South and South-West Asia

A. Developing economies of the subregion

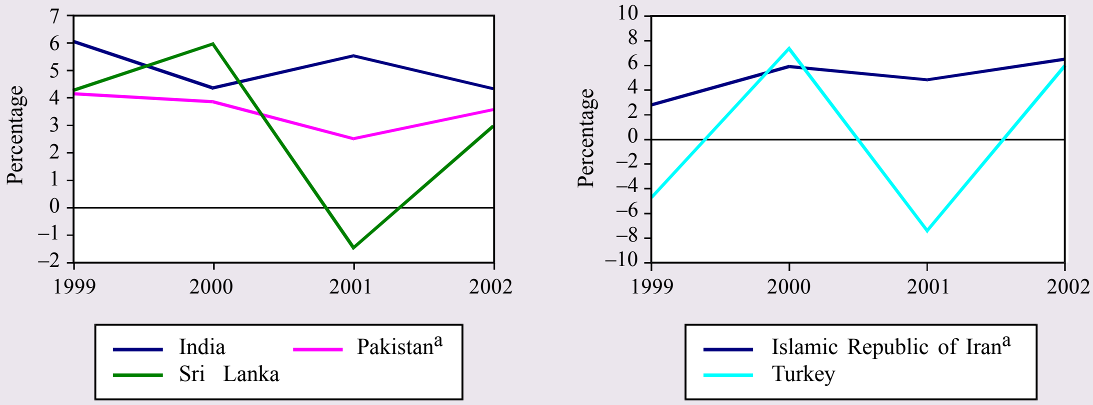
Subregional overview and prospects

Improved growth performance across the subregion

GDP growth was stronger in most countries of the subregion in 2002, despite continuing weather disturbances and unfavourable external factors (figure II.16). The recovery in the agricultural sector, the revival of trading activities in Sri Lanka, and strong foreign investments, coupled with an improved business climate in Turkey, contributed to the economic expansion in these countries. India and Pakistan showed some resilience against the severe drought that occurred in 2002. Robust growth in the industrial and service sectors in India, and a higher flow of overseas remittances and foreign aid into Pakistan, as well as the improved performance of the service sector, partly offset the poor out-turn in the agricultural sector in those two countries. Meanwhile, a higher level of activities in the oil sector, rising domestic demand, increased business confidence and recovery in agricultural output helped to maintain a robust rate of economic growth in the Islamic Republic of Iran.

Figure II.16. Rates of GDP growth in selected South and South-West Asian economies, 1999-2002

(a) India, Pakistan and Sri Lanka **(b) Islamic Republic of Iran and Turkey**



Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002) and *Asian Development Outlook 2002 Update* (ADB, 2002); Economist Intelligence Unit, *Country Reports* and *Country Forecasts* (London, 2002), various issues; and national sources.

Note: Data for 2002 are estimates.

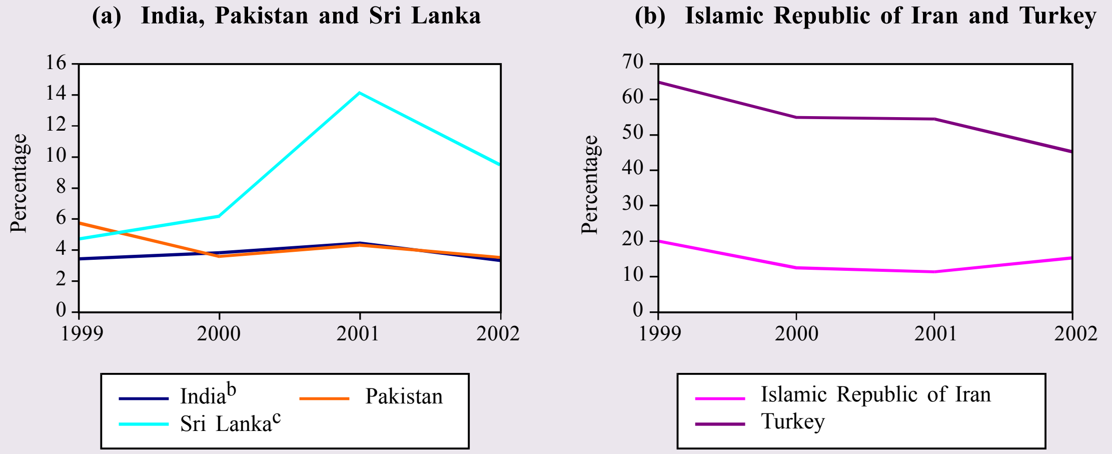
[a] Real GDP at factor cost.

The agricultural sector plays an important role in income and employment generation, and hence in poverty reduction in the subregion. However, it is still primarily dependent on weather conditions owing to insufficient irrigation and drainage facilities. In 2002, a severe drought, one of the worst and most widespread, struck a large part of the subregion, causing significant losses in agricultural output. Aggregate foodgrain output in India, for example, was estimated to have dropped by about 7.5 per cent and the agricultural sector as a whole contracted by 3.1 per cent in 2002. In Pakistan, the output from major crops also fell, but the impressive performance by the livestock subsector helped the agricultural sector to show marginal growth. The economic performance and prospects of the least developed countries in the subregion, Bangladesh, Bhutan, Maldives and Nepal, are discussed separately below.

Inflation rates came down but remained a source of concern in some countries

The inflation situation improved in 2002, but continued to be a matter of concern in some countries (figure II.17). In 2001, consumer prices had risen by over 54 and 14 per cent respectively in Turkey and Sri Lanka. Although some moderation occurred in 2002, inflation remained worrisome in Turkey (at some 45 per cent). Meanwhile, India continued to record relative price stability with inflation at around 3.5 per cent;

Figure II.17. Inflation in selected South and South-West Asian economies, 1999-2002[a]



Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002); IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002); Economist Intelligence Unit, *Country Reports* and *Country Profiles* (London, 2002), various issues; and national sources.

Note: Data for 2002 are estimates.

[a] Changes in the consumer price index.
[b] Consumer price index for industrial workers.
[c] Colombo only.

the huge food stocks from the previous year's bumper crop, a recovery of industrial output and greater competition from liberalized imports were contributing factors. Consumer prices went up by 3.5 per cent in Pakistan in 2002, compared with 4.4 per cent in 2001, owing to comfortable food supplies, weak international prices for petroleum in the first half of the year, lower prices of cotton and the appreciation of the Pakistani rupee. There was some pickup in consumer prices in the Islamic Republic of Iran.

The depreciation of domestic currencies slowed

The rate of depreciation of the Turkish lira and Sri Lankan rupee tapered off in 2002, although the lira exchange rate became quite volatile during part of the year owing to political uncertainties. In Sri Lanka, reduced inflation rates, an improved fiscal performance, a manageable current account deficit and the relatively stable political environment slowed depreciation of the domestic currency. The Indian rupee displayed a fluctuating trend in 2002 and appreciated for some time relative to the United States dollar. However, it was expected to depreciate slightly by 0.5 per cent in 2002 compared with 4.4 per cent in the previous year. The Pakistani rupee appreciated by 6.8 per cent in 2002 compared with a 19 per cent depreciation in 2001. The appreciation was supported by a large current account surplus, a substantial increase in overseas workers' remittances, and debt relief. Continuing its exchange rate reforms, the Islamic Republic of Iran unified its two-tier exchange rate in March 2002. The unified exchange rate remained relatively stable during the remaining part of the year.

The export performance remained subdued, except in India and Turkey

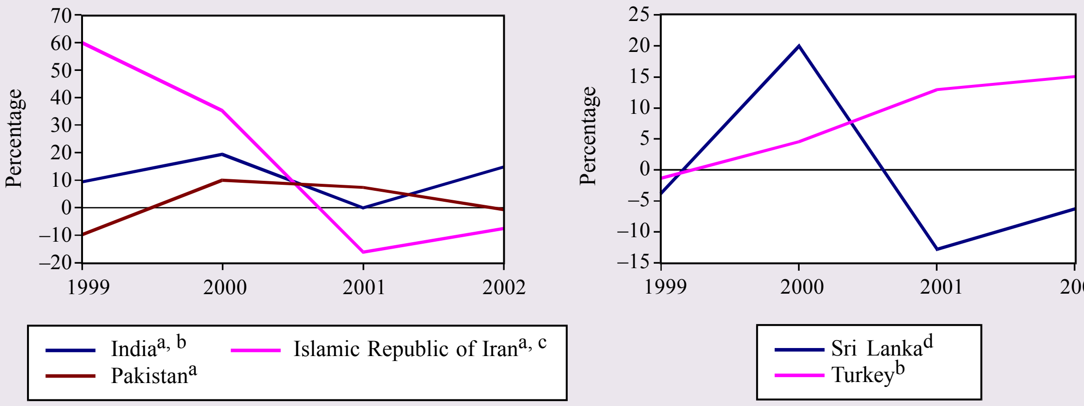
External trade was adversely affected by the ripple effects following the events of 11 September 2001 and by the slower economic growth in major export markets (figures II.18 and II.19). Pakistan's exports fell marginally in 2002, while in Sri Lanka exports continued to decline, albeit at a slower rate. The export earnings of the Islamic Republic of Iran decreased by 7.5 per cent during the first six months of 2002. However, higher oil prices and strong non-oil exports were expected to result in some positive growth in exports for the full year. India's exports remained stagnant in 2001 but staged a strong recovery and grew by 15 per cent in 2002. Similarly, exports from Turkey expanded by about 15 per cent in 2002.

The prospects for improved growth were good

A return to more normal weather conditions and a recovery in the global economy, albeit at a slower pace, should further improve economic performance in the subregion in 2003. The consequent resurgence of world trade could also translate into stronger external demand for exports from the subregion. On the assumption that there were no major internal or external shocks or military conflicts, India could achieve higher GDP growth of about 6 per cent in 2003. Agricultural output contracted in 2002; a recovery in that sector, supported by the sustained robust performance of both the industrial and service sectors, was expected to

Figure II.18. Growth rates in merchandise export earnings of selected South and South-West Asian economies, 1999-2002

(a) India, Islamic Republic of Iran and Pakistan **(b) Sri Lanka and Turkey**



Sources: Web site of the State Bank of Pakistan, <http://www.sbp.org.pk/eimports.htm>, 7 January 2003; web site of the Central Bank of Sri Lanka, <www.lanka.net/centralbank>, 8 January 2003; web site of the Central Bank of the Islamic Republic of Iran, <http://www.cbi.ir/>, 9 January 2003; Economist Intelligence Unit, *Country Reports* (London, 2002), various issues; and national sources.

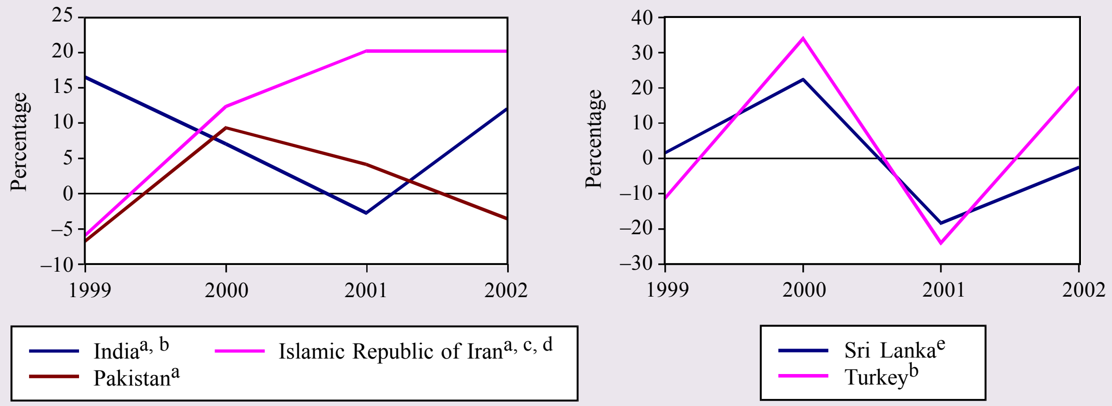
[a] Fiscal year.
[b] Data for 2002 are estimates.
[c] Data for 2002 refer to the first six months of the fiscal year.
[d] Data for 2002 refer to January-October.

accelerate growth in 2003. In Pakistan, a significant improvement in economic performance became visible in the final months of 2002, including higher export earnings and inward remittances from overseas workers. Improvement in the availability of water would contribute to a substantial recovery in agriculture, with positive knock-on effects on the industrial and service sectors. GDP is targeted to grow by 4.5 per cent in 2003 against 3.6 per cent actual growth in 2002. Sri Lanka could also rely on a sharp rebound in the export sector to fuel economic growth to reach 5.3 per cent in 2003, compared with 3 per cent in 2002. Political stability, improved security conditions, an acceleration in tourism and progress in the implementation of economic reforms would also play a major role in the uplifted growth process.

The economic outlook for the Islamic Republic of Iran and Turkey is somewhat uncertain, amid tensions and the possible adverse impact of a military conflict with Iraq. In Turkey, the massive stock-building, which acted as a large stimulus to GDP growth in 2002, was expected to decrease sharply, serving as a drag on economic growth in the

Figure II.19. Growth rates in merchandise import spending of selected South and South-West Asian economies, 1999-2002

(a) India, Islamic Republic of Iran and Pakistan **(b) Sri Lanka and Turkey**



Sources: Web site of the State Bank of Pakistan, <http://www.sbp.org.pk/eimports.htm>, 7 January 2003; web site of the Central Bank of Sri Lanka, <www.lanka.net/centralbank>, 8 January 2003; web site of the Central Bank of the Islamic Republic of Iran, <http://www.cbi.ir/>, 9 January 2003; Economist Intelligence Unit, *Country Reports* (London, 2002), various issues; and national sources.

[a] Fiscal year.
[b] Data for 2002 are estimates.
[c] Data for 2002 refer to the first six months of the fiscal year.
[d] Import value f.o.b.
[e] Data for 2002 refer to January-October.

coming year. Other constraints on the growth process included the persistently high unemployment rates, outstanding problems related to banking and corporate debt and the need to contain budget shortfalls. In the Islamic Republic of Iran, GDP growth was expected to accelerate along with firm oil prices and the ongoing implementation of economic reform programmes to encourage more investment in the oil and non-oil sectors.

GDP performance

The growth momentum in India remained strong

Despite many unfavourable factors, the economies of the subregion displayed impressive resilience. The growth momentum in India remained relatively strong; GDP expanded by 4.4 per cent in 2002, compared with 5.6 per cent in the previous year (table II.19). Higher levels of economic activity came largely from the industrial and service sectors, which, in turn, were underpinned by government spending, and by measures to boost industrial production and infrastructure development as well as to liberalize capital and money markets and encourage private and

Table II.19. Selected South and South-West Asian economies: growth rates, 1999-2002

(Percentage)

		Rates of growth			
		Gross domestic product	*Agriculture*	*Industry*	*Services*
India[a]	1999	6.1	0.3	4.8	10.1
	2000	4.4	−0.4	6.6	5.6
	2001	5.6	5.7	3.3	6.8
	2002	4.4	−3.1	6.1	7.1
Iran, Islamic Republic of[a, b]	1999	2.8	−5.6	2.3	4.5
	2000	5.9	3.8	9.1	5.0
	2001	4.8	4.7	5.0	4.8
	2002	6.5	5.5	7.1	7.4
Pakistan[a]	1999	4.2	1.9	5.0	5.0
	2000	3.9	6.1	−0.1	4.8
	2001	2.5	−2.5	4.2	4.4
	2002	3.6	1.4	2.8	5.1
Sri Lanka	1999	4.3	4.5	4.8	4.0
	2000	6.0	1.8	7.5	7.0
	2001	−1.4	−3.0	−2.0	−0.5
	2002	3.0	2.8	1.3	3.9
Turkey	1999	−4.7	−5.0	−6.2	−3.6
	2000	7.4	3.9	5.8	9.3
	2001	−7.4	−6.1	−7.3	−7.8
	2002	6.0	3.0	2.0	9.4

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002) and *Asian Development Outlook 2002 Update* (ADB, 2002); Economist Intelligence Unit, *Country Reports* and *Country Forecasts* (London, 2002), various issues; and national sources.

Notes: Data for 2002 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

[a] Real GDP at factor cost.
[b] Industry comprises oil; mining and manufacturing; water, power and gas; and construction.

foreign investment. Six core infrastructure industries, electricity, coal, steel, cement, crude oil and petroleum products, achieved average growth of 6.4 per cent from April to November 2002; it was expected to reach 6.5 per cent in the full fiscal year 2002. Reconstruction activities related to drought, greater movement of foodgrains to food-deficit regions and higher government expenditure on rural development also raised output in the industrial sector. Meanwhile, a rapid increase in expenditure on public administration, social services, rural extension services and defence had a stimulating impact on the service sector, which expanded by 7.1 per cent in 2002 compared with 6.8 per cent in the previous year. However, agricultural output contracted by 3.1 per cent in 2002 owing to the widespread and severe drought, contributing to a decline in the share of agriculture in GDP, from 23.8 to 22.2 per cent between 2000 and 2002. Barring major internal and external shocks and adverse climatic conditions, India is likely to sustain GDP growth rates in the range of 6 to 7 per cent from 2003 to 2005.

Improved economic performance in Pakistan

In Pakistan, agriculture was also constrained by a severe drought, despite relatively good irrigation facilities and improved water management practices. A marginal decline of 0.5 per cent was recorded in the output of the major crops in 2002, compared with a contraction of almost 10 per cent in the previous year. However, the strong performance of the livestock subsector enabled the agricultural sector as a whole to expand by 1.4 per cent. By contrast, the manufacturing sector, which contributed 18 per cent to GDP, suffered from weak global demand relating to the ripple effects of the events of 11 September 2001 and higher oil prices. Value added grew by 7.6 per cent in 2001 but by only 4.4 per cent in 2002. The service sector remained robust, in part owing to large increases in public administration and defence spending. It expanded by just over 5 per cent in 2002, lifting GDP growth to 3.6 per cent, from 2.6 per cent in 2001.

Recovery in Sri Lanka and Turkey

Sri Lanka and Turkey had suffered a sharp downturn in 2001. In 2002, however, GDP growth in Sri Lanka was estimated at 3 per cent, a recovery fuelled largely by a higher level of value added in services and agriculture; both sectors had contracted in 2001 owing to severe drought and a power crisis. However, recovery in the industrial sector was relatively weak owing to depressed earnings of key industrial exports. Demand for garments, for example, remained subdued, although a slight recovery was expected during the second half of 2002. Meanwhile, Turkey managed to reverse a GDP contraction of over 7 per cent in 2001 and achieve an economic expansion of 6 per cent in the following year. Growth was fuelled by an improvement in the business environment, which, in turn, benefited from declining interest rates and the relative strengthening of the Turkish lira as a result of large inflow of foreign funds, including from IMF, in the first half of the year. Despite uncertainties related to the election in November 2002 and concerns about a possible war in Iraq, economic growth was stronger than expected during the second half of 2002.

Faster GDP growth in the Islamic Republic of Iran

The Islamic Republic of Iran had experienced marginally slower GDP growth of 4.8 per cent in 2001, largely owing to declining oil production and exports, which, in turn, were attributable to a downward revision in the OPEC quota. Non-oil activities, however, expanded by 6 per cent in real terms but registered unemployment remained high at 16 per cent at the end of 2001, as the creation of 450,000 jobs lagged behind the volume of new entrants into the labour force. GDP expansion was on an upward trend, reaching an expected rate of 6.5 per cent in 2002. The upturn was underpinned by relatively favourable oil market conditions, rising domestic demand and a recovery in agricultural output. Non-oil activities also increased and were more robust because of strong public sector demand, increased business confidence and higher investment (table II.20). Construction and manufacturing, in particular, were expected to be much strengthened in line with sharply higher investment and consumer demand.

Table II.20. Selected South and South-West Asian economies: ratios of gross domestic savings and investment to GDP, 1999-2002

(Percentage)

	1999	*2000*	*2001*	*2002*
Savings as a percentage of GDP				
India	23.1	23.4	24.0	25.0
Iran (Islamic Republic of)	25.4	26.8	27.4	28.0
Pakistan	12.3	15.6	15.9	15.2
Sri Lanka	19.5	17.4	15.3	15.5
Turkey	21.4	18.3	16.0	..
Investment as a percentage of GDP				
India	24.2	24.0	23.7	23.9
Iran (Islamic Republic of)	26.0	27.1	28.3	29.5
Pakistan	15.6	16.0	15.9	13.9
Sri Lanka	27.3	28.0	22.0	24.1
Turkey	24.0	24.9	16.7	..

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002) and *Asian Development Outlook 2002* (Oxford University Press, 2002); and national sources.

Note: Data for 2002 are estimates.

Inflation

Inflation decelerated in Turkey and Sri Lanka

Inflation eased in both Turkey and Sri Lanka in line with improved supply and demand conditions. It remained high in absolute terms, at over 45 per cent, in Turkey in 2002 but this was some 9 percentage points lower than the previous year's level (table II.21). The decline was attributed to the limited monetary expansion through the Central Bank's strict adherence to the monetary programme, wage and salary increases in the public sector having been kept in line with the programmed targets, and the relative stability of the Turkish lira. To further contain inflationary pressures, the Central Bank planned to adopt a fully fledged policy of inflation-targeting in 2003. In Sri Lanka, consumer prices rose

Table II.21. Selected South and South-West Asian economies: inflation and money supply growth (M2), 1999-2002

(Percentage)

	1999	*2000*	*2001*	*2002*
Inflation[a]				
India[b]	3.4	3.8	4.3	3.5
Iran (Islamic Republic of)	20.1	12.6	11.4	15.3
Pakistan	5.7	3.6	4.4	3.5
Sri Lanka[c]	4.7	6.2	14.2	9.5
Turkey	64.9	54.9	54.4	45.2
Money supply growth (M2)				
India	17.1	15.2	14.3	17.2[d]
Iran (Islamic Republic of)	21.5	22.4	27.6	26.5[e]
Pakistan	4.3	12.1	11.7	14.8[d]
Sri Lanka	13.3	12.8	14.4	19.5[d]
Turkey	98.3	40.0	87.2	..

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Country 2002,* vol. XXXIII (ADB, 2002); IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002); Economist Intelligence Unit, *Country Reports* and *Country Forecasts* (London, 2002), various issues; and national sources.

Note: Data for 2002 are estimates.

[a] Changes in the consumer price index.
[b] Consumer price index for industrial workers.
[c] Colombo only.
[d] January-June.
[e] January-July.

at a slower rate, from over 14 per cent in 2001 to 9.5 per cent in 2002, owing to increased imports and domestic supplies of agricultural products, a relatively slower depreciation of the domestic currency and government intervention to control the prices of key commodities, including cooking gas, dairy foods, flour and petroleum. There was also some easing in the budget deficit, although it remained high (table II.22). Further progress in liberalizing the domestic market, together with improved agricultural growth in 2002, could cause inflation to fall further in 2003.

Price stability continued to prevail in India and Pakistan

Inflation remained at relatively low levels in both India and Pakistan compared with other countries of the subregion. Consumer prices in those countries eased to 3.5 per cent in 2002. In India, the inflation rate for food products, with a relative weight of 57 per cent in the consumption basket, remained modest at 3 per cent, down from 3.4 per cent in 2001, owing to the large surplus stock of foodgrains in the country. The price of manufactured products also rose moderately in line with the global decline in the prices of manufactured items, the removal of quantitative

Table II.22. Selected South and South-West Asian economies: budget and current account balance as a percentage of GDP, 1999-2002

(Percentage)

	1999	*2000*	*2001*	*2002*
Budget balance as a percentage of GDP				
India	−5.4	−5.6	−5.9	−6.5
Iran (Islamic Republic of)[a]	−0.2	−0.2	−0.1	−0.2
Pakistan[a]	−6.1	−6.4	−5.3	−7.0
Sri Lanka	−6.9	−9.5	−10.5	−8.5
Turkey	−11.7	−10.3	−15.7	−14.1
Current account balance as a percentage of GDP				
India	−1.1	−0.6	0.3	1.1
Iran (Islamic Republic of)	12.2	18.0	6.5	3.5
Pakistan	−4.1	−1.9	−0.9	2.2
Sri Lanka	−3.6	−6.4	−1.7	−3.6
Turkey	−0.7	−4.9	2.3	0.6

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002) and *Asian Development Outlook 2002 Update* (ADB, 2002); IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002); Economist Intelligence Unit, *Country Reports* and *Country Forecasts* (London, 2002), various issues; and national sources.

Note: Data for 2002 are estimates.

[a] Excluding grants.

restrictions and the continual reduction in import duties in India. Inflation in Pakistan fell to 3.5 per cent in 2002 from 4.4 per cent in 2001, owing to the better availability of essential commodities as a result of improved production of food and non-food products and the ample stocks carried over from previous years. Other stabilizing factors included appreciation of the domestic currency, which lowered the costs of imported products, and concerted government efforts to monitor consumer prices and take remedial action when needed; price stability is directly linked with the country's poverty reduction strategy.

There was a pickup in consumer prices in the Islamic Republic of Iran

Inflation had been on a downward trend during the past few years in the Islamic Republic of Iran but went up from just over 11 per cent in 2001 to more than 15 per cent in 2002. This upturn was due in large part to the unification of the exchange rate on the prices of a wide range of imported goods that had been purchased previously at the lower official exchange rate. In addition, domestic demand was expected to remain strong, adding to inflationary pressures, although the rate of increases in consumer prices could be eased in 2003 as monetary policy reforms continued and the impact of currency unification stabilized.

Foreign trade and other external transactions

External trade

The export earnings of Sri Lanka and the Islamic Republic of Iran continued to contract

Exports in Sri Lanka continued their second year of decline, with earnings in the first 10 months of 2002 falling by 6.3 per cent compared with the same period in 2001. The textile and garment sector, which accounted for a little over half of the total receipts on merchandise exports, remained depressed. It experienced a large contraction in 2001 and production further declined by 8 per cent in 2002. Tea exports, which accounted for about 15 per cent of the total export earnings, also fell, although at a slower pace, in 2002. The export earnings of the Islamic Republic of Iran showed a decline, by 7.5 per cent, during the first half of fiscal year 2002, but aggregate export receipts could register a slight increase by the end of the fiscal year (March 2003) owing to higher non-oil exports. Earnings on carpets, in particular, were particularly strong, expanding by 8 per cent during the first four months of the fiscal year.

Pakistan's export earnings, which fell marginally by 0.7 per cent to $9.1 billion in 2002 (table II.23), were on track to reach the target of $10 billion until the weakening of the international market in the aftermath of the events of 11 September 2001. There were cancellations of export orders, particularly those destined for United States and European markets, and higher freight charges on all cargo entering and leaving Pakistan.

Table II.23. Selected South and South-West Asian economies: merchandise exports and their rates of growth, 1999-2002

	Exports (f.o.b.)				
	Value (millions of US dollars)	*Annual rate of growth (percentage)*			
	2001	*1999*	*2000*	*2001*	*2002*
India[a,b]	44 915	9.5	19.6	0.0	15.0
Iran (Islamic Republic of)[a,c]	23 904	60.3	35.3	−16.0	−7.5
Pakistan[a]	9 202	−9.8	10.1	7.4	−0.7
Sri Lanka[d]	4 817	−3.9	19.8	−12.8	−6.3
Turkey[b]	31 334	−1.4	4.5	12.8	14.9

Sources: Web site of the State Bank of Pakistan, <http://www.sbp.org.pk/eimports.htm>, 7 January 2003; Web site of the Central Bank of Sri Lanka, <www.lanka.net/centralbank>, 8 January 2003; Web site of the Central Bank of the Islamic Republic of Iran, <http://www.cbi.ir/>, 9 January 2003; Economist Intelligence Unit, *Country Reports* (London, 2002), various issues; and national sources.

[a] Fiscal year.
[b] Data for 2002 are estimates.
[c] Data for 2002 refer to the first six months (April-September) of the fiscal year.
[d] Data for 2002 refer to January-October.

Earnings on primary commodity exports (e.g., rice, raw cotton, fish and fruits) registered the largest contraction at almost 15 per cent. Meanwhile, the earnings from textile products and other manufactured goods showed a marginal increase of 0.4 and 1.3 per cent, respectively.

Exports surged strongly in India and Turkey

India and Turkey recorded relatively high rates of export growth in 2002. India experienced stagnant exports, at $44.9 billion, in 2001 but earnings on exports were expected to rise by around 15 per cent by the end of fiscal year 2002 (March 2003), thus outperforming the government target of 12 per cent. This upsurge was due to various export-facilitating measures, the stability of the Indian rupee and strong performance in such key sectors as ready-made garments, engineering goods, chemicals, leather and leather products, ore and minerals, basic metals and petroleum products. Computer software and the service industry have emerged as the major export earners, contributing an estimated $10 billion in 2002. However, the share of agricultural exports declined to 12 per cent in 2002 from 20 per cent in 1996. In Turkey, export earnings, after growing at the rate of 12.8 per cent in 2001, were expected to expand by some 15 per cent in the following year.

Import spending varied among countries of the subregion

The value of merchandise imports contracted in Pakistan by 3.6 per cent and in Sri Lanka by 2.5 per cent in 2002 (table II.24). The contributing factors included the imposition of additional shipment insurance and lower imports of fuel and food in Pakistan, and subdued

Table II.24. Selected South and South-West Asian economies: merchandise imports and their rates of growth, 1999-2002

	Value (millions of US dollars)	*Imports (c.i.f.) Annual rate of growth (percentage)*			
	2001	*1999*	*2000*	*2001*	*2002*
India[a,b]	57 618	16.5	7.0	–2.8	12.0
Iran (Islamic Republic of)[a, c, d]	18 129	–6.0	12.3	20.2	20.1
Pakistan[a]	10 729	–6.8	9.3	4.1	–3.6
Sri Lanka[e]	5 974	1.5	22.4	–18.4	–2.5
Turkey[b]	41 399	–11.4	34.0	–24.0	20.3

Sources: Web site of the State Bank of Pakistan, <http://www.sbp.org.pk/eimports.htm>, 7 January 2003; Web site of the Central Bank of Sri Lanka, <www.lanka.net/centralbank>, 8 January 2003; Web site of the Central Bank of the Islamic Republic of Iran, <http://www.cbi.ir/>, 9 January 2003; Economist Intelligence Unit, *Country Reports* (London, 2002), various issues; and national sources.

[a] Fiscal year.
[b] Data for 2002 are estimates.
[c] Data for 2002 refer to the first six months (April-September) of the fiscal year.
[d] Import value f.o.b.
[e] Data for 2002 refer to January-October.

economic activities as a result of the power crisis and drought in Sri Lanka. Pakistan registered lower import expenditure on food items, with the value of imported sugar and soybean oil falling by over 90 and 70 per cent, respectively. This decline was due largely to higher domestic production of sugar and large shipments of soybean oil from the United States under the Public Law (P.L.) 480 food assistance programme. However, imports started to pick up towards the latter part of 2002 and were expected to reach a new record level of $11 billion in 2003. In Sri Lanka, import expenditure fell by 2.5 per cent during the first 10 months of 2002.

Import spending was more buoyant in other countries of the subregion. After a slight contraction in 2001, India experienced an estimated expansion of 12 per cent in imports in 2002. There were higher imports of edible oil, crude petroleum, export-related products and capital goods. In the Islamic Republic of Iran, imports have been growing at high rates during the last three years following the gradual relaxation of import restrictions, the liberalization of the foreign exchange regime and other measures for economic recovery. Import spending went up by another one fifth during the first six months of fiscal year 2002. In Turkey, a rebound in import spending occurred in 2002 owing to stronger growth in private consumption and gross fixed investment and to higher prices of non-oil commodities. Imports grew by 20.3 per cent in 2002 compared with a contraction of 24.0 per cent in 2001.

Capital flows and exchange rates

The foreign exchange reserve position strengthened in India and Pakistan

Despite the continuing weakness in the global economy, FDI flows into India grew by 2.4 per cent, to $4 billion, in 2002, reflecting the ongoing improvement in infrastructure, further liberalization of foreign investment policies and the removal of economic sanctions on India by the United States. The bulk of FDI went into ICT activities, engineering industries, services, electronics and electrical equipment, chemicals and allied products, food and dairy products. In Pakistan, FDI surged by 50 per cent, from $322 million in 2001 to $485 million in 2002. About two thirds of such investment went to the oil and gas and power sectors. There was, however, a downturn in portfolio investment in India owing to the downgrading of Indian stocks by the international credit-rating agencies and bearish domestic share markets. The modest outflow of portfolio capital from Pakistan was, in fact, a significant improvement over the massive level in the previous year.

The foreign exchange positions of India and Pakistan strengthened as a result of higher foreign investment, the improved current account balance and, specifically in the case of Pakistan, the debt-relief package from the Paris Club. In Pakistan, foreign exchange reserves were on an upward trend, totalling over $9 billion in January 2003. Meanwhile, the local currency appreciated by 6.8 per cent against the United States dollar in 2002, in contrast to a depreciation of almost one fifth in 2001.

India's foreign exchange reserves had reached an estimated $74.7 billion by the end of fiscal year 2002, compared with the previous year's level of $54.1 billion, and were equivalent to nearly 14 months of imports. Apart from booming ICT exports (see box II. 2), the increase in reserves reflected higher remittances, the quicker repatriation of export proceeds and non-debt inflows of capital. In particular, the higher interest rates had

Box II.2. Indian information technology: a success story

IT is of increasing importance in the Indian economy, in terms of both export revenue and employment generation. The highly dynamic IT industry grew at an average annual rate exceeding 50 per cent from 1991 until 2001. In that year, computer software and services, which are the main drivers of the industry and account for the bulk of IT products, generated over $10 billion in sales revenue, up from a mere $150 million 10 years earlier. In addition, the industry created 92,000 new jobs and provided 250,000 people with indirect employment during that period.[a] The industry is highly export-oriented; its export revenue was $7.6 billion in 2001. With a projected growth of 30 per cent in 2002, export revenue could reach $10 billion. Overall, IT software and service exports accounted for over 16 per cent of India's total exports in 2001. It is expected that by 2008 the industry will account for 7.7 per cent of India's GDP and 35 per cent of its total exports. India's IT software and service industry represents a mere 2 per cent of the global software market. The Government and the software industry, however, have set an ambitious goal for software exports of $50 billion by 2008, a share equivalent to 6 per cent of the relevant global market.[b]

The United States, Canada and Latin America continue to be India's foremost computer software and service export destinations, accounting for 63 per cent of its export revenue, followed by the EU at 26 per cent, Japan at 4 per cent and the rest of the world at 7 per cent. The performance of the Indian IT industry therefore depends largely on global economic conditions, particularly the United States market. This became evident in 2001, when a slowdown in the American economy had an adverse impact on the Indian IT software and service industry. Diversification of the market for Indian IT exports could reduce the industry's external vulnerabilities. Plans have been made to expand exports to Germany, France and Italy in Europe, Singapore, the Republic of Korea and Malaysia in Asia, and Chile, Mexico, Uruguay and Brazil in Latin America. The variety of IT services would also be expanded. In particular, increasing attention is being given to business process outsourcing as client firms are ceasing to buy software and are instead engaging software firms to manage their IT-intensive functions, such as operations, accounts and manpower management.

The Government of India has played an important role in providing critical inputs and removing major bottlenecks in the path of software development in order to achieve the export target of $50 billion by 2008. It is also a major client of IT products and services in line with its effort to computerize government processes and implement e-government applications. Indian spending on IT is currently around 1.7 per cent of GDP and is expected to reach 3 per cent by 2008.[c]

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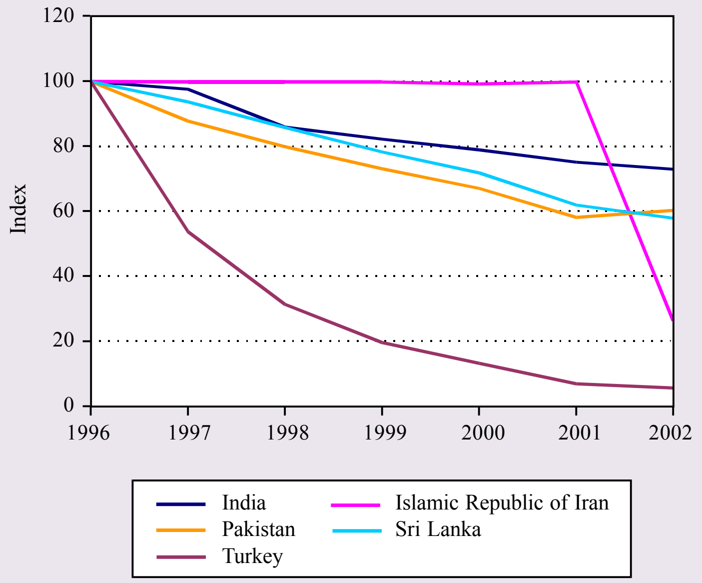
[a] OffshoreDev.com, "2003: year of revival for Indian firms: Nasscom", <http://offshoredev.com/jsp/features_details?fid=124>, 27 January 2003.

[b] Government of India, Department of Information Technology, *Annual Report 2001-2002,* <http://www.mit.gov.in>, 27 January 2003.

[c] The US Commercial Service, *India Country Commercial Guide, Fiscal Year 2002,* <http://www.usatrade.gov/website/CCG.nsf/CCGurl/CCG-INDIA2002-CH-5:-006C4DCB>, 27 January 2003.

attracted large amounts of foreign exchange from non-resident Indians. The appreciation of the United States dollar vis-à-vis major international currencies led to a depreciation of the Indian rupee by 4.4 per cent in 2001; the Indian rupee exchange rate had gone down by a mere 0.5 per cent by the end of 2002 (figure II.20).

Figure II.20. Index of exchange rates against the United States dollar of selected South and South-West Asian economies, 1996-2002



Sources: IMF, *International Financial Statistics,* vol. LV, No. 12 (December 2002); and *Far Eastern Economic Review,* various issues.

Notes: Data for 2002 are estimates. In the case of the Islamic Republic of Iran, the data refer to January-October.

The improved political climate was bringing more FDI and stability to exchange rates in Sri Lanka and Turkey

FDI into Sri Lanka was expected to recover in 2002 along with a better political climate and an active government promotion programme. Meanwhile, volatility in the exchange rate of the Turkish lira, which had been high in parts of 2002, eased somewhat following the decision of the then Government to hold an early election. The new Government, installed in November 2002, affirmed its support for the IMF-backed programme and its commitment to joining the EU. This brought much stability to the exchange rate, a crucial part of the IMF programme and the economic recovery process.

Major reforms of the exchange rate system in the Islamic Republic of Iran

In 2001 and 2002, the Islamic Republic of Iran managed to raise foreign exchange reserves, which were expected to reach $20.2 billion by the end of March 2003. The process of exchange rate unification continued along with the elimination of all the restrictions on current account transactions which had existed prior to March 2002. A single rate replaced the multi-tier exchange rate regime from the beginning of fiscal 2002. All foreign exchange transactions that had formerly taken place in the Tehran Stock Exchange market were shifted to a newly established inter-bank market; the exchange rate was unified at the rate prevailing in the Tehran Stock Exchange market before the unification. The unified exchange rate should remove uncertainties and help to ensure greater stability in the exchange rate market.

Foreign debt

Various indicators showed an improved external debt situation in India, the Islamic Republic of Iran and Pakistan

Pakistan achieved a distinct improvement in its external debt profile, reflecting the country's adherence to the debt reduction and management strategy. The successful completion of the IMF standby arrangement had paved the way for a medium-term IMF assistance programme and higher aid inflows from other international financial institutions. Moreover, Pakistan also obtained a stock re-profiling of bilateral debt from the Paris Club of creditors on generous terms. While the absolute decline in external debt and liabilities of $607 million was marginal, the debt re-profiling and the replacement of expensive commercial loans by cheaper credits led to a significant drop in the net current value of the outstanding external debt and liabilities, between 28 and 44 per cent depending on the interest rate negotiations with individual creditors.

There was also a marked improvement in the external debt position of India, which, according to a World Bank classification, had been transformed from a "moderately indebted country" to a "low indebted country" as of 1999. The debt-to-GDP ratio declined continuously from 38 per cent in 1991 to just over 20 per cent in 2002 and the debt-service ratio from 35 per cent in 1990 to 13.3 per cent in 2002. It is estimated that India's external debt, both short-term and long-term will amount to around $102.3 billion at the end of March 2003.

In the Islamic Republic of Iran, external debt fell by 11 per cent to $7.1 billion in 2001. The ratio of outstanding external debt to GDP dropped from 8.4 to 6.3 per cent in 2000-2001. Correspondingly, the debt-service ratio fell from 12.5 per cent in 2000 to 7.8 per cent in the following year; it was expected to decline further to 3.7 per cent in 2002.

Some increase was seen in the foreign debt of Sri Lanka and Turkey

The foreign debt positions of Sri Lanka and Turkey worsened in 2002. In Sri Lanka, external debt in 2002 was estimated at $9.6 billion, up from $8.8 billion in 2001. Public debt, including external debt, has become a matter of great concern but the strengthened peace process could help to reduce military spending. Turkey's estimated external debt reached $119 billion, or almost two thirds of GDP, in 2002, compared with $112 billion in 2001.

Key policy issues

The poverty reduction strategies of countries in the subregion have been based on ensuring sustained and rapid economic growth complemented by targeted programmes and the provision of social protection

In support of the millennium development goals, Governments of the subregion have reiterated their commitment to poverty reduction as an overarching development goal. Measures have been taken, for example, in India, Pakistan and Sri Lanka, to assess the poverty situation and identify pertinent policies and strategies. The broad range of policies and interventions which have been pursued in the economic and social areas can be categorized under two major themes. The first is based on the assumption that sustained economic growth is a prerequisite to achieving real progress in poverty reduction, and the second is that direct interventions targeted to benefit the poor in particular and to provide social protection in general are vital to ensure that gains from economic growth trickle down quickly to the poor and the disadvantaged groups.

The first assumption is based on past experience showing that poverty levels fall more rapidly during periods of rapid economic growth. Consequently, countries of the subregion have focused, to a large extent, on spurring economic growth and sustaining macroeconomic stability. Following the economic slowdown in 2001, the most urgent challenge to poverty reduction in 2002 was rejuvenating the economy and preparing the conditions for higher economic growth in the coming years. There are two general agenda for boosting economic growth; the first is to reduce the budget deficit and the second to enhance investment and trade through market liberalization programmes. The first was reviewed at length in the *Survey 2002;* the following discussion focuses on the progress of market liberalization, including privatization, in the subregion.

Enhancement of investment and trade through market liberalization programmes

Countries of the subregion have promoted the path to market liberalization and private sector-led growth in varying degrees. Pakistan has opened up a significant part of its economy to the private sector and offered various incentives to foreign investors, including external participation in industrial projects on a 100 per cent equity basis without any need to secure permission from the Government. A recent landmark in the privatization programme was the divestiture of the Government's minority working interests in seven oil and gas concessions, and the sale of Pak Saudi Fertilizers. That was the largest industrial transaction in the history of Pakistan's privatization programme.

However, the privatization process has generally been slow, despite the existence of numerous enabling policy frameworks. Among the causal factors are the lack of investor confidence and of a clear and fair regulatory framework, opposition from those with vested interests, and public misconceptions of and distrust for the objectives and process of privatization.[3] The Government has identified the following key measures to speed up the pace of privatization: restoring investor confidence by improving the macroeconomic situation; further deregulation and liberalization; establishing and/or strengthening regulatory frameworks; and improving transparency and public understanding of the privatization process.

Trade liberalization, simplification of the trade investment regime and further reductions in export and import restrictions are prominent in India's economic reform programmes to boost growth momentum and domestic and foreign investment. Privatization is at the forefront of these reforms and is seen a benchmark of the Government's commitment to economic reforms. Consequently, more sectors, including power, steel, oil refining and exploration, road construction, air transport, telecommunications, ports, mining, pharmaceuticals and financial services are being thrown open to private investors. Sectors such as garments and textiles, previously reserved for small-scale industries, were also delicensed to encourage competition. The Government's decision in December 2002 to resume the divestment of its stakes in two large State-owned oil companies, Hindustan Petroleum and Bharat Petroleum, is an encouraging sign of concerted government efforts towards privatization, despite heavy opposition from domestic industrial and nationalist groups. The current wave of privatization has benefited India's large-scale private sector. However, the overall success of the privatization programmes depends to a large extent on removing major infrastructure bottlenecks, including poor transport networks and insufficient and erratic power supplies, in which there is limited private investment.

The trade and investment liberalization process in Sri Lanka gained momentum in 2002 in line with government efforts to attract foreign investment. The port, electricity and petroleum sectors have been deregulated and, with effect from April 2002, 100 per cent foreign ownership has been permitted in previously regulated sectors, such as in the construction of buildings, roads, water supply, mass transport, telecommunications, banking, financial services, including stockbroking, and insurance, and the production and distribution of energy. Further

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[3] Government of Pakistan, Privatisation Commission, *Annual Report 2001* <http://www.privatisation.gov.pk>, 27 January 2003.

liberalization was planned for 2003 and 2004, including the removal of limits on inward foreign investment and expansion in the scope of privatization to more sectors, such as manufacturing (cement), services (hotels, lotteries), mining (graphite companies) and trade. The Government has also stepped up its efforts to remove impediments to trade and pursued a free trade accord with other countries, such as India and Pakistan. However, concrete progress in the resolution of the civil war will go a long way to boost trade, investment and economic growth in the country (box II.3).

The Government of Turkey enhanced the pace of liberalization in 2001 following a slowdown in its traditionally public sector-led economy. The reform focuses on market liberalization in the energy and telecommunication sectors, the privatization of State-owned enterprises, including Turk Telekom, the national airline, petroleum refineries, and iron and steel companies, and liberalization of the agricultural sector, including shifting from price subsidies to direct income payments to farmers. The reform is expected to bring down inflation and interest rates, paving the way for increased business activities and investments.

Market liberalization is also in progress in the Islamic Republic of Iran, albeit at slower pace; a privatization programme is being pursued within the framework of the current five-year plan, 2000-2004. The Government has sought to open its power and telecommunication sectors to the private sector, but issues relating to legal restrictions against privatization have yet to be fully resolved. In July 2002, the Government ended State monopoly on the import of sugar, thus opening up trade to the private sector. The move followed the lifting of the State monopoly on the import of tobacco, tea and vegetable oil.

Unemployment remained a serious problem

In the area of social protection, there has been growing concern about the rising unemployment rates in the subregion in recent years, which could seriously undermine efforts to reduce poverty. The economic slowdown in several of the economies in 2001 was obviously a factor contributing to this trend. However, an examination of long-term data revealed that, in some countries, unemployment rates continued to expand even during years of rapid economic growth. For example, unemployment rates in India widened from 6 per cent in 1993/94 to 7.3 per cent in 1999/2000 in spite of higher GDP growth, averaging 6.1 per cent a year between 1993/94 and 1999/2000. Similarly, unemployment rates in Pakistan increased from 5.9 per cent in 1998 to 7.8 per cent in 2000, while GDP growth averaged 3.4 per cent a year during that period.

Box II.3. The economic implications of the Sri Lankan peace process

After two decades of conflict, the Government of Sri Lanka successfully entered into a ceasefire agreement with the Liberation Tigers of Tamil Eelam (LTTE) in February 2002, with the assistance of the Government of Norway as a facilitator.[a] As a result, a fair degree of normalcy has been restored in the northern and eastern parts of this island country. The economic embargo on these areas has been lifted, allowing for the resumption of economic activity. Following the agreement, direct peace talks between the Sri Lankan Government and LTTE have so far yielded satisfactory outcomes. The first round of talks, in September 2002, centred around the establishment of regional autonomy. The second round, in October 2002, brought the peace process further forward with the setting up of three joint committees of the Government and LTTE to deal with economic, political and military affairs. In the third round, in December 2002, the peace talks yielded another major breakthrough: an agreement to study a federal structure of government which could be the basis for a final political solution to the conflict. The fourth round, in January 2003, tackled the details of resettlement and reconstruction in war-hit areas. Although a major breakthrough in the key area of disarmament was not expected, the fact that the talks have reached this stage can be considered a significant step towards achieving peace, and thus provide a fillip to the enhancement of economic activities.

The success of the peace process will have an immense positive impact on the economy. The large expenditure on defence contributed to government budget deficits in the 1990s. The peace process provides hope that budget deficits can be reduced and sustained at lower levels. Moreover, the cessation of hostilities would also lead to a rising influx of tourists, which is a major source of foreign exchange for the country. Sri Lanka already has tourist facilities of an international standard and therefore the potential for tourism growth would be significant. In particular, the peace process helped to raise tourist arrivals by 17 per cent in 2002;[b] a further increase of 20 per cent in 2003 would be possible through aggressive marketing.

Furthermore, real progress in the peace process has triggered a massive inflow of aid for reconstruction, particularly in war-torn areas, with significant spin-offs expected for the national economy at large. In November 2002, for example, the World Bank released $31 million to Sri Lanka for that purpose.[c] This financial assistance was to restore primary health care, repair urban water schemes, provide returning families with opportunities for income generation and employment, and build the capacity to undertake a multi-donor-funded reconstruction programme in the future. More lending was expected from the World Bank as well as from bilateral donors and other international organizations as the peace talks yielded significant progress. In January 2003, at the fourth round of talks, the World Bank became the custodian of the funds raised through international forums to be administered by the Subcommittee on Immediate Humanitarian and Rehabilitation Needs.[c] The improved prospects for peace therefore have far-reaching benefits for the economic development of the country.

Finally, as the peace process is showing significant progress, expectations are now running high among Sri Lankans and the international community that a political solution to the conflict, which has caused the death of around 64,000 people in some 20 years of fighting, will evolve. The international community has an important role to play in sustaining the momentum of the peace process and providing resources for resettlement and reconstruction.

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[a] "Peace process of Sri Lanka", official web site of the Sri Lankan Government's Secretariat for Coordinating the Peace Process, <http://www.peaceinsrilanka.org>, 17 January 2003.

[b] Reuters Foundation, Newsdesk, "Sri Lanka, on back of peace bid, eyes tourism record", <http://www.alertnet.org/thenews/newsdesk/COL174334>, 17 January 2003.

[c] World Bank, "Sri Lanka: World Bank to support reconstruction and peace building", press release No. 2003/149/SAR, 21 November 2002, <http://www.worldbank.org/lk>, 17 January 2003.

[d] World Bank, "World Bank invited to administer Sri Lanka reconstruction fund", <http://www.worldbank.org/lk>, 17 January 2003.

The targeted programme for the poor was strengthened, new modalities for providing social security were introduced, and attention was paid to generating resources for poverty reduction

In order to mitigate the impact of insufficient employment generation in the formal sector, social protection programmes in India and Pakistan have been strengthened in recent years with the expansion of existing programmes and the launching of new ones. Pakistan launched two new major initiatives, a comprehensive poverty intervention aimed at generating economic activity through public works, and a microcredit bank, as nationwide efforts to address poverty and vulnerability problems. In January 2003, to help the poor, the Prime Minister's "Falahi package" was approved by the Cabinet. Under that programme, 2.5 million families would be provided with financial assistance of 2,500 rupees each year; 5 billion rupees were allocated for this purpose. At the same time, the new civilian Government was working on additional relief packages for the benefit of the poor and low-income groups.

Similarly, India launched a number of social protection programmes during the period 2000-2002, for example, Integrated Village Employment Programme, providing wage employment and food security in rural areas, the Prime Minister's village development scheme for village-level development, the Food for Work Programme, and schemes providing foodgrains at highly subsidized prices, social security benefits to agricultural labourers and educational allowances to the children of parents living below the poverty line. At the budget presentation on 28 February 2003, the Government of India explicitly placed poverty reduction, covering health, housing, education and employment, among the five priority areas for fiscal 2003-2004. Concerns about the well-being of the poor are also being pursued in other closely interrelated priority areas, namely agriculture, where a large majority of the poor depends for their livelihood, and infrastructure development, particularly improvements in rural roads.

In Turkey, with the exception of the Bag Kur social insurance plan for the self-employed, a major part of the social security system is linked to benefits associated with holding a formal job. The Government has recently embarked upon an economic reform programme that includes action to improve the social protection system significantly. For example, Parliament approved a major policy reform introducing an unemployment insurance scheme in April 2002.

The Islamic Republic of Iran has given special emphasis to human development and social protection and has made significant progress so far. As a result of major public sector investments in the social sector over the last 20 years, with virtually universal education and extensive health coverage and an active government distributive strategy through direct transfers and indirect subsidies, the proportion of the population living below the poverty line has fallen significantly, from 47 per cent in 1978 to about 16 per cent in recent years. Virtually all social indicators have shown improvement. Of particular note is the closing of the gender gap in education, where enrolment rates for boys and girls show only small differences, in literacy and in political representation.

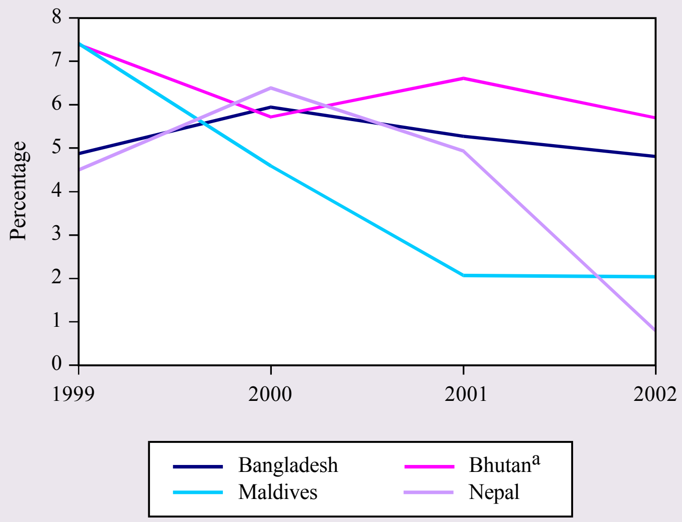
B. Least developed countries in the subregion

Overview and prospects

The slowdown in economic growth in the least developed countries of South Asia was largely led by a decline in the external sector

Economic growth in the least developed countries of South Asia generally moderated in 2002 from the levels reached the previous year; however, Nepal experienced a sharp fall in GDP expansion (figure II.21). Unlike previous periods of economic slowdown, which were largely the result of poor agricultural performance, the current decline is a reflection of the overall slowdown in the external sector. Setbacks were registered by garment exports from Bangladesh and Nepal and tourism receipts by Bhutan, Maldives and Nepal, leading to a fall in manufacturing and services linked to external trade. Agriculture remained the most important sector for Bangladesh, Bhutan and Nepal in terms of the associated volume of domestic employment and contribution to GDP. However, the composition of sectoral output in the least developed countries of the subregion confirmed the long-term, slow shift towards industry and services. In all of these countries, the persistent reliance on a small range of economic

Figure II.21. Rates of GDP growth in selected least developed countries in South and South-West Asia, 1999-2002



Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002); Economist Intelligence Unit, *Country Reports* (London, 2002), various issues; and national sources.

Note: Data for 2002 are estimates.

[a] GDP at factor cost.

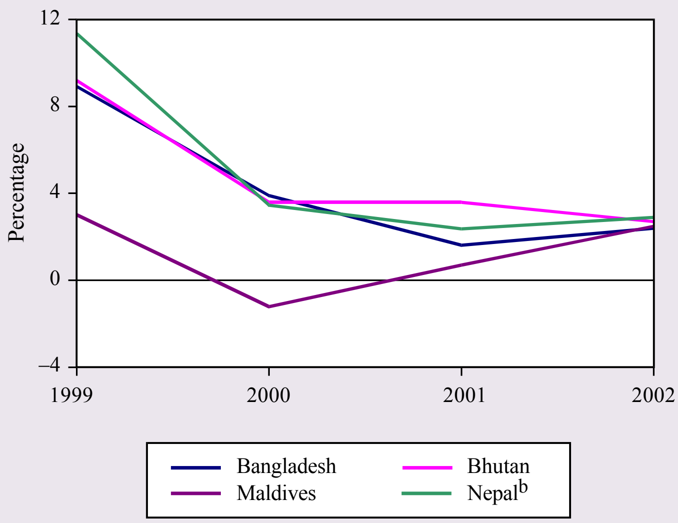
activities and a few key trading partners highlights their vulnerability to adverse external developments and underscores the need for them to achieve greater diversification in economic production and trade.

However, the outlook is for faster growth

In Bangladesh, based on steady growth in agriculture and stronger demand from foreign markets, GDP growth was projected to be on an upward trend of 5.2, 5.8 and 6.5 per cent, respectively in 2003, 2004 and 2005. Progress on structural and economic reforms would be another stimulus to private sector activity. The Ninth Five-Year Plan of Bhutan forecasts a faster rate of annual economic growth of 8.2 per cent in the period 2003-2007, considerably higher than the 6.7 per cent projected in the Eighth Plan period, owing to the ongoing construction of major hydroelectric projects which are scheduled for completion during the Plan period, the establishment of new industrial estates and greater inflows of FDI. The economic outlook for Maldives depends heavily on inward tourism, the mainstay of economic activities and related services in this island country. GDP growth was expected to be somewhat higher, at 4.2 per cent, in 2003, as tourism recovers in line with the expected stronger economic growth and revival of export demand in the EU and the United States. An additional stimulus to construction and transport comes from work on some public sector projects. Nepal expects GDP to recover and expand by 1.5 per cent in 2003 and by another 3.5 per cent in 2004, given the restoration of law and order, favourable weather conditions and external trade, continuing strong economic performance in India and progress in domestic reforms to provide a more conducive environment to private sector development.

Inflation was contained at less than 3 per cent in 2002 in the least developed countries in South Asia (figure II.22). Among the contributing factors to this

Figure II.22. Inflation in selected least developed countries in South and South-West Asia, 1999-2002[a]



Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002); IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002); Economist Intelligence Unit, *Country Reports* (London, 2002), various issues; and national sources.

Note: Data for 2002 are estimates.

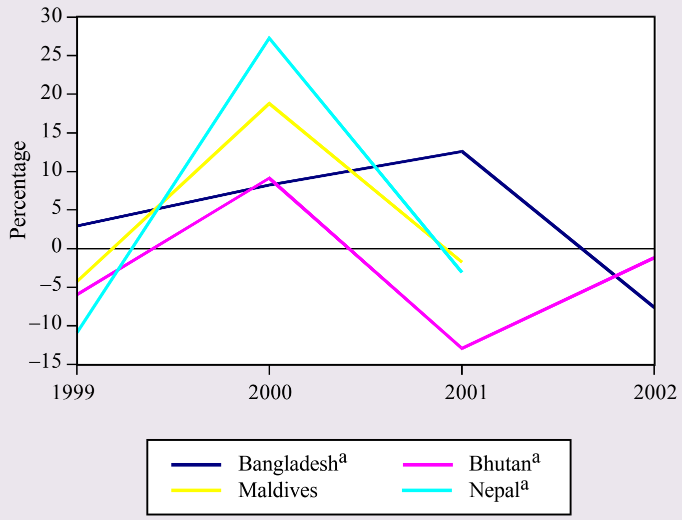
[a] Changes in the consumer price index.
[b] National urban consumer price index.

Inflation was contained below 3 per cent

relative price stability were improved food supplies owing to favourable weather conditions and stable exchange rates leading to little change in import prices; some upward pressure, however, was felt with rising world oil prices.

Merchandise exports, mainly of garments, from Bangladesh declined noticeably in fiscal 2002 (figure II.23). Imports associated with those exports as well as for domestic consumption were also on a downward trend (figure II.24), leading to lower trade and current accounts deficits. Nepal's experience was similar. Inward migrant remittances, which exceeded merchandise export earnings in the case of Nepal, increased noticeably in the two countries and contributed to a more favourable overall balance of payments. Meanwhile, Bhutan's external trade, which is strongly conditioned by developments in the hydropower sector, continued to be heavily dependent on energy demand from India in 2002. In Maldives, the weakness of merchandise exports and inward tourism reflected less than fortuitous global economic conditions, taking their toll on the current account deficit. Foreign exchange reserves in the four least developed countries of the subregion ranged from less than 3 months of

Figure II.23. Growth rates in merchandise export earnings of selected least developed countries in South and South-West Asia, 1999-2002



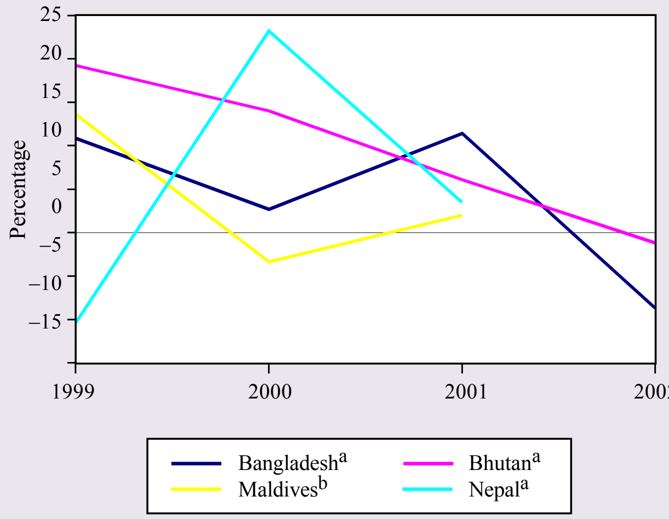
Sources: IMF, *Country Reports,* various issues; and national sources.

Note: Data for 2002 are estimates.

[a] Fiscal year.
[b] Import value f.o.b.

import cover in Bangladesh and Maldives to over 20 months in Bhutan. Their exchange rates came under some pressure in 2001-2002 and were either devalued, in the case of Bangladesh and Maldives, or depreciated in line with the Indian rupee, to which they are pegged, in the case of Bhutan and Nepal (figure II.25).

Figure II.24. Growth rates in merchandise import spending of selected least developed countries in South and South-West Asia, 1999-2002



Sources: IMF, *Country Reports,* various issues; and national sources.

Note: Data for 2002 are estimates.

[a] Fiscal year.
[b] Import value f.o.b.

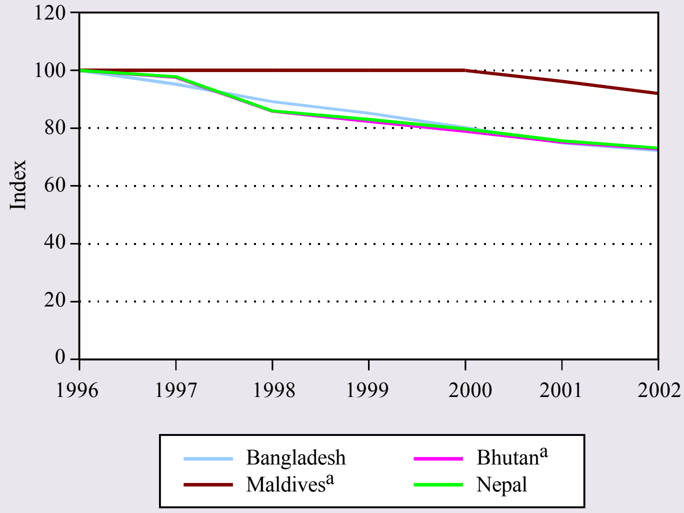
The South Asian least developed countries, among many others in the world, rely on a narrow base of products and markets in terms of both production and trade. In Bangladesh, for example, more than four fifths of the total exports are destined for North America and the EU. Some three fourths of total exports are garments, which will face open competition in all markets after the expiration of the Multifibre Arrangement on 1 January 2005. Electricity sales to India continue to be the single most important source of export revenue in Bhutan. Maldives' overwhelming reliance on export fisheries could result in difficulties in future as graduation from its status as a least developed country would entail loss of market access preferences.

Diversification of export commodities and markets is essential

The major policy issues to be managed by the least developed countries in South Asia are long-standing in nature: poverty reduction and the need for faster, pro-poor economic growth; better management of public finances and an enhanced process of domestic resource mobilization; greater private sector participation for sustained economic growth and employment generation; and strengthening of the financial sector in order to serve all members of society efficiently and adequately.

Figure II.25. Index of exchange rates against the United States dollar in selected least developed countries in South and South-West Asia, 1996-2002

(1996 = 100)



Sources: IMF, *International Financial Statistics,* vol. LV, No. 12 (December 2002); and *Far Eastern Economic Review,* various issues.

Note: Data for 2002 are estimates.

[a] Data for 2002 refer to January-October.

GDP growth performance

The global economic slowdown and fiscal and monetary tightening contributed to a marginal decline in GDP growth in Bangladesh

Aggregate production in Bangladesh expanded by an annual average of 5.6 per cent in 2000-2001 and by a slightly lower rate of 4.8 per cent in 2002. This marginal decline was a result of falling exports, owing to the global economic slowdown, unfavourable weather conditions and some demand compression resulting from fiscal and monetary tightening for stabilization purposes (table II.25). There was slower growth in the agricultural sector, from 3.1 per cent in 2001 to 2.8 per cent in 2002, as rice production suffered from adverse weather conditions. Other crops and horticulture were also affected, but fisheries recovered strongly from a decline in 2001. The rate of manufacturing growth slowed from 6.5 per cent in 2001 to 4 per cent in the following year, contributing to the observed decline in industrial value added, from 7.4 per cent in 2001 to 6.1 per cent in 2002. Falling exports of garments caused the slowdown in manufacturing activities, with many manufacturing units ceasing operations. Construction was also experiencing a slight decline, growing by just under 8 per cent in 2002 compared with 8.6 per cent a year earlier,

Table II.25. Selected least developed countries in South and South-West Asia: growth rates, 1999-2002

(Percentage)

		Rates of growth			
		Gross domestic product	*Agriculture*	*Industry*	*Services*
Bangladesh	1999	4.9	4.7	4.9	4.9
	2000	5.9	7.4	6.2	5.2
	2001	5.3	3.1	7.4	5.3
	2002	4.8	2.8	6.1	5.1
Bhutan[a]	1999	7.4	5.3	11.6	5.2
	2000	5.7	4.7	4.0	9.1
	2001	6.6	3.2	13.4	6.6
	2002	5.7	..	..	..
Maldives	1999	7.4	3.3	6.8	7.8
	2000	4.6	−0.2	−4.4	6.3
	2001	2.1	1.6	3.7	1.6
	2002	2.0	1.4	..	..
Nepal	1999	4.5	2.9	6.0	5.4
	2000	6.4	5.0	8.9	6.2
	2001	4.9	4.2	2.7	7.0
	2002	0.8	1.7	0.2[b]	..

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002); Economist Intelligence Unit, *Country Reports* (London, 2002), various issues; and national sources.

Notes: Data for 2002 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

[a] GDP at factor cost.
[b] Rate of growth of non-agriculture.

owing to the scaling-down of public sector spending. Signs of a recovery in manufacturing appeared towards the last quarter of 2002 following lower interest rates. Meanwhile, the service sector appeared to have retained its momentum, expanding by just over 5 per cent in 2002, as it had done on average between 1999 and 2001. Weakened external trade had some effect on transport, storage and communications, wholesale and retail trade and financial intermediation.

Both the domestic savings and investment ratios remained largely unchanged in Bangladesh in 2001-2002 (table II.26). The private sector component of investment increased to 16.1 per cent of GDP in 2002 from 15.9 per cent of GDP in the previous year, while the public sector component decreased slightly, to 7.1 per cent of GDP from 7.3 per cent

Table II.26. Selected least developed countries in South and South-West Asia: ratios of gross domestic savings and investment to GDP, 1999-2002

(Percentage)

	1999	*2000*	*2001*	*2002*
Savings as a percentage of GDP				
Bangladesh	17.7	17.9	18.0	18.0
Bhutan	13.5	17.2	21.0	16.0
Nepal	13.6	15.0	14.7	13.1
Investment as a percentage of GDP				
Bangladesh	22.2	23.0	23.1	23.2
Bhutan	43.1	43.8	45.7	44.0
Nepal	20.5	24.2	24.5	24.1

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002) and *Asian Development Outlook 2002* (Oxford University Press, 2002); and national sources.

Note: Data for 2002 are estimates.

over the same period, as the implementation of development projects with lower priority was curtailed. This trend in the composition of investment is expected to continue: the medium-term macroeconomic framework shows an absolute increase in public investment but a gradual decline as a share of GDP.

In Bhutan, hydropower generation remained a major source of economic growth

In Bhutan, GDP growth was about 1 percentage point lower, 5.7 per cent in 2002 compared with 6.6 per cent in the previous year. Agricultural output, including from animal husbandry and forestry, had gone up by 3.2 per cent in 2001 and continued to be the main source of domestic employment, in addition to making a contribution of 34.3 per cent to GDP. However, the industrial sector had a relative GDP share of about 23 per cent and had expanded at a much faster rate than agriculture in recent years, reflecting the gradual transformation in the production structure of the Bhutanese economy. The electricity subsector alone contributed 12 per cent of GDP. With the commissioning of two hydropower projects in 2001, the power sector was expected to emerge as the most important sector in the economy; this was due not only to its own contribution but also to its linkages to other sectors. For example, the construction and transport sectors, with relative GDP shares of 15.1 and 8.7 per cent respectively, grew by over 21 per cent in 2001 as a result of hydropower development. Tourism is the most important service industry, in terms of both convertible currency earnings and a stimulus to the hotel and retail business. However, it had suffered a major setback in 2001, when tourist arrivals fell by 15.4 per cent.

Maldives was economically vulnerable as a result of a narrow economic base

Maldives has a GDP per capita of $2,200, about twice the maximum level of $1,035 set by the United Nations for least developed country status. However, it continues to be classified as one because of its high vulnerability to external economic and other shocks, given its small size and narrow economic base. Maldives is heavily dependent on the sustainable development of two environmentally sensitive activities, tourism and fishing. Overall production remained largely stagnant, gaining around 2 per cent each in both 2001 and 2002. This was due to lower tourism receipts and tourism-related construction activities (following the opening of 14 island resorts in 1999), and subdued seafood exports compounded by adverse terms of trade brought about by falling fish prices and rising oil prices. Agricultural output was also subdued, expanding by 1.4 per cent in 2002 from 1.6 per cent in the previous year as a result of negligible growth in fisheries, which accounted for more than three fifths of the output in that sector. Industrial growth was projected to decline as a result of slower growth in construction; manufacturing and mining were of relatively minor importance. Service sector growth has declined in recent years along with tourism receipts. The Maldives currency is pegged to the United States dollar, whose strength, prior to the recent devaluation of the rufiyaa, made the country a more expensive destination for tourists from Europe and Japan, its two main sources of visitors. Visitor arrivals dropped after the 11 September 2001 events and resort prices were also softening owing to increased competition from many newly opened tourist resorts in the country.

The falling demand for garments, and civil unrest, contributed to the decline in manufacturing and tourism receipts in Nepal

Economic growth in Nepal slowed considerably, from 4.9 per cent in 2001 to less than 1 per cent in 2002; the global economic slowdown and social instability contributed to lower export and tourism revenue. There was also a sharp decline in agriculture, which employs 80 per cent of the labour force, owing to the lower output of paddy, millet, jute and tobacco. The sector as a whole added 1.7 per cent to gross output in 2002, compared with just over 4 per cent in the previous year. Industrial growth was also subdued as a result of slowing manufactured exports, while the service sector suffered from the adverse effects of an estimated fall of one third in tourism receipts in 2002. Tourist arrivals declined from a high of 491,500 recorded in 1999 to 363,000 in 2001, even as hotel bed capacity continued to grow.

Inflation

A spurt in non-food prices contributed to a marginal increase in inflation in Bangladesh

Annual inflation in Bangladesh had shown a sharp downward trend for a few years, falling from almost 9 per cent in 1999 to just 1.6 per cent in 2001 before picking up again to 2.4 per cent in 2002 (table II.27). Food prices rose by only 1.2 per cent as there was no major disruption in domestic production, but there was a sharper increase of 4.5 per cent in non-food prices, which was, due in part to fiscal and monetary tightening. Administered increases in gas, electricity and petroleum prices led to a rise in the fuel, lighting and transport components of the consumption basket, while higher regulatory duties and mandatory margin requirements on

Table II.27. Selected least developed countries in South and South-West Asia: inflation and money supply growth (M2), 1999-2002

(Percentage)

	1999	*2000*	*2001*	*2002*
Inflation[a]				
Bangladesh[b]	8.9	3.9	1.6	2.4
Bhutan[b]	9.2	3.6	3.6	2.7
Maldives	3.0	–1.2	0.7	2.5
Nepal[b, c]	11.4	3.5	2.4	2.9
Money supply growth (M2)				
Bangladesh	15.5	19.3	14.7	13.7[d]
Bhutan	32.0	17.4	7.9	19.9[e]
Maldives	3.6	4.1	9.0	15.1[f]
Nepal	20.8	21.8	15.3	11.5

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002); IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002); Economist Intelligence Unit, *Country Reports* (London, 2002), various issues; and national sources.

Note: Data for 2002 are estimates.

[a] Changes in the consumer price index.
[b] Fiscal year.
[c] National urban consumer price index.
[d] January-July.
[e] January-June.
[f] January-September.

commercial imports also raised the prices of several goods and services. The general wage index rose by 4.2 per cent in 2002, well above the rate of inflation. However, only 19 per cent of the labour force was in formal employment and therefore the impact of the wage increase on prices was limited. Annual inflation of 3 per cent has been targeted for the period 2003-2005 in line with the Government's intention to contain price increases; however, some upward pressure on prices could be felt if there were adverse weather conditions leading to higher food prices, and a depreciation of the currency leading to higher prices on landed imports.

The base lending rate was cut to sustain economic activities in Bangladesh

In view of widening fiscal deficits and weakening exports in 2001, Bangladesh tightened its monetary policy in the following year; credit to the public sector, in particular, showed a notable decline. In the first seven months of 2002, the broad money supply (M2) expanded by 13.7 per cent, higher than the targeted 10 per cent, as a result of higher inward remittances, but 1 percentage point lower than the rate recorded in 2001. To counter the slowdown in private sector economic activities resulting from the slump in export demand, the Central Bank lowered its base lending rate from 7 to 6 per cent in 2002, thus underpinning the 14.4 per cent growth of private sector credit in 2002.

Movements in consumer prices in Bhutan were linked to inflation in India

The exchange rate peg at parity of the Bhutanese ngultrum to the Indian rupee provides an important anchor for the economy but limits the scope for an independent monetary policy. The first half of 2002 witnessed a significant increase in the broad money supply (M2), a rise of almost one fifth compared with less then 8 per cent in the previous year, owing to higher net foreign assets, reasonably strong economic activities and the ongoing monetization of the economy. Inflation in Bhutan is also linked to that in India because of the exchange rate peg and close trade relationships. Inflation stabilized at 3.6 per cent in both 2000 and 2001, well below the 20-year average of 8.6 per cent. It fell further to a record low of 2.7 per cent in 2002, reflecting improved food supply and availability; in particular, food price inflation was 3.5 per cent in 2002, compared with 8 per cent a year earlier. However, according to the Ninth Five-year Plan, the average annual rate of inflation is targeted to be higher in Bhutan over the period 2003-2007.

Import prices and fish prices determined the rate of inflation in Maldives

Maldives experienced an acceleration in inflation, although at 2.5 per cent in 2002 it was still relatively low; consumer prices were very stable, rising by only 0.7 per cent in 2001. The upturn in inflation reflected, in part, the effects of a currency devaluation in July 2001 on imported goods, which comprised nearly 60 per cent of the consumption basket. Fluctuations in the prices of domestically caught fish (important in the food component, which has a relative weight of almost 37 per cent of the consumption basket) and the prices of imported consumer goods, which are exogenously determined, largely determine movements in inflation in Maldives. Notably, in this connection, Maldives experienced deflation in 2000 as a result of currency appreciation in that year, while the low rate of inflation in 2001 was the net result of a 21 per cent drop in fish prices, which compensated for an increase of just over 10 per cent in the prices of other food items. The prices of staples such as rice, flour and sugar are under government control.

Credit was provided to fund the budget deficit in Maldives

In Maldives, monetary policy has been directed to supporting low-inflation growth and maintaining an external balance while, at the same time, financing a substantial part of the fiscal deficit. In mid-2001, several reforms aimed at eliminating direct monetary controls were introduced in order to increase policy reliance on market-based, indirect instruments. The broad money supply (M2) went up by 9 per cent in 2001 and net credit to the Government by an estimated 8 per cent; in comparison, private sector credit growth accelerated to almost 30 per cent from 8 per cent in 2000. The broad money supply rose more strongly, by over 15 per cent in the first three quarters of 2002.

Inflation in Nepal was held below 3 per cent in 2001-2002 as a result of weak domestic demand and generally stable prices in India. However, inflation was expected to creep upwards towards the end of the year along with an increase in Indian food prices. Consumer prices were projected to be higher by 4.5 per cent in 2003, in line with the expected inflation rate in India.

Credit expansion to the public sector in Nepal was strong, while private sector loan demand remained weak

In Nepal, as in Maldives, monetary policy continued to accommodate fiscal needs. Broad money supply (M2) growth slowed to 11.5 per cent in 2002 from 15 per cent a year earlier, as a result of the weaker economy. However, net claims on the Government expanded by 19 per cent. Meanwhile, liquidity shortages in some banks led the Central Bank to lower cash reserve requirements as well as refinancing rates. Interest rates on deposits and treasury bills declined to around 4 per cent in 2002, below the corresponding rates in India, partly as a result of weak loan demand reflecting, in turn, the limited investment opportunities in Nepal. The Central Bank also provided a refinancing facility at 3 per cent interest to encourage commercial banks to provide concessional loans to industries affected by the economic slowdown. Nevertheless, growth in private sector credit was lower at 8 per cent in 2002, down from 16 per cent in 2001, and was mainly directed at refinancing troubled loans.

Foreign trade and other external transactions

External trade

Although export growth in Bangladesh suffered from weak overseas demand, imports declined even more sharply, leading to a narrower trade deficit

Merchandise exports had gone up by 12.6 per cent to reach $6.42 billion in 2001 in Bangladesh but declined by over 7.6 per cent in 2002 as a result of lower demand in overseas markets (table II.28). Although the volume of apparel exports increased by almost 14 per cent in 2002, falling prices were responsible for a drop of almost 6 per cent in their value. Exports of frozen foods, leather, raw jute and tea also experienced a fall-off in both volume and value terms; by contrast, the export volumes and values of jute goods and agricultural products were higher in 2002.

In the meantime, there was an absolute decline in import spending, by approximately 8.7 per cent, in 2002, as a result of lower imports of inputs for export processing activities as well as fiscal and monetary tightening (table II.29). The fall reversed a substantial expansion of over 11 per cent in import value during the previous year. In 2002, lower import expenditure on cotton, yarns and textiles led to a 13.4 per cent reduction in the value of imported intermediate goods and industrial inputs, which together constituted over two fifths of total imports. Petroleum imports were also lower, while import spending on rice, wheat and sugar went down as a result of increased domestic output; however, imports of edible oils increased considerably. Commercial imports of consumer durables and automobiles declined by over 10 per cent in 2002 after the imposition of margin requirements and supplementary duties had lowered demand. By contrast the continued positive investment outlook accounted for a modest rise in imported capital goods.

Table II.28. Selected least developed countries in South and South-West Asia: merchandise exports and their rates of growth, 1999-2002

	Value (millions of US dollars)	Exports (f.o.b.) Annual rate of growth (percentage)			
	2001	1999	2000	2001	2002
Bangladesh[a]	6 419	2.9	8.2	12.6	−7.6
Bhutan[a]	99	−5.9	9.1	−12.9	−1.2
Maldives	107	−4.3	18.8	−1.7	..
Nepal[a]	941	−10.9	27.3	−3.1	..

Sources: IMF, *Country Reports,* various issues; and national sources.

Note: Data for 2002 are estimates.

[a] Fiscal year.

Both exports and imports showed some recovery towards the end of the year and the medium-term macroeconomic framework projects a growth rate of 7.1 and 8.9 per cent for exports and imports respectively in 2003. The trade deficit narrowed in 2002 as a result of the steeper decline in imports than in exports and, together with a substantial increase in remittance receipts, contributed to narrowing of the current account deficit from 1 per cent of GDP in 2001 to 0.6 per cent in 2002 (table II.30).

Table II.29. Selected least developed countries in South and South-West Asia: merchandise imports and their rates of growth, 1999-2002

	Value (millions of US dollars)	Imports (c.i.f.) Annual rate of growth (percentage)			
	2001	1999	2000	2001	2002
Bangladesh[a]	8 430	10.9	2.7	11.4	−8.7
Bhutan[a]	196	19.2	14.0	6.1	−1.2
Maldives[b]	349	13.6	−3.4	2.0	..
Nepal[a]	1 773	−10.4	23.2	3.5	..

Sources: IMF, *Country Reports,* various issues; and national sources.

Note: Data for 2002 are estimates.

[a] Fiscal year

[b] Imports f.o.b.

Table II.30. Selected least developed countries in South and South-West Asia: budget and current account balance as a percentage of GDP, 1999-2002

(Percentage)

	1999	*2000*	*2001*	*2002*
Budget balance as a percentage of GDP				
Bangladesh[a]	–4.8	–6.2	–5.5	–4.3
Bhutan	–1.6	–4.1	–11.8	–6.8
Maldives	–4.2	–4.9	–5.3	–7.6
Nepal	–5.3	–4.7	–5.8	..
Current account balance as a percentage of GDP				
Bangladesh	–0.8	–0.7	–1.0	–0.6
Bhutan	–22.5	–26.8	–23.4	..
Maldives	–14.6	–9.5	–10.7	..
Nepal	–5.1	–5.6	–6.2	–6.0

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002) and *Asian Development Outlook 2002* (Oxford University Press, 2002); IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002); Economist Intelligence Unit, *Country Reports* (London, 2002), various issues; and national sources.

Note: Data for 2002 are estimates.

[a] Excluding grants.

Bhutan depended on India for nearly all of its merchandise exports and imports

According to Bhutan's balance-of-payments estimates for 2002, both merchandise exports and imports declined only marginally, by approximately 1.2 per cent in each case. The country is heavily dependent on India for trade as a result of the Free Trade Agreement between the two countries as well as the free convertibility between the ngultrum and the Indian rupee. India was the source of over 83 per cent of Bhutan's imports and over 95 per cent of its exports in 2002; electricity sales alone accounted for half of the total merchandise exports to India. Further growth in energy sales is expected in the medium term.

Imports into Bhutan were dominated by chemical and mineral products, machinery, mechanical appliances and base metals; many of those imported items were mainly associated with the construction of hydroelectric projects. In recent years, vehicle imports from India have increased significantly; 600 out of the 740 cars imported in 2001 originated in India. Net receipts of income and current transfers helped to offset the large trade deficit in Bhutan to some extent, narrowing the current account deficit somewhat from the 26.8 per cent of GDP recorded in 2000; nevertheless, the deficit was still equivalent to 23.4 per cent of GDP in the following year.

Maldives was heavily dependent on trade, principally on inward tourism, for its export earnings

Maldives has a ratio of trade in goods and non-factor services to GDP of around 170 per cent. Earnings from tourism constituted about 70 per cent of total export receipts, which have suffered in recent years owing to the weakness in that sector. In particular, a reduction in tourist arrivals in 2001-2002, compounded by shorter stays and lower prices resulting from low occupancy rates, led to zero growth in earnings from tourism in 2001 and a contraction of 1.3 per cent in such receipts in 2002. Meanwhile, merchandise exports were heavily dominated by marine products; fresh and processed tuna, for example, accounted for almost three fifths of the merchandise export value in 2001.

About 70 per cent of imports were sourced from Asia and the value of merchandise imports was far in excess of that of exports, including re-exports, leading to a merchandise trade deficit equivalent to nearly 4 per cent of GDP in 2001. The share of re-exports, mainly jet fuel, rose from 21 per cent of merchandise exports in 1997 to 31 per cent in 2001. Manufactured products, intermediate inputs for the apparel industry, food and fuels dominated imports; transport and insurance were the most important service imports. Exports to Asian and European markets have declined in recent years, although this trend has been offset by higher exports, mainly of garments, to the United States. There has, however, been substantial year-to-year volatility in both the value and the volume of exports to most of the major markets. The current account deficit in Maldives widened from 9.5 per cent of GDP in 2000 to just under 11 per cent in 2001, as outward remittances increased by 7.5 per cent over the same period.

Nepal's exports to countries other than India have fallen significantly

Nepal's merchandise exports, excluding re-exports, were down by about 3 per cent, to $941 million, in 2001, after a substantial expansion of over 27 per cent a year earlier. Sales to countries other than India declined by more than two fifths, owing to lower garment, carpet and pashmina exports. Earnings on exports to India were slowing as well, as a revised bilateral treaty signed in March 2002 introduced some non-tariff barriers on exports from Nepal; vegetable ghee was the only commodity to have shown a significant increase in exports in 2002. Re-exports to India had also fallen steeply between 1998 and 2001. Generally, any noticeable recovery in overall merchandise exports is expected to be slow as garment exports face increasing international competition.

Merchandise imports were led by minerals, fuels and lubricants, manufactured goods, machinery and transport equipment; their value increased by 3.5 per cent, to $1.77 billion, in 2001. Despite increased migrant remittances, which grew by 8 per cent in 2002 to exceed merchandise exports in value, the current account deficit was around 6 per cent of GDP in 2002; shortfalls in the current account had remained at 5-6 per cent of GDP for several years. An improved balance in the current account is expected in the near term along with slowing import growth, a recovery in tourism receipts and a steady rise in inward remittances.

A number of initiatives were launched to facilitate regional trade

The establishment of the South Asian Association for Regional Cooperation (SAARC) Preferential Trading Arrangement (SAPTA) was expected to provide a framework for the gradual liberalization of intra-regional trade and the exchange of concessions on tariffs and quantitative barriers. India and Sri Lanka have become the main Asian trading partners of Maldives under SAARC preferences. To promote liberalized trade, Bhutan recently renewed the bilateral Free Trade Agreement with India up to 2005 and expanded product coverage under the existing Preferential Trade Arrangement with Bangladesh. Bhutan and Nepal, which are merely observers at present, are in the process of accession to WTO as members. Both countries intend to reduce qualitative and quantitative barriers to trade; Nepal is expected to restructure its import tariff bands from five to four, with a maximum rate of 35 per cent, and to convert the exceptional tariff rates on vehicles to excise taxes. Landlocked Bhutan expects the establishment of a dry port in Phuentsholing to reduce transport costs and improve trade documentation processes and procedures (see box II.4).

Box II.4. Landlocked developing countries

Owing to their lack of territorial access to the sea, remoteness, isolation from world markets and high transit costs, landlocked developing countries are among the poorest within the developing region. Of the 30 landlocked developing countries in the world, 12 are in the ESCAP region: Afghanistan, Armenia, Azerbaijan, Bhutan, Kazakhstan, Kyrgyzstan, Lao People's Democratic Republic, Mongolia, Nepal, Tajikistan, Turkmenistan and Uzbekistan. Four of these, Afghanistan, Bhutan, the Lao People's Democratic Republic and Nepal, are also classified as least developed, while 9 are economies in transition, Armenia, Azerbaijan, Kazakhstan, Kyrgyzstan, the Lao People's Democratic Republic, Mongolia, Tajikistan, Turkmenistan and Uzbekistan.

Longer distances from international markets and time-consuming border-crossing and transit formalities increase the total costs as well as the transit time for the imports and exports of landlocked developing countries, thereby eroding their competitive edge. On the basis of IMF Balance-of-Payments Statistics, UNCTAD has estimated that in 1995 landlocked developing countries spent on average almost two times more of their export earnings for the payment of transport and insurance services than the average payment borne by developing countries, and three times more than that borne by developed economies.[a]

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[a] "Specific actions related to the particular needs and problems of landlocked developing countries", note by the Secretary-General (A/56/427) (<http://www.un.org/documents/ga/docs/56/a56427.pdf>).

The geographical disadvantage of landlocked countries is often compounded by poor infrastructure and "missing links" in transit corridors. Efforts to develop these corridors, however, tend to be hampered by the fact that landlocked developing countries find it difficult to attract FDI for infrastructure development. In 2001, for example, landlocked developing countries in Asia were the destination for less than 2 per cent of global FDI flows to all developing economies, despite the fact that the Asian and Pacific region as a whole received close to half of such flows.[b] In that context, the availability of efficient infrastructure and transport systems is often a prerequisite to attracting FDI. The international community therefore has a critical role to play in assisting landlocked developing countries in improving their basic infrastructure and related services.

While there have been some improvements in transit transport systems across the world, the rate of progress is overshadowed by rapid changes in the organization and modalities for production and trade across the globe. The globalization of supply chains and the spread of "just-in-time" delivery, for example, mean that the ease with which parts and products can be imported and exported has become a major consideration for international firms in their decision to invest and relocate overseas. Several non-physical aspects of transit transport can thus become a major barrier to transport and hence to trade and investment flows. These aspects include, to name just a few, cumbersome documentation processes, different working hours at border-crossings, duplicative customs checks and, more generally, the absence of an institutional framework for transit transport. The alignment or standardization of trade documents and the automation of customs procedures are just two of the ways in which both landlocked and transit countries can take action to remove these barriers.

As part of their efforts to address the above issues, many landlocked and transit developing countries have entered into bilateral and subregional agreements on transit trade and transport which provide the legal basis for such operations. Some of these subregional agreements facilitate the movement of transit cargo, not only from landlocked countries to third countries but also through landlocked countries themselves. International conventions represent another type of legal instrument which can facilitate transit trade and transport. On 23 April 1992, the Commission adopted resolution 48/11 on road and rail transport modes in relation to facilitation measures, in which member countries were encouraged to accede to seven international transport conventions, including those on the transport of goods under cover of TIR carnets and on the harmonization of frontier control of goods. The International Convention on the Simplification and Harmonization of Customs Procedures, which was signed at Kyoto, Japan, in 1973 and revised in 1999, relates to trade facilitation. This Convention has served to reduce the delays and paperwork associated with customs procedures. As landlocked and transit developing countries accede to WTO, they will be called upon to provide adequate transport and related infrastructure as well as a conducive regulatory environment to support trade.

In order to create a global consensus on ways and means to address the challenges discussed above, the General Assembly decided to convene the International Ministerial Conference of Landlocked and Transit Developing Countries and Donor Countries and International Financial and Development Institutions on Transit Transport Cooperation, which will be held at Almaty on 28 and 29 August 2003. The Conference will review the current status of transit transport systems around the world and identify new or recurring problems. As part of the global preparatory process, the ESCAP secretariat is conducting a series of studies and subregional seminars on the transit transport systems of its landlocked member States. The outcome of these seminars will form the basis of a regional position paper which will be debated and endorsed by the ESCAP Special Body on Least Developed and Landlocked Developing Countries at its sixth session, to be held in April 2003. This process will involve the Governments, donors and the private sector of both landlocked and transit developing countries; its aim is to ensure that the concerns of all relevant stakeholders are considered when measures to improve transit transport processes are being developed.

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[b] UNCTAD, *World Investment Report 2002.* United Nations publication, Sales No. E.02.II.D.4), table B.1. This figure excludes the Pacific island States.

Capital flows and exchange rates

External debt and debt service were manageable in Bangladesh

Net capital flows into Bangladesh declined significantly, from $580 million in fiscal 2001 to $312 million in 2002. Although total ODA receipts rose slightly, from $1.15 billion in 2001 to $ 1.23 billion in 2002, the amount of grant aid was slightly lower, from $432 million to $410 million, over the same period. Inward FDI was worth $174 million in 2001 but was down to $65 million in the following year; there was an outflow of foreign portfolio investment of $6 million. The Central Bank's foreign exchange reserves were adequate to cover 10 weeks of imports in October 2002 as a result of tightened fiscal and monetary policies, administrative measures to compress import demand, and higher remittances; this represented a notable improvement as the foreign reserve position, at $1.1 billion by October 2001, had covered less than six weeks of imports. Total official external debt, which is almost entirely on concessional terms, reached $16.6 billion (or just over 35 per cent of GDP) at the end of 2002. Debt-service obligations accounted for under 10 per cent of annual export earnings. The outstanding external debt of the private sector was estimated to be $1.1 billion as at December 2001. Given the relatively modest levels of the external debt and debt-service burden, Bangladesh is not included in the multilateral debt forgiveness arrangements under the World Bank's Heavily Indebted Poor Countries Initiative.

The transition to a market-based exchange rate regime, which is now under consideration in Bangladesh, will bring an additional variable for consideration in government efforts to stabilize prices. At present, the dealing banks anchor the taka exchange rate for customer and interbank transactions around a narrow band within which the Central Bank undertakes spot purchase and sale transactions. This exchange rate band was revised once in 2001 from Tk 54.00 per United States dollar to Tk 57.00 per dollar and again in 2002 to Tk 57.90 per dollar within a band of one taka.

Much of Bhutan's external debt consists of concessional loans for hydropower development

In Bhutan, ODA consists mainly of concessional loans for hydropower projects and the amount was estimated to have increased by around 20 per cent to $56.4 million in 2002. Bhutan also received $1.8 million in FDI, as selected sectors of the economy were opened for private investment of that type; a new FDI policy is in the final stages of approval. As a result of these developments, international reserves went up from $294.2 million at the end of 2001 to $316 million at the end of 2002; the latter sum was equivalent to 20 months of import cover. Total external debt rose by over 23 per cent at the end of 2002 to $289.6 million, or about 58 per cent of GDP; of that amount, 55 per cent was in Indian rupees for the financing of hydropower projects. Most loans in convertible currencies were on concessional terms and total debt-service payments amounted to $4.2 million in 2002, of which 31 per cent was for interest payments.

The ngultrum is pegged to the Indian rupee at parity and is freely convertible with the rupee. In line with the Indian rupee, the ngultrum depreciated by 4 per cent against the United States dollar in 2002.

In Maldives, private capital inflows decreased along with the completion of new tourist resorts

In recent years, ODA from bilateral and multilateral sources to Maldives has declined, but more of it has been on concessional terms. Official grants increased by about 10 per cent to $19.6 million in 2001, while private capital inflows were also down from almost $43 million to $24.3 million in 2001 as the construction of additional resorts was completed. External debt, of which 87 per cent was either long- or medium-term, decreased marginally from $211.6 million, or 37.7 per cent of GDP, in 2000 to $209.8 million, or just under 37 per cent of GDP, in 2001 owing to a substantial fall in the short-term foreign liabilities of commercial banks. External debt-servicing amounted to 4.3 per cent of merchandise and non-factor service exports. As a result of higher prices for imported fuel, the amortization of tourism sector debts and growing fiscal expenditure, international reserves went down from $124 million, or 3.8 months of import cover, in 2000 to $94.3 million, or 2.9 months of import cover, in the following year.

Maldives has maintained a de facto fixed exchange rate since 1994, with the rufiyaa anchored to the United States dollar. There are no exchange rate restrictions and the rufiyaa is fully convertible for current and capital account transactions. The strengthened dollar between 1995 and 2000 meant in effect an appreciation of the rufiyaa by about 30 per cent, thus affecting the international competitiveness of fishery exports and inward tourism adversely and discouraging new exports and economic diversification. The rufiyaa was subsequently devalued by 8.5 per cent to Rf 12.8 per dollar in 2001, contributing to some upward push on consumer prices in 2002 in an economy heavily reliant on imports.

Declining ODA contributed to the overall balance-of-payments deficit in Nepal

Nepal registered an overall deficit of $77 million in 2002, as compared with an overall balance-of-payments surplus of $38 million in 2001; however, the overall balance of payments was expected to be positive in 2003 as a result of improved aid disbursements. Meanwhile, gross official reserves stood at over $1 billion, covering 6.5 months of imports. The debt-service ratio remained at about 5 per cent of current account receipts as a result of the concessional nature of much of Nepal's debts as well as the high level of inward remittances. Although Nepal maintains an exchange rate system free of restrictions for current international transactions, there continue to be quantitative restrictions on the availability of foreign exchange for travel abroad. The pegging of the Nepalese rupee to the Indian currency at NRs 1.6 to Rs 1 since 1997 has provided a suitable nominal anchor, given the close economic ties with its neighbour. With the depreciation of the Indian currency, the Nepalese rupee weakened slightly against the dollar over the course of 2002. The real effective exchange rate was reported to be stable and the informal market premium was minimal.

Key policy issues

The modest levels of economic growth in Bangladesh and Nepal, where nearly half of the population live below the poverty line, posed problems for poverty reduction

Most least developed countries in South and Suth-West Asia have managed to achieve positive GDP growth rates in recent years. Afghanistan, however, is facing a formidable challenge in economic rehabilitation and reconstruction, and in nation-building more generally (see box II.5). The trend rates of economic growth in some countries, such as Bangladesh and Nepal, were not adequate to ensure sustained poverty reduction. Despite domestic and international efforts over the years, it is estimated that some two fifths of the population of Nepal live in poverty as a result of slow growth in the agricultural sector and poor infrastructure and social service delivery. To achieve the goal of poverty reduction, sustained annual growth rates of 6 per cent or higher are necessary, with deliberate pro-poor targeting of public expenditure by choosing projects with high growth and poverty reduction impact; greater attention also needs to be focused on the maintenance of existing public facilities. Given the low levels of domestic income and savings in Bangladesh and Nepal, the higher growth rates necessary for rapid poverty alleviation are attainable only with continued investment inflows from external sources, both official and private.

Bhutan and Maldives, however, have achieved perceptible changes in terms of both income and social indicators. For example, in Bhutan, during the period of the Eighth Five-year Plan ending in 2002, per capita income increased from $545 to $713, primary education enrolment reached 89 per cent and access to piped potable water was available to almost four fifths of rural households. In Maldives, GDP per capita amounted to $2,200 and the country is almost in the top one third of "medium human development" countries.

Better fiscal management continued to be an important preoccupation for least developed countries in South Asia

Although Bangladesh maintained current budget surpluses during the period 1999-2002, those surpluses were insufficient to cover development expenditure of around 6 per cent of GDP; the financing gap was bridged by external grants and by external and domestic borrowings. In 2002, the curtailment of current and development expenditure and higher revenue narrowed the deficit to 4.3 per cent of GDP from 5.5 per cent in the previous year (table II.30). A decline in the overall deficit, excluding grants, to 3.9 per cent of GDP is projected for 2003. Net domestic financing is likely to decline somewhat, while increased inflows of external grants and loans after the finalization of the Poverty Reduction Strategy Paper are expected to cover a somewhat wider future financing gap.

Bhutan narrowed its fiscal deficit by curtailing public expenditure

In Bhutan, the budget shortfall narrowed to 6.8 per cent of GDP in 2002 from 11.8 per cent in the previous year as a result of declining government outlays. Tax revenue, generated through enterprise profit taxes and direct taxes on goods and services, was up by a quarter; it was equivalent to almost 44 per cent of total domestic revenue, with the

Box II.5. Afghanistan: accomplishments and challenges

While so far the successes of the new regime with the assistance of donors are encouraging, the Government still faces daunting challenges. There are signs of economic recovery: in 2002, agricultural production grew by an estimated 82 per cent compared with 2001.[a] This large increase in agricultural production was helped by relatively improved weather conditions and the increased availability of key inputs, including seeds and fertilizer. The vast majority of the population live in rural areas and are dependent on agriculture, which is therefore the key to the revival of economic activity, enhancing food security and reducing poverty.

The Government introduced a new currency in October 2002, under which 1,000 old afghani were replaced by 1 new afghani. This should make transactions simpler and, more important, set the stage for monetary control by the Central Bank. After initial depreciation, the domestic currency recovered and was trading at 45 afghanis to the United States dollar in December 2002. A stable exchange rate is the key to promoting foreign trade. In order to expand exports, the Government has decided not to levy customs duties on them. In January 2003, the United States Government made Afghanistan a beneficiary of the generalized system of preferences, eliminating tariffs on approximately 5,700 Afghan products.

Programmes aimed at eradicating polio and vaccination against measles and tuberculosis have been launched successfully. The numbers of students and teachers returning to school have exceeded expectations, with 3 million students enrolled (including 1 million girls) and another 1.5 million looking for schooling opportunities.

Despite these successes, the challenges are enormous.[b] Most people in the country live in extreme poverty; only 23 per cent have access to safe water, 12 per cent to adequate sanitation and 6 per cent to electricity. The physical infrastructure needs to be rebuilt and most of the country's roads and more than 70 per cent of the schools need repair.

Other daunting challenges and tasks include drafting a constitution, developing a sound financial and banking system and a professional national security system and holding free and fair elections. With private sector-led growth, a central plank of its reconstruction strategy, the Government has been preparing an investment law and other laws and regulations to provide a sound enabling environment.[c]

Owing to a lack of revenue sources of its own, the Government is heavily dependent on foreign aid. About $1.9 billion in foreign aid had been promised for 2002; roughly two thirds of this was made available. A large part of the aid received was spent on such necessities as food and helping refugees through aid agencies. A small part of the funds went to the Government itself. At the International Donors Conference for Afghanistan held at Oslo in December 2002, President Hamid Karzai asked the donors to focus more on long-term infrastructure projects for economic recovery. He emphasized that his country needed help in building roads and infrastructure and restoring farming, as well as creating or rebuilding government structures and services. The donors at the Conference pledged about $1.7 billion in aid for 2003.[d]

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[a] World Bank web page "Afghanistan country update" at <http://Inweb18.worldbank.org/SAR/sa.nsf/Attachments/afghupdatetextonly/$File/afghanistanupdatetextonly.pdf>, 6 January 2003.

[b] Some of these challenges were discussed in *Survey 2002,* box II.2, pp. 44-46.

[c] William Byrd, "Afghanistan's reconstruction, regional and country context: a discussion paper", available at <http://Inweb18.worldbank.org/SAR/sa.nsf/Attachments/1031/$File/Afghanistan+Reconstruction+Paper+1031-pdf >, 6 January 2003.

[d] The exact amount of the pledges made at the Conference was difficult to determine as a number of countries' fiscal budgets have yet to be approved by their parliaments and because the countries spread out their pledges over varying periods.

(Continued overleaf)

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Earlier, most of the aid had been coordinated by a loose organization called the Afghanistan Support Group. The Oslo Conference dissolved the Group and turned responsibility over to a streamlined Consultative Group based at Kabul and led by the Finance Minister of Afghanistan. This shift signals that the Afghans are taking responsibility for their own future. Allaying the fears of corruption, President Karzai promised transparency, accountability and efficiency in the use of funds.

Just as the conflict in Afghanistan affected the surrounding countries negatively, post-conflict reconstruction brings opportunities for regional development and greater integration.[e] On 27 December 2002, Afghanistan, Pakistan and Turkmenistan signed an agreement to build a natural gas pipeline estimated to cost $2.5 billion. The 1,400-kilometre line is designed to link the vast gas reserves of Turkmenistan, the world's third largest, with Pakistan and eventually India. The only way to open the South Asian market to Turkmenistan's reserves is across Afghanistan, and decades of instability there kept the project on the drawing board. The ADB feasibility study of the project is expected to be completed by July 2003, after which international companies will have a chance to form a consortium to build the pipeline. With Turkmenistan profiting from a new market and Pakistan from a new source of supply, Afghanistan stands to gain from transit fees. The project will facilitate the building of roads and improve communications in the country, which will increase economic cooperation in the region and help the security situation.

About 2 million refugees have returned to Afghanistan from neighbouring and other countries. The process of repatriation of refugees from neighbouring countries has slowed because of the lack of adequate economic activities for the returnees. It is important for the international community to target its assistance to the rural areas from which the refugees originated so as to ensure that those who returned home have a reason to stay. The returning refugees, whose numbers are virtually unprecedented in international experience, may be a cost burden in the short term but constitute a resource for the longer term.

Security and peace are the keys to Afghanistan's reconstruction and development. The International Security Assistance Force has helped to improve the security situation in Kabul considerably. In the short run, expanding the mandate of the Force to include other Afghan cities still suffering from unrest could enhance security. Moreover, it is also important to accelerate the formation of a national army and police force not tied to or staffed by existing armed factions or militias. International donors are helping to create a national army and police force, but it will be years before they can really control the country. The Government of Afghanistan has decided to create a 70,000-strong national army to be trained by United States and French personnel. A national army would save Afghanistan from dependence on factional forces for its protection. Economic recovery through rebuilding the country and creating ample employment opportunities can help to achieve peace and security.

On 22 December 2002, the Transitional Administration of Afghanistan and the Governments of China, the Islamic Republic of Iran, Pakistan, Tajikistan, Turkmenistan and Uzbekistan signed the Kabul Declaration on Good-Neighbourly Relations, in which those countries pledged never to interfere in the affairs of the war-ravaged country. The Declaration also emphasizes constructive and amicable relations, mutual respect for sovereignty and territorial integrity and a commitment to refrain from action that could jeopardize peace. Its aim is to improve regional relations and help both the consolidation of peace in Afghanistan and the big task of reconstruction.

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[e] William Byrd, op cit.

remainder coming from non-tax revenue sources, mainly surplus transfers from State-owned enterprises. The introduction of a personal income tax in 2003 was expected to improve fiscal resource mobilization. Although foreign grants decreased by 11 per cent in 2002, they were estimated to contribute almost 38 per cent to total budgetary resources. The level of current expenditure remained modest, at around 19.4 per cent of GDP in

2002; of that total, 35 per cent was on the social sector. The ratio of capital expenditure to total expenditure, estimated at 55 per cent in 2002, was about 15 per cent lower than in the previous year. Nearly two thirds of the deficit in 2002 was financed from external loans and the remainder from internal sources.

The budget deficit increased in Maldives owing to current expenditure overruns

As a result of expansionary fiscal policies, budget deficits in Maldives have been on a rising trend, from 1.4 per cent of GDP in 1997 to 5.3 per cent in 2001 and further to 7.6 per cent in 2002; government expenditure, especially outlays on administration and social services, exceeded targets. Meanwhile, government revenue, including foreign grants and aid, was expected to rise, from 36 per cent of GDP in 2001 to nearly 39 per cent in 2002. The main sources of government revenue were tourism tax, import duty and bank profit tax, as well as non-tax revenue generated from resort leases and public enterprises. The revenue position was adversely affected by a number of commercially non-viable State-owned enterprises, despite the implicit government subsidies and monopoly powers given to them. In that connection, the role of the Public Enterprise Monitoring and Evaluation Board was expanded in 1999 to oversee their performance and remove subsidies, such as the provision of rent-free public land. Maldives is also overhauling the government accounting system and introducing "programme-oriented" budgeting to promote cost-effective public spending. Expenditure controls and financial discipline are being strengthened to curtail persistent budget overruns and ensure better prioritization of spending programmes based on a review of public expenditure.

Nepal has implemented a number of measures to improve revenue collection

Social instability in Nepal has led to higher spending on security while constraining tax collections. Partly as a result, capital spending was reduced sharply to contain the budget deficit and domestic borrowings were increased to compensate for lower financing from international sources. In 2002, there was a shortfall in revenue of 1.5 per cent of GDP as a result of weaker economic performance, and additional resources were mobilized through the introduction of a scheme for the voluntary disclosure of income and special revenue measures to fund spending on security. Such spending, at 3 per cent of GDP, was estimated to be 1 per cent higher than budgeted. Meanwhile, budgeted capital spending was reduced by 3 per cent of GDP, thus affecting foreign aid disbursements and financing. As part of public sector reforms, fiscal transparency has been much improved through greater coverage, timeliness and detail in budget reporting. At the end of fiscal 2002, the World Bank and ADB, with some bilateral donors, were considering the provision of budget support to encourage spending prioritization, the decentralization of social service provision and greater government accountability in Nepal. The fiscal 2003 budget focuses on channelling public spending towards achieving tangible improvements in basic infrastructure and social services as well as improving revenue mobilization.

Alternative means to raise government revenue must be considered

Despite efforts to raise government revenue in the least developed countries, there are still constraints on the widening and deepening of the domestic revenue base, including a small private sector, widely scattered population and subsistence farming as the primary occupation. A higher degree of reliance on direct taxes on income and profits was expected to lead to greater equity; such taxes did not exist in a number of least developed countries in South and South-West Asia, leading to a greater reliance on border taxes. In Maldives, there are no direct taxes, except for a bank profits tax, and no general consumption tax. Indirect taxes, such as import tariffs and a hotel bed tax of $6 per night levied on foreign tourists, accounted for 92 per cent of total government tax revenue in 2000. Bhutan also had no income tax until its introduction in 2003, and its impact on revenue-raising is expected to be modest. Given the highly inelastic tax base in Bhutan, most of the current revenue comes from profits from public enterprises and service fees from government agencies, while land-lease payments for tourist resorts surpassed the tourist bed tax in 1998 to become the second-largest single source of revenue after tariffs in Maldives. Although Nepal has a relatively efficient tax system based on low income tax rates and VAT, increased spending on security has contributed to the current fiscal deficit and higher domestic borrowing. The country was expected to raise revenue by 0.25 per cent of GDP, to reach 11.6 per cent of GDP, in 2003 through audits of large taxpayers and improved customs valuation.

The essential role played by the private sector in achieving sustained economic growth has been recognized in the South and South-West Asian least developed countries

The private sector in most of the least developed countries of the subregion faces a number of severe constraints, including a shortage of skilled labour, inadequate managerial and entrepreneurial capacity, high transport costs, limited credit facilities and a small domestic market with limited access to export markets. Countries have therefore focused on the provision of tax incentives, policy liberalization, human resources development and the creation of an enabling infrastructure. A number of legal instruments, such as the amended Companies Act, the Sales Tax, Customs and Excise Act, the Negotiable Instruments Act and the Bankruptcy Act were enacted in Bhutan to promote an appropriate enabling policy environment. In addition, several tax holiday schemes were introduced in July 2002 to encourage the establishment of new industries and business houses. In Maldives, the number of licensed shops and importing agencies has been increased in order to improve competition. Infrastructure limitations in ports, communications and utilities have constituted a bottleneck to business activities. These sectors are traditionally dominated by public sector entities and their restructuring requires the cooperation of all stakeholders. Transition to regulated but market-based pricing of gas and electricity could ease supply constraints by attracting additional investments and restoring the financial health of the service providers.

The privatization of State-owned enterprises has increasingly been seen as a necessary step

Recognizing the need to avoid engagement in manufacturing or commercial activities as part of its public investment strategies, Bangladesh closed a large publicly owned enterprise. In Bhutan, the privatization of public enterprises was reported as being nearly complete, with majority ownership and management of public sector enterprises transferred to the private sector. Although the privatization of State-owned enterprises was launched in Maldives in 1999, concerns about the anti-competitive effects of privatized firms in the small domestic market have impeded its progress. Efforts have instead been focused on improving the efficiency of State-owned enterprises through greater "commercialization" and the introduction of better management practices and performance monitoring. Seven State-owned enterprises have been opened to minority private participation, while greater public sector efficiency is also to be achieved by restricting the size of the public sector and limiting its role to the delivery of key services. In Nepal, restructuring and privatization efforts continued to be constrained by the fiscal liabilities of the 7 financial and 36 non-financial public enterprises, such as arrears in payments to employees and to banks and suppliers.

An effective financial sector, especially in underserved markets, is essential to promote the private sector

The least developed countries of South Asia have also recognized the need for better financial intermediation as a prerequisite to promoting greater participation and competitiveness in the private sector. Significant portions of the economically active population, particularly in rural areas, remain underserved in many least developed countries, as financial institutions focus attention on commercial and industrial activities in urban centres. In Bangladesh, only 12 per cent of domestic credit was directed to the agricultural sector, which contributed a quarter of GDP in 2002. In contrast, the term loan component alone comprised 17.6 per cent of domestic credit to the industrial sector, which contributes approximately the same share to GDP. Small-scale enterprises, which could create considerable employment and outputs in Bangladesh, received little credit from either microcredit organizations or formal financial institutions. Since banks are the major providers of finance, the high cost of bank credit has an adverse impact on the competitiveness of the private sector. Although interest rates on bank credit decreased marginally in 2002, to approximately 13.2 per cent, the real interest associated with bank borrowing is high, given the low level of inflation.

In Bhutan, development of the financial sector has been impeded by limitations on private sector development, inadequate legal and institutional infrastructure, and insufficient debt and capital markets and human resources development. However, improvements in the process of financial intermediation are expected with the establishment of specialized non-bank financial institutions to provide such services as leasing, housing finance and insurance, and policy efforts to ensure greater openness of the financial sector to foreign participation.