

is a dominant source of tourism and remittance revenues. Oil importers' current account positions are expected to remain broadly stable as the beneficial effects of lower oil prices are offset by increased leakages from strengthening domestic demand. Government revenues should benefit from reduced expenditures on energy subsidies both because of lower prices and measures to reduce these subsidies. As a result, the fiscal deficit of oil importers is projected to improve from 6.2 percent of GDP in 2006 to 2.9 percent of GDP in 2009.

For resource-poor economies in the Middle East and North Africa, inflationary pressures are expected to recede over 2007–09, in part as the workout of oil-price-related pressures from earlier lifting of fuels subsidies comes into play. From a 5.8 percent pace in 2006,⁸ CPI should ease to 4 percent in 2007. Thereafter, inflation is expected to diminish to 3.4 percent by 2009, on the back of further terms-of-trade improvement and nascent gains in productivity. For oil exporters in the current regional sample, price pressures are anticipated to remain elevated, due to continued fiscal and monetary stimulus in the Islamic Republic of Iran. From a GDP-weighted 8.7 percent advance in 2006, inflation is predicted to range between 10.5 and 11 percent through 2009, as Iranian inflation accelerates to 17 percent by the end of the forecast period.

Risks and uncertainties

The past few years represent the region's best growth performance in a decade. A major uncertainty facing the region concerns its ability to sustain such growth in the face of a less supportive international environment characterized by slower growth, lower oil prices, and increased competition. Downside risks can be clearly envisioned under a more substantial deterioration of conditions in the external environment than posited in the baseline assumptions. Additionally, the economic and political challenges of the next few years are magnified by rapidly growing populations and large cohorts of youth, who are looking for—or will be looking for—work.

For the oil exporters of the region, the future path of oil prices, global oil demand, and non-OPEC supply are critical sources of uncertainty. OPEC faces the very difficult challenge of maintaining prices at levels that are high enough to

maximize revenues for the group, but which are not so high as to induce substantial additional supply. The group's past success in achieving this balancing act is not encouraging, although long-term trends suggest that the organization's market power is likely to grow and therefore its capacity to manage global demand and supply conditions are likely to strengthen.

Managing the windfall oil revenues of the last years is a continuing challenge for oil exporters. The risk of overheating domestic demand and its potential inflationary consequences loom as an overarching threat. It appears, however, that in contrast with earlier episodes of oil booms, judicious use of oil stabilization funds and other financial management approaches have served to counter overheating and to augment the nonoil supply potential of the economy. Continued pursuit of these approaches should remain a priority. Importantly, domestic reform efforts may stand at some risk against the background of abundant liquidity and rapid growth. Should oil prices take a sudden and sustained downturn, economies may find adjustment difficult.

The emergence of large-scale capital flows within the broader region, largely among the GCC and from GCC to the resource-poor economies in the region, offers new opportunities as well as risks. The 2005/06 crash of GCC equity markets serves as a reminder of the potential of overshooting in a new financial environment. At the same time, FDI-based flows from the GCC to the Maghreb and Mashreq appear to be more deeply integrated with the structures of the host economies, and hence less subject to the risks associated with capital flight.

South Asia

Recent developments

GDP in South Asia expanded a robust 8.6 percent in 2006, reflecting generally expansionary policy conditions, although down slightly from 2005 due primarily to a deceleration of growth in Pakistan (table A.13). Inflation remains high and has shown limited signs of declining, despite lower oil prices in the second half of the year and a modest tightening of fiscal and monetary policies. Price pressures are partly being kept in check by product-specific tax cuts and direct and indirect subsidization of consumer energy prices, but by

Table A.13 South Asia forecast summary*annual percent change unless indicated otherwise*

	1991–2000 ^a	2004	2005	2006 ^e	2007 ^f	2008 ^f	2009 ^f
GDP at market prices (2000 \$) ^b	5.2	7.8	8.7	8.6	7.9	7.5	7.2
GDP per capita (units in \$)	3.2	6.1	7.0	7.0	6.4	6.0	5.8
PPP GDP ^c	6.4	7.9	8.8	8.7	8.0	7.5	7.3
Private consumption	4.0	5.7	7.3	8.5	7.1	6.5	6.2
Public consumption	3.9	5.3	8.9	5.6	5.3	4.8	4.6
Fixed investment	5.5	10.2	14.0	12.3	11.2	10.5	10.2
Exports, GNFS ^d	9.0	14.5	19.1	21.8	13.5	13.0	12.7
Imports, GNFS ^d	7.9	32.9	21.7	24.2	12.9	12.0	11.7
Net exports, contribution to growth	-3.6	-2.6	-3.4	-4.4	-4.4	-4.4	-4.3
Current account balance/GDP (%)	-1.6	-1.3	-1.9	-2.4	-2.3	-2.1	-2.1
GDP deflator (median, LCU)	8.0	4.9	4.6	7.6	8.6	6.7	6.1
Fiscal balance/GDP (%)	-7.8	-6.7	-6.7	-6.2	-5.9	-5.6	-5.3
Memo items: GDP							
South Asia excluding India	4.4	6.1	6.8	6.4	6.1	6.2	6.2
India	5.5	8.3	9.2	9.2	8.4	7.8	7.5
Pakistan	3.9	6.4	7.8	6.6	6.4	6.3	6.1
Bangladesh	4.8	6.3	6.0	6.2	6.0	6.1	6.4

Source: World Bank.

Note: e = estimate; f = forecast; LCU = local currency units.

a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.

b. GDP measured in constant 2000 \$.

c. GDP measured at PPP exchange rates.

d. GNFS denotes goods and nonfactor services.

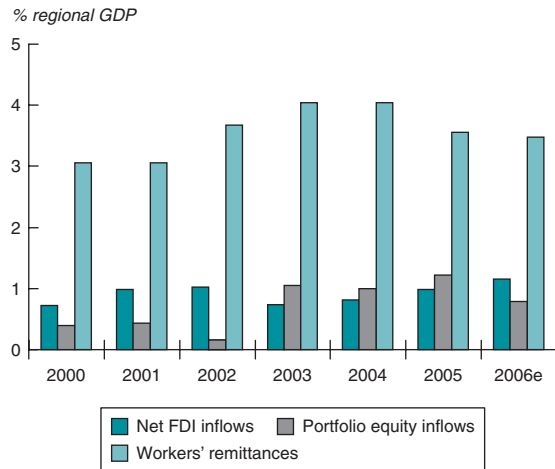
supporting real incomes these measures are contributing to strong domestic demand. Higher oil prices in the first half of 2006 and strong domestic demand contributed to deterioration in the region's current account balance despite strong exports and remittances inflows.

With the exception of Nepal, which is only now emerging from political strife, growth throughout the region was strong in 2006. In India, GDP increased by 9.2 percent, although signs of slowing appeared toward the end of the year. In the fourth quarter, GDP growth slowed to 8.6 percent, due mainly to weak (1.5 percent) agriculture growth (down from 8.7 percent in the fourth quarter of 2005), despite a firming in manufacturing output to 10.7 percent (relative to 8.2 percent in the fourth quarter of 2005). In Pakistan, GDP increased by 6.6 percent in 2006, significantly down from the 7.8 percent growth rate recorded the previous year. In part, the slowdown reflects a weakening of industrial production in the third quarter, itself likely a reflection of the waning effect of the boost to production provided by the reintroduction of quotas on Chinese clothing and textile exports the year before. Indeed, growth in the value of merchandise exports in the region declined from 30 percent in mid-year to 16 percent by the end of the year.

Output among the smaller countries in the region increased a strong 6.4 percent, the notable exception being Nepal, where economic activity expanded a disappointing 1.9 percent on account of political turmoil. Output in the Maldives was supported by a rebound in tourism and post-tsunami reconstruction efforts, while a new hydroelectric plant helped boost output in Bhutan.

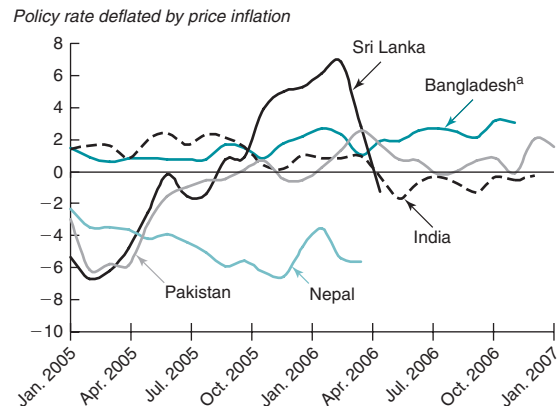
Notwithstanding robust export growth, robust domestic demand and a 20 percent increase in oil prices for the year as a whole caused the regional current-account deficit to deteriorate from 1.9 percent of GDP to 2.4 percent in 2006, with Sri Lanka exhibiting the largest deterioration. Strong remittance inflows have helped finance foreign purchases in the region for some time now (figure A.9), with such remittances having helped to propel the current account of Bangladesh to a 0.6 percent of GDP surplus in 2006.

Rapid growth and the relatively expansionary stance of fiscal and monetary policies in the region have provoked a rise in inflation. Successive hikes in policy rates in India have led to higher interest rates across the spectrum, but higher inflation means that real rates remain low (figure A.10). In Pakistan, tighter monetary policy brought inflation down to 6.6 percent in January 2007 and to 7.9 percent during 2006 from 9.3 percent in 2005,

Figure A.9 Strong workers' remittances in South Asia

Source: World Bank.

Note: e = estimate.

Figure A.10 Real interest rates in South Asia

Source: World Bank.

a. Deposit rates deflated by consumer price inflation.

although it showed signs of accelerating more recently, rising again to 7.7 percent year-over-year in March 2007. Prices have been rising particularly rapidly in Sri Lanka, reflecting pressures on domestic demand resulting from loose monetary policy. Strong capital inflows have also played a role, boosting domestic liquidity and stock market valuations. As of early March, the Standard & Poor's/IFC Global (S&P/IFCG) index⁹ was up 92 percent compared to January 2006, despite the global decline in market valuations the previous month.

Net capital inflows to South Asia increased to \$40.1 billion (3.6 percent of GDP) in 2006, up from \$28.3 billion (2.8 percent of GDP) in 2005, with most of the increase in going to India (table A.14). Strong capital inflows were largely due to a \$12 billion expansion in net private debt flows, while net equity inflows to the region increased only slightly, as a \$3 billion increase in FDI was partly offset by a decline in portfolio equity flows. At \$22.9 billion in 2006, net equity inflows nonetheless account for the bulk (60 percent) of net private inflows to the region.

Much of the FDI inflows into India were concentrated in the service sector (telecommunications in particular) in response to liberalization policies designed to attract FDI, such as easing ownership restrictions. FDI outflows from India are also on the rise due to increasing cross-border M&A purchases by Indian companies, mainly in high-income economies. Since 2004, FDI flows from India to the United Kingdom exceeded flows from the United Kingdom to India. The Indian multinational Tata acquired the Dutch steel company Corus for more than \$10 billion in early 2007. FDI inflows to Pakistan increased from \$2.2 billion in 2005 to \$3.5 billion in 2006 with much of investment in the oil and gas and financial sectors, along with installments made on a major telecom privatization deal in 2005.

Reserve accumulation in India picked up significantly in 2006, by \$39 billion, to reach \$171 billion, 6 percent of the total stock of reserves held by all developing countries. Given the strong rise in imports, foreign reserves in terms of months of import cover (for merchandise trade) declined to 11.2 months on average for 2006 from 13 in 2005.

Medium-term outlook

Regional GDP growth should moderate to about 7.5 percent and 7.2 percent in 2008 and 2009, respectively, due to a combination of tighter policy conditions and weakening of external demand (table A.15). Despite these factors, sustained high government deficits—currently running about 6.5 percent as a share of GDP in India, over 8.0 percent in Sri Lanka, and about 3.5 percent in Bangladesh and Pakistan—and strong international capital inflows are expected to keep domestic demand expanding rapidly, albeit not as strongly as in recent years. Robust domestic

Table A.14 Net capital flows to South Asia

\$ billions

	1998	1999	2000	2001	2002	2003	2004	2005	2006e
Current account balance	-9.5	-5.3	-6.3	2.2	11.4	10.6	-11.5	-19.6	-26.7
as % of GDP	-1.8	-0.9	-1.1	0.4	1.8	1.4	-1.3	-2.0	-2.4
<i>Financial flows</i>									
Net private and official flows	7.6	6.0	10.3	8.1	7.3	14.0	24.7	28.3	40.1
Net private flows (debt + equity)	5.3	3.5	9.8	6.0	9.7	15.6	23.7	24.9	37.7
Net equity flows	2.9	5.5	6.8	8.8	7.7	13.6	16.1	22.1	22.9
Net FDI inflows	3.5	3.1	4.4	6.1	6.7	5.6	7.3	9.9	12.9
Net portfolio equity inflows	-0.6	2.4	2.4	2.7	1.0	8.0	8.8	12.2	10.0
Net debt flows	4.7	0.5	3.5	-0.7	-0.4	0.4	8.6	6.2	17.2
Official creditors	2.3	2.5	0.5	2.2	-2.4	-1.7	1.0	3.4	2.5
World Bank	0.8	1.0	0.7	1.5	-1.0	-0.2	2.0	2.2	1.8
IMF	-0.4	-0.1	-0.3	0.3	0.1	-0.1	-0.3	0	-0.1
Other official	2.0	1.6	0	0.4	-1.5	-1.5	-0.7	1.2	0.8
Private creditors	2.4	-2.0	3.0	-2.8	2.0	2.0	7.6	2.8	14.8
Net medium- and long-term debt flows	3.7	-2.1	3.9	-1.9	0.2	1.3	4.9	1.2	12.0
Bonds	4.2	-1.2	5.4	-0.4	-0.7	-3.1	4.1	-2.9	2.0
Banks	0.7	-0.5	-2.0	-1.1	1.0	4.4	1.1	4.2	9.9
Other private	-1.1	-0.4	0.5	-0.3	-0.1	0	-0.3	-0.1	0.1
Net short-term debt flows	-1.3	0.1	-0.9	-0.9	1.8	0.7	2.6	1.6	2.8
Balancing item ^a	4.8	4.6	0.7	-0.1	8.2	11.3	14.0	-3.0	28.3
Change in reserves (- = increase)	-2.9	-5.3	-4.6	-10.2	-27.0	-35.9	-27.2	-5.7	-41.7
<i>Memo items</i>									
Bilateral aid grants	3.2	3.4	3.1	4.2	3.7	5.4	5.0	6.6	3.9
of which									
Technical cooperation grants	1.1	1.1	1.0	1.0	1.2	1.5	1.5	1.6	1.8
Other	2.1	2.3	2.1	3.2	2.5	3.9	3.5	5.0	2.2
Net official flows (aid + debt)	5.5	5.9	3.6	6.4	1.3	3.7	6.0	10.0	6.4
Workers' remittances	13.4	15.1	17.2	19.2	24.2	31.1	31.3	35.6	38.8
Repatriated FDI Income	0.4	0.4	1.6	1.2	1.3	1.9	1.5	2.0	—

Sources: World Bank Debtor Reporting System and staff estimates.

Note: e = estimate; — = not available.

a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.

Table A.15 South Asia country forecasts

annual percent change unless indicated otherwise

	1991-2000 ^a	2004	2005	2006e	2007f	2008f	2009f
Bangladesh							
GDP at market prices (2000 \$) ^b	4.8	6.3	6.0	6.2	6.0	6.1	6.4
Current account balance/GDP (%)	-0.4	-0.5	-0.2	0.6	0.2	-0.5	-0.8
India							
GDP at market prices (2000 \$) ^b	5.5	8.3	9.2	9.2	8.4	7.8	7.5
Current account balance/GDP (%)	-1.2	-1.4	-1.9	-2.2	-2.1	-2.0	-2.0
Nepal							
GDP at market prices (2000 \$) ^b	5.0	3.7	2.7	1.9	3.0	4.5	4.7
Current account balance/GDP (%)	-6.4	-0.7	0	0.6	-0.6	-1.6	-2.4
Pakistan							
GDP at market prices (2000 \$) ^b	3.9	6.4	7.8	6.6	6.4	6.3	6.1
Current account balance/GDP (%)	-3.7	-0.8	-3.3	-4.9	-4.3	-3.6	-3.0
Sri Lanka							
GDP at market prices (2000 \$) ^b	5.2	5.4	6.0	7.4	6.0	6.2	6.3
Current account balance/GDP (%)	-4.6	-3.4	-3.2	-4.9	-4.0	-3.9	-3.3

Source: World Bank.

Note: Growth and current account figures presented here are World Bank projections and may differ from targets contained in other Bank documents. Afghanistan, Bhutan, and the Maldives are not forecast owing to data limitations. e = estimate; f = forecast.

a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.

b. GDP measured in constant 2000 \$.

demand, combined with the delayed pass-through of higher oil prices, is expected to maintain inflationary pressures in the region and to sustain import growth in the double digits. As a result, the external sector is expected to make a significant negative contribution to growth, with the regional current account deficit projected to exceed 2.0 percent of GDP over the forecast horizon.

In India, more restrictive policy conditions are expected to lead to deceleration in investment growth and weaker private consumption and government spending, contributing to a slowdown in GDP growth to 7.8 percent and 7.5 in 2008 and 2009, respectively. In Pakistan, growth is also forecast to ease, although more gradually, as policy conditions are expected to remain broadly accommodative in the lead-up to the 2007 presidential elections, which are scheduled to take place during September and October. Recent heightened political tensions are expected to hamper business and consumer confidence and to partly contain the impact of stimulative policy conditions. Tightening of fiscal and monetary policies is expected in 2008, leading to further restraint of domestic demand and further deceleration of growth to 6.1 percent in 2009.

Among the smaller economies in the region, growth in Sri Lanka is projected to hover close to 6.0 percent during 2007–09, down from 7.4 percent in 2006, due to disruptive effects of civil war, which are partially mitigating the positive growth impacts of the ongoing recovery from the tsunami (including the reconstruction of roads and buildings). Growth is projected to strengthen in Nepal due to improved political conditions and cessation of fighting. In Bhutan, growth is expected to remain robust, rising by a projected 17 percent in 2007—a sharp acceleration from the estimated 5.5 percent in 2006—driven primarily by the stimulative effects of the Tala hydropower project (the plant is expected to begin operating at full capacity in mid-2007), and to a lesser extent by the expanding tourism industry. Growth in Bhutan is expected to decelerate to 10 percent in 2008 and 5 percent in 2009 as the stimulative impacts of the hydropower project unwind. In Afghanistan, GDP growth is expected to accelerate over the forecast horizon, initially due to an anticipated recovery from drought in the agricultural sector, and over the forecast horizon due to the stimulative impact

of donor-led construction projects. In the Maldives, an expansion of GDP growth is expected to be supported by the ongoing reconstruction effort following the devastating December 2004 tsunami.

Risk and uncertainties

The high growth rates posted in recent years have helped South Asia make significant progress toward achieving the Millennium Development Goals. Most notably, the percentage of people living on less than a dollar a day declined to just over 30 percent in 2003 from 40 percent in 1990, and is now projected to reach about 13 percent in 2015—below the initial goal of 20 percent. These headline numbers, while heartening, mask persistent social inequalities, as well as considerable subregional and subnational variation. Sustained growth will be necessary for continued poverty reduction, and achieving further improvements in institutional service delivery will be critical to making progress in all other dimensions of the MDGs.¹⁰

Sustaining high growth will require continued economic reform, expansion of infrastructure capacity, and further reduction of security threats. These efforts will also contribute to higher capital inflows, which have been spurred by progress in these areas in recent years. Revamping tax collection systems to reduce evasion and improve tax collection to help finance the extensive government agendas is also important. In Pakistan, for example, tax evasion is reportedly very high: it is estimated that less than 1 percent of the population pays income tax.

Given vibrant domestic demand and high oil prices, a significant portion of the cushion that was built up in terms of foreign currency reserves and a regional current account surplus (last recorded in 2003) has been absorbed. Since 2003, the period for which imports could be covered by foreign reserves has declined by about four months in both India and Pakistan. While reserves in India remain significantly above the level of three months worth of imports, they are much closer to that level now in Pakistan and below it in both Bangladesh and Sri Lanka, suggesting that each country would be vulnerable to a significant terms-of-trade shock, such as another hike in oil prices. In Pakistan, relatively modest (5.5 percent

as of end-2006) increases in reserve holdings since 2003 in conjunction with a more than doubling of imports (GNFS) resulted in a sharp fall in the import-cover ratio, an unsustainable trend.

Downside risks to growth are also tied to the inexorable lifting of restrictions on Chinese textile and clothing exports at end-2007 and to a stronger than projected slowdown of demand from the United States in 2007, an important trade partner for most countries in the region.

The recent surge in cross-border bank lending to multinational corporations in India has raised concerns that borrowing abroad by the corporate sector could contribute to inflationary pressures, which would require a more aggressive monetary policy response and possibly have negative repercussions for growth prospects over the medium term.

Increased political instability represents another main risk. Heightened security concerns could hurt investor sentiment and undermine foreign capital inflows, which have contributed to the region's record four-year expansion. The continued easing of political tensions between the governments of India and Pakistan bodes well for continued progress toward improved relations.

Sub-Saharan Africa

Recent developments

Strong global growth, improved macroeconomic performance, significant aid flows, rising FDI, and a continued spell of relative political stability helped GDP in Sub-Saharan Africa expand by 5.6 percent in 2006, the third consecutive year that growth exceeded 5 percent (table A.16). Despite high oil prices, oil-importing countries in the region (even when excluding South Africa) continued to grow rapidly, with output increasing by close to 5.0 percent. Output growth among oil exporters was also strong, but the expansion slowed from 7.4 percent in 2005 to 6.9 percent in 2006 as some countries pushed against production constraints and unrest in the Niger Delta undermined growth in Nigeria's oil sector.

Growth was broadly based, with output in half of the countries in the subcontinent advancing by 5.0 percent or more. Only 7 of 34 oil-importing economies grew by less than 2.0 percent: the Comoros, Eritrea, Guinea-Bissau, Swaziland, the Seychelles, Togo, and Zimbabwe. While export growth has been strong, domestic demand has provided the largest contribution to growth. Investment is estimated to have contributed more

Table A.16 Sub-Saharan Africa forecast summary

annual percent change unless indicated otherwise

	1991–2000 ^a	2004	2005	2006 ^e	2007 ^f	2008 ^f	2009 ^f
GDP at market prices (2000 \$) ^b	2.3	5.3	5.8	5.6	5.8	5.8	5.4
GDP per capita (units in \$)	-0.4	2.9	3.4	3.5	3.7	3.8	3.4
PPP GDP ^c	3.4	5.5	6.0	5.9	6.2	6.0	5.7
Private consumption	1.2	5.6	5.9	5.9	4.9	4.7	4.8
Public consumption	2.6	4.4	6.5	6.7	6.3	6.3	6.4
Fixed investment	3.7	9.0	10.0	15.5	11.6	12.3	9.4
Exports, GNFS ^d	4.7	6.4	7.4	5.8	6.9	6.4	6.8
Imports, GNFS ^d	4.4	9.4	10.2	12.7	8.6	8.6	8.4
Net exports, contribution to growth	0.5	-1.4	-2.4	-4.8	-5.5	-6.5	-7.2
Current account balance/GDP (%)	-2.1	-1.1	-0.1	-0.5	-1.4	-2.3	-2.7
GDP deflator (median, LCU)	10.1	7.0	6.7	7.2	5.0	4.5	4.5
Fiscal balance/GDP (%)	-4.0	-0.7	1.1	3.3	0.9	-1.4	-3.0
<i>Memo items: GDP</i>							
Sub-Saharan Africa excluding South Africa	2.6	5.5	6.2	5.9	6.6	6.2	5.7
Oil exporters	2.7	6.0	7.4	6.9	8.3	7.4	6.6
CFA countries	2.6	4.1	3.8	3.2	3.4	4.2	3.5
South Africa	1.8	4.8	5.1	5.0	4.4	5.2	4.9
Nigeria	2.8	6.0	6.9	5.6	6.4	6.6	5.9
Kenya	1.9	4.9	5.8	5.9	5.1	5.2	4.9

Source: World Bank.

Note: e = estimate; f = forecast; LCU = local currency units.

a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.

b. GDP measured in constant 2000 \$.

c. GDP measured at PPP exchange rates.

d. GNFS denotes goods and nonfactor services.