable mainly to global economic slowdown, drought weather conditions and some failures in the security establishments.

Figure 1: Growth Performance 1996-2008



The structure of the economy underwent significant changes, resulting in shrinking of the share of the agriculture sector in the overall economy while that of the services sector has been increasing consistently. The share of the agriculture sector at 26.3 per cent in 1990 has declined to 11.7 per cent by 2007. In contrast, the share of the services sector increased to 58.4 per cent in 2007 from 47.7 per cent in 1990. Fast growth in import and export trade, telecommunications, port services and financial services supported services sector growth. The industry sector contribution also increased to 30 per cent from 26 per cent during this period. The industrial sector growth is dominated by expansion in the factory industries, in particular food, beverages and tobacco, textile and apparel and chemical, rubber and plastic products.

Figure 2:

Figure 2A: Structure of the Economy - 1990

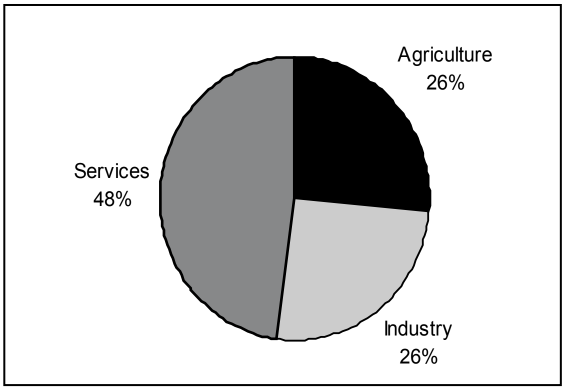
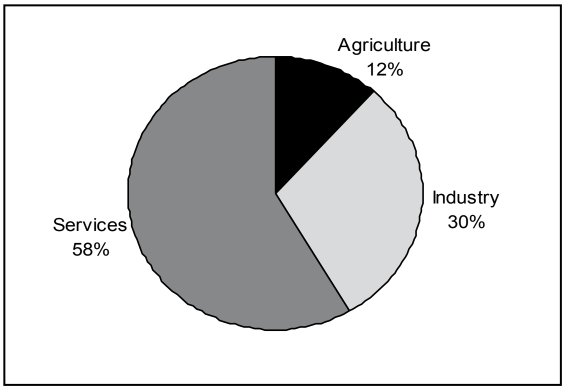


Figure 2B: Structure of the Economy - 2007



Investments as a per cent of GDP also reflected continuous increase since 2002 due to steady private investments and sustained growth in government investments. Total investment as a per cent of GDP at 22 per cent in 2003 has gradually increased to 28 per cent in 2007. Private investments grew from 19.3 per cent to 22.5 per cent while government investment increased from 2.8 per cent to 5.4 per cent during this period. Domestic savings – investment gap during this period, however, expanded from about 6 per cent of GDP to about 10 per cent, which is financed through worker remittances (about 6 per cent) and inflows to the government, FDIs and other inflows.

1.2 Fiscal Sector Performance

The fiscal management has been a challenging task for many years. The government has been fighting a war for more than two decades and the tsunami disaster, high international oil and commodity prices, and adverse weather conditions were among the various external and internal shocks faced by the government. Reflecting many developments in the revenue front, including the lower customs revenue and issues in the tax structure, base and administration, the government revenue, which averaged to around 20 per cent of GDP by 1996 took on a declining trend particularly from 1997 and reached 14.9 per cent in 2004. The recurrent expenditure averaged to 21.2 per cent of GDP during the period from 1990 to 2002. The decline in revenue coupled with high recurrent expenditure resulted in a decline in much needed public investments to 4.6 per cent of GDP by 2002 with a view of maintaining budgetary targets. The overall deficit averaged to 9.4 per cent of GDP during this period while the outstanding government debt exceeded the GDP and reached 105.4 per cent by 2002.

Table 1: Key Economic Indicators - Sri Lanka 1996-2008

			Average				Projections
	Indicator	**Units**	**1996-2000**	**2001-2005**	**2006**	**2007**	**2008**
Real Sector							
	GDP at Market Prices	US$ mn.	15411.8	19247.4	28,267	32,348	40,918
	GDP Growth	%	5.0	4.0	7.7	6.8	7.0
	Per Capita GDP at Market Prices	US$	820.8	998.3	1421.5	1616.6	2,049
	Inflation-GDP Deflator	%	8.0	9.0	11.3	14.0	17.0
	Domestic Saving	%of GDP	17.7	16.1	17.0	17.6	20.1
	National Saving	%of GDP	21.8	21.4	22.3	23.3	25.3
	Gross Investment	%of GDP	25.8	23.5	28.0	27.9	30.0
External Sector							
Trade in Goods							
	Exports	US$ mn	4732.8	5350.7	6,883	7,740	8,553
	Growth	% change	8.0	3.3	8.4	12.5	10.5
	Imports	US$ mn	6098.3	7123.0	10,254	11,301	12,932
	Growth	% change	6.9	4.8	15.7	10.2	14.4
	Trade Gap	US$ mn	-1365.5	-1772.3	-3,371	-3,560	-4,379
Trade in Services							
	Services, net	US$ mn	119.2	338.3	257	238	307
	Private Remittances (gross)	US$ mn	993.6	1467.7	2,161	2,502	2,842
	Current Account	US$ mn	-585.0	-364.1	-1,499	-1,369	-1,863
	Current Account Deficit	%of GDP	-3.8	-1.8	-5.3	-4.2	-4.5
	Capital and Financial Account	US$ mn	458.1	716.6	1,808	2,097	2,003
	Private Capital Inflows (b)	US$ mn	362.5	336.9	669	903	1,039
	Government Inflows	US$ mn	558.3	834.2	1,314	1,646	2,061
	Overall Balance	US$ mn	-130.7	271.3	204	531	140
	Overall Balance	%of GDP	-0.8	1.4	0.7	1.6	0.3
	External Reserves (without ACU)	US$ mn	1661.2	1847.0	2,526	3,063	3,127
	External Official Reserves						
	(Months of Imports)	Months	3.4	3.1	3.0	3.3	2.9
	Debt Service Ratio (c)	%	14.4	11.5	12.7	13.0	13.9
	Total External Debt	%of GDP	56.6	53.6	43.2	44.1	36.7
Fiscal Sector (d)							
	Revenue	%of GDP	17.8	15.8	16.3	15.8	18.0
	Expenditure	%of GDP	26.6	24.5	24.3	23.5	25.0
	Current Account Balance	%of GDP	-2.6	-3.8	-2.4	-1.6	-0.9
	Overall Budget Deficit	%of GDP	-8.8	-8.7	-8.0	-7.7	-7.0
	Government Debt	%of GDP	92.3	100.4	88.7	85.8	82.3
Financial Sector (f)							
	Reserve Money Growth *	%	6.1	13.6	21.2	10.2	11.8
	Broad Money Growth (M2b) *	%	13.3	16.2	17.8	16.6	13.8
	Narrow Money Growth (M1)	%	9.6	14.4	12.6	2.7	5.0
	Growth in Credit to Private Sector	%	11.6	16.3	24.0	19.3	13.8
	Growth in Credit to Public Sector	%	41.9	8.4	47.6	8.9	2.1

*2008 figures are on the basis of monthly averages.

Identifying the unsustainability of the continuation of these trends, the government implemented a series of measures to improve the fiscal performance, which was complemented by the introduction of the Fiscal Management (Responsibility) Act (FMRA) in 2002. The thrust of the overall fiscal strategy of the government has been placed on further strengthening fiscal consolidation process while promoting pro-poor development to reduce poverty and regional economic disparities on a sustainable basis. The policy measures adopted were focused on augmenting government revenue, rationalizing recurrent expenditure, enhancing public investment and improving debt management. The fiscal strategy has also been formulated in line with the policy vision enunciated in the government policy document, the "Ten Year Horizon Development Framework: 2006-2016" (Ten-year Vision), and the overall macroeconomic framework aimed at achieving a high, sustainable economic growth in the medium-term.

On the revenue front, the recent policy measures mainly focused on expanding the base, reducing loopholes, rationalizing tax incentive regimes and strengthening tax administration. In the expenditure front, measures were implemented to reducing fiscal vulnerabilities and included allowing prices of many essential goods and services to adjust according to market forces including petroleum prices to reflect the cost of fuel production and international market prices, streamlining the subsidy and other safety net programmes and introducing reforms to strengthen the financial performance of state owned enterprises. In the process of addressing the expenditure issues, the public investment has been recognized as an important element and given the prominence towards achieving expected high economic growth. In line with this, a comprehensive public investment programme was presented to support the medium-term growth potential of the country particularly by addressing infrastructure bottlenecks. The Ten-year Vision also envisages continuing fiscal operations with a view of increasing the public investment to improve the infrastructure facilities while enhancing government revenue. Accordingly, a number of projects were commenced in the recent past, both at national and rural levels, thereby showing a new wave in the development of infrastructure in Sri Lanka. In line with this, measures were taken to resolve problems associated with project implementation and faster disbursement of available resources. With respect to public debt management, measures were introduced to diversify and broaden the base of the government securities market, broad base the investor base, reduce exposure to external risks as well as those that arise from within the system.

The Fiscal Management (Responsibility) Act (FMRA), which was enacted in 2002, aims at promoting fiscal prudence and discipline by improving transparency and accountability in fiscal management and facilitating public scrutiny of fiscal policies. In addition to the specific medium term targets stipulated in the FMRA, this rule based approach to fiscal policy resulted in several improvements including the preparation of an annual budget within a medium-term macroeconomic and fiscal policy framework, and the presentation of a number of reports to Parliament and to the general public including the mid-year report on budgetary developments (Mid-year Fiscal Position Report) and Fiscal Management Report, which is presented with the annual budget.

Responding positively to these efforts, the declining trend in the revenue to GDP ratio was reversed in 2005. The expenditure and net lending as a per cent of GDP has taken on a declining trend particularly since early 2000 supported mainly by the decline in recurrent expenditure. Meanwhile, the public investment has been in the increasing trend and reached 6.4 per cent of GDP in 2007. Consequent to these developments, the overall budget deficit declined to 7.7 per cent of GDP in 2007 from 10.4 per cent of GDP in 2001. The deficit in the current account also declined to 1.6 per cent of GDP in 2007 from 4.9 per cent of GDP in 2001 bolstered by the revenue performance. The outstanding government debt to GDP ratio also declined to 85.8 per cent as at end 2007 from a peak of 105.4 per cent recorded in 2002.

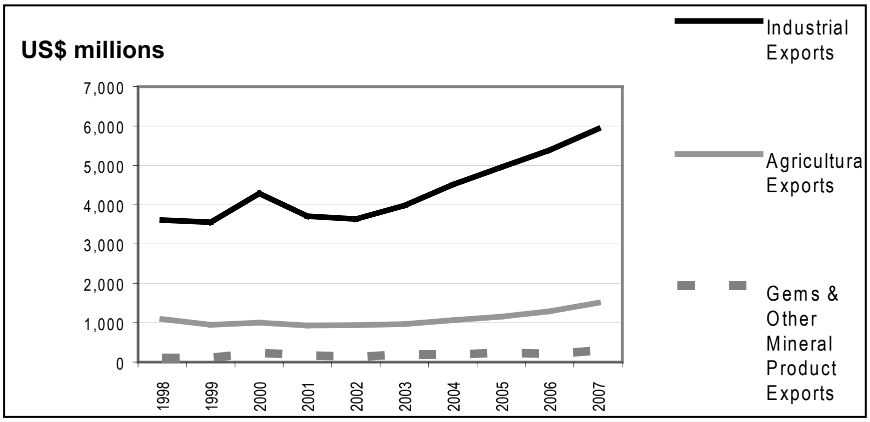
1.3. External Sector Performance

The external sector continued to provide major impetus for Sri Lanka's growth since opening up of the economy in the latter part of 1970s. In retrospect, it can be seen that 1977 inaugurated an era of liberalisation and reliance on markets and in that sense a paradigm shift in economic policies. The major plan of the new policy was the opening up of the island's economy not only in terms of trade and exchange rate reforms, but a massive flow of foreign capital channelled into donor-supported public sector investment programmes and lately into private sector led economic growth. The performance of the external sector also, supplemented by the favourable global and regional economic environment, contributed for the rapid integration of both trade, services and financial sectors of the economy.

1.3.1. Trade Policy, Trade Relations and Trade Performance

Foreign trade policy, as well as the trade structure, has undergone considerable changes since 1977. Removal of all restrictions on current international transactions by 1994 when Sri Lanka accepted obligations under Article VIII of the Articles of Agreements of the IMF, gradual removal of restrictions on capital account transactions, elimination of quantitative restrictions on imports, rationalisation of tariff structure, removal of export licensing requirement, etc. were among the major changes. The evolution of these trade related policies led to create substantial changes in the composition of exports and imports making trade the dynamic force in the economy.

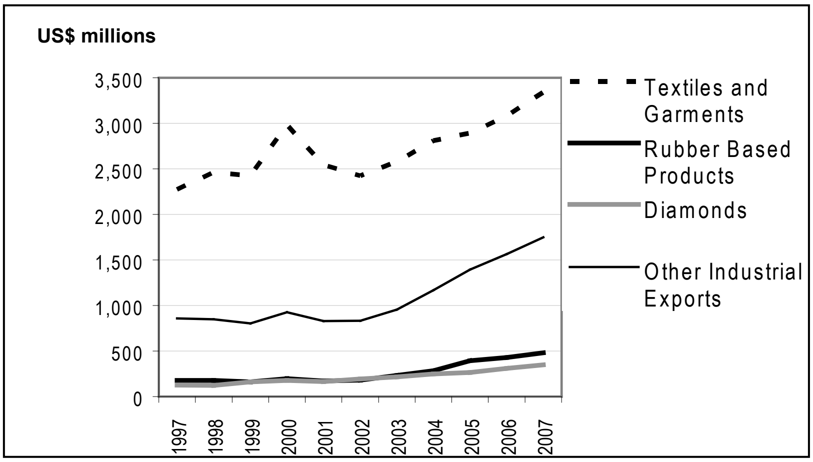
Figure 3: Sri Lanka's Exports



Agricultural exports which dominated exports accounting for more 79 per cent of total exports in 1977, was gradually replaced by industrial exports. Consumer goods which absorbed 42 per cent of import bill in 1977, also gradually declined increasing the share of investment and intermediate imports. The export structure became diversified and industrial exports led by textiles and garments became the largest contributor to export earnings, accounting to more than 70 per cent of total exports. Sri Lanka's exports have performed well over the last decade, particularly since 2003. While the average rate of annual export growth for the decade ending 2007 is 5.7 per cent, for the five-year period from 2003 to 2007, it is 10.5 per cent.

The export structure became further diversified with the emergence of export items such as rubber based products, food and beverages, electrical items, gem and diamond jewellery, petroleum products and other agricultural products. Diversification of exports into relatively broad based industrial exports has partly facilitated to reduce the vulnerability of Sri Lanka's economy to external shocks.

Figure 4: Industrial Exports



Tariffs remain the main trade policy instrument. The five-band tariff structure of 0, 2.5, 6, 15 and 28 per cent, which was introduced in 2004 continued to prevail in 2007. The average rate of import duty was 4.2 per cent in 2007 compared to Sri Lanka's average bound tariff level of 38.5 per cent. However, when the other taxes applicable to imports (excepting excise duty and VAT/GST, which are applicable to non-traded goods as well) are taken into consideration, the average rate of tariff in 2007 was 8.4 per cent, while it averaged 7.4 per cent for the five-year period from 2003 to 2007.

Figure 5A: Exports per Capita (USD)

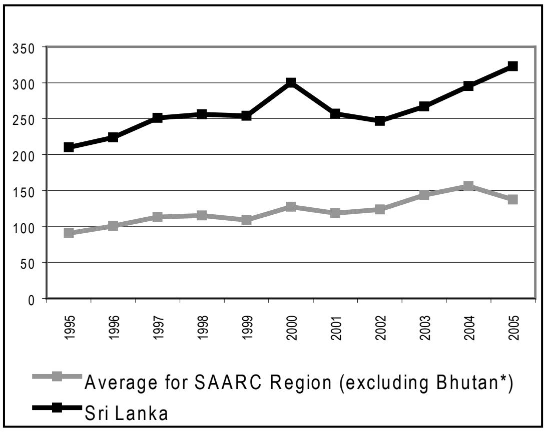
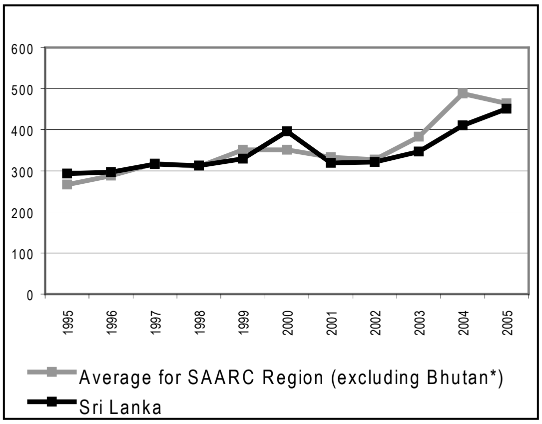


Figure 5B: Imports per Capita (USD)



Sri Lanka's trade relations with her major trading partners have played a catalytic role in the encouraging export performance. Sri Lanka is firmly engaged in the bilateral and regional trading agreements, while upholding multilateral initiatives in WTO fora as the long-term strategy to strengthen the country's position in the global trading system. With a view to strengthening the traditional ties and developing Sri Lanka as the South Asian trading hub, the country has consistently supported and promoted regional trade integration. Sri Lanka is signatory to several trade pacts including the South Asia Free Trade Agreement (SAFTA), the Asia-Pacific Trade Arrangement (APTA), the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMST-EC) and the Indian Ocean Rim Association for Regional Cooperation (IORARC).

Trade between Sri Lanka and regional countries have increased in recent years as evident from Table 2 below, partly as a result of the trade agreements signed with these countries. However, in terms of trade volume, intra regional trade still remains very low reflecting weak integration within the region.

Table 2: Trade with Selected Regions and Countries – as a Percentage of Total Trade during the Last Five Years

	2003	2004	2005	2006	2007
Groups of Countries					
APTA	16.9	18.8	21.8	21.6	22.7
European Union	22.4	22.8	21.3	21.8	22.4
SAARC/SAFTA	12.9	15.1	17.3	17.2	18.2
BIMST-EC	12.7	14.7	17.3	17.1	18.1
Middle East	6.5	7.4	6.7	8.3	12.1
C.I.S. Countries	1.7	1.5	1.5	1.6	1.5
Selected SAARC Countries					
India	11.2	13.3	15.8	15.5	16.4
Pakistan	0.9	1.1	1	1.2	1.2
Maldives	0.7	0.6	0.3	0.3	0.3
Bangladesh	0.1	0.2	0.2	0.2	0.2

*Trade covers both exports and imports.

Trade relations with the European Union have been instrumental in maintaining the export growth momentum in the face of intensifying competition in the US market for garments, the largest source of foreign exchange earnings for Sri Lanka. The concessions under the GSP+ scheme granted by the EU in respect of 7,200 products have helped diversify both products and markets in the EU, particularly during the last two years.

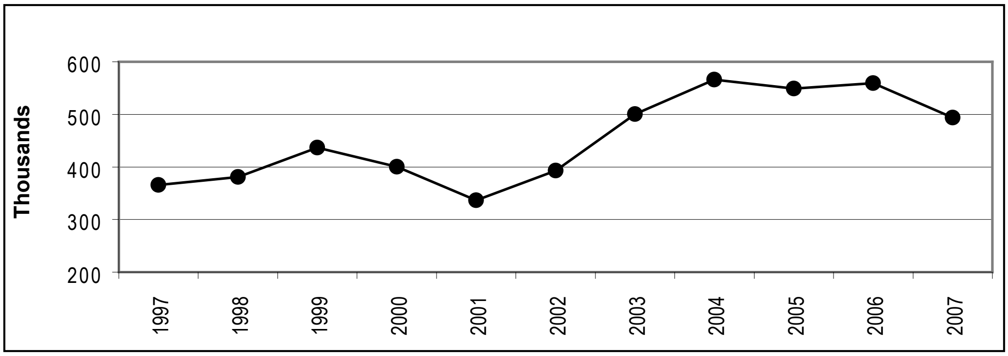
The integration of the domestic economy with trading partners as envisaged by entering into trading arrangements led not only to economic gains as specifically stated in the agreements, but also to a multiple of spin-off benefits beyond those envisaged in such agreements. Sri Lanka has made great strides in the development of backward integration by providing a conducive environment for private sector investment in domestic fabric and ancillary products.

1.3.2. Current Account, Capital Flows and Balance of Payments (BoP)

The inflows mainly in the services, income, capital and financial account over the past decade contributed to the overall external sector performance in the economy. The private remittances enabled to bring down the current account deficit into a comfortable range of 2 ½ - 3 ½ per cent of its GDP during the 1995-2007 period thus making private remittances a significant source of financing, about 60 per cent, the widening trade deficit due to increasing commodity and energy prices in the international market. In Sri Lanka, migration for employment abroad in large numbers is a development of the late 1970s with the resurgence of oil-financed demand for expatriate labour for development activity in West Asia, and employment overseas. The number of skill migrants with the possibility of earning higher wages received prominence in policy making over last half a decade and their remittances, which amounted to US dollars 2.5 billion in 2007, are expected to increase in the future.

The tourism industry has had to face many challenges over the last two decades. The impact of travel advisories issued by major tourism generating countries in view of the uncertain security situation in the country is reflected in the decline in tourist arrivals from time to time. Nevertheless, tourism is currently the fourth largest foreign exchange earner for Sri Lanka and brings in about US dollars 400 million a year to the country. While Sri Lanka has a long-standing reputation as a popular tourist destination in the world, the tourism industry has the potential to expand and develop by diversifying and promoting.

Figure 6: Tourist Arrivals in Sri Lanka



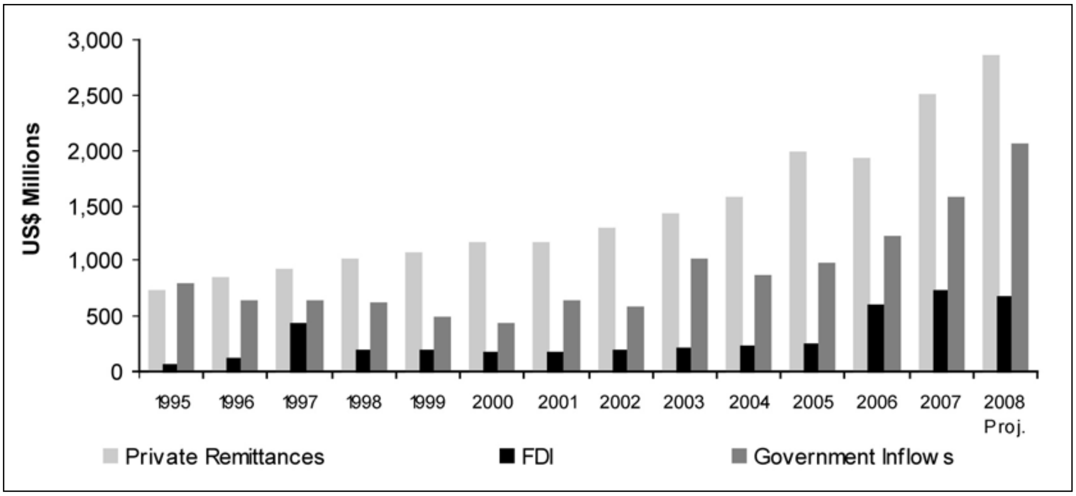
The overall investment climate and continuous investor friendly policy measures including dedicated Foreign Direct Investment (FDI) zones, rapid expansion of infrastructure, skill employees and opening up of capital account for foreign investments contributed largely to foreign investments in the country. In the latter half of 1990s the divestiture of loss making, management and technical deficient public ventures attracted sizeable FDI in the telecommunication and aviation sectors. As a result, the FDI receipts as a percentage of GDP was an insignificant 0.4 per cent in 1995 but improved to over 2 per cent in 2006 and 2007. The companies approved by the Board of Investment (BOI) law today employ over 400,000 workers, they account for nearly 70 per cent of Sri Lankan exports and 80 per cent of the country's industrial exports. The BOI has radically transformed Sri Lanka both economically and socially, placing the country in a position where it can compete in an increasingly globalized world.

The FDI contracts once entered could not be changed ensuring a degree of stability that few other countries can offer or match. Sri Lanka's FDI is mainly concentrated in the ceramic, rubber, electrical, gems and jewellery, information technology and business process outsourcing, education, tourism, agriculture, textile and apparel, fabricated metal and medical and pharmaceutical industries.

The foreign inflows to the government from both bilateral and multilateral sources contributed to the large-scale infrastructure developments in the country since opening up the economy in late 1970s. In the years immediately after the opening up of Sri Lanka's economy, the bilateral external loans for the accelerated Mahaveli Development Project received prominence in inflows to the government and in the first half of 1980s as per cent of GDP, the inflows to the government remained around 10 per cent of GDP and these inflows gradually slowed to a level of 5 per cent of GDP over the last decade. Further, the continuous increase in Sri Lanka's per capita income to a level of US dollars 1,617 by 2007, pushed the Sri Lanka authorities to look at external finances from competitive sources like international capital market borrowings. In October 2007, Sri Lanka successfully ventured into the international capital markets by issuing US dollars 500 million inaugural international bond issue. Further, in recent years, efforts to open up its capital account by way of investments by foreigners in Sri Lanka rupee denominated government securities and allowing deposits by foreign investors in domestic banking units by way of Foreign Investor Deposit Accounts (FIDA), signify the increasing desire of Sri Lanka to open up capital accounts and attract foreign investments to contribute to the rapid expansion of economic activities envisaged in the government's Ten Year Development Plan 2006-2016.

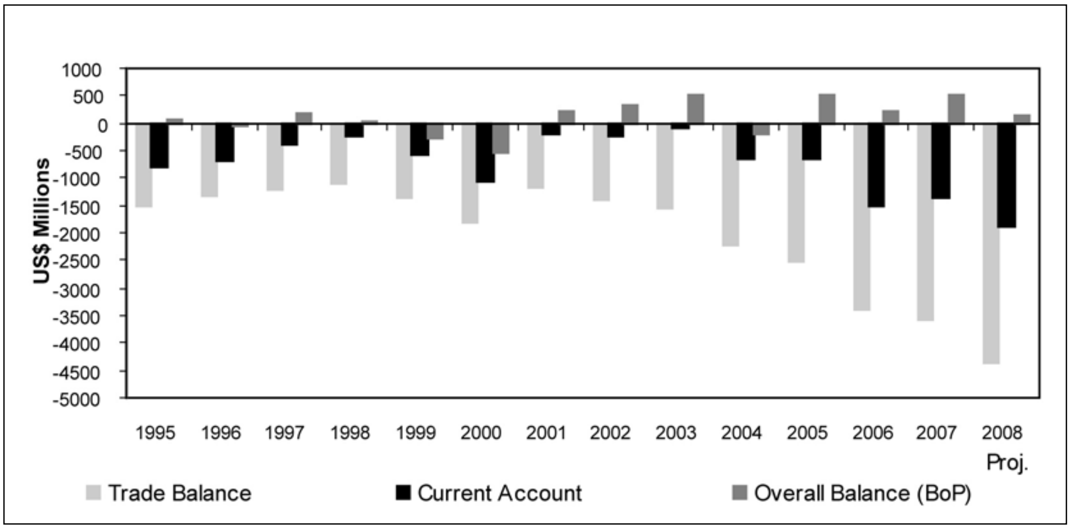
The exchange rate system in Sri Lanka evolved over the years from a fixed exchange rate to a managed float and effective January 2001 Sri Lanka has moved into an independent float where the market forces freely determine the value of the Sri Lanka rupee. The exchange market liberalization also facilitated the country's rapid integration with the rest of the world in financial and service sectors.

Figure 7: FDI, Private Remittances and Govt. Inflows



Over the years, increasing external inflows to the country supplemented to mitigate the pressures of continuous trade deficit of 9-10 per cent of GDP during the period 1996-2007 through the services, income, capital and financial inflows. For the last seven years Sri Lanka's BoP reported surpluses except in 2004, contributing to the stability of the external sector and external reserves of the country.

Figure 8: Trade, Current Account & Overall Balance (BoP)

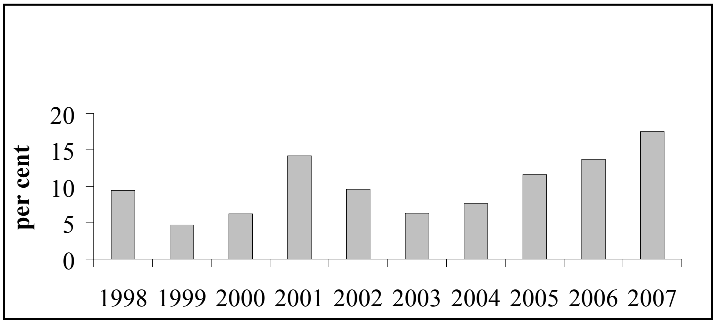


1.4. Inflation and Monetary Sector Developments

In general, Sri Lanka is considered as a relatively high inflation economy, largely due to financing of high budget deficits of the government by the banking sector resources and supply side factors such as adverse weather conditions and high international market prices of the main imported items which the economy face time to time. The share of imported items in the consumer basket accounts to around 25 per cent having a high vulnerability of rising international market prices on domestic inflation. Also, one per cent depreciation of the exchange rate against US dollar contributes to around 0.3 per cent increase in domestic inflation.

The annual average inflation in Sri Lanka during the 10 years ended 2007 was around 10 per cent. Until 2004, average inflation remained at single digits except in 2001. However, as a result of excessive monetary expansion partly due to financing of the government's budgetary requirements during 2004-2006, inflation began to accelerate since 2004. In the recent years, more attention has been given to minimize the monetization of budgetary financing of the government, which has helped to reduce demand driven inflationary pressure. In order to avoid inflationary financing being used by the government for subsidies, domestic fuel prices were allowed to be adjusted in line with international prices since 2006. However, this action resulted in a one-off increase in the price level, pushing the inflation up.

Figure 9: Annual Avearge Inflation during 1998-2007



The inflation rate that remained above its long-term average during recent years has raised some concerns. In spite of the demand-driven inflation being responding to tight monetary policy, the unprecedented increases in international food and fuel prices towards the beginning of 2008, resulted in the headline inflation to accelerate further reaching 28 per cent by June 2008. However, the Central Bank has noted that non-food inflation (including fuel) still remained at around 11 per cent. Since this high headline inflation is largely a result of an external shock, it is envisaged that the inflation would moderate to a level consistent with the tight monetary conditions, when the impact of the external shocks gradually diminishes. As the international food prices are believed to have already reached the peak, the food inflation, which was over 40 per cent, has to slowdown during the second half of 2008. The government's move to impose a ceiling for the price of rice, which has a significant weight in the price index and has increased by nearly 100 per cent during the recent 12-month period, also would apply some breaks on food inflation. The upward trend in headline inflation was reversed in July by declining it to around 26 per cent and it is expected that this declining trend would continue during the rest of the year and in 2009 with the help of continued demand management policies as well as favourable developments in the supply side.

The average core inflation as measured by excluding food and energy prices, remains in the range of 8-9 per cent. In order to avoid any second round impact of high food inflation on other commodities and hence on core inflation, continued tight monetary policy measures would have to be adopted by the Central Bank.

1.4.1. Monetary Sector Performance

The Central Bank of Sri Lanka adopts a monetary targeting policy framework to achieve one of its twin core objectives of Price and Economic Stability. Under the monetary targeting framework in Sri Lanka, Reserve Money is the Operational Target and Broad Money (M2b) is the Intermediate Target. Within the monetary targeting framework, targets for monetary aggregates are set by careful evaluation of the expected developments in the real, fiscal, external and monetary sectors of the economy and incorporated into the monetary programme.

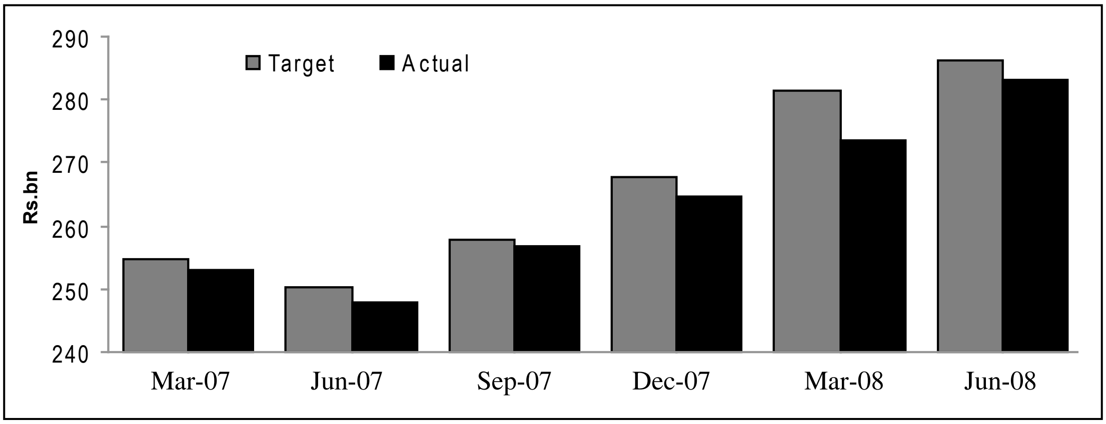
At present, the monetary policy framework of the country places greater reliance on market based policy instruments and the use of market forces to achieve the desired objectives. The main instruments are Central Bank Repurchase and Reverse Repurchase rates, Open Market Operations and Statutory Reserve Ratio (SRR). The Bank rate is also a Central Bank policy rate, though it is not an effective rate at present given the availability of other instruments. In addition to these instruments, Letter of Credit margin and Moral Suasion are also used whenever necessary.

During the 10-year period ended 2007, reserve money, on average, grew by 12.3 per cent, while the average broad money growth was 15.5 per cent. The Central Bank has usually targeted a money supply growth of around 15 per cent during recent years and achieved such targets until 2003. Accordingly, the annual broad money growth during the 1998-2003 period was within 13-15 per cent. However, the monetary growth during 2004-2006 period exceeded Central Bank's set targets. In 2004, in particular, reserve money expanded by 20.9 per cent, compared to the nominal GDP growth of 14.2 per cent, building up inflationary pressures in the economy. Broad money too recorded a 19.6 per cent growth in 2004, supported by the accommodative monetary policy as reflected by low interest rates.

Recognizing the adverse consequences of excessive monetary expansion, the Central Bank tightened the monetary policy since 2004. Policy interest rates of the Central Bank have been raised by 350 basis points during the period from 2004 to 2007. However, since 2007 the main focus of monetary management has been towards maintaining strict quantity targets (reserve money) while allowing the market rates to adjust accordingly. Hence, tighter reserve money targets were set for 2007 as well as for 2008. Also, to maintain the market liquidity at a level consistent with the tight monetary targets, open market operations have been conducted more aggressively. Accordingly, the availability of reverse repurchase facility has been restricted to only when there is a deficit in market liquidity. Also, at present, the reverse repurchase facility is provided to a particular bank only up to 3 times per month. Any borrowings of more than 3 times by a particular participant during a month are allowed at a penal rate of 19 per cent per annum which was effective from December 2007. The Central Bank has also been refraining from purchases of government Treasury bills as far as possible enabling to avoid any additional build up of market liquidity. In addition, LC margin requirements have been imposed on the importation of certain categories of vehicles and several luxury items. Moral suasion has been used to discourage the usage of reverse repurchase facility and lending to unproductive sectors by commercial banks. These monetary policy measures were complemented by some prudential measures such as imposing general provisioning requirement of 1 per cent on all performing advances of commercial banks.

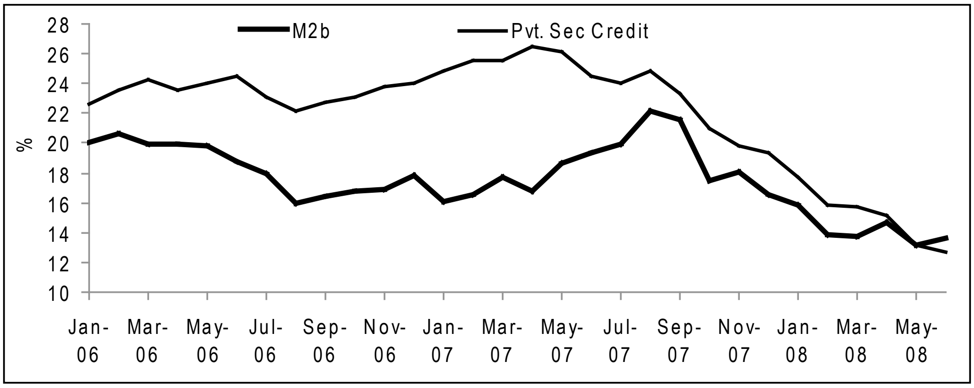
The impact of these tight monetary policy measures has led to an upward adjustment of market interest rates as expected. Accordingly, tight policy measures were instrumental in achieving reserve money targets in 2007 as well as in the first half of 2008. Thus, the adverse impact of excessive reserve money expansion in 2004 and 2006 was negated by end 2007. Also, the original reserve money targets set for 2008 at the beginning of the year were revised further downward on two occasions in April and June, considering the necessity of further tightening of liquidity to avoid second round impact on inflation of increased food and energy prices. Accordingly, the original reserve money growth target of 14.7 per cent for 2008 has been revised downward to 11.75 per cent by the end of the first half of 2008.

Figure 10: Targeted and Actual Reserve Money 2007 - 2nd Quarter 2008



Reflecting the impact of tight control of reserve money, the broad money growth also shows a decelerating trend, largely a result of significant decline in credit which has responded to the high interest rates. Credit growth which was as high as 26 per cent in mid-2007, has declined to around 13 per cent currently, while the broad money growth also hovers around 13 per cent compared to above 20 per cent growth recorded in mid-2007. In addition, credit to the public sector which include credit to both the government and public corporations by the banking system shows a lesser burden on monetary growth compared to previous years, supporting the maintenance of lower monetary expansion. Hence, the prudent monetary management policies adopted in the recent past with the improved support of the fiscal policies is expected to give a better yield in further controlling demand driven inflationary pressures in the economy.

Figure 11: Broad Money Growth and Private Sector Credit Growth



1.4.2. Moving from Monetary Targeting to Inflation Targeting

Over the years, the Monetary Targeting framework has been gradually developed and modified in line with global and domestic developments in monetary policy and macroeconomic management with a view to moving into an IT regime in the future. Notwithstanding the fact that the demand for money in Sri Lanka is fairly stable as the financial system has not yet reached such an advanced stage of sophistication, the Central Bank of Sri Lanka has also kept abreast of the widespread discussion on new developments in monetary policy conduct and has been examining and researching on the feasibility of adopting IT. Several research activities have been undertaken during last few years and such research outcomes have been presented in various publications of the Central Bank ranging from annual reports to occasional papers to Staff Studies.

A number of measures have been taken during the last decade with a proactive view of moving to an IT regime. These include:

1. Adopting the floating exchange rate regime in 2001 in order to ensure the facilitation of effective monetary policy conduct.
2. Streamlining the objectives of the Central Bank to economic and price stability and financial system stability.
3. Expanding the Monetary Board to strengthen the independence by having the majority of the Monetary Board members (3 out of 5) from the private sector.
4. Establishing the Monetary Policy Committee in order to strengthen the monetary policy decision-making process.
5. Issuing regular monetary policy statements to the public according to an advanced release calendar.
6. Commencing active open market operations in order to ensure the effective monetary policy operations.
7. Developing the communication strategy through improving awareness of stakeholders and providing adequate training to financial professionals.
8. Starting to enunciate Central Bank policies through a public policy document (Road Map), which would eventually cover an inflation report as well, under a future inflation targeting framework.
9. Establishing a Monetary Policy Consultative Committee in order to receive inputs from private sector experts and academics.
10. Guiding the Census and Statistics Department to introduce a more representative new Consumer's Price Index, improving inflation forecasting and conducting inflation expectation surveys, preparation and publishing a core inflation measure.

These measures were complemented by the enactment of the new legislation [Fiscal Management (Responsibility) Act] in 2003 designed to bring down the fiscal deficits to a sustainable level to facilitate the monetary policy conduct. The Central Bank considers moving to an IT framework from MT framework a gradual and cautious process and it is not a simple switching option. Accordingly, the Central Bank will be prudent and follow the process of fulfilling the prerequisites so as to be able to adopt a country specific and full fledged IT framework in the medium -term.

1.4.3. Financial Sector Developments

Banking sector in Sri Lanka, which comprises licensed commercial banks (LCBs) and licensed specialised banks (LSBs), dominates the financial system and accounts for around 57 per cent of the total assets of the financial system. As at end 2007, the banking sector comprised 23 LCBs and 14 LSBs. Within the banking sector, the core is the commercial banks which contribute to about 49 per cent of the financial sector assets. The banking sector is at present one of the most dynamic and vibrant sectors of the economy. It has expanded rapidly, both in terms of the volume of activity and the variety of services provided to the public. The banking density as measured by the number of licensed commercial bank branches available for 100,000 persons was 9.7 as at end 2007. The array of financial products and services and delivery channels broadened with the introduction of new schemes and Information and Communication Technology (ICT) based products and services, such as internet and mobile phone banking. There was a significant shift towards card based payment modes and automated teller machine facilities.

In addition to banks, there are a large number of other financial institutions including 32 Registered finance companies, 78 Registered Finance Leasing establishments and 15 Insurance Companies. The total financial sector assets as at end 2007 amounted to Rs.4, 323 billion which is 121 per cent of GDP.

The regulation and supervision of the financial system has been strengthened during the past several years with the implementation of several new prudential directives and measures, while the systemically important payment and settlement systems operated with high availability and safety. Several directives and measures have been introduced to improve the soundness of both banks and non- bank financial institutions. There was also a shift from compliance-based supervision towards risk-based supervision. The preparatory work for the implementation of the Basle II Capital Adequacy Framework for banks from 2008, has been completed. The adoption of Basle II is expected to improve the soundness and risk management of banks by better aligning the bank's capital with its risk profile and by providing more comprehensive capital coverage for credit, market and operational risks. Hence, the near-term risks to the financial system seem to be manageable and the outlook for financial system stability is positive, with policies and measures being implemented to mitigate risks and address vulnerabilities.

Table 3: Total Assets of the Financial System

	2007 (a)	
	Rs. Bn	**Share in Total %**
Banking Sector	**3,068.5**	**71.0**
Central Bank	561.9	13.0
Licensed Commercial Banks (b)	2,100.0	48.6
Licensed Specialised Banks	406.6	9.4
Other Deposit Taking Financial Institutions	**177.1**	**4.1**
Registered Finance Companies	142.5	3.3
Co-operative Rural Banks	28.7	0.7
Thrift and Credit Co-op. Societies	5.5	0.1
Other Specialised Financial Institutions	**192.9**	**4.5**
Specialised Leasing Companies	96.0	2.2
Primary Dealers	54.2	1.3
Specialised Leasing Companies	31.4	0.7
Merchant Banks	3.8	0.1
Unit Trusts	6.3	0.1
Venture Capital Companies	1.1	-
Credit Rating Agencies	0.1	-
Contractual Savings Institutions	**884.6**	**20.5**
Employees' Provident Fund	560.0	13.0
Employees' Trust Fund	78.8	1.8
Private Provident Funds	96.2	2.2
Insurance Companies	133.1	3.1
Public Service Provident Fund	16.5	0.4
Total	**4,323.0**	**100.0**

(a) Provisional.

(b) Consolidated assets of both DBUs and OBUs of LCBs.

Source: Central Bank of Sri Lanka

2. Challenges and Prospects to the Growth Momentum

Given the commendable performance of the economy over the last decade, the challenges in the form of volatility in operational costs due to changes in energy prices and increasing labour cost in line with increasing per capita income could also impact on the ability of export oriented industries to compete in a rapidly integrating trade environment. In this context, it is important that Sri Lanka makes every endeavour to significantly diversify her exports. A further risk factor with regard to exports is the relatively high level of dependence of exporters on concessions received through trade agreements. A case in point is the significant reduction of the effective tariff on imports of vanaspathi, a cooking oil, to India recently, and the consequent difficulties that Sri Lankan exporters are encountering in sustaining vanaspathi exports to India, which depended entirely on tariff preferences for Sri Lanka under the Indo-Sri Lanka Agreement. With respect to garment exports, there is now growing concern that the GSP+ scheme may not be extended after the end of this year. The issue of GSP+ is one of the main concerns for the Sri Lankan apparel industry. If the GSP+ scheme is discontinued from 2009, Sri Lanka will have to compete in the European Union (EU) with lower cost producer countries. The phasing out of safeguard measures in the United States of America (US) on imports of textiles and apparel from China and Vietnam is likely to enhance competition in the US market further. Following the phasing-out of the MFA in 2005, the EU and the US have implemented safeguard measures with quota restrictions on textile and clothing imports from China. Therefore, elimination of these restrictions on items which are also very sensitive to Sri Lanka will scare orders away from Sri Lanka.

The risks to the services, income, capital and financial account performance mainly come from deceleration in global and regional economic activities and domestic unstable security environment. However, over the years continuous diversification and resilience of the economy has proved that Sri Lanka could be well placed to attract foreign inflows continuously. Also, the advent of Sri Lanka into the international capital markets by issuing its maiden Sovereign Bond issue of US dollars 500 million in October 2007, augur well for the country's ability to tap much needed foreign investments as the country has already graduated from the low-income status to a lower middle-income status.

The growth prospects in exports of several agricultural and industrial products, for which the international markets are expanding is one area Sri Lanka could increase its growth potential. Processing and building brands would add value to Sri Lanka's exports. By addressing the constraints hindering the expansion of these sectors, Sri Lanka could further expand and diversify the sources of export earnings. Sri Lanka also has a huge potential for expanding service exports including tourism.

By the end of 2008, Sri Lanka can send all her exports other than those in the negative list duty free to both India and Pakistan under respective free trade agreements. However, the utilisation of these concessions have been very low. Therefore, exporters need to find ways and means to expand the market in these countries by integrating strategies such as using innovative technology, advanced information, innovative designs and evaluation into their production and marketing practices. Retaining market share in the US market is equally important as expanding trade in other new markets. Therefore, addressing the concerns of the US market with regard to price and quality is becoming increasingly important.

The medium term prospects with regard to services, income, capital and financial account performance partially co-relates with global and regional economic perspectives. The emerging West Asian economies already created opportunities for skill migrant employees and service oriented exports in the form of construction, ship building and related services, health and leisure sectors, tourism earnings for the country. The continuous facilitation of external financing for private sector development initiatives and emphasis on Public-Private Partnership for infrastructure developments is expected to contribute to the increase in FDI. The external inflows to the government will increasingly tilt in favour of international financial market financing together with accelerated bilateral and multilateral initiations with development partners of the country.

In the fiscal front, the government expects to reduce the budget deficit gradually to 5.0 per cent of GDP in the medium-term while achieving a sustainable level of government debt to complement the medium-term expectation of maintaining a low and stable inflation. It also envisages to increasing public investment to around 7 per cent of GDP in the medium-term to stimulate economic growth. The promotion of Public

Private Partnerships (PPPs) is also expected to finance large-scale infrastructure projects on a profit sharing basis with a view of reducing the burden of excessive debt financing of the government budget.

Nevertheless, the risk of having a declining government revenue may contribute to excessive government borrowings from the domestic banking sector resulting in detrimental effects on achieving price stability. From another perspective, the high inflation will result in higher interest rates and wage pressures and, the high cost of production would result in lower profit margins for the industries, which may result in lower corporate tax revenue to the government and thereby affecting the budget deficit. Also, such strains in the government budget could reduce the ability of the government to continue its infrastructure developments crippling overall growth prospects.

The thrust of the overall fiscal policy strategy of the government continued to be placed on further strengthening fiscal consolidation while promoting pro-poor and pro-growth development to reduce poverty and regional economic disparities on a sustainable basis. The fiscal policy strategy has been formulated in line with the policy vision enunciated in the government policy document the Ten Year Horizon Development Framework and the overall macroeconomic framework aimed at achieving a high, sustainable economic growth in the medium-term. Authorities have identified the need to contain recurrent expenditure further in order to reduce the budget deficit to a sustainable level and the need to increase public investment to 7-8 per cent of GDP in the medium-term, as priorities. The government expects to reduce the budget deficit gradually to 5.0 per cent of GDP in the medium-term. The Government also expects to achieve a sustainable level of government debt in the medium-term. To reduce the burden of excessive debt financing, the Government anticipates engaging in Public Private Partnerships (PPPs) to finance large-scale infrastructure projects on a profit sharing basis.

High fiscal deficits and contributing to finance such fiscal deficits through banking sector resources has been a main factor for high inflation in Sri Lanka in the past. Within the public sector, in addition to the financing needs of the government, two large public corporations, i.e. Ceylon Petroleum Corporation and the Ceylon Electricity Board have been relying much on bank financing in the past, indicating the necessity of improving the financial management of such corporations to avoid the crowding out of much needed banking resources to enhance the private investment. There has been an effort in the recent past to reduce the reliance of public sector on banking sector resources which could consider as a favorable development. When the financing needs of the public sector, become larger than originally planned levels, maintaining monetary expansion in a predetermined path would naturally be more challenging. Therefore, avoiding any deviations from the expected plans of public sector financing is essential for the successful conduct of monetary policy. Hence, maintaining budget deficits along the announced path as planned in the government's medium term policy framework would help the Central Bank to manage future inflation and inflation expectations and maintain price stability to support economic growth.