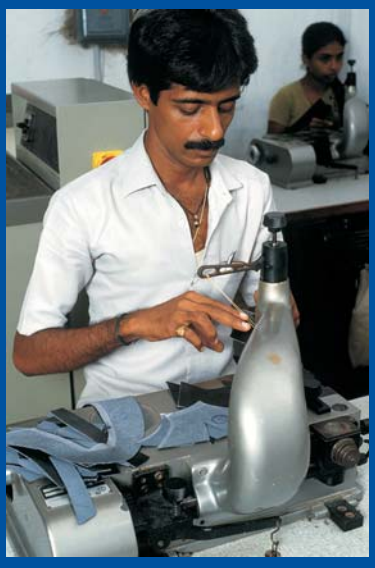
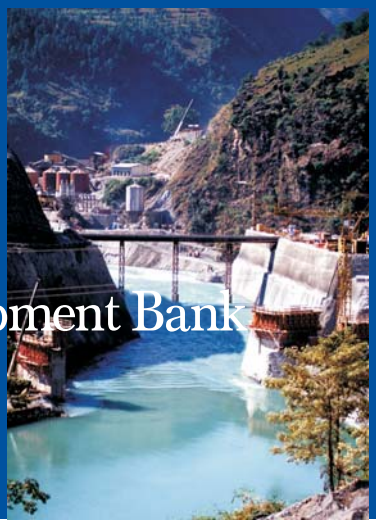
ADB

South Asia Economic Report

October 2006





Asian Development Bank

ADB

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The periodical *South Asia Economic Report* provides information and data on developing South Asian countries.

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FOREWORD

We are pleased to present the first issue of the *South Asia Economic Report* (*SAER*), a series of biannual reports on economic and development issues on the South Asia region. The *SAER* is a cooperative effort by the South Asia Department and the Central and West Asia Department of the Asian Development Bank (ADB).

Growth in South Asia has been accelerating since the early 1990s, and its economic performance during the last decade and a half has been impressive. Economic growth has contributed to significant reduction in poverty in the region. Today, South Asia stands at a point where the potential for sustained high growth and poverty reduction is excellent. The region has a unique opportunity to drastically reduce poverty over the next decade, provided the right policy choices are made.

With the *SAER,* ADB hopes to make a meaningful contribution to the debate on these crucial choices. The *SAER* aims to provide information to policymakers, academics, and ADB management and staff and highlights issues to help promote debate and foster appropriate policies and greater cooperation and integration in the region.

The *SAER* also provides a unique regional perspective. Against the background of the increasing awareness of a regional identity, the *SAER* discusses common regional trends as well as differences across South Asian countries in economic and development performance. We are convinced that South Asia will benefit enormously from recognizing and exploiting regional synergies.

The key messages of this issue of the *SAER* are the following:

- South Asia is well established on a high growth path, with strong and improving macroeconomic fundamentals. While India is in the lead, the improvement in performance in South Asia is broad-based.
- South Asia's growth pattern differs substantially from that followed by East and Southeast Asia: growth in South Asia is primarily driven by domestic demand; the services sector is a key driver of growth; investment rates, while rising, are still low; and remittances from workers living abroad exceed foreign direct investment inflows.
- Continued sound macroeconomic management, policy and institutional reforms, and targeted public investments are required to sustain high growth and eradicate poverty in South Asia— the progress in, and the role of human development and poverty reduction in the long term sustainability of economic growth in South Asia will be a special focus for the next *SAER*.
- In macroeconomic management, the key areas of concern are inflation and increasing current account deficits. This may require curbing domestic consumer demand through appropriate

monetary and fiscal policies, and action on domestic energy prices to improve energy use efficiency.

- With regard to policy and institutional reforms, there is a need to focus on improving regulatory quality and government effectiveness. Also, while banking sector reforms have reduced vulnerability in most countries in South Asia, consumer credit is expanding rapidly and it requires closer supervision and caution.
- The quality of infrastructure, particularly power, roads, and ports, is weak in most South Asian countries and could become an obstacle to sustaining high growth unless public investments are targeted at areas of emerging infrastructure bottlenecks.

We would like to thank the staff and consultants from the South Asia Department and the Central and West Asia Department of ADB for preparing this issue of the *SAER*, in close collaboration with the Economics and Research Department. The work was conducted under the overall guidance of Sultan Hafeez Rahman and Richard Vokes. The production of the *SAER* was led by Naved Hamid, assisted by Alain Borghijs.

The sections on Economic Performance and Prospects and on Governance and Investment Climate were prepared by Naved Hamid, Alain Borghijs, Ruth Francisco, Caroline Patacsil, and Rommel Rabanal. Xiaoqin Fan contributed the section on Banking Sector Vulnerability and Reforms. Toan Quoc Nguyen wrote the Box on Oil Prices and the Balance of Payments. The write-ups for the country section were provided by the country economists; Michaela Prokop for Afghanistan, Rezaul Khan for Bangladesh, Abid Hussain for Bhutan and Maldives, Hiranya Mukhopadhyay for India, Paolo Spantigati and Bipulendu Singh for Nepal, Safdar Parvez for Pakistan, and Johanna Boestel for Sri Lanka. Sharlene Lu-Quintana compiled the Statistical Appendix.

Jill Gale de Villa, with the assistance of Ruth Francisco, did the style and copy editing. Jane de Ocampo provided administrative support. The publication was made possible by the cooperation of the Department of External Relations and the Printing Unit.

Finally, we would like to thank these and other numerous colleagues from different departments, who provided invaluable inputs and comments: P. Abeygunawardena, Raza Ahmad, Johanna Boestel, Padmini Desikachar, Xiaoqin Fan, Bahodir Ganiev, Frank Harrigan, Tadateru Hayashi, Paul Heytens, Cindy Houser, Ayako Inagaki, Shikha Jha, Rezaul Khan, Dan Millison, Hiranya Mukhopadhyay, Susanne Nebel, Soo Nam Oh, Narhari Rao, Keiichi Tamaki, and Axel Weber.

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CONTENTS

Boxes

ABBREVIATIONS AND ACRONYMS

ADB	—	Asian Development Bank
ADO	—	Asian Development Outlook
AFTA	—	ASEAN Free Trade Agreement
ASEAN	—	Association of Southeast Asian Nations
CAR	—	capital adequacy ratio
CBSL	—	Central Bank of Sri Lanka
c.i.f.	—	cost, insurance, and freight
DFI	—	development finance institution
G10	—	Group of 10
GDP	—	gross domestic product
FDI	—	foreign direct investment
f.o.b.	—	free-on-board
FY	—	fiscal year
I-ANDS	—	Interim Afghanistan National Development Strategy
IT	—	information technology
MFA	—	Multifibre Arrangement
NBL	—	Nepal Bank Limited
NIE	—	newly industrialized economy
NPL	—	nonperforming loan
PRC	—	People's Republic of China
RBB	—	Rastriya Banijya Bank
RBI	—	Reserve Bank of India
ROA	—	return on assets
SAER	—	South Asia Economic Report
SAFTA	—	South Asia Free Trade Agreement
SBP	—	State Bank of Pakistan
THP	—	Tala Hydropower Project
US	—	United States
VAT	—	value-added tax

Note: The symbol "$" is used to denote the US dollar.

Abbreviation of Country Names in Tables

AFG	—	Afghanistan
BAN	—	Bangladesh
BHU	—	Bhutan
IND	—	India
INO	—	Indonesia
MAL	—	Malaysia
MLD	—	Maldives
NEP	—	Nepal
PAK	—	Pakistan
PHI	—	Philippines
SRI	—	Sri Lanka
THA	—	Thailand

DEFINITIONS

The economies discussed in the *South Asia Economic Report (SAER)* are classified by major analytic or geographic groupings. For the purposes of the *SAER*, the following apply:

- Developing Asia refers to the 43 developing member countries of the Asian Development Bank.
- Central Asia comprises Armenia, Azerbaijan, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.
- East Asia comprises People's Republic of China (PRC); Hong Kong, China; Republic of Korea; Mongolia; and Taipei,China.
- The Greater Mekong subregion comprises Cambodia, PRC, Lao People's Democratic (Lao PDR), Myanmar, Thailand, and Viet Nam.
  - Mekong 3 comprises Cambodia, Lao PDR, and Viet Nam.
- Newly industrialized economies (NIEs) refers to Hong Kong, China; Republic of Korea; Singapore; and Taipei,China.
- South Asia comprises Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.
  - South Asia 5 comprises Bangladesh, India, Nepal, Pakistan, and Sri Lanka.
  - South Asia 4 comprises Bangladesh, India, Pakistan, and Sri Lanka.
- Southeast Asia comprises Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam.
  - Southeast Asia 7 comprises Cambodia, Indonesia, Lao PDR, Malaysia, Philippines, Thailand, and Viet Nam (or Southeast Asia excluding Myanmar and Singapore).

- The Association of South East Asian Nations (ASEAN) comprises Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam.
  - ASEAN 4 comprises Indonesia, Malaysia, Philippines, and Thailand.
- The Euro Area comprises Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.
- The Group of 10 (G10) comprises 11 industrial countries: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, United Kingdom, and United States.
- The South Asian Association for Regional Cooperation (SAARC) comprises Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.

South Asian countries have varying fiscal years. The fiscal years of Maldives and Sri Lanka correspond to the calendar year; the fiscal years of the other South Asian countries are given below. In the text, unless otherwise specified, "year" refers to calendar year.

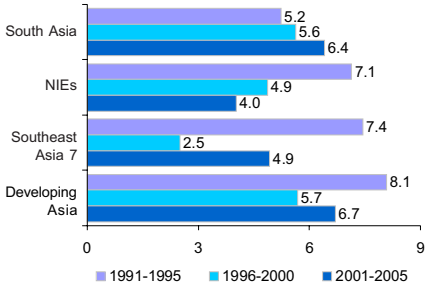
The *SAER* is based on data available up to 29 September 2006. Unless otherwise specified, data in the tables presented in this issue were obtained from the *Asian Development Outlook* (*ADO*) and *ADO Update* and South Asia Regional Department's Economic Information System. For a detailed explanation of computations and data sources, refer to the Statistical Notes at the beginning of the Statistical Appendix.

Country	Fiscal Year	Caption
Afghanistan	21 March 2005 to 20 March 2006	FY2005
Bangladesh	1 July 2004 to 30 June 2005	FY2005
Bhutan	1 July 2004 to 30 June 2005	FY2005
India	1 April 2005 to 31 March 2006	FY2005
Nepal	16 July 2004 to 15 July 2005	FY2005
Pakistan	1 July 2004 to 30 June 2005	FY2005

1. INTRODUCTION

South Asia's economy performed well in the 1990s and during the past 5 years it has done even better. The growth rate has improved steadily, and is today among the highest in Asia (Figure 1.1). Similar improvements have taken place in the macroeconomic fundamentals (lower inflation, smaller current account deficit, and declining fiscal deficit in the last 5 years), in the saving and investment rates, and in the integration with the global economy (Figure 1.2). While developments in India are clearly the predominant factor in the improved economic performance of South Asia, most other countries in the region have been on a similar trend—although their improvements generally are more modest.

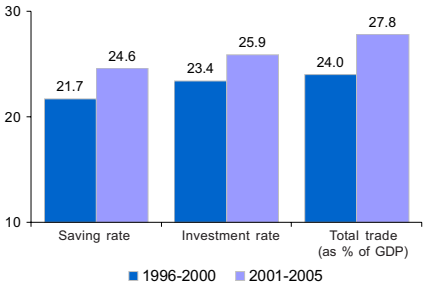
Figure 1.1. GDP Growth
(%, 1991-2005)



In many ways, the 1990s was a decade of reforms in South Asia—reforms that covered most areas of the economy and were broadly similar across many of the countries in the region. Key areas of reforms included

(1) enhancing macroeconomic stability by improving revenues through tax reforms and curbing of fiscal deficits, strengthening the independence and capacity of central banks for more effective monetary policy and bank supervision, and managing exchange rates more flexibly to avoid appreciation of the real exchange rates;
(2) improving the environment for private sector development through measures such as abolition of the investment-licensing regimes; deregulating and eliminating most price controls; privatizing or providing greater managerial autonomy for state-owned enterprises; and generally expanding space for private sector activities including areas that were traditional government monopolies such as telecommunications, electronic media, and power generation and distribution;
(3) revitalizing the banking sector by strengthening prudential regulations, deregulating interest rates, enhancing competition by liberalizing entry of private banks, and introducing professional management for public banks and/or privatizing them; and
(4) reversing the highly protective trade policies of the past by dismantling trade protection instruments, reducing tariffs, and simplifying the trade regime.

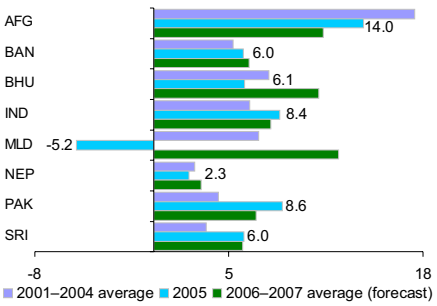
Figure 1.2. Saving and Investment Rates and Trade-to-GDP Ratio in South Asia (%, 1996-2005)



Against this backdrop of strong economic growth and successful reforms, the *South Asia Economic Report* (*SAER*) discusses South Asia's recent economic performance and prospects for sustaining growth over the long term. The next three sections address the following topics:

Section 2 of the *SAER* assesses the recent economic performance and prospects of the eight South Asian countries. The report concludes that robust global growth and strong domestic demand provided the context for rapid growth in South Asia in 2005. South Asia has grown remarkably in 2005—at 8.1%, this is well above Asia's average 7.6% growth in gross domestic product (GDP). India and Pakistan led the growth—at 8.4% and 8.6% respectively (Figure 1.3). Services (at 9.4%) and industry (8.9%) remain the drivers of growth. Growth in investment (15.1%) has surpassed that in consumption (6.5%) for the fourth year running. Saving rates, both public and private, have also improved. Foreign direct investment has increased, but remains lower than in East and Southeast Asia. Forecasts for growth of South Asia's GDP in 2006 and 2007 remain strong at about 7.5%. Risks to this forecast include the volatile oil prices, possible spread of the avian flu, and adjustments of the global payments imbalance. In macroeconomic management, the key areas of concern are inflation and increasing current account deficits. These require slowing down the rapid growth in domestic consumer demand through appropriate monetary and fiscal policies. In addition, action on domestic energy prices is needed to reduce the fiscal burden of the high and rising international oil prices and to improve efficiency of energy use.

Figure 1.3. GDP Growth, South Asia (%)



Note: Data for Afghanistan is only available starting 2002.

Section 3 covers two topics in greater depth—banking sector vulnerability and reforms, and governance and the investment climate. The banking sector plays a key role in private sector financing and macroeconomic stability. The report concludes that banking sector reforms have reduced vulnerability in most countries in South Asia, and the banking sectors in India and Pakistan are in particularly good shape. However, consumer credit has grown rapidly and needs closer supervision and caution.

The discussion on governance and investment climate is intended to help identify appropriate areas of focus for the reforms and public investment. This is important because in order to sustain its impressive performance over the longer term, South Asia has to continue the process of reforms, and not only increase public investment but also allocate it to areas where the needs are the greatest. The report argues that South Asia remains over-regulated and that there is considerable scope for improvement in the efficiency of government interventions. Also, the poor quality of infrastructure is identified as a priority area to ensure sustainability of economic growth. While the importance of human development and poverty reduction in the long-term sustainability of economic growth is fully recognized, this will be a special focus in the next *SAER* issue.

Section 4 supplements the broader regional view of section 2 with brief write-ups for each of the eight South Asian countries covering performance, issues, and risks. It provides updates on economic developments for all South Asian countries, including those not discussed in the *ADO Update 2006*.

2. ECONOMIC PERFORMANCE AND PROSPECTS

Recent Economic Performance

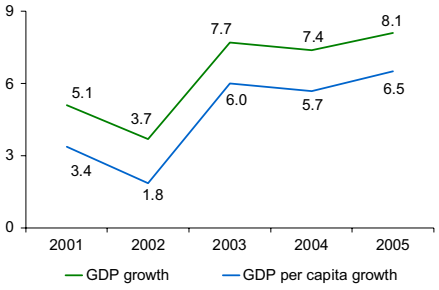
The global economy posted strong growth (4.8%) in 2005, despite the uptrend in energy prices. Global short term interest rates rose steadily throughout 2005, but long term interest rates remained broadly stable. Inflationary pressure remained moderate and, although headline inflation increased because of higher oil prices, core inflation was stable. Global financial markets expanded strongly in the developing economies, as private flows surged in 2005. World trade also saw a strong expansion (6.2%) in 2005; although lower than the record-high growth (10.2 %) in 2004, it was still above the medium-term trend (5.5%). Meanwhile, as energy prices surged, current account imbalances across the global economy continued to widen in 2005.

Against this backdrop, South Asia's output continued to expand rapidly. Growth was largely driven by the services sector from the supply side and by domestic expenditures from the demand side. Inflation remains a concern in South Asia, particularly in Bangladesh, Pakistan, and Sri Lanka. High rates of import growth, driven by strong domestic demand and rising oil prices, also resulted in widening current account deficits in South Asia.

Growth and Investment

South Asia sustained the impressive economic performance of the previous 2 years, registering high growth of 8.1% in 2005 (Figure 2.1). This is above Asia's regional average growth in GDP of 7.6%, and it significantly outpaced the world economy. The brisk growth of output translated into a 6.5% increase in per capita income in South Asia.

Figure 2.1. GDP and GDP Per Capita Growth in South Asia (%)



Economic growth accelerated in India and Pakistan, to 8.4% and 8.6% respectively. Afghanistan and Sri Lanka also surpassed the rates of growth achieved in FY2004. Conversely, the pace of growth slowed in Bangladesh, Bhutan, and Nepal, while the economy of Maldives actually contracted by 5.2% in 2005 due to the combined effects of the damage from the tsunami and rising oil prices.

The services sector remained the main driver of growth in South Asia, expanding at 9.4% in 2005. The industry sector also contributed significantly with 8.9% growth, while the agriculture sector grew by only 4.0%. Due to its consistently high growth rates, the services

Table 2.1. Consumption and Investment in South Asia

	2001	2002	2003	2004	2005
Growth (%)					
Consumption	4.5	1.9	6.1	7.0	6.5
Investment	-0.9	13.6	14.2	10.6	15.1
Share in GDP (%)					
Consumption	78.1	76.5	75.3	74.0	73.0
Private consumption	67.0	65.7	64.9	63.5	62.8
Public consumption	11.1	10.9	10.4	10.5	10.2
Investment	22.3	24.1	25.7	28.1	29.1
Private investment	15.9	18.2	19.3	21.0	21.7
Public investment	6.4	6.0	6.4	7.1	7.4
Net Exports	-1.5	-1.4	-1.6	-2.2	-2.8

sector's share in total output has been steadily increasing over the past few years (Figure 2.2).

In terms of expenditures, annual growth of investment (15.1%) surpassed that of consumption (6.5%) for the fourth consecutive year (Table 2.1). As a result, the share of consumption has been declining continuously during this period—both private and public consumption have contributed to this declining trend.

In 2005 the investment rate in South Asia increased to 29.1%. Private investment in South Asia amounted to 22% of GDP, while public investment stood at 7% of GDP. The growth in investment has primarily been driven by private investment and its share in the total has increased from 71.3% in 2001 to 74.6% in 2005. The positive private sector sentiments in South Asia are also evident from the strong performance of the equity markets in the region (Box 2.1).

Foreign direct investment (FDI) also continued its rapid expansion in 2005. While FDI in South Asia is still a fraction of that in East and Southeast Asia, it amounted to $10.2 billion, up by 43.3% from the previous year. Both the increasing share of private investment in the total and acceleration in FDI underlie South Asia's observed transformation.

The relatively slow growth in consumption expenditures has resulted in improving saving rates. The saving rate reached 27.0% of GDP in 2005, sustaining the upward trend of the past few years (Figure 2.3). The saving rate is gradually approaching that in the newly industrialized economies (32.2%) and ASEAN (29.8%). Compared to 2001, the saving rate in South Asia has increased by about 5 percentage points. Both public and private sectors have contributed to this positive trend. The public sector reduced the amount of dissaving from 5.6% to 2.4%

Figure 2.2. Services-Driven Growth

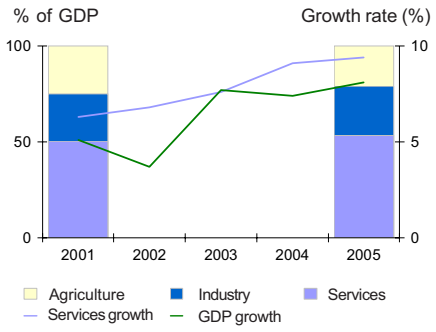
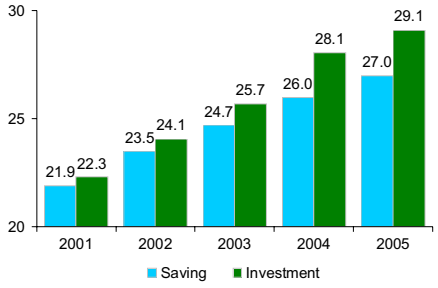


Figure 2.3. Saving and Investment Rates in South Asia (%)

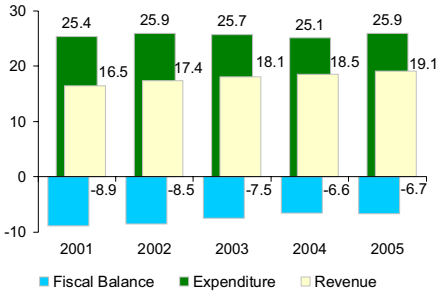


of GDP during 2001–2005. Over the same period, private saving as a share of GDP increased from about 27.5% to 29.3%.

Following the significant reductions in the fiscal deficit during the previous 2 years, the deficit as a percentage of GDP—at 6.7% in 2005—was marginally higher than in 2004 (Figure 2.4).

In India, the federal fiscal deficit at 4.1% of GDP in FY2005 was slightly higher than in the previous year; however, a number of Indian states continued fiscal consolidation efforts, and the overall combined fiscal deficit is estimated to have remained unchanged at 7.5% in FY2005. Afghanistan and Nepal achieved a significant reduction in the budgetary deficit in 2005. The other South Asian countries pursued expansionary fiscal policies, reflected in an increase in their fiscal deficits. Pakistan, having successfully implemented a stabilization program from FY2001 to FY2004, adopted an expansionary fiscal policy to accelerate growth and increase spending on infrastructure and pro-poor sectors. Its fiscal deficit increased to 3.3% of GDP in FY2005. Bangladesh also followed an expansionary policy, and its fiscal deficit was marginally higher at 3.4% of GDP. In Bhutan, the fiscal deficit increased to 10.7% of GDP in FY2005 because of large one-off capital expenditures. Sri Lanka also had a large and rising fiscal deficit (9.0% of GDP, including 1.4% due to tsunami-related expenditures) in 2005. In Maldives, the combined effects of the tsunami-related expenditures, government salary increases, and subsidies resulted in a sharply higher fiscal deficit (12.2% of GDP) in 2005.

Figure 2.4. Fiscal Performance
(% of GDP)



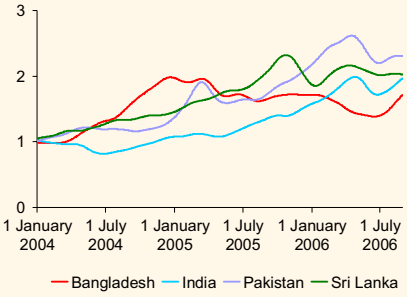
Box 2.1. Stock Market Developments

The recent impressive growth in South Asia and improved profitability of businesses are reflected in the buoyant stock markets in South Asia (Box figure). Leading indexes of stock markets in India, Pakistan, and Sri Lanka, have risen sharply from January 2004 to August 2006. The indexes for Pakistan and Sri Lanka have more than doubled in value, while India's share market index is now also approaching a twofold increase.

However, Bangladesh's share market stalled after posting an impressive performance in 2004. Due to the recent recovery, Bangladesh's market index has increased by about 75% since the beginning of 2004.

Investor concerns about rising inflation in the United States triggered a global market correction that adversely affected stock markets worldwide, including South Asia, from mid-May to mid-June 2006. Since June, South Asia's markets have partly recovered from the downturn.

Daily Stock Market Index (trend)
1 January 2004 = 1

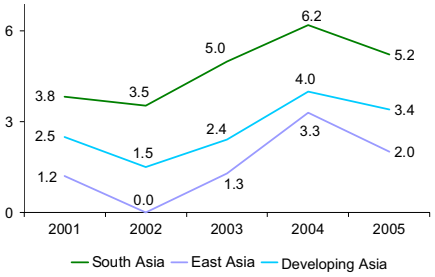


Sources: Datastream; ADB staff estimates (see Statistical Notes).

Inflation and Monetary Policy

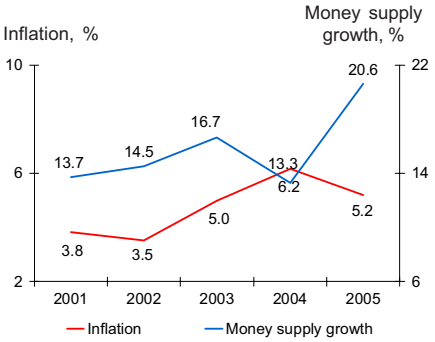
Inflation in South Asia declined in 2005, after rising sharply during the previous two years (Figure 2.5). Average inflation in South Asia slowed to 5.2% in 2005, which was largely due to a two percentage point decline in inflation in India. Inflation in Afghanistan and Maldives also slowed while the other countries posted higher inflation rates. Pakistan's and Sri Lanka's price levels increased most significantly, at 9.3% and 10.6% respectively. Overall, South Asia had a higher rate of inflation than did East Asia or Asia as a whole. Inflation in the region can be attributed to two factors in recent years: high world oil prices and the rapid rate of economic expansion driven by strong domestic demand.

Figure 2.5. Inflation in Developing Asia (%)



Most South Asian countries followed accommodative monetary policies, with money supply expanding rapidly in 2005 following the significant slowdown during the previous year (Figure 2.6). This may have occurred as monetary authorities perceived that inflationary pressures had abated, creating an environment favorable for monetary expansion geared toward economic growth.

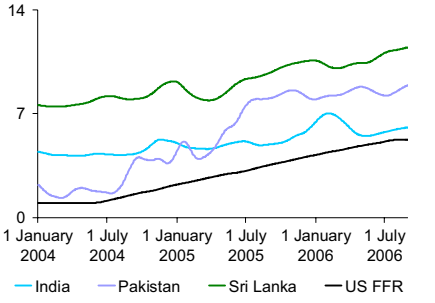
Figure 2.6. Inflation and Money Supply Growth



In India monetary growth increased sharply to 21.3% in FY2005. In Pakistan and Sri Lanka, monetary growth also remained high, at 19.3% and 19.1% respectively. Generally in all countries, expansion in money supply was driven by strong growth in private sector credit. Particularly in Pakistan and Sri Lanka, credit growth was fueled by negative or very low real interest rates resulting from high inflation.

In response to rising inflation, Pakistan and Sri Lanka raised the policy rates in FY2005. However, this seemed to have had little impact on the growth of monetary aggregates, which remained high. Also the United States (US) Federal funds rate has been gradually rising since mid-2004 and the spreads between the US and South Asian countries have moved diversely (Figure 2.7). In Sri Lanka, the spread between the call money rate and the US Federal funds rate has remained largely constant—ranging between 6% and 7%—with both rates trending up at the same pace. In Pakistan, the spread increased considerably in FY2005 from less than 1% to more than 3% around mid-2005, while India showed a decreasing spread with the US Federal funds rate from over 3% to less than 1% in mid-2006.

Figure 2.7. Short Term Interest Rates (%, trend)



Notes: The following short term interest rates are displayed: India: call money rate; Pakistan: 1–7-day repo rate; Sri Lanka: call money rate; US: Federal funds rate (FFR).
Sources: Datastream; ADB staff estimates (see Statistical Notes).

External Sector

Strong export growth of 24.3% was recorded in 2005 (Table 2.2). Export growth was particularly strong in India at 27.5%, followed by Bhutan (18.0%) and Pakistan (16.8%). Imports also continued to grow rapidly. After posting exceptionally high growth of 40.4% in 2004, imports increased by another 30.3% in 2005. The rising price of oil was an important factor in the high growth rate of imports (Box 2.2, pp. 8–9). In both India and Pakistan imports grew rapidly, at 31.6% and 39.6% respectively. In Bhutan, the purchase of two aircrafts boosted imports by 67.6%.

Table 2.2. Growth of Merchandise Trade in South Asia (%)

	2001	2002	2003	2004	2005
Exports	0.1	12.9	20.4	21.4	24.3
Imports	-1.7	7.9	21.4	40.4	30.3

With imports growing faster than exports, trade deficits are common to all countries within the region. As a whole, South Asia maintains an overall trade deficit against the rest of the world. While total exports to countries outside the region increased by over $26 billion during the year, imports from these countries increased by almost double this amount, resulting in an overall trade deficit in excess of $63 billion in 2005 (Figure 2.8). Sharp increases in the price of oil and strong domestic demand contributed to the increasing deficit.

Trade in services continues to gain significance in South Asia. Three of the eight countries in South Asia are net exporters of services. India's services receipts, relative to GDP, increased by 1 percentage point to 7.6% in FY2005 due to the rapid growth in export of information technology (IT) and IT-enabled services and earnings for business process outsourcing. Maldives' export of services, primarily tourism-related, declined significantly, to 41.4% of GDP in 2005. Sri Lanka's services exports also declined, to 6.5% of total output, in the wake of the tsunami (Table 2.3).

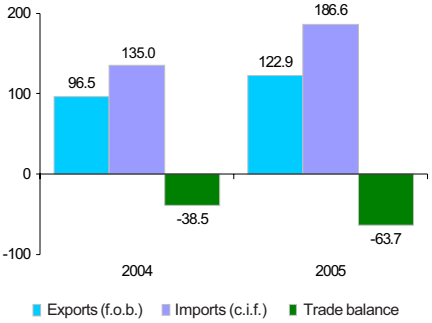
The services account surpluses offset part of the merchandise trade deficits in the current accounts of these net service exporting countries. Another mitigating factor was the further increase in workers' remittances, which climbed by almost $5 billion to over $35 billion. Nevertheless, the average current account deficit in South Asia increased from 0.5% of GDP in 2004 to 1.4% in 2005 (Figure 2.9).

Rising capital flows into South Asia are becoming more important in the balance-of-payments dynamics. The influx of foreign capital continued to gain momentum. In 2005, net capital flows increased by 52.7% to $21.4 billion. Of this, FDI amounted to $8.2 billion (gross FDI was $10.2 billion), while portfolio investments totaled $13.1 billion.

Table 2.3. Services Receipts (% of GDP)

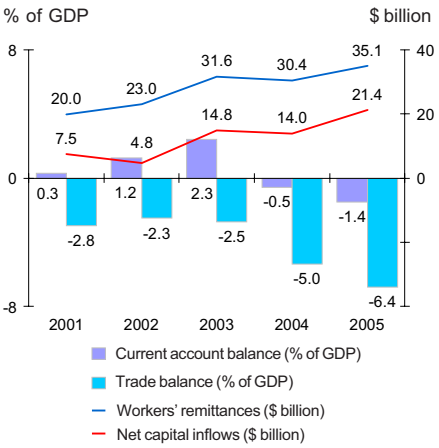
	2001	2002	2003	2004	2005
South Asia	3.4	3.9	4.3	6.0	6.7
Net Service Exporting Countries					
India	3.6	4.1	4.5	6.6	7.6
Maldives	56.6	56.6	62.4	65.3	41.4
Sri Lanka	8.6	7.7	7.7	7.6	6.5

Figure 2.8. Trade Balance of South Asia
($ billion)



Sources: International Monetary Fund Direction of Trade Statistics (DOTS) CD-ROM (May 2006); ADB staff estimates.

Figure 2.9. Balance of Payments



Box 2.2. Oil Prices and the Balance of Payments

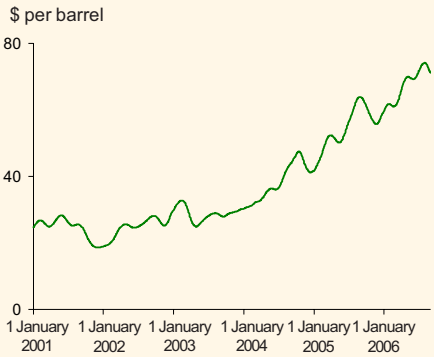
Oil prices have risen rapidly since the start of the current oil crisis in 2003 (Box figure). As of 31 August 2006 the price of Brent crude oil stood at $67 per barrel, more than twice of that in 2003. The rising oil price has been driven by strong demand in countries of the Organisation for Economic Co-operation and Development (OECD) and in fast growing emerging economies like the People's Republic of China and India. Expectations of constrained future oil supply have also put significant upward pressure on oil prices. The Energy Information Administration predicts that oil prices will remain high for the foreseeable future.[1]

Rising oil prices have hit South Asia especially hard. South Asia is highly dependent on oil imports, with one of the lowest oil self-sufficiency indexes and a relatively energy intensive economy. The Box table shows the estimated impact of the rise in oil prices on major South Asian economies.[2] In all the countries oil import expenditure in 2005 was about twice that in 2003, except for Pakistan which was able to partly substitute imported oil with domestically produced natural gas and coal. The four countries together spent an additional $14.3 billion on oil imports in 2005. Oil import expenditure as a percentage of GDP increased dramatically in 2005, to 7.0% in Sri Lanka, 5.5% in India, 3.7% in Pakistan, and 2.7% in Bangladesh. More than 20% of export earnings in India, Pakistan, and Sri Lanka and 16.4% in Bangladesh went toward paying for oil imports.

For Bangladesh and India, the expenditure on additional oil imports was greater than the current account deficit, and were it not for the rise in oil prices they might have had small current account surpluses. The additional oil imports accounted for about 85% of the current account deficit for Sri Lanka and 49% for Pakistan in 2005.

Despite a heavy burden on the current account balance, growth in South Asia has been quite resilient in the face of high oil prices. The pressure on the balance of payments in the region was mitigated by strong export growth, increasing inflow of foreign capital, and rising workers' remittances. In addition, most South Asian countries have to a great extent shielded the domestic economy from higher fuel prices through subsidies or reduction in taxes and duties on petroleum products, particularly on (1) diesel, to limit the impact on transportation; and (2) kerosene and liquefied petroleum gas (LPG), which are widely used as domestic cooking fuel. However, this policy may not be sustainable given that oil prices are expected to remain high, and it could lead to a buildup of inflationary expectations and jeopardize the hard won recent gains in fiscal consolidation.

World Crude Oil Price (trend)



Sources: Energy Information Administration, available: http://www.eia.doe.gov/emeu/international/prices.html#Crude, downloaded 2 September 2006; ADB staff estimates (see Statistical Notes).

[1] Annual Energy Outlook 2006 with Projections to 2030, Report #:DOE/EIA-0383(2006), available: http://www.eia.doe.gov/oiaf/aeo/forecast.html#wop, downloaded 3 September 2006.

[2] The impact is understated for Bangladesh and Pakistan since FY2005 is from July 2004 to June 2005. For example, in Pakistan, oil imports in 2005 grew by $0.9 billion on an FY basis but by $1.5 billion on a calendar year basis.

Impact of Rising Oil Prices (Major South Asian Economies, 2003–2005)

Country	2003	2004	2005
Bangladesh			
Total Oil Imports			
($ million)	887	1,022	1,602
(% of exports of goods and services)	12.0	12.1	16.4
(% of GDP)	1.7	1.8	2.7
Additional Oil Expenditure because of Rising Oil Prices			
($ million)	164	135	580
(% of GDP)	0.3	0.2	1.0
(% of current account deficit)	*	*	104.1
India			
Total Oil Imports			
($ million)	20,570	29,844	44,000
(% of exports of goods and services)	22.1	23.3	26.6
(% of GDP)	3.4	4.3	5.5
Additional Oil Expenditure because of Rising Oil Prices			
($ million)	1,107	7,959	12,349
(% of GDP)	0.2	1.1	1.5
(% of current account deficit)	*	147.4	116.4
Pakistan			
Total Oil Imports			
($ million)	3,066	3,167	4,081
(% of exports of goods and services)	22.1	20.7	22.4
(% of GDP)	3.7	3.2	3.7
Additional Oil Expenditure because of Rising Oil Prices			
($ million)	451	489	867
(% of GDP)	0.5	0.5	0.8
(% of current account deficit)	*	*	48.6
Sri Lanka			
Total Oil Imports			
($ million)	838	1,209	1,655
(% of exports of goods and services)	12.8	16.6	21.0
(% of GDP)	4.6	6.0	7.0
Additional Oil Expenditure because of Rising Oil Prices			
($ million)	154	285	552
(% of GDP)	0.8	1.4	2.3
(% of current account deficit)	216.4	44.0	84.9

Notes: "Additional oil expenditure because of rising oil prices" is calculated as the difference between current oil import expenditure and estimated current expenditure at the previous year's oil price, taking into account the change in volume. To calculate the estimated figures, it is assumed that the composition of oil imports (petroleum products and crude oil) is relatively unchanged over the years.
* Denotes current account surplus.
Sources: A*sian Development Outlook* (*ADO*) and *ADO Update 2005*; Reserve Bank of India; State Bank of Pakistan; Central Bank of Sri Lanka; Bangladesh Bank; CEIC database; and ADB staff estimates.

Table 2.4. Gross International Reserves

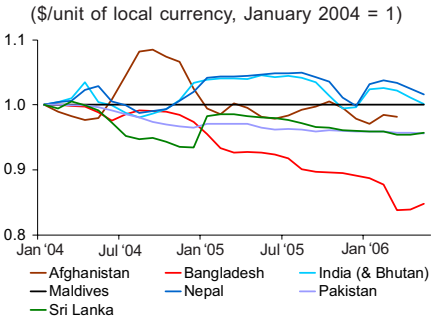
	2001	2002	2003	2004	2005
South Asia ($ billion)	59.8	85.2	129.0	159.0	169.1
Growth (%)	26.6	42.4	51.4	23.3	6.4

The rising inflows of FDI and portfolio investments contributed to the capital account surpluses, which have more than financed the current account deficits and thus contributed to the increasing foreign exchange reserves. Gross international reserves grew by $10.0 billion, representing a 6.4% increase from the previous year (Table 2.4). The level of international reserves in South Asia climbed to $169.1 billion at end-2005.

Currencies in South Asia have generally been stable against the US dollar. The exception is the Bangladeshi taka, the value of which has continued to decline (Figure 2.10). The Indian rupee has been the strongest currency in the region since 2005, but two episodes of sharp depreciation have caused its value to slip back to its January 2004 level. The Bhutanese ngultrum and the Nepalese rupee also remained strong, as Bhutan continued to maintain a parity peg of the ngultrum with the Indian rupee, while the nominal value of the Nepalese rupee is also closely anchored to the Indian currency. The Maldivian rufiyaa has maintained its fixed value against the US dollar since July 2001. Pakistan and Sri Lanka have allowed a relatively small nominal depreciation against the US dollar as high inflation in these countries caused real currency appreciation.

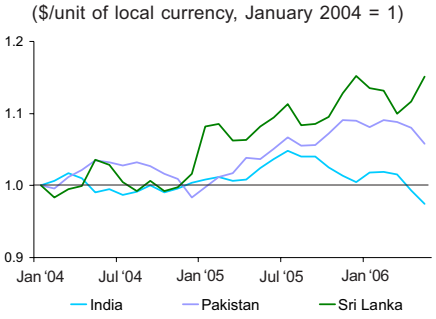
In terms of real effective exchange rates, the currencies of Pakistan and Sri Lanka have been appreciating since December 2004, although the former has depreciated somewhat lately. The Indian rupee has been remarkably stable, with some appreciation in early 2005 followed by a depreciation since the third quarter of 2005 (Figure 2.11).

Figure 2.10. Index of Nominal Exchange Rate



Sources: International Monetary Fund International Financial Statistics Online database, available: http://ifs.apdi.net/, downloaded 2 September 2006; ADB staff estimates.

Figure 2.11. Index of Real Effective Exchange Rate



Notes: India's real effective exchange rate (REER) is computed using 36-currency export-based weights; For Pakistan, the REER is derived using a weighting scheme based on bilateral trade in manufactures and primary commodities for 20 countries; Sri Lanka's REER uses bilateral trade weights for 24 partner countries.
Sources: *Reserve Bank of India Bulletin* (14 August 2006), available: http://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/72008.pdf, downloaded 5 September 2006; International Monetary Fund International Financial Statistics Online database, available: http://ifs.apdi.net, downloaded 5 September 2006; Central Bank of Sri Lanka website: http://www. centralbanklanka.org/reer24.html, downloaded 5 September 2006.

Regional Outlook and Risks

Outlook

The outlook for the global economic environment remains strong in 2006 and 2007. Growth of the world economy is expected to continue at a robust pace (4.9%) in 2006, as the major economies are likely to remain buoyant. Growth may slow modestly to 4.7% in 2007. The US economy is expected to grow at 3.3% and 2.8% in 2006 and 2007 respectively, compared to 3.2% in 2005 (Table 2.5). Japan will see higher growth (2.8%) in 2006, before slowing down to 2.4% in 2007. The Euro Area, on the other hand, is expected to post around 2.0% growth

Table 2.5. GDP Growth in Selected Economies (%, 2001–2007)

Economy	Actual		Forecast	
	2001–05	2005	2006	2007
United States	2.4	3.2	3.3	2.8
Euro Area	1.2	1.3	2.3	1.8
Japan	1.3	2.6	2.8	2.4
Central Asia	10.3	10.9	11.3	10.3
East Asia	7.2	7.9	8.2	7.5
South Asia	6.4	8.1	7.5	7.5

Sources: US Bureau of Economic Analysis website: http://www.bea.gov/bea/dn/nipaweb/SelectTable.asp?Selected=N, downloaded 6 September 2006; *Asian Development Outlook* (*ADO*) various issues, *ADO Update 2006,* and ADB staff estimates.

through 2007, up significantly from 1.3% in 2005. Inflationary pressures of increasing world oil prices are seen to persist across the world economy but at a rather moderate pace. Growth in international trade (goods and services) will accelerate to 11.0% in 2006, before moderating in 2007 to a still healthy pace of 8.0%. External demand for the region's exports is likely to be boosted as growth in the major export markets remains robust or strengthens.

Within this context, growth prospects for South Asia for 2006 and 2007 remain bright, due to strong domestic demand and robust investment in the region. South Asia is seen to maintain its strong GDP growth performance at 7.5% in 2006 and 2007, albeit slightly weaker from last year's historic high GDP growth (8.1%).

South Asia sustained rapid economic growth in early 2006. Initial estimates for FY2006 reveal strong GDP growth for Bangladesh (6.7%) and Pakistan (6.6 %). Meanwhile, Sri Lanka posted an impressive GDP growth of 8.1% in the first quarter of 2006, exceeding the 6.1% forecast for 2006. In India, most business expectation and confidence surveys indicate that the growth momentum in the Indian economy is likely to be maintained in FY2006. The estimated GDP growth of 8.9% in the first quarter of FY2006 in India also exceeds the 7.8% forecast for FY2006. All South Asian economies, except Afghanistan and Nepal, are expected to see GDP growth in 2006 above the 2001–2005 average. Maldives is expected to recover from its economic contraction in 2005 following the tsunami, with growth in 2006 projected at 18.7%

Strong economic growth in the region is seen to continue through 2007. India is projected to maintain its robust growth at 7.8% because of strong domestic demand, rising investment, and continued rapid export growth, particularly that of IT and business processing outsourcing services exports. Growth of the Pakistan economy is expected to accelerate to 7.0% in 2007 as a result of a recovery in the

agriculture sector. The Bhutan economy is likely to strengthen its growth momentum in 2007 to 12.0%, as the new Tala Hydropower Project comes on line, and Nepal is also expected to post above-trend growth. Meanwhile, economic growth for the rest of South Asia is seen to continue in 2007, albeit at a less pronounced pace than projected in 2006. Over the medium to long term, South Asia could sustain or even accelerate its growth with India and further regional economic integration, providing momentum for the higher growth (Box 2.3).

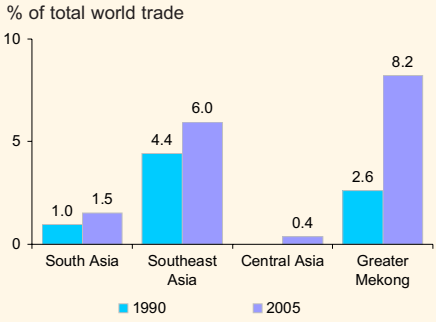
Box 2.3. India as the Engine of South Asian Economic Growth

India is by far the largest economy in South Asia. In 2005, India accounted for about 80% of South Asia's GDP, trade, and regional growth. Therefore, the current accelerated growth of the Indian economy will naturally have positive externalities for the neighboring countries. Proactive policies to increase economic integration with other South Asian countries could multiply these benefits many fold, and the impact on the economic development of the neighboring countries could be dramatic. The political implications of a more economically integrated and rapidly developing South Asia for the countries in the region could be a major additional benefit.

In the last 15 years, South Asia has been increasingly integrated with the rest of the world, but significant scope for further expansion of trade remains, as is evident from the trade ratios of other Asian subregions such as Southeast Asia and the Greater Mekong region (Box figure 1). In 2005 South Asia's share in total world trade was one quarter of Southeast Asia's share, and less than one fifth of that of the Greater Mekong region. Also in terms of intraregional trade, despite the increase, South Asia is lagging far behind Southeast Asia (Box figure 2).

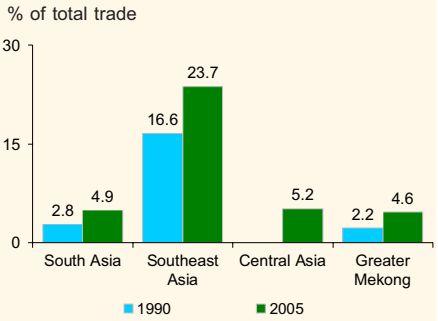
Expansion of intraregional trade offers immense opportunities for sustaining high growth and reducing poverty in South Asia. Because South Asian economies have largely similar export baskets, the economies could expand trade by promoting intra-industry trade in the region. For example, most South Asian countries are large exporters of intermediate and finished clothing and textile goods. The region could gain greatly if South Asian countries cooperate strategically to enhance efficiency, improve product quality, and increase value. As India shares borders with most South Asian countries and has good marketing capability and linkages in the major importing countries, it could become a hub for spurring the growth of intra-industry trade in the South Asia region. With its central location and size, India could serve as an assembly and exit point of high value South Asian goods, as well as services, for both domestic and international markets. Intra-industry trade could also be boosted by greater cross-border foreign direct investment.

Box figure 1. Total Trade Ratio
(1990 and 2005)



Notes: Total trade ratio is defined as the average percentage share of total exports and imports of the relevant subregion to world trade. Data used are on a calendar year basis. No 1990 data available for Central Asia.
Sources: International Monetary Fund Direction of Trade Statistics (DOTS) CD-ROM (May 2006); ADB staff estimates.

Box figure 2. Intraregional Trade Ratio
(1990 and 2005)



Notes: Intraregional trade ratio is defined as the average percentage share of total exports and imports within the subregion to total exports and imports of the relevant subregion. Data used are on a calendar year basis. No 1990 data available for Central Asia.
Sources: International Monetary Fund Direction of Trade Statistics (DOTS) CD-ROM (May 2006); ADB staff estimates.

Singapore, with its open economy and efficient trade handling and marketing capability, plays such a role for Southeast Asia. Singapore sources intermediate goods from the other Southeast Asian countries and exports high value goods within and outside the region. Singapore's intra-Southeast Asian trade alone is more than five times the total intra-South Asian trade (Box table). The key to the rapid expansion of intraregional trade in the ASEAN region has been collective action under the ASEAN Free Trade Agreement's (AFTA) framework. The reduction in tariffs, elimination of nontariff barriers, and simplification and harmonization of customs procedures have played an important part in this success.

However, in South Asia, obstacles to trade remain high. While tariff concessions have been issued under the South Asian Preferential Trade Agreement and despite the recent ratification and implementation of South Asia Free Trade Agreement (SAFTA), issues such as complicated customs procedures at borders make intraregional trade difficult and costly. High nontariff barriers may be one of the reasons for the low level and asymmetric pattern of intraregional trade in South Asia. Therefore, attention to behind-the-border issues is crucial to India's development as the regional hub and to achieving deeper regional integration in South Asia.

The experience of successful regional trade blocs demonstrates that trade liberalization can benefit all participants. In South Asia, India's development into a regional hub would attract additional foreign direct investment into India and from India to other South Asian countries, thus boosting economic growth in the entire region. The strong backward linkages that South Asian countries would develop with India would in turn translate into greater demand for Indian imports from the rest of South Asia, thereby further boosting growth in India. In brief, India is not only crucial for the success of regional trade cooperation in South Asia; it could also transform the development and growth pattern of the entire region.

Intraregional Exports and Imports
($ billion, 2005)

	Exports	Imports
South Asia	7.6	7.9
India	5.2	1.1
(% of South Asia)	69.2	13.9
Southeast Asia	145.7	152.7
Singapore	49.4	41.5
(% of Southeast Asia)	33.9	27.2
Greater Mekong	35.0	45.0
PRC	15.0	16.9
(% of Greater Mekong)	43.0	37.5

Notes: Data used are on a calendar year basis. Figures may not add-up due to rounding. Discrepancies between intraregional exports (imports) are due to inconsistencies between data provided by the reporting and partner countries.
Sources: International Monetary Fund Direction of Trade Statistics (DOTS) CD-Rom (May 2006); ADB staff estimates.

Inflation, as measured by year-on-year percentage change in consumer price index (CPI), is expected to increase to 6.0% in 2006 from 5.2% in 2005 due to continued strong domestic demand (Table 2.6). In India, inflation has picked up significantly in 2006 and the Reserve Bank of India has raised the policy interest rates three times since March 2006. In Pakistan, there was some monetary tightening in FY2006 and money supply growth was reduced to 15%. The State Bank of Pakistan (SBP) has stepped up its tight policy stance for FY2007 and it raised the reserve requirements and the policy rates in July 2006.

In 2007, inflation in South Asia is seen to moderate to 5.4%, as tighter monetary policies will take effect. However, inflation will remain above trend as the cost of sustained high world oil prices is gradually passed through to domestic oil prices.

Table 2.6. Other Macroeconomic Indicators (South Asia, 2001–2007)

	Actual		Forecast	
	2001–2005	2005	2006	2007
Inflation Rate (%)	4.8	5.2	6.0	5.4
Exports Growth (%)	15.8	24.3	18.8	18.6
Imports Growth (%)	19.7	30.3	25.0	19.3
Trade Balance				
($ billion)	-31.8	-63.8	-87.1	-105.2
(% of GDP)	-3.8	-6.4	-7.8	-8.4
Current Account Balance				
($ billion)	1.7	-14.0	-24.4	-27.4
(% of GDP)	0.4	-1.4	-2.1	-2.1

Sources: *ADO Update 2006*; ADB staff estimates.

Both trade and current account deficits are seen to expand in 2006 and 2007 as growth in merchandise imports continues to outpace growth in merchandise exports. Growth in exports is seen to decelerate from 24.3% in 2005 to 18.8% in 2006 and 18.6% in 2007, while growth in imports is also seen to slow toward its medium term trend, to 25.0% in 2006 and 19.3% in 2007 (Table 2.6), largely due to declining import growth in India.

With stronger import than export growth, the region's overall trade deficit is forecast to increase to 7.8% of GDP in 2006 from 6.4% in 2005. The trade deficit is expected to deteriorate further in 2007, to 8.4% of GDP, and the current account deficit is expected to increase to 2.1% of GDP in 2006 and 2007.

In the current economic environment of high oil and commodity prices, it is easy for an economy to run into inflation and balance-of-payments problems. Thus the countries with relatively high inflation and increasing current account deficits must closely monitor their real exchange rates and be prepared to take appropriate policy action to prevent erosion of competitiveness. Since growth in South Asian countries is largely driven by domestic demand and current account deficits are growing, the task of achieving a policy balance between the needs for sustaining growth and for maintaining price stability and external balance will be difficult. Thus, fiscal, monetary, and exchange rate policies have to be carefully crafted to achieve the appropriate balance.

Risks

High and volatile world oil prices, the possibility of a disruptive adjustment of global payments imbalances, and the threat of an avian flu pandemic are the major economic risks to the favorable growth prospects for the global economy as well as South Asia.

A major risk to sustaining the high growth rates in South Asia is the high and volatile international oil price. South Asian countries have been fairly successful in insulating their economies (in terms of growth and the impact on the poor) from the adverse effects of the high oil prices thus far, by only partially passing through the increase in international oil prices. But the continuing rise in energy prices is making this policy increasingly difficult to sustain. With oil prices likely to stay high for an extended period, South Asian countries could greatly benefit from well-structured energy policies.

To increase economic resilience and reduce regional dependence on external sources of energy, especially oil, South Asian countries need to design and implement effective energy policies aimed at reducing excessive long-term demand while supporting the development and expansion of local energy supply. Although actual policy requirements may differ from country to country, in general, substantial improvements in energy efficiency could be achieved through appropriate pricing policies, including cutting energy subsidies. Efforts at enhancing regional cooperation in development of the region's energy resources, and development of regional distribution networks that open up the possibility of cost effective transfers of power and gas from countries with an energy surplus to countries with an energy deficit, should also be explored.

A sudden and disruptive correction of growing global payments imbalances, which may abruptly check capital flows and increase the cost of funds for developing countries, may pose a substantial additional risk, particularly for South Asian countries with increasing current account deficits.

Increased political uncertainty, within as well as outside the region, could dampen the favorable growth prospects. Political uncertainties within the region include increasing security concerns in Afghanistan, election-related uncertainty in Bangladesh, a reversal of the positive developments in Nepal, and an escalation of civil conflict in Sri Lanka. Outside the region, escalating costs related to international terrorism are an important risk. Finally, although an avian flu pandemic is not likely in the immediate future, such an event would pose a serious risk to the global economy. Concerted efforts to mitigate the threat of such a pandemic are being pursued simultaneously by health agencies at international, regional, and national levels.

3. BANKING, GOVERNANCE, AND INVESTMENT CLIMATE

A strong banking sector is crucial for both avoiding financial crises, which can threaten macroeconomic stability, and for providing the private sector with ready access to finance, which is essential for it to play its role as the driver of growth. The progress made in strengthening and deepening the banking sector in South Asia since the early 1990s is discussed in the first part of this section (due to the availability of data, this section mainly discusses Bangladesh, India, Nepal, Pakistan, and Sri Lanka). Good governance and a healthy investment climate are also important factors in sustaining growth performance. They provide an enabling environment for the domestic private sector and for attracting foreign investment. The discussion in the second part of this section focuses on areas of governance and the investment climate that have a large potential for improvement to further accelerate economic growth in South Asia.

Banking Sector Vulnerability and Reforms

A strong financial sector plays a vital role in channeling funds to productive investment projects and in promoting economic efficiency. A healthy banking sector is particularly important in developing countries, where capital markets are less developed. In the South Asian subregion, the total assets of the banking sector account for about 70% of total financial sector assets. Thus, the strength and stability of the banking sector in these countries have major implications for the efficiency and stability of the regional economy.

To enhance the soundness of the financial system, widespread financial reforms, in particular banking sector reform, have been carried out across South Asia. Reforms in the banking sector consisted of deregulating interest rates, restructuring and privatizing state-owned banks, allowing the entry of private sector banks, easing restrictions on foreign banks, reducing directed lending, and shifting the focus of banking sector supervision from micro-intervention toward prudential regulation. As a result, the financial repression of the previous decades has receded, and the banking sector has become stronger.

The benefits of reforms are borne out by banking sector performance indicators: financial intermediation has been enhanced, the ratio of

nonperforming loans (NPLs) to total loans has fallen, the capital adequacy ratio (CAR) has increased, and profitability has risen. The banking sectors in South Asia have not only improved their performance over the recent past, but have also reduced the performance gap between themselves and other economies in Asia. This section provides an overview of the banking sector's performance in South Asia during recent years.

Deposits and Credit

A measure of the success of banking systems at providing financial services, in the form of payment services and saving instruments, is their capacity to attract deposits. Growth in deposits has been strong in most economies (Figure 3.1; for more details see Appendix Table A20). Steady growth in deposit has enhanced the ability of banks to intermediate funds from savers to investors, and the growth in banking sector domestic credit has also been strong during this period.

As a result, the average bank deposits-to-GDP and domestic credit-to-GDP ratios have increased in most South Asian economies during recent years. India has been particularly impressive with ratios of around 60% of GDP in 2005 (figures 3.2 and 3.3). Despite this, the ratios in South Asian economies are generally lower than those in East and Southeast Asian economies, indicating relatively weaker capacity in banking intermediation.

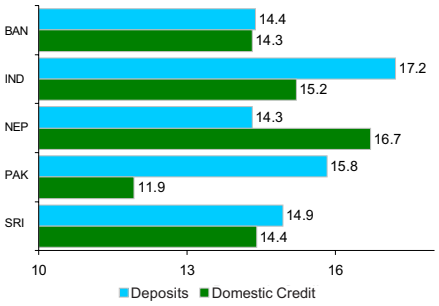
Capital Adequacy Ratios

Capital adequacy reflects the overall position of bank capital. Adequate capital helps in absorbing financial risks and protects depositors from losses that a bank might incur.

Risk-weighted CARs of banks in most South Asian economies have improved in recent years. In India, the average banking sector CAR increased to 12.8% in FY2004. In Pakistan, the phenomenal increase in the volume of credit since 2003 has not hampered the improvement in financial health of banks. The average banking sector CAR increased from 4.5% in 1997 to 10.9% in 2005. In Sri Lanka, the average CAR for the licensed commercial banks improved from 10.3% in 2004 to 12.4% in 2005. The average CAR of state-owned commercial banks in Sri Lanka increased from 2.9% in 2001 to 5.5% in 2004, and that of domestic private banks increased from 10.5% to 11.1%.

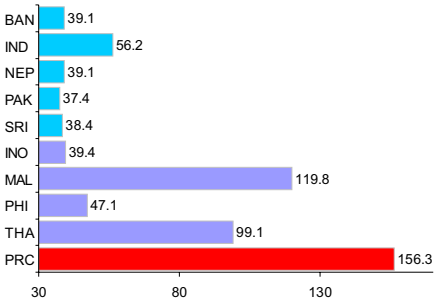
In Bangladesh, the banking sector's average CAR rose from 6.7% in 2000 to 8.7% in 2004. However, the four state-owned commercial banks could not attain the required level, while a number of private and other banks also failed to maintain the required CAR. In Nepal, the dire situation of under-capitalization in the banking sector has been mitigated somewhat but remains serious. The overall CAR changed from -12.0% in FY2003 to -2.6% in FY2005. The overall CAR has been

Figure 3.1. Growth in Bank Deposits and Credit
(%, annual average, 1996-2005)



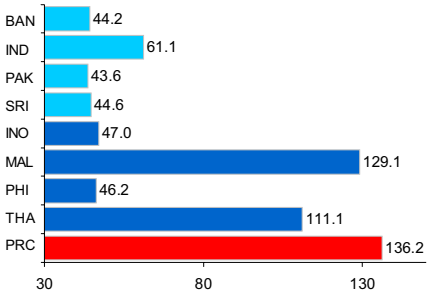
Notes: Deposits growth data for Nepal and Sri Lanka are from 1996 to 2004 only; available domestic credit growth for Nepal is from 1996 to 2000 only.
Sources: International Monetary Fund International Financial Statistics Online database, available: http://ifs.apdi.net/, downloaded 3 August 2006; ADB staff estimates.

Figure 3.2. Deposits-to-GDP Ratio
(%, 2005)



Note: Data for Nepal refers to 2004.
Source: International Monetary Fund International Financial Statistics Online database, available: http://ifs.apdi.net/, downloaded 3 August 2006; ADB staff estimates.

Figure 3.3. Credit-to-GDP Ratio
(%, 2005)

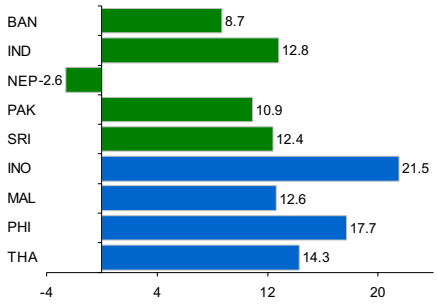


Note: No data available for Nepal.
Source: International Monetary Fund International Financial Statistics Online database, available: http://ifs.apdi.net/, downloaded 3 August 2006; ADB staff estimates.

dragged down by the dismaying figures of Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB), the two largest banks, which account for 50% of banking system deposits. The CAR of NBL changed from -28.3% in FY2003 to -22.2% in FY20005; and that of RBB changed from -44.3% to -35.0% over the same period. CARs for other commercial banks increased to 13.5% in FY2005.

Despite the across-the-board improvement over recent years, CARs in South Asian economies are generally lower than those in their Southeast Asia counterparts. As shown in Figure 3.4, the CARs in emerging Southeast Asian economies are well above the 8% international norm. This reflects improved performance in economic fundamentals, tightened prudential requirements, and the banks' own efforts to reduce risks after the 1997 Asian financial crisis. In some economies, such as Indonesia and the Philippines, high CARs are also attributable to a lack of profitable lending opportunities.

Figure 3.4. Capital Adequacy Ratio of Banks



Notes: Latest available data (as of end): Bangladesh—2004; India—FY2004; Nepal—FY2005; Pakistan and Sri Lanka—2005; Indonesia and Thailand—April 2006; Malaysia—May 2006; Philippines—September 2005.
Sources: Central Bank Annual Report of various countries; *Asia Economic Monitor* (July 2006), available: http://www.aric.adb.org

Nonperforming Loans

An important indicator for asset quality is the NPL ratio (Box 3.1). NPL ratios have improved in the banking sectors in South Asia. In India, net NPLs as a percentage of outstanding net loans declined from 5.5% in FY2001 to 2.0% in FY2004. For public sector banks, the ratio decreased from 5.8% in FY2001 to 2.1% in FY2004, for domestic private banks it declined from 5.7% to 2.2%, while for foreign banks it fell from 1.9% to 0.9% during the same period. In Pakistan, gross NPLs to gross loans decreased from 23.6% in 1997 to 10.6% in 2005. The low interest rate environment has been a major factor in the improvement of the banks' asset quality in recent years. However, the recent rise in interest rates could have a negative impact on the capacity of borrowers to repay their loans in the future.

In Sri Lanka, NPLs as a percentage of gross loans decreased from 9.3% in 2004 to 7.0% in 2005 for licensed commercial banks. NPLs as a percentage of total loans declined from 21.8% in 2001 to 14.2% in 2004 for state-owned banks, from 18.1% to 10.5% for domestic private banks, and from 12.8% to 3.3% for foreign banks over the same period. The reduction in NPLs largely reflects a pick-up in credit but also gains in NPL recovery and favorable economic conditions.

In Nepal, the NPL ratio has improved somewhat but remains a serious problem. The overall ratio declined from 28.7% in FY2003 to 18.7% in FY2005. However, the NPL ratio was still as high as 49.0% in NBL and 50.7% in RBB in FY2005. A critical issue facing these two banks is the need to increase loan recoveries from large and willful defaulters. Banks' efforts to seize collateral from defaulters have been stalled by stay orders issued by the judiciary. New debt recovery mechanisms introduced recently, such as blacklisting directives, the Debt Recovery Tribunal, and an appellate tribunal, have provided financial institutions with additional instruments to deal with NPLs. This has led to some

Box 3.1. Defining Nonperforming Loans (NPLs)

Countries normally adopt the International Monetary Fund's definition that a loan is nonperforming when

(1) the principal and interest payments on a loan are past due by 90 days or more;
(2) at least 90 days of interest payments have been capitalized, refinanced, or delayed by agreement; or
(3) payments are less than 90 days overdue, but there are other good reasons to doubt that payments will be made in full.

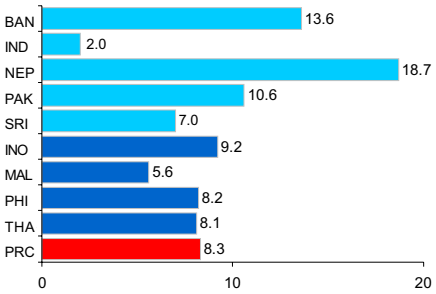
The ratio between the nonperforming loans and total loans is referred to as the "NPL ratio."

recoveries from small- and medium-sized defaulters, but the banks have been reluctant to pursue large cases.

NPLs are also a concern in Bangladesh. The overall NPL ratio has declined from a peak of 41.1% in 1999, although the aggregate ratio was still as high as 13.6% in December 2005. The gross NPL ratio was 21.4% in 2005 for the state-owned commercial banks and 34.9% for development finance institutions (DFIs). The ratios are lower for private commercial banks, at 5.6%, and foreign commercial banks, at 1.3%. The continued high NPL ratios of state-owned commercial banks and DFIs are mainly due to substantial loans provided by them on the basis of noncommercial considerations and under directed credit programs during the 1970s and 1980s. Although lending practices have improved somewhat, many loans are still disbursed that have little commercial merit and minimal subsequent oversight.

While Bangladesh and Nepal remain plagued with very high NPL ratios, the NPL ratios in India, Pakistan, and Sri Lanka are comparable to those in the East and Southeast Asian economies (Figure 3.5).

Figure 3.5 Nonperforming Loans (%)



Notes: Latest available data (as of end): Bangladesh, Pakistan, and Sri Lanka–2005; India–FY2004; Nepal–FY2005; Indonesia and Philippines–April 2006; Malaysia and Thailand–May 2006; PRC–March 2006.
Sources: Central Bank Annual Report of various countries; *Asia Economic Monitor* (July 2006), available: http://www.aric.adb.org

Profitability of Banks

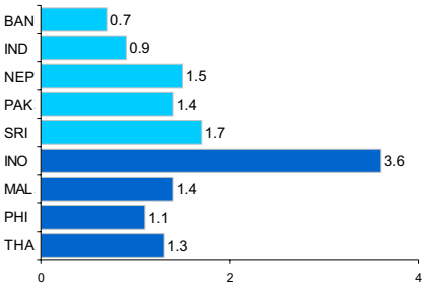
Strong earnings and profitability helped Indian banks build an adequate capital base and finance their operations and expansion. The net profit rate of commercial banks in India increased from 0.8% in FY2001 to 0.9% in FY2004. In particular, the rate for foreign banks increased from 0.7% to 1.3% over the same period. In Pakistan, strong loan growth has boosted profitability. After-tax returns on assets (ROAs) reached 1.4% in the second quarter of 2005—which is a far cry from the chronic losses of 1997–2001. In Sri Lanka, the ROA for licensed commercial banks increased from 1.4% in 2004 to 1.7% in 2005.

Progress has been made in restructuring commercial and development banks in Nepal. The ROA increased from -1.1% in FY2003 to 1.5% in FY2005. External management teams at NBL and RBB have brought about a turnaround, with both banks making profits in FY2004 and FY2005. This was achieved mainly through voluntary retirement schemes to reduce excess staff and reductions in the deposit rates to lower the cost of funds.

In Bangladesh, the overall ROA has increased to 0.7% in 2004 from 0.3% in 2003. However, the ROA of state-owned commercial banks has been very low and turned negative in 2004, while that of the DFIs is even worse. Private commercial banks have had an inconsistent trend, while foreign commercial banks have generally displayed strong profitability.

As a result of improved performance, the profitability of banks in South Asia, as measured by after-tax returns on assets, has become comparable to that of banks in East and Southeast Asian economies (Figure 3.6).

Figure 3.6. Return on Assets (%) **in the Banking Sector**



Notes: Latest available data (as of end): Bangladesh–2004; India–FY2004; Nepal–FY2005; Pakistan–FY2005; Sri Lanka, Indonesia, Malaysia, Philippines, and Thailand–2005.
Sources: Central Bank Annual Report of various countries; *Asia Economic Monitor* (July 2006), available: http://www.aric.adb.org

Prudential Regulations and Basel II

The 1988 Basel Capital Accord, commonly referred to as "Basel I," established the first internationally accepted definition and measure of bank capital, stipulating a capital requirement of 8% of risk-weighted assets. Efforts at prudential regulation reforms in recent years have centered on adopting the Basel II Framework. The Basel II recommendations came into being when the Basel Committee on Banking Supervision published its revised framework in *International Convergence of Capital Measurement and Capital Standards* on 26 June 2006. While Basel I has played an important role in introducing widely accepted rules concerning banking supervision and regulations across the world, advances in technology and the increased sophistication of banking operations during the past two decades have led to calls for more flexible rules in managing banks' risks. The revised Basel Accord, Basel II, aims to establish a more risk sensitive framework on minimum levels of capital for banks.

Basel II incorporates a capital charge for operational risk and three mutually reinforcing pillars in the maintenance of capital adequacy (Box 3.2). The first pillar aligns the minimum capital requirement more closely with banks' actual underlying risks. There are two broad methodologies for calculating bank capital requirements for credit risk. The Standardized Approach measures credit risks with various risk weightings stipulated by the Basel Committee, supported by external credit assessment by external rating agencies or export credit agencies. The Internal Ratings-Based Approach allows banks to use their internal ratings system to determine capital requirements for any given credit risks, subject to the explicit approval of the bank's supervisor and stricter disclosure requirements.

The complexity of implementing Basel II requires banks and their supervisors to significantly strengthen their risk management and supervision capacity. In Asia, Japan is a member of the Basel Committee. Hong Kong, China; Singapore; Taipei,China; and possibly the Republic of Korea have offered to begin implementing all Basel II options by end-2006, broadly in line with the schedule for G10 countries. In addition, India, Indonesia, Republic of Korea, Malaysia, Pakistan, Philippines, and Thailand have indicated that they will adopt Basel II.

Against this backdrop, some of the economies in South Asia have announced schedules for adoption of Basel II (Figure 3.7). Commercial banks in India (excluding regional rural banks) have been required to adopt the Basel II's Standardized Approach for credit risk and the Basic Indicator Approach for operational risk by 31 March 2007. After adequate skills are developed, some banks will be allowed to change to the Internal Ratings-Based Approach. The Reserve Bank of India (RBI) has adopted measures to ensure a smooth transition to Basel II, including appointing a steering committee comprising senior officials from 14 banks and forming an internal working group for identifying eligible domestic credit rating agencies.

Box 3.2. The Three Pillars of Basel II[1]

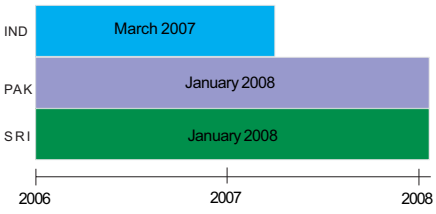
Pillar I —minimum capital requirements to support banks' credit, market, and operational risks

Pillar II—a supervisory review process to foster communications and dialogue between central banks and other banks

Pillar III—market discipline through enhanced disclosure and transparency

[1] The discussion on Basel II in this box and section draws on the note circulated by the Asian Development Bank's Regional and Sustainable Development Department in September 2005, entitled *Information Note on Basel II.*

Figure 3.7. Schedule for Implementation of Basel II Framework



In Pakistan, the State Bank of Pakistan (SBP) has established a road map for implementing Basel II. SBP has prepared detailed instructions for the adoption of various approaches for calculating capital adequacy requirements for credit, market, and operational risks under Pillar I of the Basel II Capital Accord. SBP expects banks to adopt the Standardized Approach for credit risk by 1 January 2008, and Internal Ratings-Based Approach by 1 January 2010. Banks and DFIs are also advised to adopt a parallel run of 1.5 years for the Standardized Approach and 2 years for the Internal Ratings-Based Approach starting from 1 July 2006 and 1 January 2008 respectively. During the transition period, banks will be required to submit quarterly statements on CARs, calculated under both the new and the old systems.

The Central Bank of Sri Lanka (CBSL) has decided to adopt Basel II for all banks in Sri Lanka effective from January 2008. The Standardized Approach will be adopted for calculating credit and market risks and the Basic Indicator Approach will be adopted for calculating operational risk. As a precursor to the implementation of Basel II, CBSL has introduced a capital charge for market risk, based on the standardized measurement method, with effect from 31 March 2006. The banks are required to have a parallel application of the new rules commencing from the first quarter of 2006.

Bangladesh and Nepal have not announced plans to implement the Basel II recommendations in the short term. However, Bangladesh has considerably improved bank regulation (Box 3.3) and a national steering committee led by the Bangladesh Bank has been formed to move forward with implementing Basel II banking standards. In Nepal, efforts are under way to strengthen financial sector supervision, and to raise internal audit and accounting standards.

Despite significant progress, relatively weak risk management capacity and infrastructure in the financial system means that South Asian economies' adoption of the Basel II provisions still present many challenges. Implementation of Basel II relies heavily on the internal risk management systems of banks. The benefits of Basel II can only be realized through improved bank risk management and central bank supervision and regulation capacity.

Other Issues

Despite improved indicators of bank soundness and performance in most South Asian economies, a number of developments warrant careful monitoring of the banks, and continued attention to remaining reform areas is needed.

First, some economies, noticeably those of India and Pakistan, have experienced rapid credit growth in recent years (Appendix Table A20). Rapid growth in lending could lead to a deterioration of asset quality and a buildup of vulnerabilities. Strong bank supervision and tight internal risk management are required to mitigate these risks.

Box 3.3. Improving Regulation of the Banking System in Bangladesh and Nepal

The *Bangladesh Bank* has taken steps to improve the regulatory oversight of the banking system. It has developed and issued guidelines covering core risk management, information technology, consumer and small business lending, and Islamic banking. Provisioning standards have also been tightened through the creation of "special mention" accounts for loans that have become nonperforming after 90 days.

The *Nepal Rastra Bank* (NRB) has made some progress with implementing its financial sector reform strategy since 2002, aimed at "re-engineering" and transforming NRB into an effective central bank.

Second, retail banking, particularly for housing and credit cards, is a new growth area for banks in India and Pakistan. In Pakistan, for example, consumer financing now accounts for over 10% of loans. While NPLs on consumer financing remain below 1% in Pakistan, experience in other countries such as the Republic of Korea indicate that problems can develop quickly. In India, credit card debt should also be carefully monitored. Although still in its infancy, credit card debt rose by 36% in FY2004. Such a rapid rise points to the need for close supervision and consumer education. NPLs from this debt stand at about 8%.

Third, some segments of the banking sector and individual banks remain vulnerable. In each economy, a number of banks are unprofitable, are undercapitalized, and have high NPLs. One particular area of concern for India is the poor state of cooperatives, which account for about 6% of banking system assets. NPL ratios in some rural cooperatives stand at over 35%. While cooperative banks do not present a systemic risk, failures of these banks could impinge on the confidence of the banking system. Strengthening prudential regulations for these cooperatives is therefore important.

Fourth, despite overall improvement in banking performance, the performance in state-owned banks has generally been weaker than that of private and foreign banks. In economies such as those of Bangladesh and Nepal, state-owned banks and development institutions have exerted a major drag on the overall soundness of the financial sector. A major achievement of Pakistan over the past few years has been the transformation of its predominantly state-owned and weak banking system into a healthier, market-based system, owned primarily by the private sector. However, state-owned banks still dominate in a number of economies including those of Bangladesh and India, whose prudential indicators remain less favorable than those of new private and foreign banks despite recent improvements.

Restructuring and privatizing state-owned banks should remain a high priority on the reform agenda. In this regard, RBI's recent effort at increasing public sector banks' autonomy and gradually lifting restrictions on foreign competition is commendable. Measures that would help accelerate foreign participation and spur efficiency gains include bringing forward the 2009 target date for expanding foreign direct investment in domestic banks to include non-distressed banks and lifting the 10% cap on voting rights—the latter is contemplated under amendments to India's Banking Act currently in Parliament.

Governance and Investment Climate

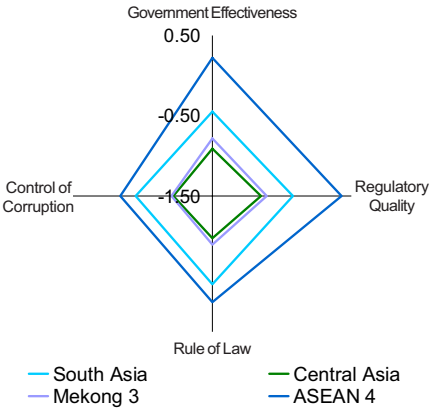
Most economists would agree that sustained economic growth is the surest way to fight poverty. There is considerable evidence, both at the macro and the micro levels, that good governance and a competitive investment climate are important in achieving and sustaining high growth rates. Therefore, to sustain the recent strong growth performance over the longer term, it is important for South Asia to continuously improve governance and competitiveness through appropriate policies, reforms, and investments.

In a recent ADB Working Paper, Hasan et al. (2006) examine the relationship between poverty, economic growth, and indicators of business regulations and governance. They find that "good governance, as measured by a strong commitment to the rule of law, a competent and efficient government sector, and control of corruption matters for poverty reduction largely through effect on growth." They also find that less cumbersome regulations governing private sector operations matter for economic growth as well as poverty reduction more directly.

In another paper, Dollar et al. (2005), take a firm-based approach to address the question "why some locations in the developing world grow so rapidly, while others stagnate." Their hypothesis is that differences in the investment climate across locations explain much of the variation in growth rates. Investment climate can be defined as those factors that determine "the effective functioning of product markets, financial and non-financial factor markets, and infrastructure services, including, in particular, weaknesses in an economy's legal, regulatory and institutional framework" (IBRD 2003). Dollar et al. focus on the impact of the investment climate on a range of variables, and conclude that "investment climate matters for the level of productivity, wages, profit rates, and the growth rates of output, employment and capital stock at the firm level." For a sample of firms in the garment industry in Bangladesh, India, Pakistan, and the People's Republic of China (PRC), they conclude that "productivity improvements would be 18% for firms in Bangalore, 43% for those in Dhaka, 78% for those in Calcutta, and 81% for those in Karachi" if cities in South Asia had the same investment climate characteristics as Shanghai.

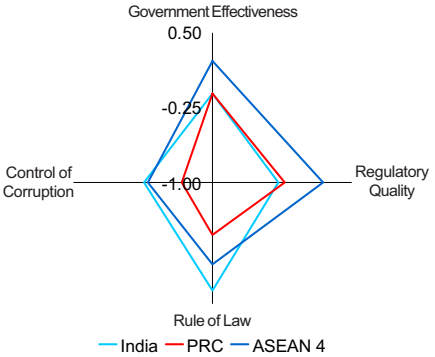
Against this background, the objective of this section is to concentrate our attention on elements of governance and the investment climate that are today most crucial to sustaining economic growth in South Asia. The approach is to benchmark performance of South Asian countries on the relevant governance and investment climate indicators against those of countries in Southeast Asia and PRC, which have an established track record of sustained high economic growth. Such a comparison, by identifying areas where there is substantial scope for improvement, can provide guidance in determining priorities for policies, reforms, and investments in South Asia.

Figure 3.8. Governance Scores
(by region)



Note: Scale is from -2.5 to +2.5.
Source: World Bank, Worldwide Governance Research Indicators Dataset, available: http://www.worldbank.org/wbi/governance/govdata, downloaded 25 September 2006.

Figure 3.9. Governance Scores
(India vs. PRC and ASEAN 4)



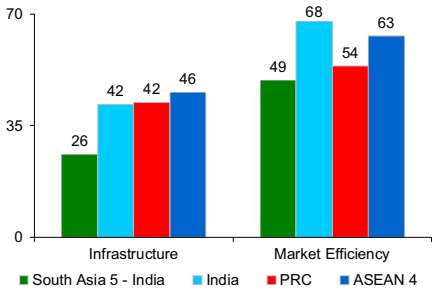
Note: Scale is from -2.5 to +2.5.
Source: World Bank, Worldwide Governance Research Indicators Dataset, available: http://www.worldbank.org/wbi/governance/govdata, downloaded 25 September 2006.

The four governance dimensions that Hasan et al. (2006) identified as particularly relevant for poverty reduction and growth include the rule of law, government effectiveness, control of corruption, and the quality of regulations. Considering these four pillars, Figure 3.8 shows that South Asia particularly lags behind ASEAN 4 in regulatory quality and government effectiveness (these are discussed in more detail below). The gap in rule of law and control of corruption is small. Note, on the other hand, that South Asia performs better in all respects compared to both Central Asia and Mekong 3. India's ratings are equal to or better than those of the PRC for all four pillars, while they lag behind those of ASEAN 4 for the quality of regulations and government effectiveness (Figure 3.9).

As for the investment climate indicators, infrastructure and the efficiency of markets (product, financial, and nonfinancial factor), Figure 3.10 clearly illustrates that the major scope for improvement in South Asia lies in the quality of its infrastructure. The poor quality of infrastructure is particularly apparent for South Asian countries other than India (with an average score of 26 out of 100). While the latest *Global Competitiveness Report* (on which this figure is based) seems to indicate that India has almost caught up with both the PRC and ASEAN 4, it is widely perceived that the quality of infrastructure is slowing manufacturing growth in India (see Box 3.4). Performance in the overall market efficiency, despite significant distortions in the labor markets, is considerably better with an average score of 68 for India (ahead of both the PRC and ASEAN 4) and 49 for the rest of South Asia.

The rest of this section focuses on the three main areas in which there is considerable scope for South Asian countries to improve as compared to the top performers: the quality of regulations, the effectiveness of government interventions, and the quality of infrastructure.

Figure 3.10. Infrastructure and Market Efficiency



Note: Rescaled to 0-100.
Sources: World Economic Forum, *Global Competitiveness Report 2006-2007*, available: http://www.weforum.org/pdf/Global_Competitiveness_Reports/Reports/gcr_2006/chapter_1_1.pdf, downloaded 28 September 2006; ADB staff estimates.

Box 3.4. Impact of Infrastructure on Manufacturing Growth in India

"India leads the market in offshored back-office services, but as a manufacturing center it lags behind [the People's Republic of] China, Thailand, and the rest of Asia. The reasons are well documented: multinational companies operating in India must overcome erratic electricity supplies, poor roads, and gridlocked seaports and airports while contending with government policies that discourage hiring and hold back domestic demand for goods in many sectors." (Luthra et al. 2005)

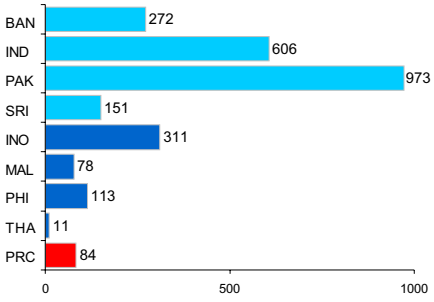
Regulatory Quality

A good regulatory environment results in a healthy balance between government intervention and the market mechanism and provides a stable and supporting business environment. Despite a general shift toward market liberalization, South Asia continues to be over-regulated. As a result, South Asia is not fully realizing its growth potential. McLiesh and Martin (2005) estimate that if South Asian countries would improve the quality of regulations to the level of Thailand, the additional GDP growth could amount to 0.8% for Bangladesh and Pakistan, and to 1.6% for India.

One of the areas that is overregulated relates to setting up and running a business enterprise. Firms are frequently confronted with a heavy burden of administrative regulations in their daily activities. Complying with administrative requirements such as permits and regulations issued by the government is substantially more complicated in South Asia. For example, the permits and licensing fees associated with

building a warehouse in South Asia as a percentage of income per capita are on the average substantially higher than in the PRC and Southeast Asia. India exceeds the regional average, costing an estimated 606% of income per capita while in Pakistan, these costs are as high as 973% . This contrasts starkly to the costs in Thailand (11%) or even Malaysia (78%) and the PRC (84%) (Figure 3.11).

Figure 3.11. Costs of Permits and Licenses to Construct a Warehouse
(% of income per capita)

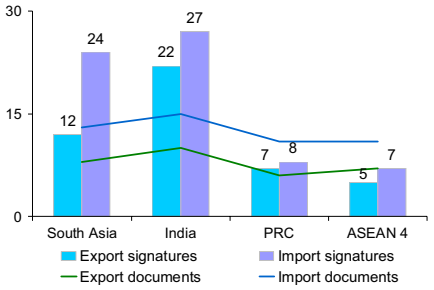


Source: World Bank, *Doing Business 2007*, available: http://www.doingbusiness.org/, downloaded 8 September 2006.

Also the complexity of the taxation system is singled out as a weak regulatory feature in South Asia. In some cases, the cost of compliance with tax regulations even exceeds the revenues collected. The frequent use of exemptions and exclusions complicate the taxation system and make the system vulnerable to tax avoidance and evasion, and to discretionary tax assessments.

Another area of economic activity that suffers from excessive regulation is international trade. In terms of paperwork related to trade, the number of required documents is roughly the same as in ASEAN 4 and the PRC, but the number of signatures required on these documents is considerably higher in South Asia. While it only takes an average of 5 signatures to export goods and 7 to import in ASEAN 4, the corresponding number of signatures in South Asia are 12 to export and 24 to import. In India, the number is as high as 22 to export and 27 to import (Figure 3.12).

Figure 3.12. Documents and Signatures Required to Export and Import



Source: World Bank, *Doing Business 2006*.

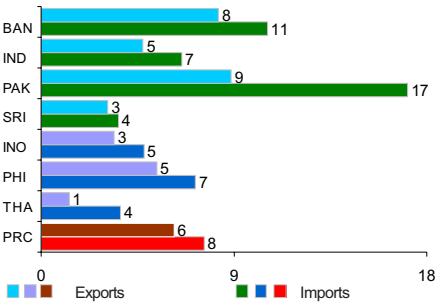
Another regulatory trade barrier is the long time required to clear goods for export and import through customs in South Asia (Figure 3.13). Slow processing is mainly due to lack of computerization in customs and the excessive number of signatures required. Many steps in customs clearance require manual intervention, including extensive physical examination of goods.

In addition to the considerable regulatory non-tariffs barriers, and despite the fact that South Asia has made significant progress in reducing tariffs, substantial tariff barriers to trade persist. The average import tariff in South Asia is about 18%, which is high compared to the the average tariff in ASEAN 4 which is about 9%.

Government Effectiveness

An effective government is able to respond appropriately to the needs of its citizens through efficient policy making and service delivery. Considerable scope for improvement remains in this area for the governments of South Asia. Compared to the frontrunners Malaysia and Thailand, government interventions through public spending are found to be less effective and efficient in South Asian countries (Figure 3.14). Pakistan scores best in South Asia, equaling the PRC. Among the four South Asian countries, Sri Lanka ranks lowest.

Figure 3.13. Days to Clear Exports and Imports through Customs



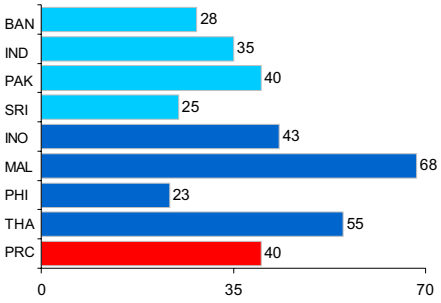
Source: World Bank, *Investment Climate Surveys*, available: http://www.enterprisesurveys.org/, downloaded 5 September 2006.

The effectiveness of government spending is a broad concept and few quantitative indicators exist that pinpoint the specific weaknesses in South Asia. The following are some of the common problems that

have been identified across South Asian countries as limiting the effectiveness of government interventions. One important factor that contributes to poor service delivery is the highly bureaucratic nature of governments in South Asia. Key problems are a lack of transparency and accountability in service delivery and a focus on processes and procedures, rather than results. In some countries, governments have responded by devolving a number of services to local governments, with varying success.

Another factor that contributes to the lack of effectiveness and efficiency of government policy in South Asia is the large number of ministries and government agencies and the lack of coordination among them, and between national and local governments. Policies are designated among the different responsible ministries and implemented in an ad-hoc manner with limited follow-up and monitoring. Coordination can indeed be a challenging task; in Sri Lanka, the government counts not less than 61 ministries. In addition, many departments are overstaffed while pay and benefit levels are generally inadequate. The latter results in difficulties in attracting and retaining high quality staff in key technical areas. Consequently, governments in South Asia sometimes lack the capacity and technical skills to adequately design and implement effective policies.

Figure 3.14. Effectiveness of Government Spending



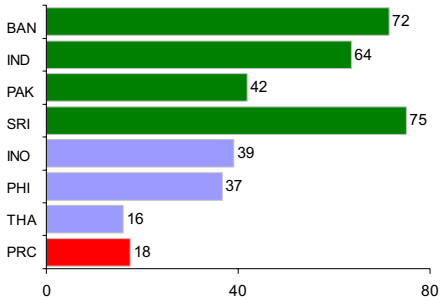
Note: Rescaled to 0-100.
Sources: World Economic Forum, *Global Competitiveness Report 2005-2006*; ADB staff estimates.

Infrastructure

Physical infrastructure, such as power, transportation, and telecommunication facilities, are critical for the efficient functioning of the economy. The lack of adequate physical infrastructure in South Asia is well documented, and is repeatedly highlighted as one of the major constraints to sustaining high economic growth in the region, particularly for the manufacturing sector. The reliability of power supply and the quality of railroads, ports, and air transport are of particular concern.

Electricity is the most critical bottleneck. According to the World Bank's Investment Climate Surveys, more than 40% of respondent firms in South Asia cited access to a reliable source of electricity as a major or very severe constraint in business. The time to obtain an electrical connection averages 55 days for South Asia compared to only 7 days in the Philippines or 10 days in the PRC. Around 63% of firms in South Asia have installed costly generators compared to only 16% in Thailand and 18% in the PRC (Figure 3.15). On average, generators have to provide 15% of electric consumption in South Asia; a figure that only amounts to 2% in the PRC and 3% in Thailand. Within South Asia, Bangladesh experiences most problems in power supply. More than 70% of firms view electricity as a major or very severe constraint to business. Electrical outages occur 249 times a year. More than 70% of firms have generators that supply 19% of total electric consumption. Also, in India, electricity is viewed as a major or very severe constraint to business by more than 25% of firms. About 64% of firms have generators that also supply 19% of total electric consumption.

Figure 3.15. Percentage of Firms that Own a Generator



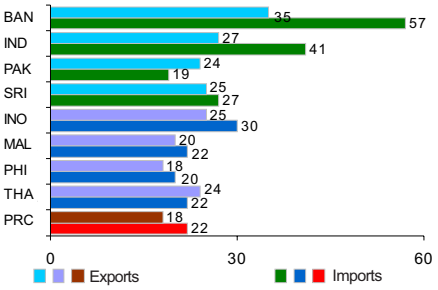
Source: World Bank, *Investment Climate Surveys*, available: http://www.enterprisesurveys.org/, downloaded 5 September 2006.

Improvements in the quality of the transport infrastructure would also result in substantial economic gains. Bottlenecks occur in all modes of transportation infrastructure: road, rail, maritime, and air transport. In road infrastructure major bottlenecks include insufficient and poor quality roads and a lack of intraregional connectivity between the national road systems. The rail transport system suffers from decades of underinvestment. This has resulted in a gradual shift to road transport, which currently accounts for about 70% of mainland transport in South Asia. Maritime transport is hampered by capacity constraints and inefficient operations in the main ports, and by inadequate road and rail connectivity with the hinterland. In air transport, capacity constraints in airports in terms of runways, parking, and cargo processing facilities hamper smooth operation (ADB 2006b). As a result of these multiple transport infrastructure constraints, in South Asia it takes considerably more time to export and import goods compared to countries in ASEAN 4 and the PRC (Figure 3.16). Export and import in the PRC or the better performers in ASEAN 4 takes about 20 days. Of the South Asian countries, only Pakistan scores similarly. Export-import time averages 34 days in India and 46 days in Bangladesh.

Similarly, the cost of exporting and importing goods is higher in South Asian countries than in other regions. While it costs less than $400 in the PRC and less than $500 in Malaysia to bring a standard 20-foot container across the border, prices in South Asia range from about $800 in Sri Lanka to up to $1,100 in Bangladesh (Figure 3.17).

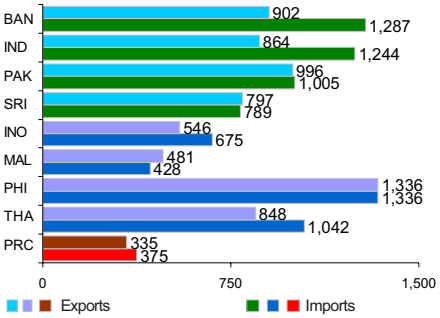
However, progress is being made in the infrastructure sector in South Asia. As a result of reforms in telecommunication policies, South Asia has one of the fastest growing mobile phone markets in the world. India has initiated policy reforms in roads, ports, airports, and urban sectors which have attracted about $8 billion in public-private partnerships. Pakistan has successfully privatized the Pakistan Telecommunication Corporation and the Karachi Electric Supply Company. Most South Asian countries have also increased public spending on infrastructure. However, in addition to increasing public investment, there is a need for better targeting of such investment and further improving sector policies and institutional environment.

Figure 3.16. Number of days to Export and Import



Source: World Bank, *Doing Business 2007*, available: http://www.doingbusiness.org/, downloaded 8 September 2006.

Figure 3.17. Cost to Export and Import
($ per container)



Source: World Bank, *Doing Business 2007*, available: http://www.doingbusiness.org/, downloaded 8 September 2006.

4. COUNTRY SECTION

Afghanistan

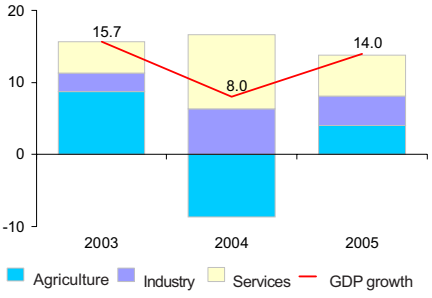
Table 4.1. Country Macroeconomic Indicators: Afghanistan

Indicator	Actual		Forecast	
	2002–04 Average	2005	2006	2007
GDP (*annual change, %*)	17.4	14.0	12.0	10.6
Inflation (*annual change, %*)	14.1	12.3	9.2	5.0
Overall Budgetary Surplus/Deficit (*% of GDP*)	-1.5	-0.9	-1.5	-2.1
Money supply (*annual change, %*)	46.2*	14.1	17.7	—
Exports (*annual change, %*)	38.5	-2.6	7.9	5.9
Imports (*annual change, %*)	35.2	9.0	10.1	4.0
Current Account Balance (*% of GDP*)	0.3	-0.9	-2.0	-4.8

* Refers only to 2003–2004 average.

With a rebound in agricultural output, Afghanistan's growth in FY2005 (21 March 2005 to 20 March 2006) accelerated to 14% (Figure 4.1). Reconstruction efforts continued to prop up growth in the construction, trade, and transport and telecommunication sectors. Opium production declined only marginally in 2005. Despite strong growth of the licit economy, the total export value of opium remains more than one third of the value of GDP from legal products. General security has deteriorated significantly during the past year, threatening overall reconstruction efforts and political stability. In 2006 large parts of the country were affected by drought, leading to food shortages and migration. This is likely to affect the growth rate, which is projected to decline to 12% in FY2006.

Figure 4.1. Sources of Growth



Inflation is estimated to have declined to 12.3% in FY2005. Monetary policy continues to be in line with the International Monetary Fund's Staff Monitored Program, and inflation is projected to decline further to 9.2% in FY2006.

In FY2005 the budgetary deficit declined to 0.9% of GDP. Domestic government revenue as a percentage of GDP increased from 4.5% in FY2004 to 5.5% in FY2005 and is expected to reach 6% in FY2006. Despite improving revenues, the budget deficit is expected to increase to 1.5% of GDP in FY2006, due to a sharp rise in expenditures.

The trade deficit is estimated at $2.6 billion in FY2005. Imports of goods increased to $4.2 billion and exports to $1.6 billion, although only $566 million came from domestic exports and the balance comprised re-exports, mainly border trade with Pakistan. The current account deficit as a percentage of GDP declined slightly to 42.6%, excluding grants (0.9%, including grants).

In January 2006 the government approved the Interim Afghanistan National Development Strategy (I-ANDS), which was presented to the international community at the London Conference. The I-ANDS Compact benchmarks are highly ambitious, and the government will require sustained donor support to translate these benchmarks into a prioritized and achievable reform program. In addition, the sustainability of growth over the longer term needs to be addressed, particularly regarding two issues:

(1) Alternatives must be developed to the current drivers of growth, which are linked to the reconstruction effort.
(2) Because of large foreign exchange inflows, the currency is presently strong. This is narrowing opportunities for export expansion and domestic production.

Bangladesh

Table 4.2. Country Macroeconomic Indicators: Bangladesh

Indicator	Actual		Estimate	Forecast
	2001–04 Average	2005	2006	2007
GDP (*annual change, %*)	5.3	6.0	6.7	6.0
Inflation (*annual change, %*)	3.7	6.5	7.2	7.0
Overall Budgetary Surplus/Deficit (*% of GDP*)	-4.1	-3.4	-3.9	-3.7
Money Supply (*annual change, %*)	14.8	16.8	19.5	15.5
Exports (*annual change, %*)	7.6	14.0	21.6	18.0
Imports (*annual change, %*)	7.2	20.6	12.1	12.0
Current Account Balance (*% of GDP*)	-0.3	-0.9	0.9	0.3

GDP growth in FY2006 (1 July 2005 to 30 June 2006) accelerated to 6.7% because of a rebound in agriculture, strong expansion in export-oriented manufacturing, and continued buoyancy in services. Based on the assumption that political uncertainty in the lead-up to the general elections in January 2007 will not impact economic activity significantly, the economy is projected to continue to grow strongly. However, GDP growth is forecast to slow down somewhat to 6% in FY2007 because lower growth is likely in agriculture (following the post-flood high of the previous year) and due to further tightening of monetary policy.

Inflation was also higher in FY2006 (7.2%) due to continued rapid growth in money supply, high international commodity prices, and depreciation of the taka (8.5% in FY2006). Higher domestic fuel prices and continued depreciation of the currency will exert inflationary pressures in FY2007, but because of the tighter monetary policy, inflation is forecast to moderate to 7%.

In June the government increased fuel prices by 10–30%, and that should reduce the fuel subsidy by about $210 million annually. However, implicit fuel subsidy continues to be high—estimated at about $810 million or 1.3% of GDP. The state-owned Bangladesh Petroleum Corporation, which is required to sell petroleum products below cost, is consequently accumulating losses. That in turn has had negative consequences for the effectiveness of monetary policy in dealing with inflation and for the health of the banking sector.

Despite Bangladesh Bank's tighter monetary stance, monetary expansion remained strong, with broad money and domestic credit increasing by 19.5% and 20.2% respectively in FY2006. Although private sector credit growth decelerated, public sector credit surged mainly due to Bangladesh Petroleum Corporation's huge borrowing from the state-owned commercial banks—estimated at $1.5 billion. Because of continuing concern about rising inflation and credit growth, Bangladesh Bank is expected to tighten monetary policy further in FY2007.

The fiscal deficit increased to 3.9% in FY2006. However, it was lower than the original budget target of 4.5%, mainly due to under-performance of development spending. The FY2007 budget envisages a fiscal deficit of 3.7% of GDP, with a sharper focus on pro-poor public spending, augmentation in revenues (increase domestic revenues as a percentage of GDP by 0.5%), and reduction of losses of the state-owned enterprises.

Rapid growth in export earnings (21.6%) and overseas workers' remittances (25%), and a slowdown in non-oil imports, helped to move the current account balance into surplus in FY2006 (figures 4.2 and 4.3) despite the higher oil prices. Concerns about the impact on the economy of the phase out of the Multifibre Arrangement (MFA) have thus far not materialized. Textile and clothing exports, which primarily consist of garments, account for over 70% of Bangladesh's total merchandise exports. Garments exports continue to grow strongly (23%), outperforming many competing countries. Sustained growth in exports, together with the high level of workers' remittances, should maintain a small surplus on the current account balance in FY2007. However, for Bangladesh to sustain high growth in the garments sector infrastructure improvements would be required and particular attention would have to be paid to social compliance issues that have surfaced recently, including serious labor unrest.

Figure 4.2. Growth of Merchandise Exports and Imports and the Current Account Balance

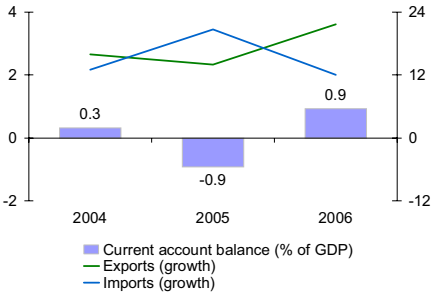
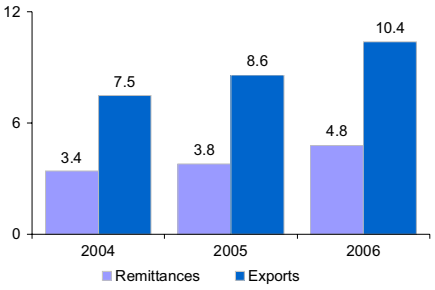


Figure 4.3. Remittances and Merchandise Exports
($ billion)



Bhutan

Table 4.3. Country Macroeconomic Indicators: Bhutan

Indicator	Actual		Forecast	
	2001–04 Average	2005	2006	2007
GDP (*annual change, %*)	7.7	6.1	10.0	12.0
Inflation (*annual change, %*)	2.9*	4.8	4.9	4.5
Overall Budgetary Surplus/Deficit (*% of GDP*)	-6.7	-10.7	-5.4	-4.0
Money Supply (*annual change, %*)	14.0	10.7	12.0	—
Exports (*annual change, %*)	9.9	18.0	—	—
Imports (*annual change, %*)	8.1	67.6	—	—
Current Account Balance (*% of GDP*)	-9.3	-25.7	-9.0	—

*Refers only to 2002–2004 average.

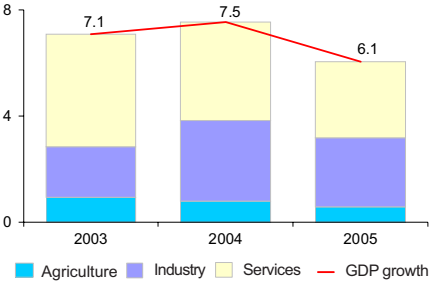
Compared to its medium-term trend of over 7%, growth in Bhutan slowed to 6.1% in 2005. The lower growth in GDP is largely due to the decline in the growth rate of the construction and transport sectors (Figure 4.4)—which were buoyant during the construction of the 1,020-megawatt Tala Hydropower Project (THP). With the THP coming on stream, GDP growth is projected to accelerate to 10% in 2006 and 12% in 2007.

Inflation increased from 3.6% in FY2004 to 4.8% for FY2005 (1 July 2004 to 30 June 2005). The increase was influenced by price movements in India, particularly higher food and fuel prices. For FY2006 as a whole, inflation is estimated to remain at 4.9%, while money supply growth is estimated at 12%. Inflation is projected to decline in FY2007.

Fiscal consolidation took place in FY2006, and the budget deficit is estimated to be 5.4% of GDP, down from 10.7% a year earlier. In FY2007, because of the THP, domestic revenues are projected to increase by 37% and the budget deficit to decline further to 4.0% of GDP.

In FY2005, imports expanded rapidly, driven largely by the construction requirements of the THP, and the current account deficit increased to 25.7% of GDP. Despite substantial inflows of concessional assistance, the overall balance turned negative and foreign exchange reserves declined by 4.4%. However, preliminary data as of March 2006 show a 28.3% increase in reserves over end-FY2005. In FY2007 electricity exports to India, which already account for nearly 50% of total export earnings, are expected to double following the completion of the THP in June 2006. This will significantly reduce the current account deficit.

Figure 4.4. Sources of Growth



India

Table 4.4. Country Macroeconomic Indicators: India

Indicator	Actual		Forecast	
	2001–04 Average	2005	2006	2007
GDP (*annual change, %*)	6.4	8.4	7.8	7.8
Inflation (*annual change, %*)	4.7	4.4	5.5	5.0
Overall Budgetary Surplus/Deficit (*% of GDP*)	-8.9	-7.5	-7.0	-6.5
Money Supply (*annual change, %*)	14.4	21.3	16.0	15.2
Exports (*annual change, %*)	16.5	27.5	20.0	20.0
Imports (*annual change, %*)	21.1	31.6	26.2	21.0
Current Account Balance (*% of GDP*)	0.9	-1.3	-2.1	-1.9

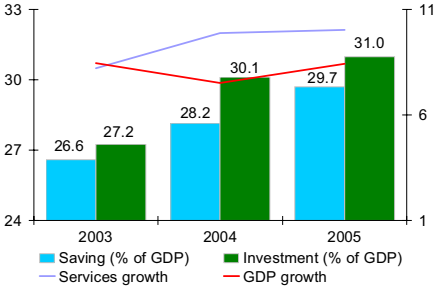
Recovery in agricultural growth and continued strong expansion of industry and services sectors (Figure 4.5) contributed to India's higher GDP growth of 8.4% in FY2005 (1 April 2005 to 3 March 2006). Strong economic performance during the past 3 years, rising private investment, improving business confidence, and modest inflation provide the basis for continued growth momentum in FY2006. A normal monsoon and robust manufacturing growth in the first quarter of FY2006 suggest that the overall GDP growth will remain high, at 7.8% in FY2006.

Inflation was at a moderate level of 4.4% in FY2005. The government has so far successfully protected consumers from high international oil prices. However, incomplete pass-through of international oil prices has been a source of expectations that inflation will increase. In June the government raised fuel prices by 7–9%. Rising domestic fuel prices, strong domestic demand, and high international commodity prices are likely to boost inflation to around 5.5% in FY2006.

In July, the Reserve Bank of India (RBI) increased its two key short-term interest rates by 25 basis points, the fifth such increase since October 2005. In addition, RBI raised the provisioning requirements on personal bank loans and real estate lending. RBI appears to be firm in its commitment to ensure an inflation rate of 5.0–5.5% in FY2006, and all indications suggest that RBI's monetary policy will be substantially less accommodating in FY2006.

Following the significant decline in FY2004, the consolidated fiscal deficit remained unchanged in FY2005, and at 7.5% of GDP it remains a matter of concern. In the Federal Budget for FY2006 the government attempted to maintain a balance between fiscal prudence and providing resources for development expenditure. Both the revenue deficit and

Figure 4.5. Drivers of Growth

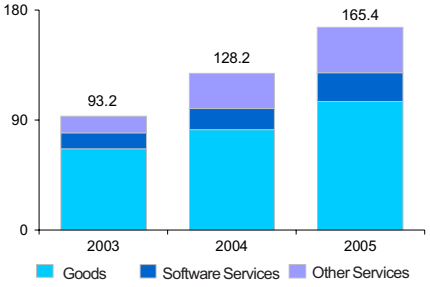


Note: 2005 saving and investment are preliminary estimates.

the overall fiscal deficit, as a percentage of GDP, are targeted to be lower in FY2006. This is primarily attributable to the expected strong GDP growth and better tax effort. Gross tax revenues are projected to rise by 20%, with tax collection from services (because of the inclusion of additional items in the service tax net) increasing by 50%. On the expenditure side, the bulk of additional spending is focused on flagship social sector programs (including the National Rural Employment Guarantee scheme) and the recently announced "Build India" infrastructure program.

Exports expanded strongly (27.5%) in FY2005 supported by broad-based manufacturing exports including transport equipment, machinery, basic chemicals, woolen yarn, and ready-made garments. Also service exports expanded strongly, boosted by earnings from the export of software services (IT and IT-enabled services), which grew by over 30% to about $24 billion (Figure 4.6). Despite a surplus in the current account in the last quarter of FY2005, the current account deficit rose to $10.6 billion from $5.4 billion in FY 2004. This was largely because of the 47.3% increase in imports of petroleum, oil, and lubricants. However, a steady increase in both foreign direct investment and portfolio investment helped to sustain a healthy level of foreign exchange reserves of $145 billion by the end of FY2005. The current account deficit is expected to increase to 2.1% of GDP in FY2006.

Figure 4.6. Exports of Goods and Services ($ billion)



Source: Reserve Bank of India *Handbook of Statistics on Indian Economy* (18 September 2006), available: http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/72777.pdf, downloaded 19 September 2006.

Maldives

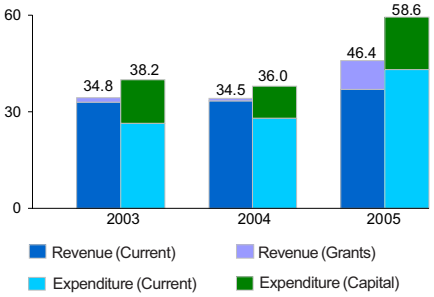
Table 4.5. Country Macroeconomic Indicators: Maldives

Indicator	Actual		Forecast	
	2001–04 Average	2005	2006	2007
GDP (*annual change, %*)	7.0	-5.2	18.7	6.0
Inflation (*annual change, %*)	1.3	3.3	2.8	2.5
Overall Budgetary Surplus/Deficit (*% of GDP*)	-3.7	-12.2	-17.3	—
Money Supply (*annual change, %*)	19.0	11.7	—	—
Exports (*annual change, %*)	13.9	-10.7	—	—
Imports (*annual change, %*)	14.5	15.5	—	—
Current Account Balance (*% of GDP*)	-9.2	-43.1	-21.4	-16.9

In 2005, GDP contracted by 5.2% and the macroeconomic situation deteriorated significantly. This was the result of the combined effects of tsunami-related damage; increased expenditures (related to the restructuring of the government and associated salary increases, rising international oil prices, and subsidies on power and water); and stagnant revenues. The budget deficit increased to 12.2% of GDP in

2005 (Figure 4.7) and the current account deficit on the balance of payments reached 40% of GDP. Tourism is showing good signs of revival, with tourist arrivals now matching the pre-tsunami levels, and GDP growth is projected to accelerate to 18.7% in 2006. However, Maldives needs to address its fiscal crisis in order to resume its sustainable growth trajectory.

Figure 4.7. Revenues and Expenditures (% of GDP)



After peaking at 6.4% in 2004, inflation is estimated to have moderated to 3.3% at end-December 2005 (month-on-month) and is projected to decline to under 3% in 2006. The growth in money supply slowed to 11.7% in 2005, largely because of a 47% drawdown in net foreign assets.

Maldives, like other small clothing exporters to the US, saw its market share evaporate following the end of quota restrictions on textile and clothing exports of developing countries at the end of 2004. In 2005 Maldives' garment factories ceased operations, clothing exports to the US fell by 94% in value terms. As a result, total exports contracted by 10.7% in 2005, while imports, driven by higher oil prices and reconstruction needs, grew by 15.5% and the current account deficit increased to 43.1% of GDP from 17.2% in 2004. Exports are expected to pick up in 2006, but so will imports and the current account deficit, while significantly lower, is likely to remain large.

Nepal

Table 4.6. Country Macroeconomic Indicators: Nepal

Indicator	Actual		Estimate	Forecast
	2001–04 Average	2005	2006	2007
GDP (*annual change, %*)	2.7	2.3	2.3	4.0
Inflation (*annual change, %*)	3.5	4.5	7.9	6.5
Overall Budgetary Surplus/Deficit (*% of GDP*)	-2.7	-0.8	-1.8	-3.0
Money Supply (*annual change, %*)	10.6	8.3	16.3	—
Exports (*annual change, %*)	-1.9	11.0	6.8	12.5
Imports (*annual change, %*)	3.6	12.1	15.5	20.0
Current Account Balance (*% of GDP*)	3.7	12.2	2.4	2.0

In FY2006 (16 July 2005 to 15 July 2006) Nepal's economy grew by only 2.3%, reflecting a weather-related slowdown in agriculture and the adverse impact of the conflict and political agitations on manufacturing, transport, and communication sectors. The recent political developments and the improved security situation could yield a significant "peace dividend" for the economy over the next few years. GDP growth is projected to increase to 4% in FY2007. However, the

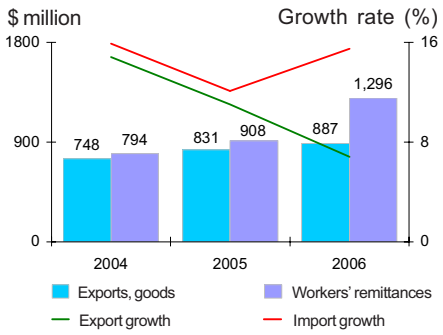
outlook has significant downside risks. The most critical risks relate to the progress in the peace talks. Failure to sustain the ceasefire and make headway in the peace process will seriously undermine macroeconomic performance and poverty reduction.

Inflation increased sharply to 7.9% in FY2006 from 4.5% in FY2005 on account of upward adjustments in petroleum prices and the value-added tax (VAT) rate, and low agricultural production. In response to the acceleration of inflation and the rising interest rate differential with India, Nepal Rastra Bank initiated some monetary tightening in FY2006 and increased the bank rate by 75 basis points to 6.25%. In FY2007 inflation is forecast to moderate to 6.5% as the effects of upward adjustment in VAT and petroleum prices subside and food production returns to normal levels.

In FY2006 the budget deficit widened to 1.8% of GDP due to a significant shortfall in revenue collection and rapid growth in recurrent spending. The shortfall in the revenue collection target was due both to the sluggishness of the economy and the reduction of tariff rates by the government. Capital expenditure remained well below target, as development activities were constrained in the conflict environment. Since there was a sharp decline in foreign loans, domestic borrowing increased seven times, to 1.4% of GDP, to cover the deficit. The FY2007 budget announced by the government is expansionary to support reconstruction, rehabilitation, and reintegration of the Maoist insurgents into Nepal's mainstream politics and development process. The budget deficit in FY2007 is forecast to increase to 3.0% of GDP.

Despite a slowdown in exports and continued recovery in imports, the current account surplus widened in FY2006 due to a sharp increase in remittances (Figure 4.8). However, the surplus is projected to decline in FY2007, as the investment climate improves and imports grow strongly.

Figure 4.8. Exports, Imports, and Workers' Remittances



Pakistan

Pakistan's GDP growth slowed in FY2006 (1 July 2005 to 30 June 2006) to 6.6%, largely because of the impact of adverse weather conditions on the major crops. This significantly reduced growth in the agriculture sector and in agro-based industries, particularly cotton textiles and sugar. Recovery in the agriculture sector, higher private investment, and increased development spending are projected to boost economic growth to 7.0% in FY2007.

Inflation declined in FY2006, but was still high at 8.0%. A significant decline in food inflation was in part offset by higher oil prices. Tight monetary policy and measures, such as liberalized imports of food and other essential items in short supply, helped to combat inflation. Slower growth in money supply in FY2006 and continued tight monetary policy should reduce inflation to 6.5% in FY2007.

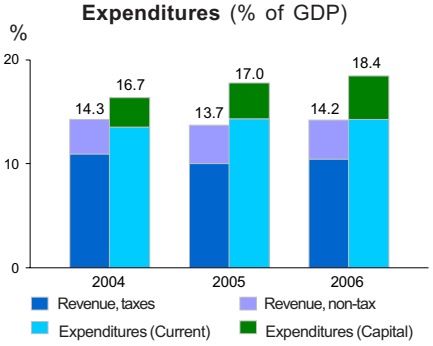
Table 4.7. Country Macroeconomic Indicators: Pakistan

Indicator	Actual		Estimate	Forecast
	2001–04 Average	2005	2006	2007
GDP (*annual change, %*)	4.3	8.6	6.6	7.0
Inflation (*annual change, %*)	3.9	9.3	8.0	6.5
Overall Budgetary Surplus/Deficit (*% of GDP*)	-3.7	-3.3	-4.2	-5.0
Money Supply (*annual change, %*)	15.5	19.3	15.0	13.5
Exports (*annual change, %*)	11.1	16.8	14.0	13.0
Imports (*annual change, %*)	9.7	39.6	31.3	15.0
Current Account Balance (*% of GDP*)	1.6	-1.6	-4.4	-5.5

The State Bank of Pakistan (SBP) maintained a tight monetary policy stance in FY2006, and the rate of increase in broad money was below the growth in nominal GDP. SBP kept liquidity tight through open market operations without significantly raising the benchmark 6-month Treasury-bill rate. In July 2006, SBP accelerated the monetary tightening by raising the cash reserve requirement, the statutory liquidity requirement, and its policy rate by 50 basis points to 9.5%.

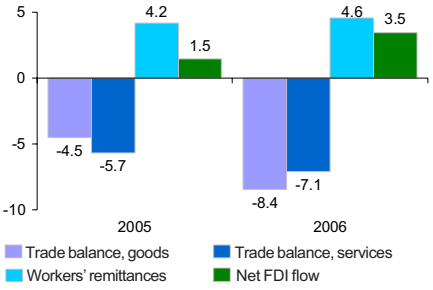
The government continued with its expansionary fiscal policy initiated in FY2005, aimed at increasing development spending and accelerating growth (Figure 4.9). In FY2006 development expenditure increased by 37.8%, to 4.1% of GDP compared to 2.8% two years earlier. In FY2006 the fiscal deficit increased to 4.2% of GDP, including expenditures amounting to 0.85% of GDP on earthquake relief and rehabilitation. The FY2007 budget continues the growth-oriented policy stance, and development spending is projected to increase to 4.9% of GDP. The budget also aims to increase revenues through broadening the tax base, and the tax-to-GDP ratio is projected to rise by 0.4% of GDP. The overall fiscal deficit could increase to 5% in 2007, including expenditures related to earthquake reconstruction, equivalent to 0.6% of GDP.

Figure 4.9. Revenues and Expenditures (% of GDP)



Domestic production was unable to meet the increase in domestic demand in FY2006, and imports rose more than twice as fast as exports. Imports were also boosted by the large increase in the oil import bill and the trade deficit increased sharply. The current account deficit swelled to 4.4% of GDP. However, because of a more-than-two-fold increase in foreign direct investment to $3.5 billion (Figure 4.10), including privatization proceeds, a well-received $800 million Eurobond issue by the government, larger inflows of official assistance, and lower amortization, official foreign exchange reserves rose by $955 million to $10.8 billion. In FY2007 import growth is projected to slow down significantly as tight monetary policy dampens growth in domestic demand, and exports are likely to more or less sustain their growth

Figure 4.10. External Sector
($ billion)



because of (1) improved agriculture production, and (2) the reduction by the European Union of the anti-dumping duty on bed linen exports and restoration of some benefits under the Generalized System of Preferences. However, the current account deficit is expected to rise to 5.5% of GDP.

Sri Lanka

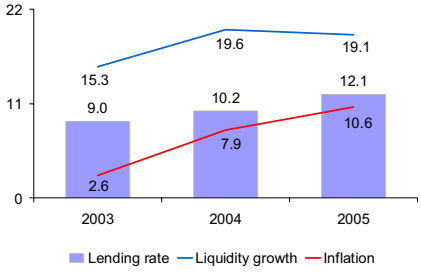
Table 4.8. Country Macroeconomic Indicators: Sri Lanka

Indicator	Actual		Forecast	
	2001–04 Average	2005	2006	2007
GDP (*annual change, %*)	3.5	6.0	6.1	5.8
Inflation (*annual change, %*)	8.2	10.6	9.0	8.0
Overall Budgetary Surplus/Deficit (*% of GDP*)	-8.9	-9.0	-9.4	-8.4
Money Supply (*annual change, %*)	15.5	19.1	10.5	10.0
Exports (*annual change, %*)	1.5	10.2	8.0	7.5
Imports (*annual change, %*)	3.2	10.8	9.0	6.5
Current Account Balance (*% of GDP*)	-1.6	-2.8	-3.6	-2.8

In 2005 GDP growth in Sri Lanka increased to 6.0% despite the tsunami of December 2004. The growth was led mainly by the services sector, especially telecommunications. In the first quarter of 2006, GDP recorded an impressive 8.1% growth, but it is partly due to the low base in 2005 after the tsunami. The intensified conflict between the government and the Liberation Tigers of Tamil Eelam (LTTE) has not yet noticeably dented economic growth; however, any escalation of violence could constrain it in the subsequent quarters.

Although rising global oil prices were only partly passed through, inflation, as measured by the Colombo consumer price index, increased to 10.6% in 2005. The continued rapid growth in money supply fueled by low real interest rates was largely responsible for the acceleration in inflation (Figure 4.11). Harvest-related food shortages and demand for construction materials for the tsunami reconstruction also affected prices adversely. Fuel price increases in April and June 2006, power tariff hikes scheduled for September, and increases in civil service salaries and indirect taxes will continue to exert upward pressures on prices. The Central Bank of Sri Lanka raised policy interest rates four times during 2005, totaling 125 basis points, but this failed to slow growth in monetary aggregates. The central bank further increased the policy interest rates in June and July 2006, and it is expected to continue the tight monetary stance throughout 2006. This is expected to reduce inflation to an average of 9% in 2006.

Figure 4.11. Money, Prices, and Interest Rates



The overall fiscal deficit widened to 9.0% of GDP in 2005, including tsunami-associated expenditures of 1.4% of GDP. This figure however understates the impact of fuel and electricity subsidies as these are off-budget and financed by two state-owned corporations. The fiscal deficit in 2006 is targeted at 9.4% of GDP, including tsunami reconstruction costs. Although the recent increase in fuel prices will reduce expenditure on subsidies, it will not eliminate them and achieving the fiscal target will be a challenge for the government.

In 2005 Sri Lanka's trade deficit widened to $2.5 billion, but that was offset by increased workers' remittances, which amounted to $1.9 billion, or almost 10% of GDP. As a result, the current account deficit declined to 2.8% of GDP, but it is projected to increase again in 2006 because of substantially higher imports (of both oil and capital goods).

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STATISTICAL APPENDIX

Statistical Notes

Macroeconomic Indicators

National Accounts

Money and Prices

Government Finance

External Sector

Banking Sector Vulnerability and Reforms

Statistical Notes

Data in the tables presented in this issue refer to the fiscal year unless otherwise specified. Annual data were obtained from the *Asian Development Outlook* (*ADO*) and *ADO Update*, South Asia Regional Department's Economic Information System, official and secondary sources, and statistical publications. Monthly and daily data were obtained from official sources, Thomson Financial's Datastream Advance database (v.3.5; cited as "Datastream"), and CEIC Data Company Ltd.'s Asia database ("CEIC").

As much as possible, efforts were undertaken to standardize the data to allow comparability over time and across South Asian countries. However, limitations are imposed by the lack of available quarterly and monthly data records and differences in fiscal year coverage for most South Asian countries (for a complete list, see the Definitions). Regional aggregates (sum or average) for South Asia that are reported in the figures and tables reflect aggregates of national-level data of all South Asian countries for the relevant fiscal year, excluding Afghanistan. The majority of Bhutan's accounts are recorded on a fiscal year basis, except for its gross domestic product (GDP) data which is recorded on a calendar year basis.

Regional averages are weighted according to gross national income in current US dollars (World Bank Atlas method) except the averages reported in Section 3. Other regional aggregates are unweighted aggregates of the relevant countries in the group, unless otherwise indicated.

Where country data are missing for a given year, regional aggregates are computed on the basis of available information only. For weighted regional averages where the missing data is for 2005, the data for 2004 is used instead.

Regional aggregates indicated on tables on annual changes of exports and imports of goods and exports of services (tables A11, A12, and A14) are computed on the basis of a consistent sum (i.e., in cases where country data are missing for a given year, the sum of the prior year used for computing the growth rate excludes the corresponding country data).

In Section 2, figures showing trend estimates were derived using the Hodrick-Prescott filter with a 14,400 penalty on variation.

Tables in Section 4 (Country Section) present selected national macroeconomic indicators including GDP growth, inflation, overall budgetary surplus/deficit, liquidity growth, exports and imports of goods, and current account balance. Unless otherwise indicated, data in these tables cover FY2001 to FY2007: FY2001–2004 data are an average, FY2005 data are actual, and FY2006 and FY2007 are forecasts (except for Bangladesh, Nepal, and Pakistan, which report initial estimates for FY2006).

The Statistical Appendix is organized in two sections.

Macroeconomic Indicators. This section presents selected macroeconomic indicators for the eight South Asian countries. The tables are generally grouped under the following headings:

- national accounts (A1–A6),
- money and prices (A7–A8),
- government finance (A9–A10), and
- external sector (A11–A19).

Data presented in these tables are based on the data provided by Asian Development Bank country economists for the *ADO*. For a detailed discussion of statistical sources, methodology, definitions, scope, and limitations, refer to *ADO 2006* and *ADO Update 2006*.

GDP and GDP per capita valued at current market prices are presented in Table A1. GDP per capita is defined as GDP at current prices divided by total population.

Annual growth rates of GDP (A2) and GDP per capita (A3) for Afghanistan, Bangladesh, and Bhutan are reported based on GDP valued at constant market prices. For Maldives, A2 and A3 are based on constant basic prices. For the rest of South Asia (India, Nepal, Pakistan, and Sri Lanka), A2 and A3 are based on GDP valued at constant factor cost.

Shares of the three major sectors—agriculture, industry, and services—for 2000 to 2005 are presented in Table A4, based on constant prices. The agriculture sector includes agricultural crops, livestock, poultry, fisheries, and forestry; the industry sector includes the manufacturing and nonmanufacturing subsectors such as mining and quarrying, construction, and utilities; and the services sector includes trade, banking, finance, real estate, public administration, and other services.

In the case of Bhutan, previous calendar-year GDP is used as the base or the denominator for all national data presented as a percentage of GDP (A9–A10, A13–A14, A16; and A19).

Tables A5 and A6 report the respective shares in GDP of major expenditure items such as consumption, saving, investment, exports, and imports based on current prices. Gross domestic investment as reported in Table A5 refers to the sum of gross fixed capital formation plus changes in inventories. For India, gross domestic investment includes valuables and errors and omissions, while changes in inventories are excluded for Bangladesh.

Data on inflation rates presented in Table A7 represent period averages based on the consumer price index except for India, which reports wholesale price index. The consumer price index for Nepal is for urban consumers only.

Except for Sri Lanka and India, liquidity growth (A8) is presented as annual percentage change in the end-of-period supply of broad money as represented by M2, which is the sum of currency in

circulation plus demand deposits (M1) and quasi-money. Liquidity growth for Sri Lanka is based on M2b (M2 plus time and savings deposits held by commercial banks' foreign currency banking units), while for India broad money is represented by M3 (M2 plus other assets that are less liquid, including deposits with the Reserve Bank of India).

Tables A9 and A10 present central government finance except for India and Pakistan, which report government finance on a consolidated basis. Government revenues (percentage of GDP) generally comprise nonrepayable current and capital receipts plus grants divided by GDP at current prices. In A9, Bangladesh, India, and Pakistan capital receipts and grants are not reported. For India, revenues from disinvestment are also included. For Afghanistan, both current revenues and capital receipts are reported. Expenditures (percentage of GDP) comprise all nonrepayable payments to both current and capital expenses, plus net lending divided by GDP at current prices. Fiscal deficit (percentage of GDP) presented in Table A10 is the difference between government revenues and expenditures divided by GDP at current prices.

Annual changes on exports of goods (A11) are reported based on free-on-board (f.o.b) valuation of exports. Annual changes on imports of goods (A12) are also reported on an f.o.b. basis, except for Afghanistan, Bhutan, and India as these countries report imports on a cost, insurance, and freight (c.i.f.) basis. Trade balance (A13) is the difference between exports and imports of goods.

Tables A14 and A15 report services exports and workers' remittances, respectively. Services export may include transport and travel services, communication, computers, and other services.

Current account balances (% of GDP) presented in Table A16 are based on the sum of the balance of trade for merchandise and services, net factor income, and net transfers divided by GDP at current prices in US dollars.

Foreign direct investment presented in Table A17 refers to equity capital, reinvested earnings, investment in debt securities, and other capital associated with the transactions of enterprises, net of repatriations and intercompany loan repayments. For Bangladesh, only capital investments passing through banking channels are reported.

Except for Maldives and Pakistan, gross international reserves (GIR) comprise holdings of special drawing rights (SDR), reserve position in the International Monetary Fund (IMF), and foreign exchange at the end of the given period (A18). GIR comprises foreign assets of the Maldives Monetary Authority, while for Pakistan, GIR comprises net foreign reserves with the State Bank of Pakistan.

Table A19 presents outstanding external debt (percentage of GDP) and debt service ratio (percentage of exports of goods and services).

For Bangladesh, the sum of exports of goods, nonfactor services, and workers' remittances is the denominator for the ratio.

Banking Sector Reforms and Vulnerability. The tables (A20–A21) in this section comprise historical information on bank deposit and credit in selected South Asian economies, selected Southeast Asian economies, and the People's Republic of China covering 1995 through 2005. Data in these tables are based on the IMF's *International Financial Statistics Online*.

Macroeconomic Indicators

National Accounts

Table A1. GDP and Per Capita GDP (current market prices)

	GDP ($ billion)		Per Capita GDP ($)	
	2000	2005	2000	2005
South Asia	605.6	1,001.4	465.4	710.0
Afghanistan	—	7.3	—	295.9
Bangladesh	47.1	60.4	363.1	440.8
Bhutan	0.4	0.9	655.8	1,110.2
India	461.4	797.6	452.8	720.5
Maldives	0.6	0.8	2,300.3	2,575.0
Nepal	5.5	7.4	243.8	292.2
Pakistan	73.9	110.9	528.8	720.1
Sri Lanka	16.6	23.5	898.7	1,196.8

Table A2. Growth Rate of GDP (annual change, %)

	2000	2001	2002	2003	2004	2005	2006	2007
South Asia	4.5	5.1	3.7	7.7	7.4	8.1	7.5	7.5
Afghanistan	—	—	28.6	15.7	8.0	14.0	12.0	10.6
Bangladesh	5.9	5.3	4.4	5.3	6.3	6.0	6.7	6.0
Bhutan	5.6	7.5	8.9	7.1	7.5	6.1	10.0	12.0
India	4.4	5.8	3.8	8.5	7.5	8.4	7.8	7.8
Maldives	4.8	3.5	6.5	8.5	9.5	-5.2	18.7	6.0
Nepal	6.0	4.8	-0.4	3.0	3.5	2.3	2.3	4.0
Pakistan	3.9	2.0	3.1	4.7	7.5	8.6	6.6	7.0
Sri Lanka	6.0	-1.5	4.0	6.0	5.4	6.0	6.1	5.8

Table A3. Growth Rate of Per Capita GDP (annual change, %)

	2000	2001	2002	2003	2004	2005	2006	2007
South Asia	2.7	3.4	1.8	6.0	5.7	6.5	6.0	5.9
Afghanistan	—	—	—	13.6	3.3	6.9	7.8	6.8
Bangladesh	4.6	5.2	3.1	3.8	4.9	4.6	5.3	3.7
Bhutan	2.4	4.8	6.2	4.5	5.0	3.8	—	—
India	2.5	3.9	2.0	6.6	5.8	6.9	6.3	6.3
Maldives	2.7	1.7	4.8	6.8	8.0	-7.8	15.9	3.5
Nepal	5.0	2.2	-13.6	13.5	1.3	0.1	0.1	2.3
Pakistan	1.6	-0.2	0.9	2.6	6.4	6.1	4.7	4.6
Sri Lanka	4.5	-2.9	2.5	4.7	4.3	4.9	5.2	5.0

Table A4: Shares of Major Sectors (% of GDP)

	Agriculture		Industry		Services	
	2000	**2005**	**2000**	**2005**	**2000**	**2005**
South Asia	24.6	20.4	25.6	26.2	49.8	53.3
Afghanistan	—	37.8	—	24.6	—	37.6
Bangladesh	25.6	22.3	25.7	28.3	48.7	49.4
Bhutan	28.2	23.3	34.9	38.8	36.9	37.9
India	24.3	19.9	25.9	26.1	49.8	54.0
Maldives	9.0	9.7	13.9	16.8	77.1	73.5
Nepal	37.8	39.1	23.8	22.2	38.4	38.8
Pakistan	25.9	22.5	23.3	26.2	50.7	51.3
Sri Lanka	20.5	17.2	27.6	27.0	52.0	55.8

Table A5. Shares of Consumption, Saving, and Investment (% of GDP)

	Total Consumption		Gross Domestic Saving		Gross Domestic Investment	
	2000	**2005**	**2000**	**2005**	**2000**	**2005**
South Asia	77.8	73.0	22.2	27.0	23.4	29.1
Afghanistan	—	102.3	—	–2.3	—	40.3
Bangladesh	82.1	80.0	17.9	20.0	23.0	24.5
Bhutan	68.0	55.6 [a]	32.0	44.4 [a]	47.4	61.0 [a]
India	76.3	70.3 [b]	23.7	29.7 [b]	24.2	31.0 [b]
Maldives	55.8	51.9 [a]	44.2	48.1 [a]	26.3	36.0 [a]
Nepal	84.8	87.6	15.2	12.4	24.3	28.9
Pakistan	83.2	85.7	16.8	14.3	17.2	18.1
Sri Lanka	82.6	82.8	17.4	17.2	28.0	26.5

[a] 2004 data.
[b] Based on preliminary data.

Table A6. Shares of Exports and Imports (% of GDP)

	Exports		Imports		Net Exports	
	2000	**2005**	**2000**	**2005**	**2000**	**2005**
South Asia	14.1	18.8	15.8	21.6	-1.6	-2.8
Afghanistan	—	8.3	—	51.0	—	-42.6
Bangladesh	14.0	16.6	19.2	23.0	-5.2	-6.5
Bhutan	29.4	28.2 [a]	46.9	41.5 [a]	-17.5	-13.3 [a]
India	13.2	19.0 [a]	14.1	21.0 [a]	-0.9	-2.0 [a]
Maldives	89.5	92.4 [a]	71.6	85.9 [a]	17.9	6.5 [a]
Nepal	23.3	16.1	32.4	32.6	-9.1	-16.5
Pakistan	13.4	15.5	14.7	19.3	-1.2	-3.8
Sri Lanka	39.0	33.5	49.6	42.8	-10.6	-9.3

[a] 2004 data.

Money and Prices

Table A7. Inflation Rate (annual change, %)

	2000	2001	2002	2003	2004	2005	2006	2007
South Asia	6.1	3.8	3.5	5.0	6.2	5.2	6.0	5.4
Afghanistan	—	—	5.1	24.1	13.2	12.3	9.2	5.0
Bangladesh	2.8	1.9	2.8	4.4	5.8	6.5	7.2	7.0
Bhutan	—	—	2.9	2.1	3.6	4.8	4.9	4.5
India	7.1	3.7	3.4	5.4	6.4	4.4	5.5	5.0
Maldives	-1.2	0.7	0.9	-2.9	6.4	3.3	2.8	2.5
Nepal	3.5	2.4	2.9	4.8	4.0	4.5	7.9	6.5
Pakistan	3.6	4.4	3.5	3.1	4.6	9.3	8.0	6.5
Sri Lanka	1.5	12.1	10.2	2.6	7.9	10.6	9.0	8.0

Table A8. Liquidity Growth (annual change, %)

	2000	2001	2002	2003	2004	2005
South Asia	16.1	13.7	14.5	16.7	13.3	20.6
Afghanistan	—	—	—	50.5	41.8	14.1
Bangladesh	18.6	16.6	13.1	15.6	13.8	16.8
Bhutan	21.4	5.5	17.6	28.7	4.0	10.7
India	16.8	14.1	14.7	16.7	12.3	21.3
Maldives	4.2	9.1	19.5	14.5	32.7	11.7
Nepal	21.8	15.2	4.4	9.8	12.8	8.3
Pakistan	9.4	9.0	15.4	18.0	19.6	19.3
Sri Lanka	12.9	13.6	13.4	15.3	19.6	19.1

Government Finance

Table A9. Revenues and Expenditure (% of GDP)

	Tax Revenue		Total Revenue		Expenditure	
	2000	2005	2000	2005	2000	2005
South Asia	13.3	15.3	16.7	19.1	25.3	25.9
Afghanistan	—	3.7	—	13.6	—	14.5
Bangladesh	6.7	8.2	8.4	10.3	13.5	13.7
Bhutan	9.8	9.2	43.8	36.5	48.1	47.1
India [a]	14.5	16.8	18.1	20.8	27.6	28.2
Maldives	—	—	32.3	46.4	36.7	58.6
Nepal	8.8	10.2	12.2	15.6	15.5	16.5
Pakistan	10.6	10.0	13.4	13.7	18.8	17.0
Sri Lanka	14.5	14.2	16.8	16.1	26.7	25.2

[a] Data from Reserve Bank of India *Annual Report 2005-06*, available: http://rbidocs.rbi.org.in/rdocs/AnnualReport/PDFs/72286.pdf

Table A10. Fiscal Deficit (% of GDP)

	2000	2001	2002	2003	2004	2005
South Asia	8.6	8.9	8.5	7.5	6.6	6.7
Afghanistan	—	—	0.1	3.0	1.2	0.9
Bangladesh	5.1	5.0	4.6	3.4	3.2	3.4
Bhutan	4.3	12.4	5.3	11.0	-2.0	10.7
India	9.5	9.9	9.6	8.5	7.5	7.5
Maldives	4.4	4.7	4.9	3.4	1.6	12.2
Nepal	3.3	4.5	3.9	1.5	1.0	0.8
Pakistan	5.4	4.3	4.3	3.7	2.4	3.3
Sri Lanka	9.9	10.8	8.9	8.0	8.1	9.0

External Sector

Table A11. Exports: Goods (annual change, %)

	2000	2001	2002	2003	2004	2005	2006	2007
South Asia	18.0	0.1	12.9	20.4	21.4	24.3	18.8	18.6
Afghanistan	—	—	82.1	46.7	-13.3	-2.6	7.9	5.9
Bangladesh	7.9	12.6	-7.6	9.5	15.9	14.0	21.6	18.0
Bhutan	9.1	-12.9	4.1	8.9	39.7	18.0	—	—
India	21.1	-1.6	20.3	23.3	23.9	27.5	20.0	20.0
Maldives	18.8	1.4	20.1	14.9	19.1	-10.7	—	—
Nepal	—	11.7	-20.3	-13.8	14.8	11.0	6.8	12.5
Pakistan	8.8	9.1	2.3	19.1	13.8	16.8	14.0	13.0
Sri Lanka	19.8	-12.8	-2.4	9.2	12.2	10.2	8.0	7.5

Table A12. Imports: Goods (annual change, %)

	2000	2001	2002	2003	2004	2005	2006	2007
South Asia	5.4	-1.7	7.9	21.4	40.4	30.3	25.0	19.3
Afghanistan	—	—	52.5	50.9	2.3	9.0	10.1	4.0
Bangladesh	4.8	11.4	-8.7	13.1	13.0	20.6	12.1	12.0
Bhutan	14.0	-8.3	9.9	1.7	29.2	67.6	—	—
India	4.6	-2.8	14.5	24.1	48.5	31.6	26.2	21.0
Maldives	-3.4	1.3	-0.5	20.2	36.9	15.5	—	—
Nepal	—	6.7	-15.3	7.1	15.9	12.1	15.5	20.0
Pakistan	-0.1	6.2	-7.5	20.1	20.0	39.6	31.3	15.0
Sri Lanka	22.4	-18.4	2.2	9.3	19.9	10.8	9.0	6.5

Table A13. Trade Balance (% of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007
South Asia	-3.1	-2.8	-2.3	-2.5	-5.0	-6.4	-7.8	-8.4
Afghanistan	—	-38.0	-29.8	-41.3	-37.4	-35.9	-33.0	-29.1
Bangladesh	-4.0	-4.3	-3.7	-4.3	-4.1	-5.5	-4.6	-4.1
Bhutan	-15.8	-14.4	-15.3	-12.3	-12.0	-26.3	—	—
India	-2.7	-2.4	-2.1	-2.3	-5.3	-6.5	-8.1	-8.9
Maldives	-37.4	-37.8	-33.2	-37.9	-49.8	-64.5	—	—
Nepal	-13.8	-13.7	-12.6	-15.4	-15.6	-16.1	-17.9	-20.6
Pakistan	-1.9	-1.8	-0.4	-0.5	-1.2	-4.1	-6.6	-7.0
Sri Lanka	-10.8	-7.3	-8.5	-8.4	-11.2	-10.7	-10.6	-9.9

Table A14. Exports: Services

	Annual Change (%)						Percentage of GDP	
	2000	2001	2002	2003	2004	2005	2000	2005
South Asia	4.1	5.8	20.0	28.7	59.3	29.5	3.3	6.7
Afghanistan	—	—	—	107.7	-12.3	30.3	—	1.6
Bangladesh	20.1	-10.6	14.0	2.5	4.2	27.4	1.8	1.9
Bhutan	-0.6	76.0	-5.6	-15.2	25.6	48.3	4.0	5.4
India	3.6	5.4	21.1	29.4	71.3	31.7	3.5	7.6
Maldives	1.7	1.6	2.5	19.1	17.4	-37.5	55.8	41.4
Nepal	—	—	—	—	—	-22.5	—	4.9
Pakistan	6.5	-2.5	38.5	46.4	-2.5	29.8	2.0	3.4
Sri Lanka	-1.5	42.2	-6.4	11.3	8.2	0.9	5.7	6.5

Table A15. Workers' Remittances ($ million)

	2000	2001	2002	2003	2004	2005
South Asia	17,198	19,980	23,015	31,575	30,445	35,118
Afghanistan	—	—	—	—	—	—
Bangladesh	1,949	1,882	2,501	3,062	3,372	3,848
Bhutan	—	—	—	—	—	—
India [a]	13,106	15,856	16,838	22,162	20,844	24,276
Maldives	—	—	—	—	—	—
Nepal [b]	—	—	—	700	794	908
Pakistan	983	1,087	2,389	4,237	3,871	4,168
Sri Lanka	1,160	1,155	1,287	1,414	1,564	1,918

[a] Data from Reserve Bank of India, *Handbook of Statistics on Indian Economy* (18 September 2006), available: http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/72777.pdf

[b] 2003 data from Nepal Rastra Bank, *Macroeconomic Indicators of Nepal* (December 2005), available: http://www.nrb.org.np/red/publication/Macroeconomic_Indicators_of_Nepal--2005-12(December_2005).pdf

Table A16. Current Account Balance (% of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007
South Asia	-0.8	0.3	1.2	2.3	-0.5	-1.4	-2.1	-2.1
Afghanistan	—	—	-3.6	3.0	1.4	-0.9	-2.0	-4.8
Bangladesh	-0.9	-2.3	0.3	0.3	0.3	-0.9	0.9	0.3
Bhutan	-10.4	-5.9	-9.9	-12.4	-8.9	-25.7	-9.0	—
India	-0.6	0.7	1.3	2.3	-0.8	-1.3	-2.1	-1.9
Maldives	-8.2	-9.4	-5.6	-4.6	-17.2	-43.1	-21.4	-16.9
Nepal	4.5	4.9	4.3	2.5	2.9	2.2	2.4	2.0
Pakistan	-1.5	-0.7	1.9	3.8	1.3	-1.6	-4.4	-5.5
Sri Lanka	-6.4	-1.4	-1.4	-0.4	-3.2	-2.8	-3.6	-2.8

Table A17. Foreign Direct Investment ($ million)

	2000	2001	2002	2003	2004	2005
South Asia	5,062	7,080	6,091	5,682	7,145	10,237
Afghanistan	—	—	50	58	187	378
Bangladesh	383	550	391	376	385	776
Bhutan	—	—	2	2	3	9
India [a]	4,031	6,125	5,036	4,322	5,589	7,691
Maldives	—	—	—	—	—	—
Nepal	3	—	-4	12	—	2
Pakistan [a]	472	323	485	798	951	1,525
Sri Lanka	173	82	181	171	217	234

[a] Inward FDI; Pakistan data from State Bank of Pakistan, *Handbook of Statistics on Pakistan Economy 2005*, available: http://www.sbp.org.pk/departments/stats/PakEconomy_HandBook/Chap_7.pdf

Table A18. Gross International Reserves

	$ Million		Months of Import Coverage	
	2000	2005	2000	2005
South Asia	47,266	169,121	5.4	8.2
Afghanistan	—	1,662	—	4.1
Bangladesh	1,602	2,930	2.1	2.5
Bhutan	291	367	16.3	9.4
India	42,281	151,622	7.0	9.3
Maldives	124	187	3.3	2.7
Nepal	927	1,476	6.9	7.4
Pakistan	991	9,805	0.9	4.1
Sri Lanka	1,049	2,735	1.5	3.3

Table A19. External Debt

	% of GDP		Debt Service (% of exports of goods and services)	
	2000	2005	2000	2005
South Asia	26.5	19.4	17.0	10.2
Afghanistan	—	11.6	—	0.5
Bangladesh	33.4	30.5	7.3	4.8
Bhutan	41.8	83.2	4.9	7.0
India	22.0	15.7	16.6	10.2
Maldives	33.9	56.6	4.2	6.5
Nepal	46.8	41.9	6.0	9.4
Pakistan	43.6	30.7	31.5	14.9
Sri Lanka	54.4	48.3	14.7	7.9

Banking Sector Vulnerability and Reforms

Table A20. Growth of Domestic Bank Deposits and Credit (%, annual average)

	Domestic Deposits					Domestic Credit				
Year	BAN	IND	NEP	PAK	SRI	BAN	IND	NEP	PAK	SRI
1996	11.6	20.7	13.6	24.8	13.2	17.0	19.7	18.0	21.0	8.9
1997	9.5	19.5	18.0	24.2	17.1	12.3	11.9	14.5	9.8	10.1
1998	12.3	19.7	26.6	6.9	13.2	13.1	15.7	14.8	8.9	13.9
1999	15.3	17.0	22.3	1.7	13.5	15.3	17.9	19.1	4.8	16.2
2000	18.4	17.5	19.9	9.2	13.8	13.7	16.0	17.1	10.3	27.0
2001	15.6	14.7	-1.3	14.3	14.9	17.2	11.8	—	-0.2	12.0
2002	14.6	17.4	4.2	18.9	13.2	12.2	16.0	—	2.7	12.2
2003	13.8	12.6	12.9	17.9	15.5	4.9	9.5	—	10.7	7.3
2004	16.1	17.3	12.6	22.1	20.0	18.4	18.0	—	28.1	22.0
2005	16.6	15.7	—	18.2	—	19.0	15.5	—	23.2	—

Table A21. Bank Deposits and Domestic Credit-to-GDP Ratios (%)

Year	BAN	IND	NEP	PAK	SRI	PRC	INO	MAL	PHI	THA
	Average Bank Deposits-to-GDP Ratio									
1995	24.7	34.1	27.1	30.8	32.5	86.1	44.0	103.3	43.9	78.3
1996	25.3	35.8	27.1	33.9	32.0	94.0	48.4	104.6	48.2	78.9
1997	25.5	38.4	28.4	36.7	32.3	103.3	51.5	110.2	55.1	92.4
1998	25.8	40.2	33.5	35.6	31.2	112.4	55.5	114.1	55.0	105.2
1999	27.1	41.8	36.1	33.0	33.4	124.1	53.0	122.1	55.6	105.6
2000	29.8	45.7	39.0	27.9	33.5	129.1	48.2	117.2	54.1	106.6
2001	32.2	48.4	35.5	29.1	34.4	134.9	45.1	132.9	52.7	107.5
2002	34.2	53.0	36.0	32.7	34.6	157.3	42.7	126.9	52.6	104.4
2003	35.4	52.9	37.7	35.1	35.9	165.9	41.8	127.2	50.2	106.5
2004	37.1	54.9	39.1	37.4	37.4	151.1	40.5	123.9	49.4	102.2
2005	39.1	56.2	—	37.4	38.4	156.3	39.4	119.8	47.1	99.1
	Average Domestic Credit-to-GDP Ratio									
1995	28.2	44.3	34.6	51.0	40.9	91.1	51.8	126.7	55.7	141.3
1996	30.2	46.0	36.0	54.4	38.7	97.2	54.0	142.4	67.9	146.4
1997	31.3	46.3	36.5	52.1	36.8	106.2	59.6	163.4	78.5	177.6
1998	31.9	46.8	39.1	51.4	35.7	120.8	59.9	162.1	70.1	176.7
1999	33.5	49.1	41.0	49.1	39.2	129.4	62.1	150.1	64.2	155.8
2000	35.3	52.9	43.2	42.0	43.7	132.9	60.7	143.7	62.3	138.3
2001	38.7	54.6	—	38.2	43.8	136.8	53.2	154.5	58.7	128.6
2002	40.3	59.0	—	37.1	43.7	160.0	51.2	152.1	56.7	127.8
2003	38.4	57.3	—	37.5	42.1	169.5	48.7	148.3	55.6	122.7
2004	41.1	59.8	—	41.8	44.6	140.0	50.1	134.3	53.8	116.3
2005	44.2	61.1	—	43.6	—	136.2	47.0	129.1	46.2	111.1

South Asia Economic Report

This issue of the *South Asia Economic Report* (*SAER*) is the first in a series of biannual reports on economic and development issues in South Asia. The *SAER* is a cooperative effort by the South Asia Department and the Central and West Asia Department of the Asian Development Bank. The *SAER* aims to provide information to policy makers, academics, and ADB management and staff and highlights issues that help promote debate and foster appropriate policies and greater cooperation and integration in the region.

The key messages of the *SAER* are the following:

- South Asia is on a high growth path.
- Growth is primarily driven by domestic demand and the services sector, unlike in East and Southeast Asia.
- Continued sound macroeconomic management, policy and institutional reforms, and targeted public investments in infrastructure are needed to sustain the high growth.
- In macroeconomic management, the key areas of concern are inflation and increasing current account deficits.
- With regard to policy and institutional reforms, there is a need to focus on improving regulatory quality and government effectiveness.

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