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fertility and high population growth rates, per capita agricultural production in Pacific island countries appears to be declining and it is probably becoming harder to maintain livelihoods in rural areas.[b] Because of the poor opportunities for formal employment, many rural migrants have not found jobs in the formal sector and therefore have to sustain themselves and their families with informal sector activity. Underemployment is a much more relevant issue for the Pacific island countries than unemployment.

Economies such as Cook Islands, the Federated States of Micronesia, Marshall Islands, Samoa and Tonga have relatively easy access to emigration, which reduces the working-age population and therefore increases formal sector employment as a percentage of the working-age population.

In the Pacific island countries that do not have such easy access to emigration, such as Papua New Guinea, Solomon Islands and Vanuatu, the bulk of the population (75 per cent or more) live in rural areas and earn their livelihood from mixed subsistence cash-crop activity. Most of those in rural areas are unskilled and would have little chance of migrating even if easier access to metropolitan countries were provided.

The Governments of Pacific island countries must improve the investment climate if they are to see increases in formal sector employment and reductions in unemployment and underemployment. Otherwise, workers will continue to leave for overseas employment or remain underemployed in the rural sector; another alternative is that they will continue to migrate to urban centres, where they will have to support themselves through legal or illegal informal activity.

[b] Mahendra, Reddy and Ron C. Duncan, "Causes of decline in Pacific island agriculture", (mimeo) (Suva, University of South Pacific, 2005); Marin Yari and Ron C. Duncan, "Food security: development issue for Pacific island countries", *Bulletin on Asia-Pacific Perspectives 2004/05* (United Nations publication Sales No. E.04.II.F.47), pp. 97-116.

Moreover, in the larger countries such as Papua New Guinea, Solomon Islands and Vanuatu, emigration and remittances cannot be expected to become as important as they are in the smaller and atoll economies.

For land-rich countries such as Fiji, Papua New Guinea, Solomon Islands and Vanuatu, where most of the populations continue to live and work in the rural sector, the development strategy should focus on the rural sector. Agricultural productivity has to increase so that rural incomes and welfare improve, helping to spur growth in rural services. Growth in the urban manufacturing and services sectors will create employment for labour that will be able to move out of the rural sector as its productivity improves. Increased research is needed to provide improved and new varieties of crops and improved farming systems. Improved access to markets for rural produce will demand improved infrastructure and better market information.

South and South-West Asia

Overview

Despite high oil prices, the momentum of growth was maintained …

Despite high oil prices, the South and South-West Asian subregion maintained its growth momentum in 2005. The continuing reforms and structural changes of the last few years are bearing fruit. The subregion's increasing integration into an expanding global economy, rising consumer spending and generally accommodative policies are also helping to foster economic growth. Both India and Pakistan have achieved impressive growth rates in recent years. On the basis of sustained high economic growth, India is increasingly becoming a leading contributor to global growth. A strong earthquake in October 2005 resulted in massive loss of human life and damage to property and infrastructure in Pakistan, but the impact on GDP growth is expected to be minimal as the areas affected are mountainous and their contribution to GDP is small. Sri Lanka maintained its growth momentum despite the tsunami disaster in late 2004. After the immediate relief work in 2004 and 2005, the country is now engaged in reconstruction and rehabilitation in the affected area. Higher growth is projected for 2006, driven by improved performance in various sectors of the economy and the continuing reconstruction work. High oil prices are helping the Islamic Republic of Iran to maintain its growth momentum, while in Turkey growth has slowed to a more sustainable level in 2005.

... but inflationary pressures are emerging

Partly because of higher oil prices, inflationary pressures are emerging. In India, inflation increased by 0.7 percentage point in 2005 over that in 2004, while in Pakistan and Sri Lanka the increase has been much sharper, at more than 4 percentage points. In some countries food price increases outpaced overall consumer prices, becoming an extra burden for the poor, the bulk of whose income is spent on food items. The increase in the prices of domestic petroleum products in some countries was lower than the upsurge in international oil prices, because a part of the increase was absorbed by the Governments to contain inflation. In the Islamic Republic of Iran, inflation declined only marginally in 2005, while Turkey, which began a major stabilization programme in 2001, experienced lower inflation in 2005 despite the higher oil prices. In the subregion as a whole, inflationary pressures are expected to subside somewhat in 2006 as the impact of higher oil prices is absorbed and most countries pursue tighter monetary policies.

Higher oil prices are hurting current account balances

Currently high oil prices are hurting countries by threatening more sustained inflationary pressure and by eroding the current account of the balance of payments. While export growth remains strong in most countries, imports are growing faster, widening the gap between exports and imports. As a result, the current account surplus turned into deficit in fiscal year 2005 in Pakistan and the deficit widened in India, Sri Lanka and Turkey. If oil prices rise further, the balance of payments situation could deteriorate further in most countries in the subregion in 2006. The Islamic Republic of Iran, however, being a major exporter of oil, would have a much larger surplus on its current account.

Main challenge is to maintain growth with macroeconomic stability

The main challenges facing the subregion include sustaining the higher growth momentum while maintaining macroeconomic stability. Containing inflationary pressures while oil prices are rising has to be the main priority. Judicious use of fiscal and monetary policies can help to limit the increase in consumer prices. Several countries in the subregion are growing rapidly, in part fuelled by higher consumer spending financed by credit. There is a need to remain vigilant, especially where rapid economic growth is accompanied by a wider current account deficit and higher inflation. Containing credit booms usually requires strengthened surveillance of the banking system and close scrutiny of corporate borrowing during periods of rapid economic growth to prevent the impairment of asset quality in the financial system.

Fiscal consolidation should be high on the agenda in all countries

The Governments of virtually all countries in the subregion are trying to bring budget deficits down to more sustainable levels. In India, under the Fiscal Responsibility and Budget Management Act, 2003, the Government has formulated a medium-term strategy for putting the fiscal balance on a sustainable basis. Pakistan also passed similar legislation, the Fiscal Responsibility and Debt Limitation Act, 2005, to limit the fiscal deficit and public debt. The Government of Sri Lanka has reiterated its commitment to a phased reduction of the budget deficit over the medium term to ensure an orderly correction of the structural weaknesses in the fiscal system. Continuing budget deficits have led to high public debt in most countries of the subregion, although the public debt as a ratio of GDP is falling in some countries, including India and Pakistan. A large part of the public debt is domestically held, so when huge public financial resources are needed for debt servicing, Governments are forced to limit their expenditures on priority areas such as poverty reduction and social development. Containing public debt by limiting the budget deficit should therefore remain a major priority of all countries in the subregion.

GDP growth performance

India maintains high growth

India has achieved high GDP growth in recent years. Growth of 8.5 per cent in 2003 slowed to 7.5 per cent in 2004, as agricultural growth slowed (see figure II.21). GDP growth accelerated to 8.1 per cent in 2005, aided by growth in all the main sectors. In addition to the return to a near-normal harvest, the strong response of the private sector to emerging opportunities sustained robust growth in industry and services. Capital goods and consumer goods performed well, indicating an acceleration in both consumer and investment demand. The economy also benefited from substantial inflows of foreign investment and the Government's efforts to contain the fiscal deficit despite

Figure II.21. GDP and sectoral growth in selected South and South-West Asian economies, 2003-2005[a]

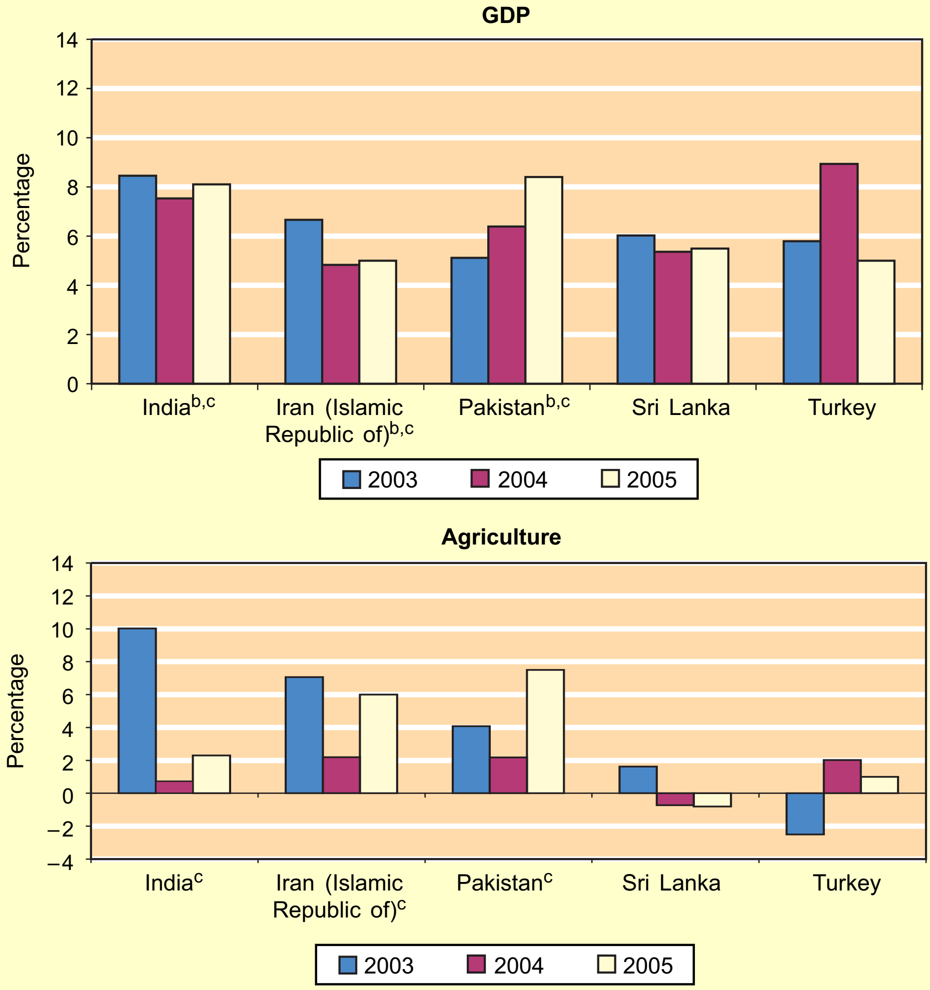

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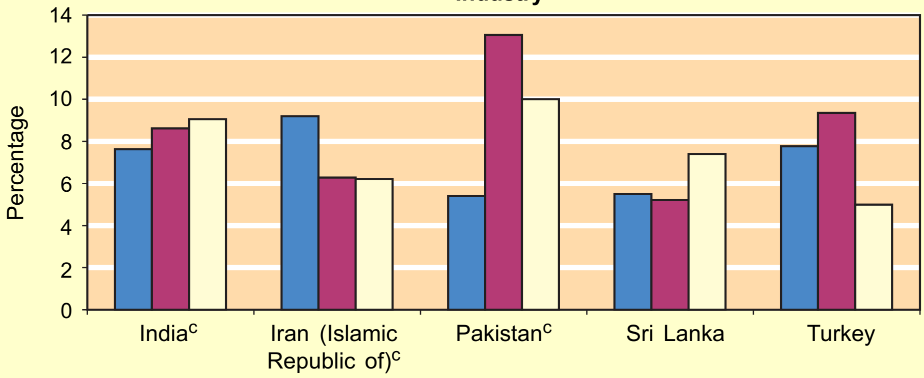
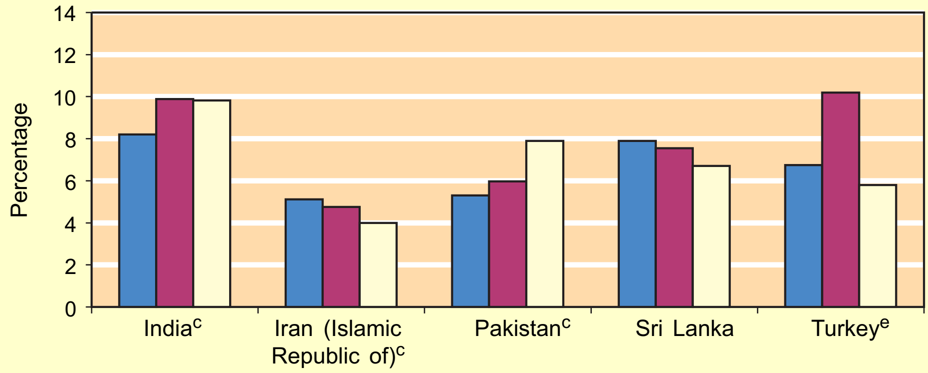
Figure II.21 *(continued)*

Industry[d]



Services



Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on national sources; India, Ministry of Finance, *Economic Survey of India 2004-2005* (New Delhi, 2005); Central Bank of Iran, *Economic Trends* (Tehran, 2005); Pakistan, *Economic Survey of Pakistan 2004-05* (Islamabad, 2005); Central Bank of Sri Lanka, *Annual Report 2004* (Colombo, 2005); and Central Bank of the Republic of Turkey, *Annual Report 2004* (Ankara, 2005).

[a] Growth rates for 2005 are estimates.
[b] GDP growth rate refers to real GDP at factor cost.
[c] Fiscal year data.
[d] Industry comprises mining and quarrying; manufacturing; electricity-generation, gas and power; and construction.
[e] Construction is included under services.

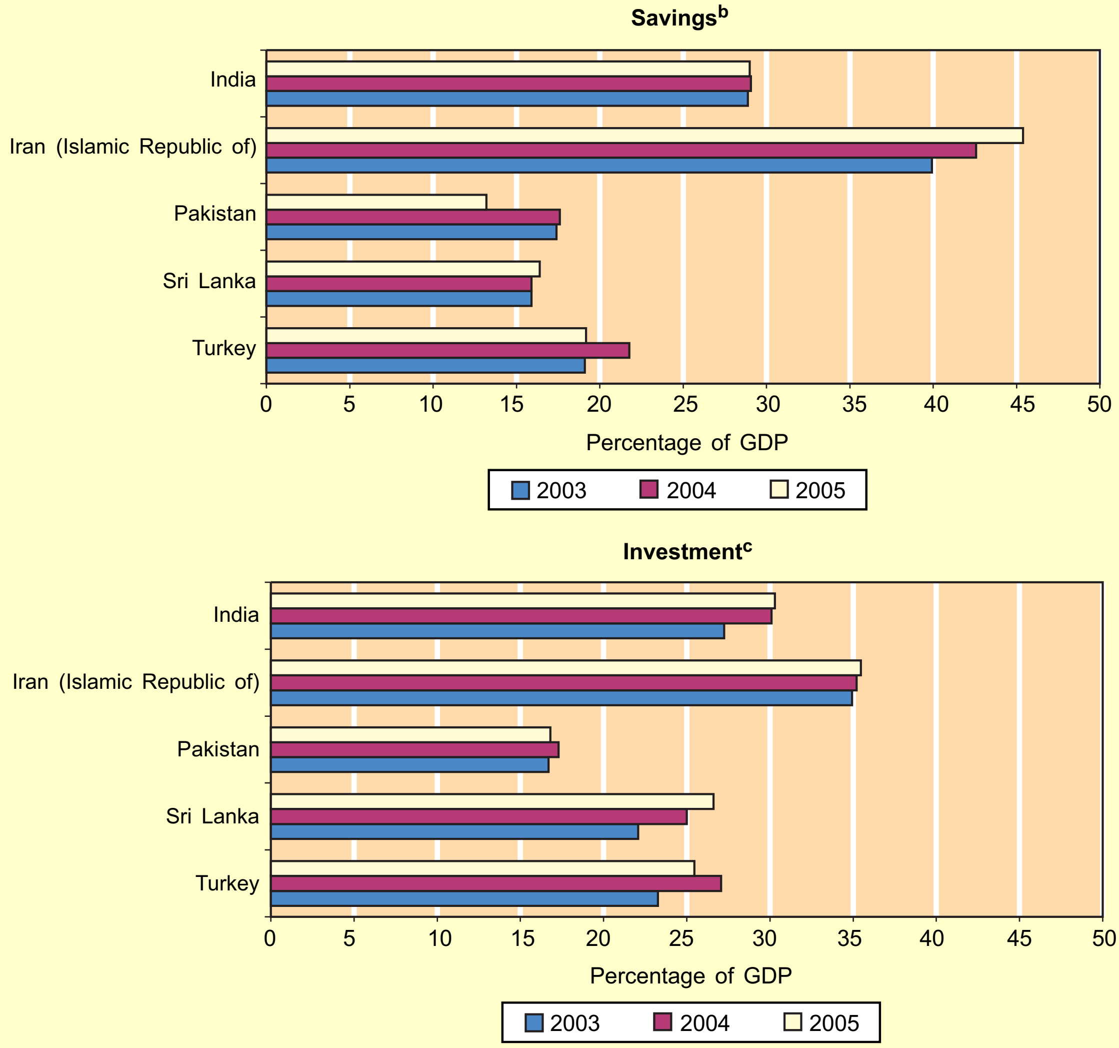
higher public expenditure for employment generation programmes. The good performance of agriculture and industry in recent years has generated a strong demand for transport and communications, trade-related activities and financial services. Rapid increases in expenditure on public administration, social services and rural extension services have also had a favourable impact on growth in the service sector, which accounted for more than 50 per cent of GDP in 2005.

Growth accelerated in Pakistan in 2005

Pakistan appears to be in the midst of a strong economic upturn, recording its third straight year of impressive economic growth in

2005. GDP growth of 8.4 per cent in 2005 was the highest in the last two decades. Contributing to the acceleration were strong domestic demand, better weather conditions for agriculture, continuity of economic policies and a robust financial sector. There was a sharp increase in nominal investment supported by strong macroeconomic fundamentals, increased availability of credit and a significant rise in foreign direct investment. However, the investment to GDP ratio has remained at about 17 per cent in the last four years (see figure II.22). On the supply side, agriculture

Figure II.22. Savings and investment in selected South and South-West Asian economies, 2003-2005[a]



Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on national sources; India, Ministry of Finance, *Economic Survey of India 2004-2005* (New Delhi, 2005); Central Bank of Iran, *Economic Trends* (Tehran, 2005); Pakistan, *Economic Survey of Pakistan 2004-05* (Islamabad, 2005); Central Bank of Sri Lanka, *Annual Report 2004* (Colombo, 2005); and Central Bank of the Republic of Turkey, *Annual Report 2004* (Ankara, 2005).

[a] Data for 2005 are estimates.
[b] Gross domestic savings.
[c] Gross domestic investment.

performed exceptionally well in 2005, with good weather and supportive government policies contributing a growth rate of 7.5 per cent, an increase over the 2.2 per cent rate in 2004. Large-scale manufacturing recorded an impressive and broad-based growth rate of 15.4 per cent in 2005. The service sector grew by 7.9 per cent in 2005, in line with the higher growth in the commodity-producing sectors.

Despite the tsunami disaster, Sri Lanka maintained growth momentum

The economy of Sri Lanka expanded by 5.4 per cent in 2004. Towards the end of the year the tsunami struck, leading to enormous human and material losses. Economic growth slowed to 4.4 per cent in the first quarter of 2005, reflecting negative impacts on the tourism and fisheries sectors. As these sectors recovered, GDP growth improved to 5.5 per cent for the year as a whole.[2] The service sector grew by 6.7 per cent and industry grew by 7.4 per cent. Agriculture, however, contracted by 0.8 per cent in 2005 on top of a 0.7 per cent contraction in 2004. Unfavourable weather conditions for certain crops and the adverse impact of the tsunami on the fisheries sector contributed primarily to negative growth in the agricultural sector. Investment, particularly from the public sector, was channelled towards rehabilitation and reconstruction activities to normalize life in the tsunami-affected areas. As a result, investment rose from 25 per cent of GDP in 2004 to 26.6 per cent in 2005, while savings rose from 15.9 per cent of GDP to 16.4 per cent over the same period.

Higher oil prices helped the Islamic Republic of Iran to sustain growth

In the Islamic Republic of Iran, GDP grew by 4.8 per cent in 2004 compared with 6.7 per cent in 2003. Oil sector growth was limited to 2.6 per cent because of lower production. Agricultural growth also slowed. However, the industrial sector registered somewhat higher growth on better performance of large-scale manufacturing. There was a slight deceleration in the services sector. GDP was expected to grow by 5 per cent in 2005, slightly faster than in the previous year, partly as a result of the increase in oil prices. Agriculture also staged a major recovery in 2005, and there was some expansion in the industrial sector. However, service sector growth slowed further. On the demand side, the ratio of savings to GDP rose faster than the ratio of investment to GDP, reflecting the growing current account surplus.

Growth in Turkey slowed to a more sustainable level

In Turkey, GDP grew by an impressive 8.9 per cent in 2004, driven mainly by private domestic demand, with almost equal contributions from consumption and investment expenditure. Growth is estimated to have slowed to 5.0 per cent in 2005, with both production and consumption adversely affected by higher energy prices. In 2004, lower interest rates and a credit boom fuelled spending on durable goods and machinery and equipment, while a tight fiscal policy reduced public consumption and investment spending. Domestic demand began to slow in the second half of 2004, bringing production to a more sustainable level and reducing the demand for imports.

Reducing unemployment and poverty requires maintaining high growth rates

In the subregion, high growth rates need to be maintained to tackle poverty, a key challenge in most countries, as the South Asian Association for Regional Cooperation also recognized at its thirteenth Summit in Dhaka in November 2005 (see box II.3). Unemployment and underemployment are among the major reasons for the high incidence of poverty in South Asia. Official figures place open unemployment in the subregion at about 8 per cent, although the rate varies across countries. There is a lack of data on underemployment, but it is likely to be high. More than half the labour force is employed in the informal sector, where people tend to be underemployed and their income levels are low.

Urbanization is progressing in the subregion, but the largest share of people still live in rural areas and most are dependent on agriculture. Rural industrialization, based on the processing of agricultural products, is thus the key to generating additional employment in rural areas. Although fertility rates are declining in all countries in South Asia, population pressure con-

[2] Estimates based on data for the first three quarters of 2005.

Box II.3. Thirteenth Summit of the South Asian Association for Regional Cooperation: high priority for fighting poverty, managing natural disasters and combating terrorism

The South Asian Association for Regional Cooperation (SAARC), an intergovernmental organization that comprises Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka, held its thirteenth Summit in Dhaka, Bangladesh, in November 2005.[a] The Dhaka Declaration, issued by the Summit, called for stronger efforts for alleviating poverty, managing natural disasters and combating terrorism.

Recognizing poverty as the greatest challenge in the region, the Summit declared the decade of 2006-2015 the SAARC Decade of Poverty Alleviation, calling on Governments to infuse poverty-reduction efforts at the national and the regional levels with a renewed sense of commitment and urgency. It called for the establishment of a "SAARC poverty alleviation fund" and for enhanced economic cooperation, the main emphasis of which would be securing a wider economic space to realize fully the economic potential of South Asia so that all can share in its benefits and opportunities. Efforts would be made to create dynamic complementarities in the development of human resources and the capacity of member States to address common challenges. For this, regional cooperation would be accelerated through all available means, including the exchange of information on best practices. Member States were encouraged to undertake projects, under SAARC auspices, in the economic and social sectors, including human resource development and poverty alleviation. Financial or technical assistance from international financial institutions, the United Nations or any non-member State can be sought for undertaking these projects.

The Dhaka Declaration also stressed the need for meeting the 1 January 2006 deadline for implementation of the South Asian Free Trade Area Agreement. The Declaration also reiterated the need for closer regional cooperation in information and communication technologies and for stronger transportation and communication links for accelerated and balanced economic growth.

In recent years, South Asia has suffered extensive loss of life and colossal damage to property as a result of natural disasters such as the 2004 tsunami and 2005 earthquake. Member States agreed to establish a permanent regional response mechanism for disaster preparedness, emergency relief and rehabilitation. National authorities would coordinate their activities in early warning, information exchange, training, sharing of best practices in emergency relief efforts and other disaster-management activities.

Terrorism was also identified as a critical threat to economic stability and social development. Member States expressed a determination to join together to combat terrorism in the region.

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[a] Afghanistan has been admitted to SAARC as a full member subject to the completion of various formalities. A decision in principle has been taken to allow China and Japan to become observers.

tinues to be a serious problem. It is clear therefore that a comprehensive package of population policies and programmes is needed to tackle the problem of unemployment and poverty.

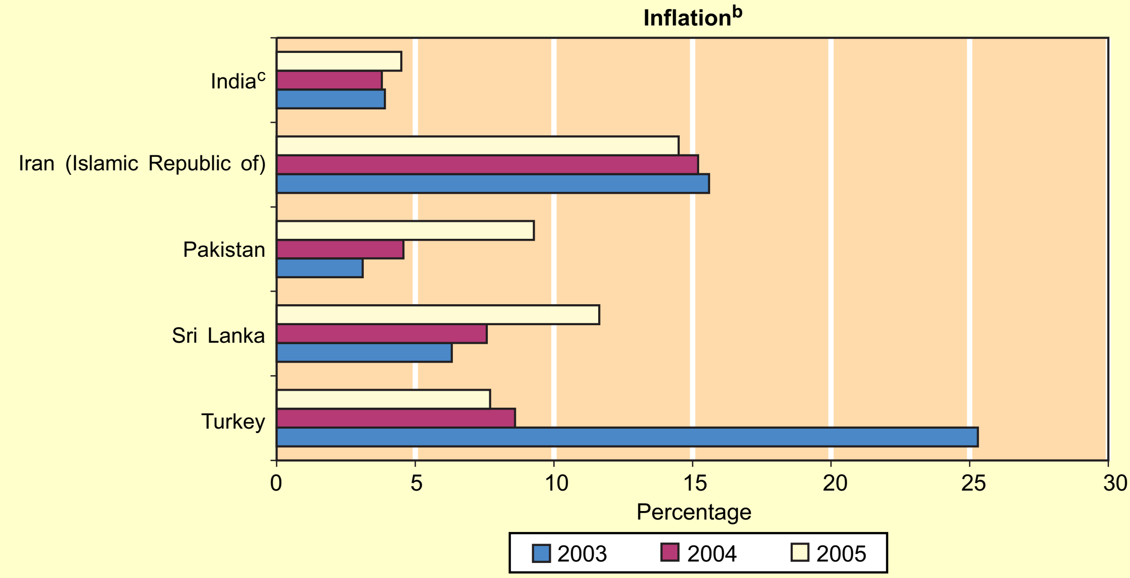
Key macroeconomic policy developments

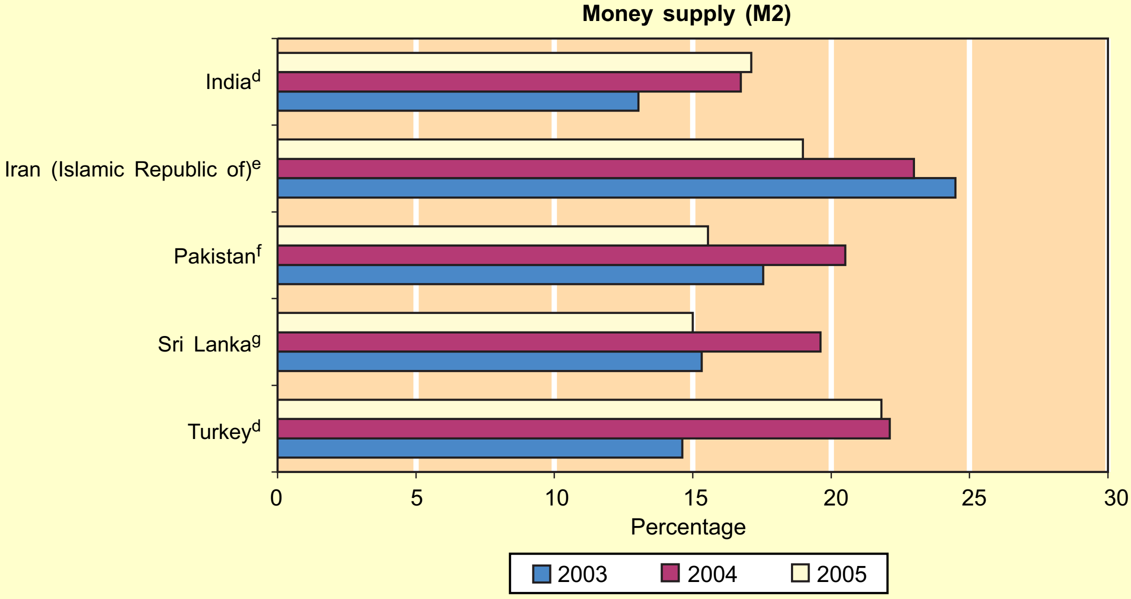
Inflation

Inflation in India remains low despite some acceleration

In India, average inflation based on the consumer price index rose from 3.8 per cent in 2004 to 4.5 per cent in 2005 (see figure II.23). Higher oil prices exerted considerable upward pressure, but the less than full price adjustment in the domestic market cushioned the impact of those prices. Other anti-inflationary policies in recent years include strict monetary and fiscal discipline and an effective management of supply and demand for essential consumer goods and raw materials through liberal imports. These policies have been aided by a strengthening of the public distribution system for food grains, sugar and kerosene. Successive budgets have provided various fiscal concessions and extended the value added tax to ensure that indirect taxes do not create cascading effects and unduly add to the prices of essential items.

Figure II.23. Inflation and money supply growth in selected South and South-West Asian economies, 2003-2005[a]





Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on national sources; India, Ministry of Finance, *Economic Survey of India 2004-2005* (New Delhi, 2005); Central Bank of Iran, *Economic Trends* (Tehran, 2005); Pakistan, *Economic Survey of Pakistan 2004-05* (Islamabad, 2005); Central Bank of Sri Lanka, *Annual Report 2004* (Colombo, 2005); Central Bank of the Republic of Turkey, *Annual Report 2004* (Ankara, 2005); and International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, January 2006).

[a] Data for 2005 are estimates.
[b] Inflation refers to changes in the consumer price index.
[c] Consumer price index for industrial workers.
[d] Data for 2005 are for January-September.
[e] Data for 2005 are for January-June.
[f] Data for 2005 are for January-October.
[g] Data for 2005 are for January-May.

Buoyant industrial growth improved the supply of manufactured items, while continuing government procurement built up stocks of food grains.

Inflation picked up in Pakistan and Sri Lanka

In Pakistan, inflationary pressure strengthened considerably in 2005, as inflation rose from 4.6 per cent in 2004 to 9.3 per cent. It is not uncommon to see price pressures build when economic activity accelerates because of various distribution bottlenecks in the country. Three years of strong economic growth, complemented by record low interest rates and the ongoing structural shift of many households towards higher consumption, have injected new life into domestic spending. This spending, coupled with rising oil and other commodity prices, contributed to a sharp increase in inflation in 2005. Food inflation reached double digits, a heavy burden on the poor who spend most of their income on food. The Government took several measures to ease inflationary pressures. It did not pass on to consumers, the entire increase in the international price of oil, and it began to tighten monetary policy to ease demand pressures. To improve the supply of food items, it allowed imports of food items from neighbouring countries.

Inflation also increased in Sri Lanka in 2005, rising from 7.6 per cent in 2004 to 11.6 per cent. Prices rose for both domestically produced and imported goods. Higher oil prices exerted substantial indirect pressure on consumer prices, although the full increase in oil prices was not passed on to consumers. The removal of the value added tax on certain imported products also dampened the impact of the rising cost of imported goods on consumer prices. Nonetheless, higher monetary expansion contributed to demand-driven inflationary pressures.

Inflation was on the decline in the Islamic Republic of Iran and Turkey

In contrast to the South Asian economies, the gradual downward trend in inflation in the Islamic Republic of Iran continued, falling from 15.6 per cent in 2003 to 15.2 per cent in 2004 and to 14.5 per cent in 2005. In general, prices rose faster for services than for goods. Also, price increases were greater than average for housing, fuel and electricity and fresh fruits and vegetables because of supply constraints.

Turkey has been particularly successful in bringing down inflation from very high levels to low levels in recent years as part of the stabilization programme begun in 2001. A stronger lira, tight fiscal policy, major improvements in productivity and falling inflationary expectations have all contributed to this outcome. In 2004, continued slack in the labour market and rising productivity prevented strong domestic demand from being translated into increased price pressures. The average annual inflation rate, as measured by the consumer price index, was 8.6 per cent in 2004 and was estimated at 7.7 per cent for 2005 as a whole.[3]

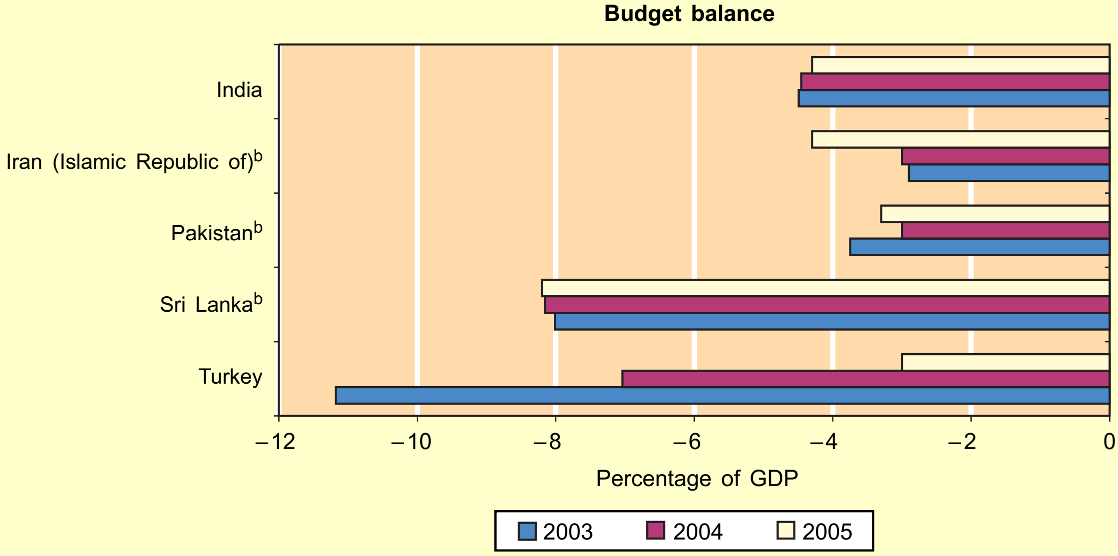
Fiscal policy developments

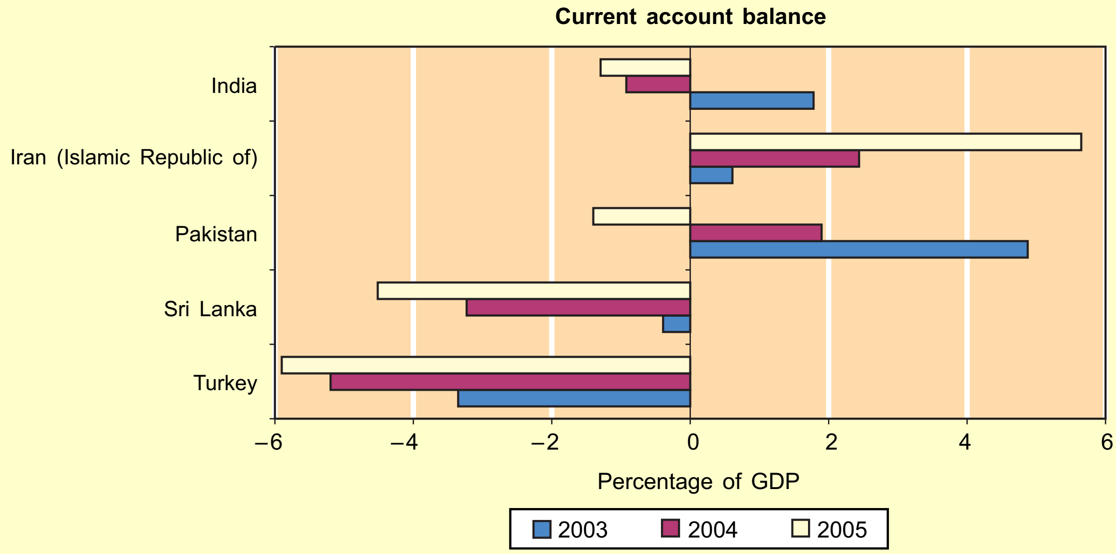
The public debt of India remains high, but is falling as a ratio to GDP

In India, the budget for 2005 was aimed at reducing marginally the central Government fiscal deficit to 4.3 per cent of GDP from 4.5 per cent in 2004 (see figure II.24). Under the Fiscal Responsibility and Budget Management Act, 2003, the Government has formulated a medium-term strategy to put the fiscal situation on a sustainable path. As a step in that direction, the Government implemented the value added tax at the state level on 1 April 2005. India's public debt remains high and is a major policy issue. Central Government debt as a ratio to GDP has decreased slightly in recent years, from 69.4 per cent at the end of March 2003 to 68.4 per cent at the end of March 2005 and was estimated to be 67.2 per cent by the end of March 2006. Most public debt is domestic. Nevertheless, a high overhang of domestic debt poses significant challenges, putting pressure on interest rates, crowding out private investment and creating problems for future debt servicing.

[3] Point-to-point inflation, which compares price levels at the beginning and end of year, was also less than 8 per cent in 2005, in line with the target of 8 per cent set by the Government.

Figure II.24. Budget balance and current account balance in selected South and South-West Asian economies, 2003-2005[a]





Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on national sources; India, Ministry of Finance, *Economic Survey of India 2004-2005* (New Delhi, 2005); Central Bank of Iran, *Economic Trends* (Tehran, 2005); Pakistan, *Economic Survey of Pakistan 2004-05* (Islamabad, 2005); Central Bank of Sri Lanka, *Annual Report 2004* (Colombo, 2005); and Central Bank of the Republic of Turkey, *Annual Report 2004* (Ankara, 2005).

[a] Data for 2005 are estimates.
[b] Excludes grants.

Budget deficits were brought down in Pakistan but may rise again

The budget deficit in Pakistan has been brought down to a relatively low level in recent years. In 2004 the deficit stood at 3.0 per cent of GDP but rose slightly to 3.3 per cent in 2005. The Central Board of Revenue of Pakistan has been achieving its tax revenue targets in recent years. However, tax revenue buoyancy remains weak, as reflected in the continuing fall in the tax to GDP ratio that limits the Government's ability to provide adequate funds for infrastructure and social programmes. Strengthening tax administration could generate additional tax revenue by improving compliance. In Pakistan non-tax revenues have been making a significant contribution to the revenues of the federal Government. However, part of the increase has come form non-recurring items. On the expenditure side, rehabilitation and reconstruction activities related to the 2005 earthquake will increase government expenditure. This raises concern about the overall budgetary deficit in the years ahead. On the positive side, the public debt (explicit liabilities) has decreased to 64 per cent of GDP in 2005 from 71 per cent in 2004 and 93 per cent in 2001.

The budget deficit in Sri Lanka needs to be contained

The overall budget deficit of Sri Lanka for 2005 is estimated at 8.2 per cent of GDP, the same as in 2004. The high deficit in 2005 was due partly to tsunami-related relief, rehabilitation and reconstruction expenditure. The target for 2006 is to bring the deficit to below 8 per cent of GDP, and the Government of Sri Lanka has reiterated its commitment to a phased reduction of the budget deficit to ensure an orderly correction of the structural weaknesses in the fiscal system over the medium term. The reduction in outstanding public debt stock from 105.5 per cent of GDP in 2004 to an estimated 98 per cent in 2005 was due mainly to the appreciation of the rupee against major currencies and higher nominal GDP growth, which exceeded the rate of increase in the government debt stock.

The budget deficit of the Islamic Republic of Iran expanded despite a rise in oil revenue

In the Islamic Republic of Iran, the fiscal year 2005 budget continued the expansionary policy of recent years. Most of the surplus oil revenues resulting from higher oil prices went into the budget instead of the Oil Stabilization Fund, as had been expected. However, non-oil revenue and privatization receipts were overestimated, resulting in a revenue shortfall. Furthermore, capital outlays were budgeted to rise significantly. Efforts were made accordingly to improve tax collection and contain the growth of current spending. The fiscal policy objectives set forth in the Fourth Five-year Development Plan (2005-2009) are aimed at reducing the dependence on oil revenue and limiting growth in current expenditure. The reform agenda also includes a gradual phasing out of implicit energy subsidies (10 per cent of GDP in 2004). There is, nonetheless, a need for more sustained efforts to strengthen administration, eliminate tax exemptions and complete the preparatory work for introduction of a value added tax.

Turkey has taken innovative measures for achieving fiscal stability under fiscal decentralization

The Government of Turkey remains committed to implementing greater fiscal decentralization in order to improve basic services at the local level. Aware that this initiative could lead local governments to spend more than their revenues, thus raising the overall fiscal deficit, the central Government plans to submit legislation to parliament to ensure that the new spending mandates of local administrations are adequately matched by local tax instruments and revenue capabilities and supported by a stable and transparent system of revenue-sharing. Strict borrowing and debt limits for special provincial administrations and municipalities will be put in place. The debt stock of municipalities and special provincial administrations will be limited to no more than their annual revenue, while the debt stock of metropolitan municipalities will be limited to 1.5 times annual revenue. New borrowing by local administrations in excess of 10 per cent of their annual revenues will require authorization of the central Government. These limits will be closely monitored and tightened if needed to contain the budget deficit.

Monetary policy and financial sector developments

Monetary policy is tightened in India, Pakistan and Sri Lanka

The Reserve Bank of India is following a policy of gradual monetary tightening aimed at controlling inflation in response to a sharp pickup in private sector credit demand. It started publishing quarterly policy assessments in July 2005, paving the way for more frequent policy adjustments. In Pakistan, monetary policy witnessed a significant change during fiscal year 2005. After several years of accommodative monetary policy, the central bank switched to aggressive tightening in the second half of fiscal year 2005 in order to contain inflation. Sri Lanka also tightened its monetary policy during 2005 in order to reduce inflationary pressures and expectations. As a result, the interest rate structure moved upward during the year.

Turkey followed a formal inflation-targeting policy from early 2006

The central bank of Turkey has followed a strategy of implicit inflation-targeting in the past few years. The move to formal inflation-targeting from early 2006 should help in the fight against inflation. The central bank will be using short-term interest rates as its main policy instrument against inflation. Monetary policy transparency and predictability, critical elements of inflation-targeting, have been further enhanced by fixing the time of Monetary Policy Committee meetings and interest rate decisions in advance. After each meeting of the Committee, the central bank explains its decision and publishes as a report summarizing the inflation outlook and the deliberations of the Committee. The Committee was to assume full responsibility for setting interest rates in early 2006.

Developments in the external sector

Foreign trade

High growth of exports outpaced by even higher growth of imports and current account turned into deficit in India …

In India the current account, after remaining in surplus for 2001-2003 with the pickup in economic activity, turned in a deficit of $6.4 billion (to 0.9 per cent of GDP) in 2004. While exports rose 24.9 per cent in 2004, imports rose even faster at 48.4 per cent, resulting in a widening of the trade deficit (see figure II.25). Although net invisibles, at $31.7 billion in 2004, increased by more than $5 billion over the previous year, the increase was too small to compensate for the substantial increase in the trade deficit. For 2005, exports were estimated to grow by 26 per cent on buoyant world demand and improvements in world commodity prices. Also contributing were export facilitating measures and good performance in key manufacturing sectors such as engineering goods, chemicals, automobiles and basic metals. Imports were expected to rise 28 per cent in 2005, due mainly to higher imports of crude oil and export-related products. As a result, the trade deficit as a percentage of GDP was estimated to increase from 5.5 per cent in 2004 to 6.3 per cent in 2005. The overall current account balance was again expected to be in deficit, at 1.3 per cent of GDP in 2005, higher than the deficit of 0.9 per cent of GDP in 2004.

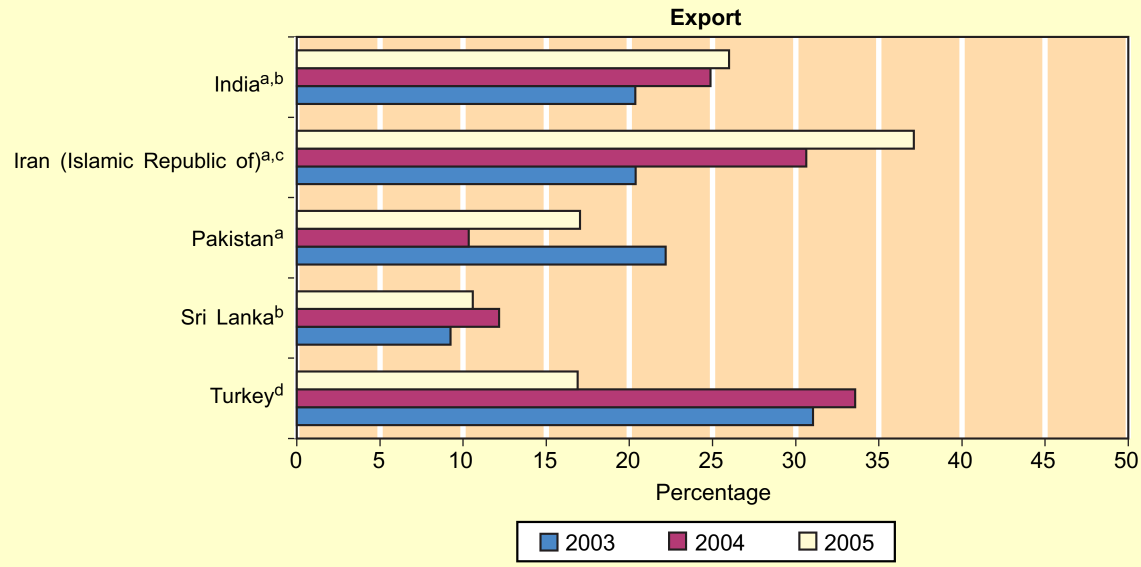
… and in Pakistan also

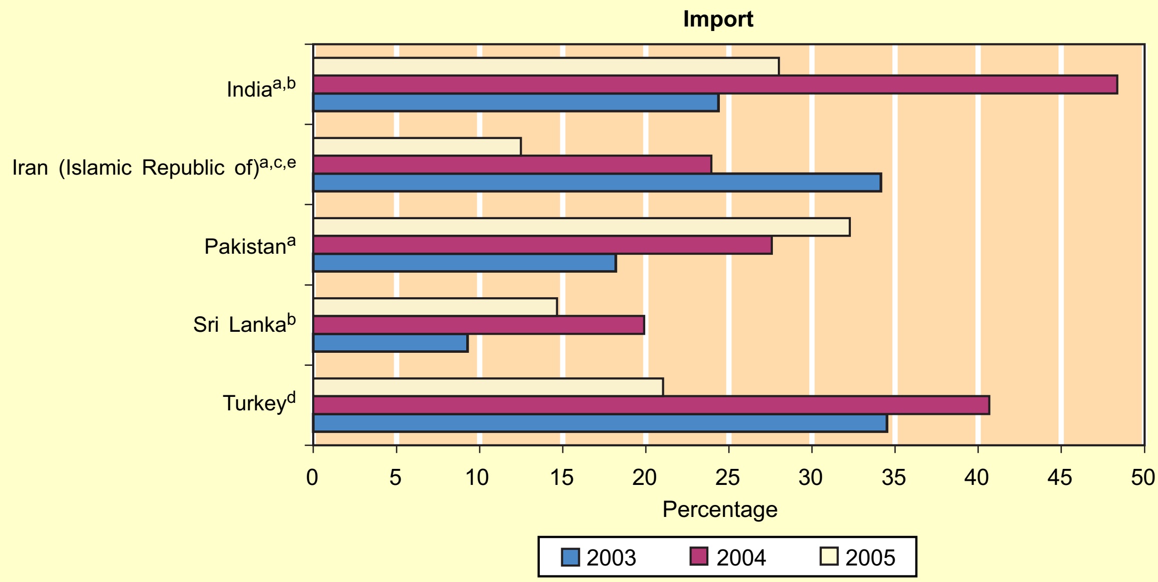
In Pakistan, a $1.8 billion surplus in the current account in 2004 became a $1.5 billion deficit in 2005, as a result of a high trade deficit of $4.5 billion in 2005. While exports grew by the healthy rate of 16.9 per cent, imports grew almost twice as fast, by 32.3 per cent. Higher oil prices led to a substantial increase in import payments for oil and to higher shipment charges and so to higher prices for other imports as well. While growing domestic demand increased the demand for imports, machinery and raw material imports also increased substantially. These imports should improve the productive capacity of the economy and increase manufacturing activities and exports. Remittances from Pakistanis abroad have been about $4 billion in recent years and have been an important element in the balance of payments. Coupled with these large remittances, gains from the lower interest payments on the external debt and liabilities of Pakistan partially offset the impact of the large trade gap. As a result, the current account deficit was contained in 2005.

The current account deficit widened in Sri Lanka

In Sri Lanka, the trade deficit widened in 2005 as imports grew faster than exports. A significant increase in oil prices caused a strain on the balance of payments. Despite the foreign assistance for tsunami victims and a sharp increase in workers' remittances, the current ac-

Figure II.25. Growth rates in merchandise export earnings and import spending in selected South and South-West Asian economies, 2003-2005





Sources: State Bank of Pakistan website <www.sbp.org.pk>, accessed on 5 September 2005; Central Bank of the Islamic Republic of Iran website <www.cbi.ir/publications/default.asp>, accessed on 28 December 2005; Central Bank of Sri Lanka website <www.lanka.net>, accessed on 28 December 2005; Republic of Turkey State Institute of Statistics website <www.die.gov.tr>, accessed on 28 December 2005; and national sources.

[a] Fiscal year.
[b] Growth rates for 2005 are projections
[c] Data for 2005 refer to 6 months.
[d] Data for 2005 refer to 10 months.
[e] Valued free on board (f.o.b.).

count deficit increased significantly in 2005. Exports increased by 11 per cent in 2005 compared with 12.2 per cent in 2004. Export growth resulted from modest price gains and substantial improvements in trade volume. Exports of textiles and clothing continued to grow despite the phase-out of the WTO Agreement on Textiles and Clothing in January 2005 and accounted for more than 46 per cent of exports in the first eight months of 2005. Imports grew by 15 per cent in 2005, the faster rate being partly due to the tsunami-related reconstruction work. The major contributors to overall import growth were petroleum and petroleum products, textile industry inputs, building materials, fertilizer and chemicals.

As a net exporter of oil the Islamic Republic of Iran recorded a higher current account surplus

Exports of the Islamic Republic of Iran increased by 30.6 per cent in 2004 compared with 2003. Most of the increase came from higher prices for oil and gas exports, amounting to $36.8 billion in 2004, an increase of 24.6 per cent over the comparable figure of the previous year. Non-oil exports increased by 14.9 per cent, due largely to the increased export of industrial goods. Imports rose by 23.9 per cent in 2004. Machinery and machine tools enjoyed the largest share of total goods imported in 2004, accounting for 29.6 per cent of the total value of imported goods. Both exports and imports increased with foreign trade liberalization and deregulation; these measures included the elimination of collateral and surrender requirements, greater freedom to use foreign exchange proceeds, gradual elimination of non-tariff barriers, exemption of exports from taxes and levies and stabilization of the foreign exchange market. As a result of the sharp increase in the export of oil and gas, the trade balance recorded a large surplus of $6.7 billion in 2004. Despite a $4.8 billion deficit in the services account, the current account recorded a surplus of about $4 billion, much higher than the $816 million surplus in 2003. High oil prices were expected to lead to a large current surplus in 2005 as well.

Turkey incurs large current account deficit

In Turkey, exports increased sharply by 33.6 per cent in 2004. Larger gains in productivity than in real wages helped firms to maintain their competitiveness in foreign markets and paved the way for handsome increase in exports. However, growth in imports outpaced the growth in exports. Imports grew by 40.7 per cent and this was partly the result of a rise in the import of intermediate goods to meet the demand for increased domestic production and exports. Strong domestic demand contributed to higher imports of durables and investment goods, while higher oil prices made the situation worse. The overvalued lira also contributed to the increase in imports. With imports growing faster than exports, the current account deficit widened to 5.2 per cent of GDP, even though growing revenues from tourism led to a substantial increase in services income. To contain the rapid growth in imports, the Government stopped the State banks' aggressive expansion of consumer credit, reduced generous tax credits for buying new cars and raised the intermediation tax on consumer credit. Such measures, in combination with a moderation of pent-up demand for consumer durables, caused import growth to slow somewhat in 2005, but it still outpaced export growth. The current account deficit was estimated at 5.9 per cent of GDP. The real effective exchange rate has appreciated significantly over the past few years. This, along with strong domestic demand, contributed to the large current account deficit.

Capital flows, foreign exchange reserves and exchange rates

Build up of foreign exchange reserves continues in India

In India, there has been a major shift in favour of long-term and non-debt-creating financial flows such as FDI and portfolio investment attracted by the sound macroeconomic environment, the stability of the exchange rate, further liberalization of foreign investment policies and relatively high returns on investment compared with that of other countries. There have been increases in both FDI and portfolio investment. Foreign investment inflows increased threefold, from $4.6 billion in 2002 to $14.8 billion in 2003, dropping to $12 billion in 2004. They were expected to exceed $12 billion in 2005, attracted by bullish stock markets, moderate inflation, sustained high economic growth and the strong rupee.

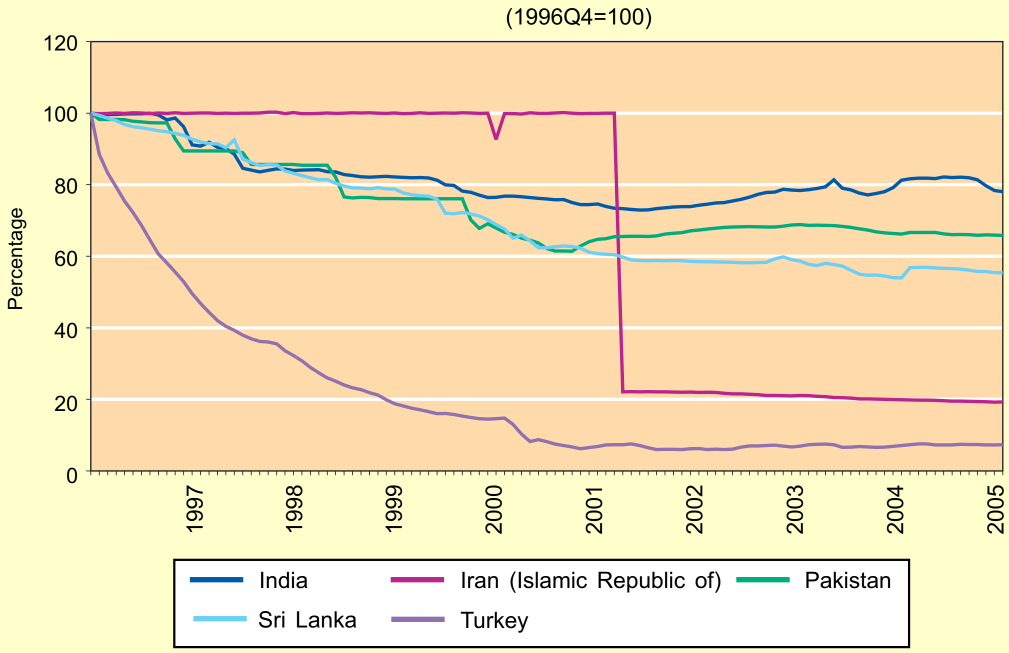
After a substantial build-up of foreign exchange reserves by $31 billion in 2003 owing to private transfers, receipts on travel and tourism on the current account and sustained foreign investment inflows on the capital account, there was a further build-up of $26 billion in 2004. Foreign exchange reserves stood at $144 billion at the end of December 2005 and were estimated to be $152 billion at the end of March 2006. The exchange rate of the rupee against major currencies exhibited some volatility during 2005, although on average it appreciated slightly against the dollar in 2005 as compared with 2004 (see figure II.26).

Foreign direct investment increased substantially in Pakistan

In Pakistan, too, there has been a significant increase in net inflows of capital. Capital inflows included mainly one-off inflows (such as $354 million through privatization and $600 million through sovereign debt issued internationally) and an increase in concessional long-term loans from the World Bank and the Asian Development Bank. FDI reached $1.5 billion in 2005, 61 per cent higher than in 2004. New FDI so far is concentrated in a few sectors such as telecommunications, finance and insurance and oil and gas exploration.

Foreign exchange reserves stood at $12.6 billion at the end of fiscal year 2005, $289 million higher than a year ago, and their pace of accretion appears to have slackened because of the deterioration in the external account. This also put pressure on the exchange rate of the rupee in the initial months of fiscal year 2005. The central bank intervened discreetly, injecting foreign exchange into the system; it made a

Figure II.26. Index of exchange rates against the United States dollar in selected South and South-West Asian economies, 1996-2005[a]



Sources: International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2005); and *The Economist,* various issues.

[a] Data for 2005 are estimates.

public commitment to smooth the payments for oil imports. This had a positive impact on the value of the rupee, wiping out much of its losses during the initial months of fiscal year 2005. On average, the value of the rupee against the dollar depreciated by 3 per cent in fiscal year 2005.

Foreign funds flowed into Sri Lanka for the victims of the 2004 tsunami

In Sri Lanka, flows of FDI, portfolio investment and loan capital to the private sector showed marked improvements. Grants in aid for the victims of the tsunami and reconstruction of infrastructure enhanced the inflow of foreign funds to the Government. Net capital inflows were more than sufficient to finance the current account deficit, resulting in a surplus in the overall balance of payments.

Gross official reserves increased from \$2.2 billion at the end of December 2004 to \$2.4 billion at the end of August 2005. The value of the rupee began to appreciate against major currencies in the wake of the tsunami because of expected inflows of financial assistance. The rupee appreciated by 3.3 per cent against the dollar during the first nine months of 2005, as compared with a 6.7 per cent depreciation during the same period in the previous year.

Capital inflows increased in the Islamic Republic of Iran

In the Islamic Republic of Iran, the capital account of the balance of payments continued its upward trend. While net long-term inflows declined from \$2.1 billion in 2003 to \$1.2 billion in 2004, the surplus in short-term inflows rose from \$2.4 billion to \$4.4 billion. With surpluses in both the current account and capital account, the balance of payments registered a surplus of \$8.3 billion in 2004. This amount was added to the foreign exchange reserves of the country.

FDI and portfolio equity increased from \$1.7 billion in 2003 to \$2.7 billion in 2004. With a large market, the country offers many investment opportunities to foreign investors. However, few foreign firms outside the energy sector have established significant interests in the country. To build the confidence of foreign investors, the Government has taken several measures including membership in the Multilateral Investment Guarantee Agency. The foreign exchange market has operated smoothly in the recent past, and the exchange rate is not considered to be misaligned.

Short-term capital dominated capital inflows in Turkey

In Turkey, despite the large current account deficit in 2004, gross official reserves increased as a result of strong capital inflows, a major share of which, however, remained short-term debt and debt-creating inflows. The inflows consisted mainly of foreign borrowing (trade-related credits, interbank and corporate borrowing) as FDI remained low and portfolio investments going into government bonds were larger than going into equities. Gross official reserves, at \$37.6 billion in 2004, were estimated to have risen to \$44.8 billion in October 2005. The exchange rate of the lira appreciated slightly during 2005 against the dollar and the euro.

External debt

India and Pakistan made significant progress in reducing external debt as a ratio to GDP

In India, trends in various debt indicators such as the ratio of external debt to GDP indicate a marked improvement in the country's external indebtedness. The total external debt of India, that is; short- and long-term liabilities on both government and non-government accounts, increased from \$111.7 billion at the end of March 2004 to \$123.3 billion at the end of March 2005 and was expected to reach \$129 billion at the end of March 2006. Multilateral and bilateral debt constitutes 42 per cent of total debt stock and the share of concessionary debt was 34 per cent of total debt in 2005. The share of short-term debt has declined steadily in recent years and stood at 6.3 per cent of total external debt in 2005. The external debt to GDP ratio has also declined steadily from a high of 38 per cent in 1991 to 18 per cent in 2003 and 16 per cent in 2005.

Following the adoption of a robust strategy of debt reduction, Pakistan's external debt declined from $37.9 billion at the end of June 2000 to $36.6 billion at the end of March 2005. Contributing to this positive outcome have been the surplus in the current account, prepayment of expensive debt and debt write-offs. As a percentage of GDP, external debt has fallen from 51.7 per cent at the end of June 2000 to 33.1 per cent at the end of March 2005. There was a small increase of $576 million in external debt in 2005, owing mainly to fresh inflows from multilateral creditors and the issuance of a sovereign bond.

In Sri Lanka, the external debt has been increasing in recent years, reaching 65 per cent of GDP in 2004. This ratio was estimated to have declined slightly in 2005, due partly to appreciation of the domestic currency.

High share of short-term external debt is a source of concern in Turkey

In Turkey, dollar-denominated external debt increased from $145.5 billion in 2003 to $161.7 billion in 2004 and was estimated to have climbed to $168.7 billion in 2005. However, external debt as a ratio to GNP has been falling and stood at 48.3 per cent in 2005 compared with 53.6 per cent in 2004. More than 40 per cent of the external debt is owed by the private sector, 43 per cent of it short term. A high share of short-term debt is a concern as it implies strong roll-over pressures and high exposure to sudden changes in the exchange rate, interest rates and market sentiment.

Medium-term prospects and key policy issues

India to maintain high growth and low inflation

Assuming no major internal or external shocks, which could destabilize the economy, India should be able to sustain a real GDP growth rate of about 8 per cent over the period 2006-2008, supported by a growth rate of 2.5-3 per cent in agricultural value added, 8.5 per cent in industry and 9.0 per cent in services. The industrial and service sectors are expected to sustain their growth momentum driven largely by cyclical factors and induced by a rise in rural income and increased public spending on physical and social infrastructure. Higher growth over the medium term would be feasible with sustained fiscal reforms by both central and state Governments. Thus, increased public and private sector savings should boost the country's investment rate and provide resources for upgrading critical areas of infrastructure. While some increased use of foreign capital, particularly of FDI and portfolio investment, is consistent with external sector viability, the bulk of the savings would need to be generated domestically.

Both the wholesale and consumer price indices are likely to remain at about 4 per cent in the period 2006-2008, given the Government's commitment to reform, including strict fiscal prudence, monetary discipline, orderly movement of the rupee exchange rate, continued reduction of import duties and other indirect taxes and the removal of all quantitative restrictions on imports of consumer goods. It is important to lock in recent gains on the inflation front to protect the interests of the vulnerable and weaker sections of society.

Some slowdown in growth and inflation may be expected in Pakistan in 2006

The Government of Pakistan set a growth target of 7 per cent of GDP for 2006, less than the rapid 8.4 per cent achieved in 2005 but higher than the long-term growth trajectory of 6 per cent. A number of factors may interfere, however. Agriculture, prone to weather-related fluctuations, may perform below expectations. On the other hand, large-scale manufacturing could well exceed the target of 13 per cent, and growth in services is expected to remain strong. Sustaining a higher growth rate is thus possible.

A strong earthquake in October 2005 resulted in massive loss of human life and damage to property (including houses, schools, hospitals and other buildings) and infrastructure. More than 73,000 people died and even more were injured. More than 3 million people became homeless. Damage to assets was estimated at $5.2 billion or higher. The international community has responded generously, pledging more than $6 billion in soft loans and grants at a donor conference in November 2005 in Islamabad. The policy challenge is to convert these pledges into contributions and to create the machinery to effectively carry out the rehabilitation and reconstruction on a timely basis. For now, it is expected that the earthquake will have a minimal impact on economic growth. Although such natural disasters damage and destroy assets, the repair and rebuilding of these assets generates economic activity that can help to stimulate economic growth. Keeping all these factors in view, GDP should grow by 6.5 per cent in 2006.

Inflation is expected to drop to about 8 per cent in 2006, from 9.3 per cent in 2005, owing to the decline in aggregate demand implicit in the lower growth estimate, a high base effect for 2006 prices and an anticipated improvement in food supplies. However, prices of construction materials are expected to increase at a faster pace because of supply bottlenecks associated with the reconstruction work associated with the earthquake. Government expenditure related to the earthquake is likely to put pressure on the budgetary balance. However, with the continuing fiscal discipline, prudent monetary policy and focused attention on improving infrastructure and social sector indicators, the economy should maintain its medium-term growth trajectory. There is, nonetheless, a need to enhance the buoyancy of tax revenues to improve the tax to GDP ratio. In addition, growth in current expenditure needs to be curtailed and imbalances in the external sectors need to be addressed to ensure that the economy does not deviate from the growth path achieved in the past few years.

Sri Lanka to experience higher growth and lower inflation

In Sri Lanka, assuming that the current ceasefire agreement and improved political stability continue to hold and weather conditions remain favourable, GDP is projected to grow by 6 per cent in 2006. However, if the ceasefire agreement breaks down and internal conflict begins again, the growth rate could be lower. In any case, tsunami-related reconstruction work could further boost aggregate demand and output. The acceleration in economic growth is projected to be broad based. The agricultural sector is expected to benefit from better weather conditions and recovery in the fisheries sector. Four main categories of the industrial sector will make major contributions to higher growth of the sector: textiles, wearing apparel and leather products; food, beverages and tobacco; chemicals, petroleum, rubber and plastic products; and non-metallic mineral products. The service sector is also expected to grow more rapidly, due partly to reconstruction activities and new investments in the leisure industry and tourism-promotion activities. The government target is to boost both domestic and foreign investment levels to accelerate economic growth towards 8 per cent over the medium term. Inflation is expected to moderate to 9 per cent in 2006, with expected recovery of the agricultural sector and a drop in international oil prices.

There is a need for continuing fiscal consolidation by maintaining healthy growth in government revenue and rationalizing recurrent expenditures, strengthening debt management and restructuring public enterprises, while ensuring that public investment that supports pro-poor growth is not neglected. Moreover, domestic borrowing by the Government will be reduced to release resources for private sector activities, especially in small and medium-size enterprises.

The Islamic Republic of Iran plans for high growth

In the Islamic Republic of Iran, the Fourth Five-year Development Plan (2005-2009) targets an average annual real GDP growth rate of 8 per cent compared with 5.4 per cent during the previous plan period. This is expected to be achieved through higher private sector investment and improved efficiency resulting from accelerated implementation of structural reforms. GDP growth is forecast to rise to 7.4 per cent in 2006. Rapid expansion in oil and services are expected to accelerate GDP growth. With a growing population, the non-oil economy needs to develop much more rapidly to provide much-needed employment opportunities in the country.

In Turkey, growth to moderate and inflation to fall further

The Turkish lira is expected to depreciate against the dollar and euro in 2006. This should lead to a moderate rise in interest rates, which could dampen domestic demand. However, GDP growth is projected to be about 5 per cent in

2006 and over the next few years, supported by both the increases in the factors of production and productivity. For Turkey, the long-awaited European Union accession negotiations began in October 2005. Negotiations are likely to be long and difficult, lasting perhaps 10 years. If the negotiations proceed well and the economy of Turkey converges towards the economies of the European Union, the growing confidence of investors should attract increasing flows of foreign investment. The Government recently negotiated a new stand-by arrangement with the International Monetary Fund to support a three-year economic programme aimed at sustaining growth to raise living standards and reduce unemployment, delivering price stability and moving towards convergence with the economies of the European Union. Success in the programme would greatly aid the negotiating process.

South-East Asia

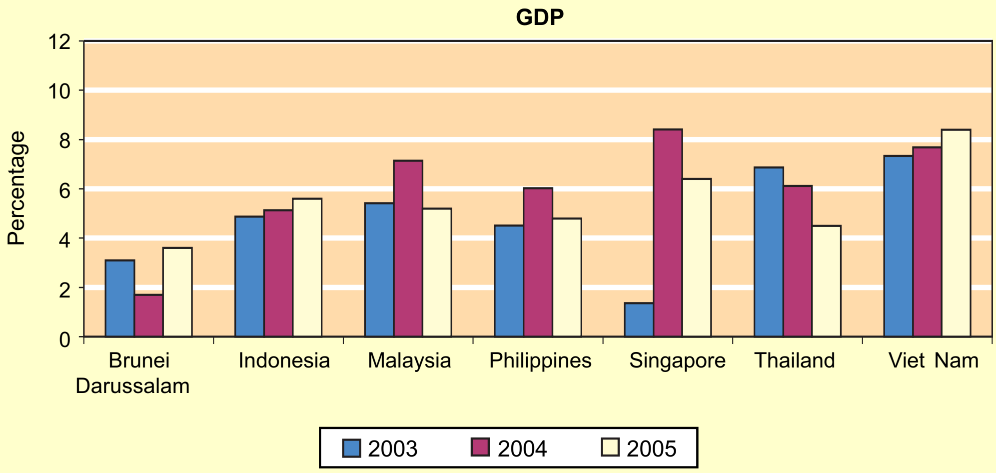
Overview

Growth eases in the subregion

Economic growth in the South-East Asian subregion eased in 2005 after an unusually good performance in 2004 when strong global demand for manufactures, especially electronics and information and communication technology products, drove the GDP growth rate up to 6.4 per cent. With the global electronics cycle subsequently experiencing a downturn, economic growth fell to about 5.4 per cent in 2005. The sharpest decline was in the trade-dependent economy of Singapore, which grew by 6.4 per cent after achieving an unusually high growth rate of 8.4 per cent in 2004. Against the general trend of the subregion, Indonesia and Viet Nam grew faster in 2005 than in 2004 (see figure II.27).

Fiscal and monetary policies in the subregion were tight during 2005, responding to the build-up of inflationary pressures caused by high oil prices. While oil prices doubled between 2002 and 2004, inflationary pressures did not emerge until the second quarter of 2005, because huge oil subsidies insulated final goods and services from the effects of the oil price increases. However, the high fiscal burden made the continuation of subsidies unsustainable from the middle of 2005. Many countries began phasing out oil subsidies, and inflation inched up to 5.8 per cent in 2005. In general, individual country policy responses to oil subsidies influenced the magnitude of their fiscal deficit. Thailand's elimination of oil subsidies in July 2005 increased the budget surplus, making it easier for the Government to finance the large infrastruc-

Figure II.27. GDP and sectoral growth in selected South-East Asian economies, 2003-2005[a]



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