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## South Asia: Policy Responses to the Global Crisis

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### Abstract

*The impact of the economic crisis of 2008-09 was felt significantly in the economies of South Asia. Demand for exports and foreign investments fell in the real economy as well as in the financial markets. This led to a softening of domestic demand in the consumption sectors, leading to a slowdown in the growth of these economies. The economies in South Asia have now recovered and the problems of 2009 and 2010 have been left behind. Policy interventions that were adopted in the different countries varied not just due to differing macroeconomic considerations, but also because of the political economy considerations in these countries. This paper attempts to examine these interventions, their causes and effects.*

### Introduction

Both advanced and emerging economies initiated various fiscal and monetary measures in the form of bailouts and stimulus packages during the economic meltdown in 2007-08. The objectives of such initiatives appear to be: to restore confidence in the financial system and revamp and stabilise the financial markets; to stimulate domestic demand; to create new job opportunities; to support domestic industries; and to safeguard export interests.

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A review of stimulus packages by countries mentioned above reveals some common policy stances: boosting domestic demand through additional investment in infrastructure and productive sectors; fiscal stimuli by way of reduced duties and taxes; aggressive monetary policy through rate cuts and reduced interest rates; readiness to go for higher deficits to stimulate the economy; fiscal/financial incentives in the form of cash compensation schemes, income tax rebates, credit at reduced interest rates in support of export-oriented sectors.

The impact of the economic crisis in 2008-09 was felt significantly in the economies of South Asia. Demand for exports and foreign investments fell in the real economy, as well as, in the financial markets. This led to a softening of domestic demand in the consumption sectors, leading to a slow down in the growth of these economies. However, most of the South Asian economies had recovered remarkably in 2009-10 and have regained much of the momentum that they had lost in 2007-08. This was a consequence of a combination of prudent fiscal and monetary policy measures, as well as a consistent focus on growth, even at the risk of some inflationary pressures. The monetary and fiscal policies pursued by these countries did not quite address all the features outlined above, but these were due to peculiar political and economic constraints that each country was facing. In some of the South Asian countries – notably Pakistan, Sri Lanka and Nepal – factors such as political stability and changes in regime have had their impact on the recovery process. This paper attempts to trace the features of these economies during this period (2007-10) and to outline the steps taken to deal with the consequences of the global economic crisis.

## **India**

In India, the impact of the crisis was first felt in the financial markets, as institutional investors withdrew close to US\$16 billion in the months following the Lehman Brothers' collapse. The market capitalisation of the National Stock Exchange listed that equities fell by over 40 per cent and the Sensex fell from 20,800 in January 2008 to 8,600 by December 2008. In the real economy, exports fell every month from October 2008, with a 16 per cent drop in January 2009 alone. The decline in orders from the European Union (EU) – among India's most important trading partners – played a significant role in driving this overall fall of exports. As a result there was a considerable increase in unemployment in the export sector, with the Government of India estimating a loss of 1.5 million jobs from September 2008 to March 2009 alone. While no export sector was immune from the downturn, the effect was particularly severe in the labour intensive industries such as textiles, leather goods, automobiles and gems and jewellery.

The subsequent recovery has been remarkably swift. Exports recovered in 2010, with a growth averaging 26.5 per cent year-on-year (YoY) to US\$18.8 billion in November 2010.<sup>2</sup>

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<sup>2</sup> 'Nov exports rise 27%, may exceed \$200-bn target', *BS Reporter* (4 January 2011).

Exports continue to be buoyant. Real estate prices that fell in 2008, recovered in the urban centres, though there is some sluggishness in the recovery of commercial and retail space.

In short, India has been quick to recover from the effects of the financial meltdown in the developed countries and appears well on its path to recovery. The gross domestic product (GDP) growth that fell to 6.0 per cent in 2008-09 is set to reach 8.5 per cent in 2010-11<sup>3</sup> and the estimates for fiscal year (FY) 2011-12 appear to be in the same order.

This recovery has been in part due to policy responses of the Government and in part due to the inherent strengths in the Indian economy.

### Policy Response

At the beginning of 2008, the Government of India took the step of waiving recovery of debt to agriculture and this combined with substantial increases in the material requirement planning (MRP) for wheat and rice, resulted in increasing the fiscal deficit 6.1 per cent of the GDP against the 2.7 per cent a year earlier.<sup>4</sup> The combined fiscal deficit of the centre and the states rose to around 11 per cent, thus impacting state revenues.<sup>5</sup>

During the year, confronted with the slowdown, the Government decided to make a virtue out of necessity. They deepened the fiscal giveaways that were targeted to the poorer sections, increased subsidies on food and petroleum, and took the risk of inflationary pressures as a measure to counter the slowdown. The norms of the Fiscal Responsibility and Budget Management (FRBM) Act were given a go ahead as the budget opted for greater deficit financing. The initial fiscal stimulus was provided in the budget for FY 2008-09, announced in February 2008. Electoral considerations made this into an expansionary exercise that included massive increases in public outlays in support of employment guarantee schemes, farm loan waivers, paid commission rewards, and increases in food and fertiliser subsidies. This fiscal expansion resulted in the revenue deficit increasing from 1.4 per cent of the GDP in FY 2007-08 to 4.3 per cent in FY 2008-09.<sup>6</sup> At the same time the fiscal deficit of the central government increased from 2.7 per cent in FY 2007-08 to 6.1 per cent in FY 2008-09. The expansionary public outlays included some measures that implied a hefty transfer of purchasing power to farmers and to the rural sector in general. These included farm loan waivers, funds allocated to the National Rural Employment Guarantee Programme (NREGP), Bharat Nirman (targeted for improving rural infrastructure), the Prime Minister's Rural Road

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<sup>3</sup> 'Economic Outlook for 2010/11', *Economic Advisory Council to the Prime Minister* (July 2010), [http://pmindia.nic.in/Economic\\_Outlook\\_2010-11.pdf](http://pmindia.nic.in/Economic_Outlook_2010-11.pdf). Accessed on 9 May 2011.

<sup>4</sup> 'India budget expected to cut deficit; borrowing a worry', *Reuters* (25 February 2010).

<sup>5</sup> 'Fiscal deficit, the biggest challenge', *The Hindu* (20 July 2009).

<sup>6</sup> 'ADB-INDIA Economic Bulletin April-June 2009', *Asian Development Bank/India Resident Mission* (July 2009), [www.adb.org/Documents/Economic\\_Updates/IND/2009/eco-bulletin-ind01.pdf](http://www.adb.org/Documents/Economic_Updates/IND/2009/eco-bulletin-ind01.pdf). Accessed on 9 May 2011.

Programme, and a large increase in subsidies for fertilisers and electricity supplied to the farmers. There was the comment that these measures were taken because of political considerations and not in response to the global crisis. Nevertheless, they helped to shore up rural demand for both consumer durables and non-durables.

In effect the higher than expected GDP growth rate in both the third and fourth quarters of FY 2008-09 could be attributed to the budgetary splurge announced in February 2008.<sup>7</sup> However, while this has succeeded in shoring up GDP growth, by raising rural demand, it did not leave much fiscal space for the Government of India.

Three fiscal stimulus packages – one each in the months of December, January, and March – were announced in 2008.<sup>8</sup> These in aggregate amounted to ₹106,050 crore or US\$21 billion, which is approximately two per cent of the GDP. This can be compared to the four per cent of the GDP that was provided as stimulus in the FY 2008-09 Budget, discussed in the paragraph above. The three post-December 2008 stimulus packages included increased government spending on infrastructure, reduction in indirect taxes, and some assistance for export-oriented industries. In an attempt to boost the infrastructure spending that has been acknowledged as the most effective tool to counter the economic downturn, the Government increased its planned spending by US\$4 billion and also allowed the state governments to borrow an additional amount of US\$6 billion from the market.<sup>9</sup> Apart from this, the India Infrastructure Finance Company Limited (IIFCL), a special purpose vehicle, established in 2007, was allowed to issue interest free bonds worth US\$6 billion for refinancing the long-term loans for various infrastructure projects.<sup>10</sup>

The budgets of 2009-10 and 2010-11 outlined a bold policy towards ensuring that growth was not impaired by the global crisis. First, there was a focus on the poor – the *aam aadmi* – through direct grants and subsidies. The ambit of the National Employment Guarantee Programme was extended to cover all districts – this would enable the rural unemployed to seek and be assured of a minimum of 100 days of unskilled labour. Several states extended the availability of cereals through the Public Distribution System at subsidised prices. Subsidies continued for fertilisers, cooking gas and kerosene, and the prices of all petroleum products continued to be controlled. These measures provided a substantial amount of liquidity that was targeted at the poor and disadvantaged.

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<sup>7</sup> Rajiv Kumar and Pankaj Vashisht, 'The Global Economic Crisis: Impact on India and Policy Responses', *Asian Development Bank Institute* (November 2009), [www.adbi.org/working-paper/2009/11/12/3367.global.economic.crisis.india/](http://www.adbi.org/working-paper/2009/11/12/3367.global.economic.crisis.india/). Accessed on 9 May 2011.

<sup>8</sup> D. Subbarao, 'Annual Policy Statement for the Year 2009-10', *Reserve Bank of India* (21 April 2009), [www.rbi.org.in/scripts/NotificationUser.aspx?Id=4936&Mode=0](http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=4936&Mode=0). Accessed on 9 May 2011.

<sup>9</sup> 'G20 Statistical Update, India', *International Labour Office* (July 2010).

<sup>10</sup> Rajiv Kumar and Pankaj Vashisht, 'The Global Economic Crisis: Impact on India and Policy Responses', *Asian Development Bank Institute* (November 2009), [www.adbi.org/working-paper/2009/11/12/3367.global.economic.crisis.india/](http://www.adbi.org/working-paper/2009/11/12/3367.global.economic.crisis.india/). Accessed on 9 May 2011.

Second, there was a focus on public spending in infrastructure, education and health with increased budgetary allocations during the two years. In the budget of FY 2010-11, the Government announced a policy of being a facilitator in economic development rather than a prime actor and enjoined the private sector to play an even more active role in economic development through public and private partnerships.

Third, in order to encourage capital formation and investments, there was some further opening up of the financial markets, including derivatives trading and currency futures. This created room for new products and activities in the primary and secondary markets, with considerable interest from foreign institutional investors driving up the market capitalisation of equities. Market related buoyancy enabled several corporates to raise funds through public offerings, thus providing the capital for growth. Simultaneously, monetary policy was cautious and interest rates reasonable, to enable access to debt financing. The financial markets recovered smartly in 2009 and 2010, and market capitalisation was at levels close to the peak seen in the end of 2007. Foreign institutional investors continue to see secondary markets in India as an opportunity, and there is significant flow into the equity and commodity markets. There are new instruments including derivatives that are attracting investor attention: it is possible to say that financial markets would continue to be healthy and investor friendly, though somewhat volatile, in 2011.

The Central Bank of India responded by letting the exchange rate depreciate to stem the outflow on the current accounts, by providing extra liquidity to the financial sector and by raising the limit on private foreign borrowing. Prudential monetary management ensured that foreign debt and debt service remained low and reserve cover (US\$274 billion) substantial. The high domestic saving rate (34 per cent of the GDP) provided added cushion.<sup>11</sup>

Fourth, the Government decided to tackle the consequent inflationary pressures of these fiscal expansion measures head on. With food and commodity price inflation in the double digits, the Government resolved to bite the bullet and go for growth. There were two advantages to this strategy. First, with fiscal deficits mounting, a higher rate of inflation would enable the Government to balance its books better – an approach of inflating one's way out of the deficit. Further, the buoyant financial markets enabled the Government to go in for sales of shares in its public sector undertakings, the resultant revenues coming as a relief to the revenue flows in the budget.

These measures have not been without attendant risks. First, the growing inflationary pressures have caused serious concerns for the poor. After remaining in the negative territory for over three months, the Wholesale Price Index (WPI) based inflation rate gradually inched up to positive territory during 2009. There was some respite in the early months of 2010, but

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<sup>11</sup> 'Global Financial Crisis: Implications for South Asia', *South Asia Region, The World Bank* (21 October 2008), <http://siteresources.worldbank.org/SOUTHASIAEXT/Resources/223546-1171488994713/3455847-1212859608658/5080465-1224618094138/SARGlobalFinancialCrisis.pdf>. Accessed on 9 May 2011.

subsequent months have aggravated the problem, with food inflation crossing 14 per cent by the end of 2010.<sup>12</sup> The recent monetary tightening measures announced by the Reserve Bank of India (RBI) have given little relief to the increases in prices.

Going into 2011, the Government has realised the dangers of inflationary pressures that have been caused by the easy liquidity. The RBI has progressively tightened liquidity but supply side bottlenecks, an inability to progress with reforms, and growing demand continue to be causes for concern. The inflation versus growth debate is strident in India, and there are fears that the inflationary pressures due to global commodity price increases, would funnel down into price increases for the consumer.

In short, the response was timely, swift and effective. It kept the economy growing, but the attendant risks of a lax fiscal and monetary policy need to be tackled during this year. The 2011 budget has unveiled cuts in expenditure, as well as fiscal tightening, and it remains to be seen whether these measures, when implemented, would hold the balance between increases in prices and growth.

## **Pakistan**

The second largest economy, Pakistan, is much more fragile and faces the most vulnerability in the region. High fiscal and current account deficits, rapid inflation, low reserves, a weak currency, and a declining economy have placed Pakistan in a very difficult situation to face the global financial crisis. Efforts are now underway to arrest the decline of the macro-economy through appropriate demand management including tightening of monetary and fiscal policies. Pakistan's ability to borrow externally is already heavily constrained and bond spreads are very high. The global financial crisis has meant that non-official foreign capital flows would be even more expensive than in early 2011. Pakistan's economy has been under strain due to excess demand pressures that have been building since 2004. The combined effects of global food, fuel and financial crises took quite a toll on the economy as the current account balance and fiscal deficits increased, inflation surged and growth slowed. Economic growth has taken a hit, with growth slowing down from 7.3 per cent during 2004-07 to 5.8 per cent in 2008 and down to around 4.0 per cent in 2009.<sup>13</sup> The scope for counter cyclical fiscal policy is limited at this time, but Pakistan is taking measures to protect social spending to help reduce the adverse effects of the crisis on the poor.

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<sup>12</sup> 'Food inflation at 10-week high of 14.44 pc'. *Press Trust of India*, (30 December 2010).

<sup>13</sup> 'Impact of Global Financial Crisis on South Asia', *South Asia Region, The World Bank* (17 February 2009), <http://siteresources.worldbank.org/SOUTHASIAEXT/Resources/223546-1171488994713/3455847-1232124140958/gfcsouthasiafeb172009.pdf>. Accessed on 9 May 2011.

## Fiscal Policy

One of the main objectives of the fiscal policy was to reduce the fiscal deficit to a sustainable level of 4.2 per cent of GDP from 7.4 per cent in 2007-08.<sup>14</sup> In 2008-09, the Pakistan government announced a programme that would enable this to be achieved.<sup>15</sup>

1. To achieve this goal, the Government planned to reduce its expenditure and increase revenues. In this regard, the tax revenue was to be increased by 0.6 percentage points of GDP and non-interest current expenditure reduced by about 1.5 percentage points of GDP. This reduction was to be achieved mainly through the elimination of both oil and electricity subsidies by June 2009.
2. The Government also announced to cut the domestically financed development spending by about one percentage point of the GDP through better project prioritisation during the 2010-11 fiscal year. A number of steps were implemented consistent with the planned fiscal adjustments. More specifically:
3.
  - a. The subsidy on petroleum has already been completely eliminated by adjusting the petroleum prices three times since June 2008.
  - b. At the same time, electricity tariffs were adjusted by an average of 18 per cent effective 5 September 2008.
  - c. In addition, steps were taken to slow the pace of development spending.
  - d. The research and development subsidy for the textile industry were fully eliminated.
  - e. Wheat procurement prices have been raised to international levels, and
  - f. The general sales tax (GST) rate has been raised by one percentage point to 16 per cent.
4. The targeted reduction in the fiscal deficit in 2008-09 was to prevent the State Bank of Pakistan (SBP) from financing of the budget. The Government planned to reduce borrowing from SBP to zero to finance its spending from 1 October 2008 to 30 June 2009. During this period, the fiscal deficit was to be fully financed by available external disbursements, the acceleration of the privatisation process, the issuance of treasury bills, and other domestic financing instruments (including Pakistan Investment Bonds) and the National Savings Scheme (NSS).

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<sup>14</sup> 'Pakistan Gets \$7.6 Billion Loan from IMF', *IMF Survey* (24 November 2008).

<sup>15</sup> Zafar Mueen Nasir, 'National Policy Responses to the Financial and Economic Crisis: The Case of Pakistan', *International Labour Organization*, (5 February 2009), [www.ilo.org/public/libdoc/jobcrisis/download/rapid\\_assessment\\_pakistan.pdf](http://www.ilo.org/public/libdoc/jobcrisis/download/rapid_assessment_pakistan.pdf). Accessed on 9 May 2011.

5. A further reduction in the fiscal deficit to 3.3 per cent of the GDP was envisaged for 2009-10.
6. The Government's fiscal consolidation efforts will continue over the medium-term. The Government's fiscal framework assumes a further reduction in the fiscal deficit to 2.0-2.5 per cent of the GDP by 2012-13. Fiscal consolidation will be supported by a strong tax effort, which will allow for higher spending in infrastructure and the social sectors. Specifically, the Government is committed to increasing tax revenue by at least 3.5 percentage points of the GDP over the medium-term as a result of measures to broaden the GST base, significantly reduce income tax exemptions and further improve tax enforcement.

Interestingly, the approach in Pakistan, post 2008-09, was a measure of fiscal tightening and control, rather than the approach of fiscal easing that was followed by India. The result was that Pakistan's economy went into a steady decline in 2008. After several years of strong and comparatively stable growth, Pakistan quickly slid into a severe economic crisis in 2008. Growth in real GDP declined sharply from about eight per cent to three-four per cent;<sup>16</sup> inflation rose to nearly 24 per cent; and Pakistan's Rupee depreciated by over 23 per cent against the US dollar. Pakistan's unemployment rate rose and the United Nations (UN) reported that ten million Pakistanis were undernourished.<sup>17</sup>

Rising trade and current account deficits generated a 'capital crisis' in the autumn of 2008. Pakistan's foreign reserves slid from US\$14.2 billion in October 2007 to US\$4.1 billion by the end of October 2008. Pakistan needed US\$4 to 5 billion by the end of November 2008 to avoid defaulting on maturing sovereign debt obligations. In addition, even after securing this assistance, the Government stated that Pakistan required US\$10 to 15 billion in assistance over the next two to three years to continue to service its account deficits and outstanding debt.<sup>18</sup>

Several factors, in addition to the current global financial crisis, contributed to the downturn in Pakistan's economy. Pakistan's continuing struggle against Islamist militancy in its tribal areas along the border with Afghanistan had led to high federal deficits and uncertainty about the stability of the Pakistan government. A recent escalation of bombings and violence in Pakistan has raised the risk for many foreign investors and businesses. This has worsened the nation's capital shortage. In addition, the flight from risk that has followed the US financial

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<sup>16</sup> 'Economic Survey 2008-09', *Ministry of Finance, Government of Pakistan*, [http://finance.gov.pk/survey\\_0809.html](http://finance.gov.pk/survey_0809.html). Accessed on 20 April 2011.

<sup>17</sup> Dick K. Nanto, 'The Global Financial Crisis: Analysis and Policy Implications', *Congressional Research Service* (2 October 2009).

<sup>18</sup> Simon Cameron-Moore, 'Pakistan Needs \$10-15 Bln Fast, Says PM's Adviser', *Reuters* (21 October 2008).



crisis has apparently contributed to some capital flight from Pakistan, especially among overseas Pakistanis and investors from the Middle East.<sup>19</sup>

Pakistan sought the required assistance from several countries (including China, Saudi Arabia, and the US), international financial institutions (including the Asian Development Bank (ADB), the International Monetary Fund (IMF), the Islamic Development Bank (IDB), the World Bank and an informal group of nations called the 'Friends of Pakistan'. Although the ADB, the World Bank and others did offer some support, the total amount was insufficient to avoid the default risk. As a consequence, Pakistan reluctantly began negotiating a loan with the IMF (International Monetary Fund).<sup>20</sup> Finally, Pakistan had reached a tentative agreement with the IMF to borrow US\$7.6 billion in 2009 and 2010, to be repaid by 2016.<sup>21</sup>

This US\$7.6 billion loan is well short of the estimated US\$10 billion to US\$15 billion Pakistan says it needs over the next two years, to avoid a financial crisis. Some observers speculate that the IMF agreement will spur help from other potential donors, such as China, Saudi Arabia, and the US. However, given the continuing economic problems of the potential donor nations, Pakistan may not be able to secure the full amount of assistance it says it needs. As a result, the IMF loan may end up being only a short-term patch to a long-term economic problem.

There were reforms in the taxation policy that were also announced, including measures to reduce tax evasion. These measures, though unpopular are likely to have been part of the IMF mandate. The elimination of food, electricity and fuel subsidies impacted the poor in the country. In short, Pakistan's approach was to tighten its belt, and go for fiscal prudence rather than growth.

In 2009-10, the economy started to recover. Real GDP growth was close to four per cent and inflation came down from 25 per cent in October 2008 to 12-13 per cent by late 2009. To contain inflation, in July, the State Bank increased its policy interest rate by 50 basis points to 13 per cent. Gross reserves reached US\$13 billion in June 2010, and the exchange rate has been stable around 85-86 Pakistan rupees per dollar. The pickup in reserves resulted from a steady narrowing of the current account deficit to US\$3.5 billion (2 per cent of GDP) in 2009-10.<sup>22</sup> Consequently, the 2009-10 fiscal deficit reached 6.3 per cent of the GDP, compared with an unadjusted programme target of 5.1 per cent and an adjusted target of 4.6 per cent of the GDP.

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<sup>19</sup> Dick K. Nanto, 'The Global Financial Crisis: Analysis and Policy Implications', *Congressional Research Service* (2 October 2009).

<sup>20</sup> 'IMF Okays \$7.6 Bln Package for Pakistan: Tareen', *Associated Press of Pakistan* (15 November 2008).

<sup>21</sup> Jamie Anderson, 'Pakistan Turns to IMF for Financial Aid', *Money Times* (16 November 2008).

<sup>22</sup> 'Pakistan: Letter of Intent', *Government of Pakistan and the IMF* (10 September 2010). [www.imf.org/external/np/loi/2010/pak/091010.pdf](http://www.imf.org/external/np/loi/2010/pak/091010.pdf). Accessed on 9 May 2011.

The Budget for fiscal year 2010-11, set before the floods, targets a deficit of four per cent of the GDP – a federal fiscal deficit of five per cent of the GDP, combined with a provincial surplus of one per cent of GDP. To achieve this target, the General Sales Tax (GST) rate was raised by one per cent and increases effected in some excise and direct taxes.

The economic outlook has deteriorated sharply as a result of the floods. The agriculture sector – which accounts for 21 per cent of GDP and 45 per cent of employment – has been hit particularly hard. An estimated eight per cent of total cropped area has been flooded, with very significant damage to industrial crops (i.e., cotton and sugarcane), wheat, vegetables, fruits and livestock. Lower agricultural output will reduce domestic demand. Manufacturing output and exports have also been affected. Real GDP growth is unlikely to exceed 2.75 per cent in 2010-11, mainly because of sharply lower agricultural output growth. GDP growth could be even lower if damage to crops exceeds preliminary assessments or if the floods recede at a slower pace than expected. Disruption of supply chains and the agricultural damage has already started to push up prices, especially for food items, while additional demands for building material, medicine, and social services will also contribute to price pressures. Annual inflation projections are of 13.5 per cent in 2010-11 compared to 11.7 per cent in 2009-10. Inflation jumped in August 2010, due to a sharp increase in the prices of perishable foods. Headline month-on-month inflation increased by 2.5 per cent and YoY inflation was 13.2 per cent, while core inflation declined to 9.8 per cent.<sup>23</sup>

**Table 1: Macro economic Indicators: 2009-10 to 2010-11**

	<u>2009-10</u>	<u>2010-11</u>	
		Pre-flood	Post-flood
Real GDP growth at factor cost	4.1	4.3	2.8
CPI inflation (period average)	11.7	11.5	13.5
Current account deficit/GDP	-2.0	-2.5	-3.1
<i>Memorandum items</i>			
External debt/GDP	31.6	30.7	31.8
Official reserves/months of imports	3.7	4.6	4.6

**Source:** Collated from Pakistan Ministry of Finance data for IMF review

<sup>23</sup> ‘Pakistan: Use of Fund Resources – Request for Emergency Assistance – Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Pakistan’, *IMF Country Report*, No.10/295 (September 2010). For Bangladesh see, *IMF Country Report* No.10/38 (February 2010); Mustafizur Rahman and Debapriya Bhattacharya, ‘Paper 1: Bangladesh Discussion Series, Global Financial Crisis’, *Overseas Development Institute* (May 2009); Ahmed Taneem Muzaffar, ‘Experiences from the Past and Lessons for Bangladesh: Global Financial Crisis and Recession’, *Global Business and Management Forum* (22 December 2009). For Nepal and Sri Lanka see, ADB Regional Forum, ‘Report-5’, *Asian Development Bank* (14 January 2010); ‘Country Case Studies, Early Impact Assessment of the Global, Financial Crisis on Education Financing’ *UNESCO Institute for Statistics* (2009).

The outlook for this economy remains uncertain. On the one hand, the continuing problems of internal strife and the war in Afghanistan are diverting resources and policy away from addressing economic issues. On the other, the structure of manufacturing and the goods and services sector has been affected by the continued conflict and lack of confidence among investors. Poor governance and severe shortage of capital is affecting public expenditure while the economy continues to rely on remittances and aid to tide it through the current crisis.

## **Bangladesh**

For Bangladesh, cross-country evidence has relevance in two ways: first, it provides an insight into the thinking of policymakers of neighbouring countries in the area of macroeconomic management against the backdrop of the ongoing crisis; second, it provides an idea about how export-competing sectors of these countries are being supported, with consequent impacts on Bangladesh's own relative competitiveness situation in the global market.

Bangladesh Bank took a number of steps when the financial sector crisis first kicked off in October 2008. Central bank reserves were safeguarded through withdrawal from risky investments and transfer to reliable central bank accounts, and private sector financial institutions were immediately advised by the bank to protect their respective deposits. The capital market was only exposed to foreign portfolio investment to a limited scale (2.4 per cent of market capitalisation) and exotic but toxic derivatives were not traded on the country's capital market. This enabled Bangladesh to avoid the consequences of the first wave of the adverse impact. However, as the analysis indicates, Bangladesh has not been immune to the second wave of impact, when financial crisis hit the real economy. The adverse impacts were to be transmitted through various channels into the domestic economy.

Bangladesh has maintained generally prudent macroeconomic policies. Balance of payments has been in surplus owing to rapidly rising remittances and prudent demand management. Fiscal deficit has increased five to six per cent, but remains manageable in view of falling global oil and food prices from their global peaks during 2009-10. The financial sector is showing signs of improved health from past reforms and is mostly insulated from foreign markets because of very low private capital inflows. External debt is low and reserves are comfortable.

The Government of Bangladesh announced, on 19 April 2009, an interim package of fiscal and policy supports for the country's agriculture, power and export sectors to help combat the immediate effects of the ongoing global recession. To finance the package an additional allocation of Tk34.24 billion were allocated in the revised budget for the next fiscal year. Under the fiscal support part of the package for the April-June period of the FY 2008-09, the

rates of export subsidy were increased for some sectors. Cash support rates for other export items remained unchanged. Because of the increase in export subsidy the total amount of export subsidy was Tk15 billion in the revised budget for the FY 2008-09 as opposed to the earlier allocation of Tk10.50 billion.

The initiatives taken by the Government also suggests that to weaken the effects of global recession, the Government reviewed public spending and strengthening social safety nets to help come through the storm of the global crisis. The subsequent year's budget is likely to be an expansionist one, to take care of social safety nets and subsidies. There is however, concern about the implementation capabilities of several of the programmes.

The budget for FY 2008-09 (presented in June 2008) was relatively large, prepared against the backdrop of high inflation, commodity prices, import burden and subsidies. A large deficit projection of Tk30,623 crore, equivalent to 5.0 per cent of the GDP, made the task of balancing the budget challenging. This higher deficit was to be met by higher revenue generation and higher financing by development partners, to be replenished by increased government borrowing from domestic sources, both banking and non-banking.

Subsequent developments had repercussions for the budget in FY 2008-09 – some bringing comfort and some adding to the challenges. With the onslaught of the financial crisis and the consequent decline in global demand, global commodity prices experienced a significant fall. This was particularly for petroleum products, which were the single largest contributor to demand for subsidy in the budget. The rate of duty on capital machinery imports and spare parts was reduced from five per cent to three per cent in the FY 2008-09 budget. In this regard, the Central Planning Department (2008) observed at the time, given the depressed investment scenario, that imports of capital machinery and spare parts may be made duty free to stimulate industrial investment.

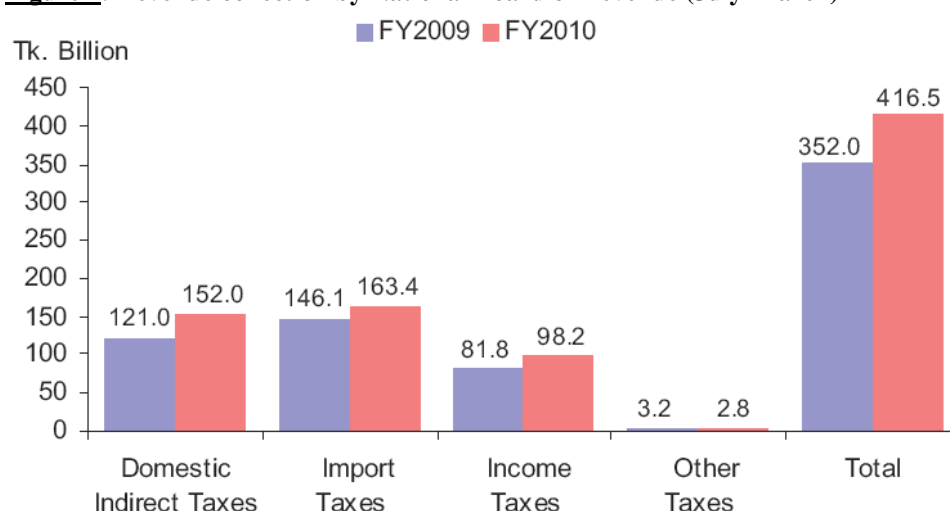
In July 2008, the Government relaxed import conditions to enable producers to take advantage of low-cost Indian yarn. To protect the interests of the local spinning sector, the Bangladesh government tightened rules on yarn imports, particularly from India. However, additionally, local spin millers are demanding a rescheduling of the loan payback time. In view of this, extension of loan settlement could be considered.

A number of fiscal measures were proposed in the budget for FY 2008-09 in support of SMEs. For example, the SME sector was given income tax relief by defining SMEs as entities with an annual turnover below Tk2.4 million. The upper limit of investment in capital machinery, in order to enjoy the cottage industry benefit (i.e. no value added tax (VAT)), was increased from Tk700,000 to Tk1.5 million and the turnover limit was raised from Tk2 million to Tk2.4 million. A tax holiday was given to agro-processing industries.

As noted earlier, in the US and the EU apparels markets, China, India and Vietnam are some of Bangladesh's major competitors. Stimulus packages of these countries have significantly enhanced their competitive edge vis-à-vis Bangladesh. Until now, Bangladesh's performance record has been maintained, thanks mainly to readiness of exporters to accept lower cuts, make charges and profit margins. Yet, another example relates to the adverse impact on backward linkage sectors, such as yarn spinning, which have now lost a large part of their competitiveness as a consequence of stimulus-induced lower import prices of Indian yarns. It may also be recalled in this connection that, in the recent past, a number of large-scale buyers, particularly from Japan, have shown interest in sourcing apparels from Bangladesh in view of higher prices in China. The stimulus packages put in place by China have now limited Bangladesh's opportunity to avail itself of these new opportunities.

The Government's medium-term macroeconomic framework (MTMF) envisages a fiscal policy that will help attain pro-poor growth along with maintaining macroeconomic balance and debt sustainability.

**Figure 1: Revenue collection by National Board of Revenue (July-March)**



**Source:** National Board of Revenue, Bangladesh

During July–March of FY 2010, total tax revenue, collected by the National Board of Revenue, which accounts for more than 95 per cent of total revenue, rose by 18.3 per cent over the same period of the previous year. This commendable performance, especially during the economic recession is mainly due to implementation of ongoing tax reform measures. The Government seeks to improve tax collection by implementing reform measures including widening the tax base; decreasing tax evasion and leakages; enhancing transparency, accountability, efficiency in the revenue administration and tax collection system; simplifying tax rules; curbing discretionary power in tax laws; and implementing reforms and capacity building of the National Board of Revenue.

Tax collection from import-based taxes started to improve with the recovery of imports after a lull during the first half (July-December) of the FY 2010. Collections rose by 11.8 per cent during July-March FY 2010 over the same period of FY 2009. During July-March FY 2010, customs duty grew by 4.3 per cent, import stage value-added tax by 13.4 per cent and supplementary duty by 36.1 per cent. Revenue from domestic indirect taxes rose by 25.7 per cent, with value added tax growing by 27.1 per cent, supplementary duty by 22.4 per cent and excise duty by 41.9 per cent. Turnover tax experienced a decline of 6.4 per cent. Income tax, which constitutes slightly more than one-fourth of total tax revenue, grew by 20.1 per cent.

Through the revised Second National Strategy for Accelerated Poverty Reduction, the Government announced a fast-track poverty reduction strategy, requiring a sustained increase in public expenditure. The FY 2010 budget targets an increase in total expenditure from 15.3 per cent of the GDP in FY 2009 to 16.5 per cent in FY 2010. Higher expenditures include a fiscal stimulus package to address the global economic crisis; support agriculture, finance infrastructure (particularly power and gas), achieve greater regional balance and support comprehensive social safety net programmes. In parallel, the Government emphasises mobilising external grants and concessional loans to finance development activities and to offset the impacts of the global economic recession. During July-January 2010, 33.9 per cent of total current expenditure allocated for the FY 2010 budget was spent. The utilisation rate was four per cent less than the corresponding period of FY 2009. The sector utilisation pattern shows that education (21.5 per cent) has the largest share followed by interest payment (21.1 per cent), public order and safety (10.0 per cent), and defence (9.8 per cent).<sup>24</sup>

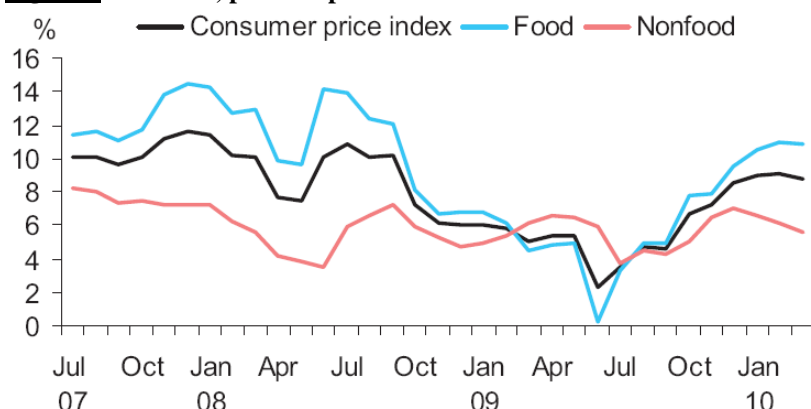
Poor implementation of the Annual Development Programme (ADP) is a major problem. Despite isolated reforms, utilisation of the ADP is still low because of institutional weaknesses, especially the weak implementation capacity of the line ministries. During July-April FY 2010, the ADP utilisation rate was 59.0 per cent compared with 52.0 per cent during the same time of FY 2009, the fiscal deficit remains within limits. During July-February FY 2010, the total deficit financing was Tk52.8 billion, down from Tk143.5 billion during the same period of FY 2009. Foreign financing was higher at Tk64.8 billion compared with Tk50.4 billion in the corresponding period of the previous year. The Government repaid Tk12 billion net to domestic lenders compared with net borrowing of Tk93.1 billion in the same period of FY 2009.

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<sup>24</sup> 'Bangladesh: Financial System Stability Assessment', *IMF Country Report* No.10/38, (12 February 2010).

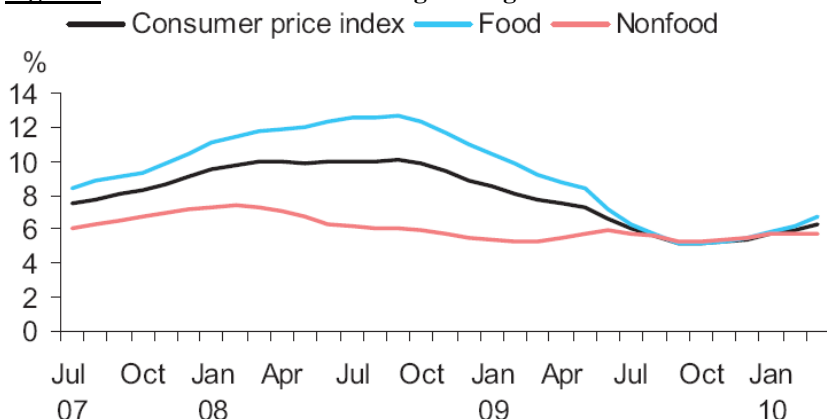
## Inflation

**Figure 2: Inflation, point-to-point**



**Source:** IMF Country Report, February 2010

**Figure 3: Inflation 12 Month Moving Average**



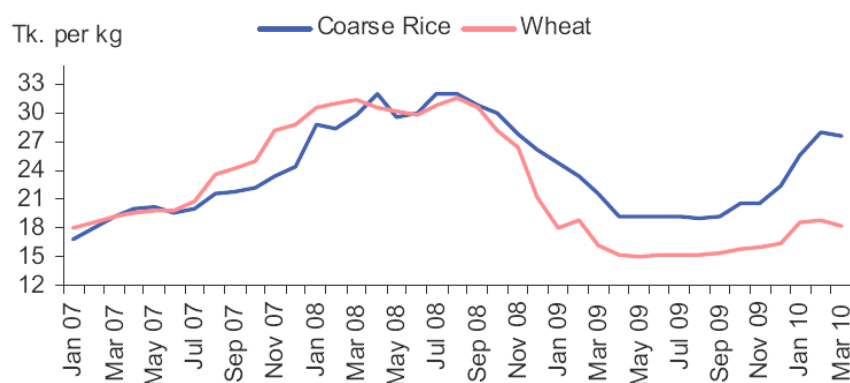
**Source:** IMF Country Report, February 2010

Inflation has been steadily rising in FY 2010, reaching 8.8 per cent YoY in March 2010 up from 3.5 per cent in July 2009, largely due to an increase in domestic food prices. The price of the main staple food, rice (coarse), reached Tk28.0 per kg in February 2010, a 16-month high, from Tk19.2 per kg in July 2009. Domestic production was affected by unfavourable weather. The price of wheat reached Tk18.7 per kg from Tk15.2 per kg during the same period. The continued rise in international commodity prices, including oil, along with higher-than-targeted money supply growth contributed to the recent price escalation. While food inflation surged to 10.8 per cent in March 2010 from 3.3 per cent in July 2009, non-food inflation marginally rose to 5.6 per cent from 3.7 per cent.

The Government and the Bangladesh Bank continue to take measures to contain inflation. The Government imposed a ban on rice exports in early December 2009; issued 'krishi cards' (agricultural cards) to 18.2 million farmers for fertilisers, agricultural loans, and subsidies for diesel and other inputs; started open market sales of rice in Dhaka, the capital city, and

adjoining districts in January 2010; and introduced fair price cards in February for 2.5 million ultra poor families across the country.

**Figure 4: Domestic open market retail prices of food grains**



**Source: IMF Country Report, February 2010**

**Figure 5: Average spot-crude oil price international market**



**Source: IMF Country Report, February 2010**

Bangladesh Bank raised the interest rates on government securities, particularly bonds, and resumed the auction of 30-day Bangladesh Bank bills as a step to reduce the excess liquidity. To curb inflationary pressure, it raised the rates on the cash reserve ratio and the statutory liquidity ratio by 0.5 percentage points. Also, as a precautionary step, Bangladesh Bank directed all commercial banks to cap interest rates at 12.0 per cent on import finance for essential items (edible oil, gram, lentils, pulse, onions, spices, dates, fruits, and sugar) to ensure an adequate supply of these items and to keep prices under control during the ensuing Ramadan.

The management of the economy and the markets has not been without hiccups. In the second half of 2010, there have been allegations about manipulations in the secondary markets for equity through price fixing and insider trading that has left traces of suspicion against the regulators as well as some market operators. A report by regulators alleging wrong doing by some market operators has not found favour with the Government. In short, market volatility, as well as lack of transparency is affecting secondary markets. It is also



alleged that the lax monetary policy of keeping interest rates low has been a ploy to lure unwary investors into secondary markets. These signals indicate that policy making on the macro-economy has yet to reach levels of stability and transparency.

## Nepal<sup>25</sup>

Nepal has been experiencing serious economic challenges caused by internal political crisis as well as global phenomena. Economic growth has been low in Nepal compared to other South Asian countries, and increases in commodity prices have increased inflationary pressures. Nepal is thus emerging from a conflict situation with low growth and the adverse effects of a global food and fuel crisis. Its domestic financial sector is weak in terms of financial indicators with non-performing loans and low capital adequacy even though the financial sector is insulated from global finances due to the negligible amount of foreign private capital flows.

**Table 2: GDP and Sectoral Growth Rates (in percent)**

<b>GDP</b>					
<b>Per cent YoY</b>	<b>2004-05</b>	<b>2005-06</b>	<b>2006-07</b>	<b>2007-08</b>	<b>2008-09</b>
GDP	3.5	3.4	3.3	5.4	4.7
Agriculture	3.5	1.7	0.9	4.7	2.2
Mining	6.8	8.3	1.5	2.8	2.5
Manufacturing	2.6	2.0	2.6	0.2	-0.5
Utilities	4.0	4.0	13.0	3.7	-1.1
Construction	2.9	7.7	2.5	3.1	5.7
Wholesale and retail trade	-6.2	3.7	-4.5	7.0	4.7
Hotels and restaurants	-5.4	6.0	3.5	8.5	5.1
Transport and Communication	2.0	7.0	4.6	7.1	7.9
Financial service	24.3	24.4	11.4	13.8	3.3

**Source:** Collated by Centennial Group using report from the Nepal Ministry of Finance.

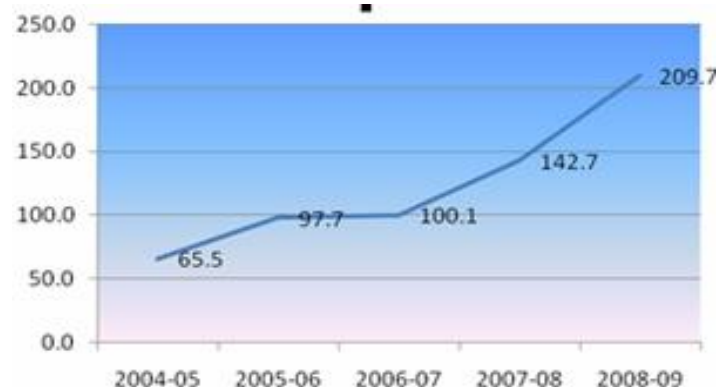
**Note:** (1) Fiscal year in Nepal ends on 15th July; (2) Numbers for 2008-09 are preliminary estimates by the Central Bureau of Statistics, calculated by producer prices.

The economy of Nepal has several unique features, as it is one of the highly liberalised countries in South Asia. Trade is completely deregulated and no trade and non-trade barriers including the complete lack of support measures in exports. Subsidies are also small, and except for transportation and fertiliser subsidy in remote areas, there is no other subsidy. In large and medium industries up to 100 per cent of foreign equity participation is allowed with repatriation facilities. Foreign equity participation is allowed for up to 75 per cent in banking

<sup>25</sup> All references of Rs. in this section refer to the Nepalese rupee.

and 100 per cent in the insurance sector, even if on a selected basis. The actual average tariff rate has reduced to 5.13 per cent in 2007 from 6.1 per cent in 2003. Likewise, the imports tariff rate has gone down to 6.23 per cent from 7.72 per cent during the same period. Remittances are the major source of external inflow exceeding more than Rs.140 billion. These remittance flows have led to the growth of banking and financial institutions.

**Figure 7: Annual Remittance for the Last Five Years (Amount in PKR Billion)**



**Source:** Nepal Investment Bank Limited, Research and Development Department, Durbar Marg, Kathmandu

Though there is no formal research on the uses of remittance inflows in Nepal, anecdotal evidence shows that most of the remittance income has been used up for consumption purposes. Even if the remittance incomes are used predominantly in consumption they can be productive provided that higher consumption, through multiplier effects, leads to expansion of production. However, the manufacturing sector has not been able to pick up in Nepal (in FY 2008-09, the manufacturing sector witnessed a decline of 0.5 per cent). Given the above background of elevating remittance inflows and shrinking and stagnant production sector, one can argue that remittance has also been instrumental in driving up the price levels.

Foreign aid is an important contributor to the development budget, and Nepal has always adhered to aid conditionality. Aid flow has therefore been consistent, supporting the budget and development projects. The economy remains vulnerable to external shocks due to high dependences on aid and remittances.

Given the vulnerabilities, the global financial crisis resulted in a decreasing trend of export growth, slowdown in overseas employment and hence decreases in remittances, and increasing unemployment. Tourism industry revenues were affected, and the foreign direct investment (FDI) in industry decreased. There was a tightening of credit, and interest rate spreads increased for banking transactions.

However, these developments were as much due to the political uncertainties in Nepal, as they were to the global crisis. There has been no diminution of foreign aid for development

programmes. The balance of payments and the fiscal situation are not stressed, and there is no evidence of a liquidity constraint on domestic demand.

Nepal has also been affected by inflationary pressures especially the rise in prices of food and beverages. Officials at the Nepal Rastra Bank (NRB) and the Ministry of Finance (MOF) have attributed higher inflation to supply constraints emanating from energy crisis, constant strikes and *bandhs* and carteling among businessmen.

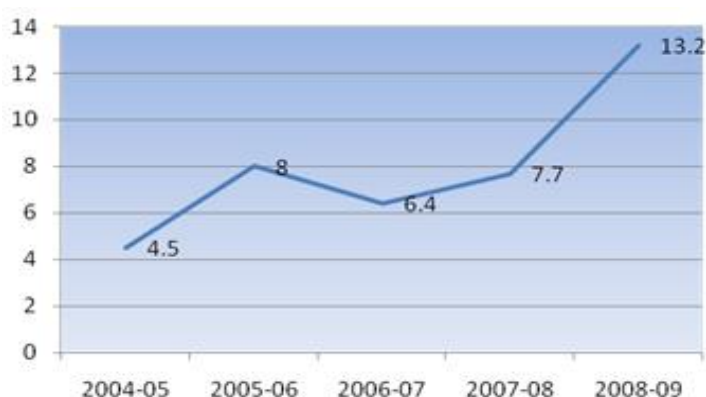
**Figure 8: YoY Inflation Figures (2009)**



**Source: NRB (Nepal Rastra Bank)**

These supply-side factors have played a major role in pushing the prices up, however, going forward if the NRB is not able to soak up the excess liquidity in the market then inflation might further creep up especially with a larger government expenditure programmes. On the monetary side, the NRB, with the view of containing inflation, has put a lower projection on the growth of M2 – broad money- of 17 per cent in 2009-10 compared to 21 per cent in 2008-09.

**Figure 9: 5 year Annual Average CPI Based Inflation**



**Source: Nepal Investment Bank Limited, Research and Development Department, Durbar Marg, Kathmandu, Nepal**

Investments of the state and the private sector have been shrinking because of several reasons. Therefore, expected improvements have not been attained in economic growth, poverty, unemployment, etc. The major challenge has been the lack of favourable investment climate in the country, due to inflation and the concerns over the peace and security situation.

The year 2010 did not witness any major improvements on the fiscal and monetary front. The country remained caught up in political uncertainty that made economic decision making difficult. GDP growth remained at 3.5 per cent in 2010, much lower than the neighbouring countries. The Government expects agriculture to grow by 1.1 per cent, against the earlier projection of 3.3 per cent. Non-agricultural growth is expected to nearly halve to 3.6 per cent from the 6.6 per cent projected earlier.

Prolonged drought and unseasonal rains adversely affected Nepal's agriculture, which contributes to 33 per cent of the GDP. A grain deficit of 400,000 tons is expected in FY 2010, and there has been little or no new investment to mitigate the effects of weather. Investment in agriculture and irrigation remained at a low average of 0.55 per cent of the GDP in FY 2009

Improved foreign aid has helped to finance rising spending. Foreign aid rose from 3.6 per cent of the GDP in FY 2007 to 4.7 per cent of the GDP in FY 2009. Official remittances rose from about 13.8 per cent of GDP in FY 2007 to 22 per cent of the GDP in FY 2009. This is less than the total amount as it does not account for inflows from India and informal channels. Fuelled by high remittances, monetary growth has been high in the last two years.

Imports have risen fast from US\$1.6 billion (26 per cent of the GDP) in FY 2001 to US\$3.6 billion (30 per cent of the GDP) in FY 2009 – largely due to thriving consumption made possible by remittances. Exports have remained under US\$1 billion, and as a share of the GDP, have continuously declined from 13 per cent to 7.0 per cent. Exports of readymade garments, carpets and Pashmina – erstwhile main exports have declined.

Since 2007, fiscal and monetary policy interventions in Nepal have been characterised by ad hoc responses to events rather than a conscious strategy to react to the events in the global arena. One of the reasons could be that, as a small emerging economy with little exposure to the sophisticated markets of the west, it was somewhat protected from the fluctuations in the developed markets. It could also be that this period witnessed considerable political turmoil within the country and that these political developments prevented the Government from acting in a decisive and a far sighted manner. Even at present, the economy remains fragile and unless there is a strong government in place the economy of the country will continue to be vulnerable.

## Sri Lanka

Sri Lanka was one of the hardest-hit countries by the crisis. Economic growth dropped from 7.7 per cent in 2006 to 2.5 per cent in 2009 due to slowing economic activities, especially in international trade. While the Sri Lankan banking sector was relatively free of toxic assets, the global financial crunch resulted in a sudden withdrawal of foreign funds. This resulted in a quick deterioration of the current account balance and, moreover, hit the fiscal sector hard which relied heavily on international borrowing. In mid-2009, the country received a US\$2.6 billion stand-by arrangement from the IMF, leading to a recovery in the industrial sentiment. In 2009, the long internal strife with the Tamil separatists was finally over, and the law and order situation improved. The subsequent national elections saw the Government returned with a strong majority, following this there has been a significant pickup in economic activity in the country.

The Central Bank of Sri Lanka (CBSL) has been vigilant in maintaining stable interest rates and exchange rate to protect the domestic economy and strengthen it. CBSL has been concerned about the adverse implications that would arise due to any undisciplined lending by banks. Because of this reason, directed all the banks to make a general provision of one per cent on performing loans and advances, in November 2006, also increased the risk weight applicable for housing loans from 50 per cent to 55 per cent in November 2006. It placed a limit on commercial banks' borrowing from abroad to 15 per cent of their capital. The Central Bank took measures to formalise and strengthen the banking supervision activities and to educate the banks on the management of risks, issued new far reaching directions on corporate governance, limits on shareholdings, maximum accommodation and single borrower limits, and enforced these new directions stringently. Internationally, CBSL invested its external reserves with highly rated international banks, basically with other foreign central banks, and thereby ensured the security and safety of its own reserves.

Sri Lanka has taken actions to reduce monetary growth and contain the fiscal deficit. This, along with lower commodity prices, has helped reduce inflation, which has come down sharply from a peak of 28 per cent in June 2008 to 11 per cent in January 2009. But Sri Lanka's balance of payments is under stress, as current account deficit surged to about 7.5 per cent of the GDP in 2008 and reserves fell to less than two months of imports. Access to foreign commercial credit was sharply curtailed by the rapid rise in the cost of borrowing. Economic growth came down from seven per cent during 2006-07 to six per cent in 2008 and to decline to four per cent in 2009.<sup>26</sup> The problems were exacerbated by the commitments to accommodate public investments relating to continuation of the infrastructure development, maintaining government support to agriculture, SMEs, education, health, there was resort to additional public expenditure in 2009. Fiscal stimulus provided by way of subsidised credit for agriculture and SMEs, tax moratorium, concessionary electricity and fuel prices for

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<sup>26</sup> 'Fiscal Management Report - 2010', *Government of Sri Lanka* (29 June 2010), [www.treasury.gov.lk/FPPFM/fpd/pdfdocs/fmr2010/fmr2010-eng.pdf](http://www.treasury.gov.lk/FPPFM/fpd/pdfdocs/fmr2010/fmr2010-eng.pdf). Accessed on 9 May 2011.

industry etc helped private sector to manage challenges in global economic situation. These developments together with high interest rates on public debt and falling government revenues due to depressed global trade, caused the Government's fiscal deficit to deteriorate to 9.9 per cent of the GDP. The high interest rates also had an adverse effect on the Budget. Interest expenditure increased from 4.8 per cent in 2008 to 6.4 per cent in 2009. As a consequence, the Government missed out on the fiscal management targets.

In view of the parliamentary elections, the cabinet approved an interim, pre-election (vote-on-account) budget in early 2010. This interim budget limited expenditure in the first four months of 2010 to one-third of the budgeted Sri Lanka rupee expenditure for 2009, thus helping to deflect pre-election spending pressures. In particular, the interim budget made ambitious cuts in non-interest recurrent expenditure of 1.75 per cent of GDP (on an annualised basis) relative to the first four months of 2009.

Soon after the elections, the Government unveiled a fiscal management report in June 2010, outlining a medium-term fiscal strategy, in which it said:

‘Given the prevailing uncertainty in the speed of recovery of international trade and hence on Government revenues, a modest improvement in revenue to the GDP ratio of 14.8 per cent is expected in 2010. While maintaining the public investment at 6.5 per cent of GDP, total expenditure will be 23.2 per cent of GDP, which is a reduction of around two per cent of the GDP compared to 2009. The budget deficit in 2010 is expected to be contained at eight per cent of GDP and further improvements are required to bring it below seven per cent in 2011 and around five per cent in 2012.’

This deficit reduction path is expected to be realised with the economy accelerating its growth rate from six per cent to eight per cent in the medium-term which requires sustained public investments at current level and facilitating to augment private investment well in excess of 28 per cent of GDP through continuous improvements in infrastructure, tax system, regulatory arrangements and quality improvement in public services

As part of this strategy, the Government has planned revenue enhancement through a broadening of both the indirect and direct tax bases, removal of concessions and tax holidays, and simplification of the VAT and indirect tax regimes. The fiscal management programme is being closely supervised by the IMF and multilateral lending agencies that are focusing on tightening the fiscal gap through raising revenues as well as expenditure control measures. The ADB has agreed to fund a fiscal efficiency management project.

**Table 3: Medium Term Macro Financial Framework 2010-2013 (as a percentage of GDP)**  
**Medium Term Macro Fiscal Framework 2010-2013**  
**(as a percentage of GDP)**

Indicator	2009	Projections			
		2010	2011	2012	2013
<b>Revenue</b>	<b>14.5</b>	<b>14.8</b>	<b>15.5</b>	<b>16.6</b>	<b>17.0</b>
Tax Revenue	12.8	13.1	13.8	14.8	15.2
Income Tax	2.9	2.9	3.0	3.4	3.5
VAT	3.6	3.8	4.4	5.1	5.5
Excise Tax	2.0	2.1	2.0	2.0	2.0
Tax on External Trade	3.4	3.4	3.5	3.5	3.5
Other	0.9	1.0	0.9	0.8	0.7
Non Tax Revenue	1.7	1.6	1.7	1.8	1.8
<b>Grants</b>	<b>0.5</b>	<b>0.4</b>	<b>0.4</b>	<b>0.3</b>	<b>0.1</b>
<b>Expenditure</b>	<b>24.9</b>	<b>23.2</b>	<b>22.7</b>	<b>22.0</b>	<b>21.9</b>
Current Expenditure	18.2	16.9	16.5	15.8	15.6
Salaries and Wages	5.6	5.4	5.3	5.1	5.1
Interest payments	6.4	6.1	6.0	5.8	5.7
Subsidies and Transfers	3.9	3.8	3.7	3.5	3.5
Other goods and services	2.2	1.6	1.5	1.4	1.3
Public Investment	6.8	6.5	6.5	6.5	6.3
<i>O/W:</i>					
Highways	1.7	1.5	1.7	1.4	1.3
Ports and Aviation	0.6	0.6	0.3	0.3	0.2
Electricity	0.6	0.3	0.3	0.3	0.2
Water and Irrigation	0.8	0.7	1.0	1.5	1.3
Education and Health	0.6	0.7	0.9	0.8	0.8
Rural Sector	0.3	0.3	0.3	0.3	0.2
Revenue Deficit (-)/Surplus (+)	(3.7)	(2.1)	(1.0)	0.8	1.4
Budget Deficit (-)/Surplus (+)	(9.9)	(8.0)	(6.8)	(5.2)	(4.8)
Government Debt (% of GDP)	86.2	83.1	78.0	72.0	70.0

*Source : Department of Fiscal Policy*

**Source:** Department of Fiscal Policy, Sri Lanka

The year 2010 has also seen considerable activity in the inflows of the FDI, primarily into infrastructure projects, funded by China. There is considerable capital formation happening through road and port projects, as well as development of hospitality services. The resultant economic activity has, to some extent, cushioned the economy from the consequences of the sharp tightening mandated by the IMF managers. Among the measures to stem the deteriorating macro-balances, Sri Lanka has started tightening monetary policy and is also trying to contain the fiscal deficit by passing on the energy price increases to consumers. The performance of the financial sector has improved over time, although there is a slight upward trend in non-performing loans (NPL) in recent years. The role of foreign capital in Sri Lanka's domestic financial sector is limited. The main downside risk on the financial sector is a reduction in capital flows from outside, including for the Government. There is already evidence of a rise in spreads for Sri Lanka bonds. Switching of demand to domestic financing in an environment of inflation and further tightening of monetary policy would raise interest

rates and slowdown economic activity. Financial difficulties in domestic firms could also adversely affect NPLs. Though, overall, there is little risk of a financial collapse.

## **Conclusion**

The patterns of policy interventions in the major South Asian economies in response to the challenges of the global financial crisis of 2008 have been varied. These variations have arisen from the nature of the economies at the beginning of the crisis, their openness to the global economy, and in no small measure to the internal political economy. It is not wrong to conclude that the reactions have been primarily with the domestic constituency and conditions in mind, rather than a technical response to an economic problem. For example, in India, the largest of the South Asian economies, responded with the traditional medicine of fiscal expansion and public expenditure, while keeping monetary policy as a tool for controlling inflationary pressures. However, the fiscal expansion was targeted towards providing social support to the weaker sections, rather than towards capital formation – a policy dictated by the structure of the economy and by internal politics of ‘inclusive growth’ rather than by economic theory. The consequences of inflation now have to be dealt with.

In Bangladesh, with a more limited exposure to the external markets, and with a steady growth in the economy, the responses were less in terms of fiscal expansion, and rather more in terms of liberalisation of trade and remittance flows – the economy benefited, during the global crisis, by an increase in global demand for the low-end textiles it was exporting. There were also measures to keep the currency stable and to provide support for the weaker sections – the caution that was exercised, quite rightly, was to keep the currency stable and inflation in check. With the advantage of a capital surplus and not enough public investment, the country weathered the crisis well and ended up with higher than before reserves. Again, this was more due to the lethargy in public expenditure and public expenditure rather than lack of need for utilisation of these scarce resources.

During this period, both Sri Lanka and Nepal had to contend with internal political strife. Of the two, Sri Lanka has emerged stronger, with a decisive government victory over the Liberation Tigers of Tamil Eelam, and an election that has established a strong government. This government has now focused on infrastructure development and economic reforms, and appears well on the way to regaining its economic strength as a major producer and exporter in the region. On the other hand, solutions for political turmoil have been difficult to find in Nepal, and the governance of finance has taken a back seat. Nepal has been affected by falling aid and falling remittances, but as its integration with the global economy has been small, the effects have been limited. It is to be hoped that the establishment of a new government will enable the policy makers to address pressing problems of the economy.



Of all the countries, the situation in Pakistan is most difficult to predict. The country has managed to keep its head above water, due to a good aid package and IMF support, and is trying hard to control fiscal deficit and to increase tariff compliance. Long term reform measures in the real economy as well as in financial markets have been few, and it may be some more time before this country is able to address its pressing economic problems.

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