CHAPTER 3

CALCULATION OF CAPITAL FLIGHT AND OPENNESS INDEX FOR THE SIX SELECTED COUNTRIES

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CHAPTER 3

CALCULATION OF CAPITAL FLIGHT AND OPENNESS INDEX FOR SIX CELECTED COUNTRIES

3.1 INTRODUCTION

The magnitude of capital flight is estimated for six of the seven SAARC nations viz. India, Bangladesh, Pakistan, Sri Lanka, Nepal & Bhutan over the time period 1987-2004. The remaining country is Maldives due to non-availability of proper data for the chosen time period. The selection of the time period is done on the basis of economic and structural reforms adopted in these countries. The amount of Capital flight is associated with several factor influencing it, here we consider Trade Openness as the primary determining factor of Capital Flight. Trade Openness is defined as the ratio of total external trade to GDP, both expressed in Dollar ($) terms. After economic liberalization international trade has increased to a large extent with all its variants. There are also several other factors like Macroeconomic Instability, Political Instability, Rate of Return differential, Capital Inflow, the Stock of Capital Flight etc. which influence the CF from these countries over the period, but the analysis of these factors are out of the scope of this paper presently.

The selection of trade openness as an important determinant of CF is done on the basis that in the post WTO era total trade has increased to a large extent form these countries and import and export duties has been reduced drastically. It is evident that the trading channel is used as a way of capital flow from the South-East Asian countries.

For the six selected South-East Asian countries a brief economic review is presented for better understanding of these countries socio-economic position. Then a simple regression line is fitted from the data regarding CF and Openness Index (OI). In this part the data sources WDR, BOP statistics, IFS of various years. CF is calculated on the basis of Residual Measure using BOP data.

3.2: INDIA

3.2.1 *THE ECONOMIC OVERVIEW OF INDIA*

The growth of the Indian economy has been decelerating since 1999, with the slowdown becoming more pronounced from the second half of 2000. The slowdown has been driven by sluggishness in the industry sector. The services sector, the prime engine of economic growth during the 1990s, has also shown a moderate decline. Agriculture growth will be high in 2001 compared with a very low turnout in both 1999 and 2000.

In 2000, the gross domestic product (GDP) grew at 5.2 percent. In the first quarter of 2001, GDP growth was a mere 4.4 percent over its level in the same quarter of 2000. In 2001, economic growth is expected to be around 5.0 percent.1 While a disappointing outcome compared with India's high growth rates in the mid-1990s, this still makes the Indian economy— together with the People's Republic of China—one of the best performing economies in 2001. Several factors may have caused below-expectations economic performance.

The global economic slowdown affected the Indian economy, but its impact is, in our assessment, limited. This is because, despite achievements in trade liberalization under the post-1991 reforms and in compliance with World Trade Organization (WTO) commitments, India's openness remains relatively limited. This softens the impact on the economy of external shocks as the September 11 attacks on the United States, and of cyclical patterns in global demand. Of all possible transmission channels—trade, capital flows, and exchange rate—the first is the most likely to be hit by the deepening global slowdown. India's export growth—particularly software and related services—dropped in 2001; however, import growth has slowed even more sharply and the trade balance and current account deficit are unlikely to worsen in 2001. So far, there is no significant impact on foreign capital flows to India, which remain small. And the rupee is fairly stable in the context of a comfortable foreign exchange reserves position.

There were also some major domestic shocks, such as the devastating earthquake in Gujarat in January 2001. Economic losses caused by the earthquake have been estimated at roughly 1 percent of India's GDP. However, aid from the international community, supporting immediate efforts at reconstruction, has helped lessen the impact of the shock.

The main causes of the relatively poor performance of the Indian economy appear to be domestic structural factors. These can be traced back to the unfinished reform agenda. First-generation reforms were designed, on the one hand, to rein in public finances in the medium term by redefining the role of the public sector and, on the other hand, to spur private sector growth. The three key areas covered by the reforms were industrial policy, trade and exchange rate, and the financial sector. A key element in the redefinition of the public sector role was an ambitious program of reform of center and state public sector undertakings (PSU), including restructuring, accompanied by decreasing reliance on the public budget and gradual divestiture.

Trade liberalization involved eliminating export subsidies and reducing peak tariff rates, easing some quantitative restrictions on exports and imports, and allowing current account convertibility of the rupee. Steps were taken to facilitate foreign capital inflows by raising the limits on foreign equity holdings and giving tax concessions for foreign institutional investment. Finally, financial sector reforms pursued the objectives of strengthening and liberalizing the financial market and

improving monetary management. They included measures to simplify and liberalize the interest rate structure; to align capital adequacy, accounting, and provisioning standards with international benchmarks; and to strengthen banking supervision and stock market regulation.

Progress made under first-generation reforms has been substantial. Most industries previously under state monopoly have been opened to the private sector. The role of industrial licensing and small-scale industry reservations has been substantially curtailed. The insurance business has been opened to the private sector. Import restrictions have been substantially liberalized with the abolition of import licensing, removal of quantitative restrictions (QRs) in fulfillment of WTO obligations, and lower tariff rates. Norms relating to ceilings in relation to foreign direct investment and foreign institutional investment have been substantially eased.

However, more remain to be achieved, particularly in terms of

(i) Fiscal consolidation efforts,
(ii) Divestiture and privatization, and
(iii) Creating an enabling environment for private sector growth.

Post-reform efforts at fiscal consolidation were eroded in the second half of the 1990s by the impact of increases in public sector salaries mandated by the Fifth Pay Commission and by the rapidly deteriorating fiscal position of the states. State finances and issues in center-state fiscal relations are given special emphasis in this country economic review, with the final chapter being dedicated to them.

In 2000/01 the consolidated fiscal deficit was back at the pre-crisis level of above 9 percent of GDP. This was accompanied by a worsening in the overall quality of public expenditures, with a decrease in the share of capital and development expenditures, and an increase in revenue deficits as a percentage of gross fiscal deficits. In the context of a slowing economy, tax revenues were low in 2001.

Combined with efforts to pump-prime the economy this led to an acceleration of the Government's borrowing program for 2001 and created some concern that fiscal consolidation efforts may be further undermined. Achievements under the Government's disinvestment and privatization program have been mixed. While there were some successes in privatizing the telecommunications sector, the vicissitudes experienced in the power sector, for example, are well known. Of a targeted disinvestment of Rs100 billion in 2000, only Rs25 billion was realized. Progress toward achieving the 2001 target of Rs120 billion has been limited.

Contrary to the expectations at the onset of the reform process, private sector investment did not effectively substitute for public sector capital expenditure. A significant gap emerged in the infrastructure sector, as the government's

privatization program stalled and the expected private sector investment in the key infrastructure services did not materialize. The drop in public capital investment, combined with slow progress in pursuing restructuring and privatization of public sector undertakings, undermined the quality of the infrastructure base of the economy and created the infrastructure bottlenecks that constrain economic growth today.

The 1991 reform program had included a review of industrial exit policies aimed at easing existing barriers to exit such as laws and regulations on bankruptcy, labor retrenchment, and transfer of land. However, little if any progress has been achieved on all these accounts due to the complex political economy dynamics impeding the reform process. Small-scale industry reservation policies continue to undermine the efficiency of the productive sector.

The program of second-generation reforms articulated in the 2001 budget is comprehensive. The program covers fiscal consolidation, with efforts to contain growth in public expenditures and to rationalize the tax system. It extends reforms to the agriculture sector that had largely been bypassed by first-generation reforms. The program focuses on improving quality in public expenditure with a focus on raising investment in infrastructure and making this investment viable through appropriate user charges. The program in particular addresses the reform of the power sector. Subsidies on non-merit goods continue to be among the main causes of escalating revenue deficits and worsening state finances. Power sector subsidies are a large component of the total subsidy bill. Memoranda of Understanding between central and state governments, which several states have signed, include power sector reforms.

The budget also announced measures easing price control in key sectors. It further promoted financial sector reforms and continuing, progressive liberalization of the capital account. A supplementary plan of reforms to enhance competition, including reform of labor laws, was presented by the Prime Minister to the Council of Economic Advisors in September 2001.

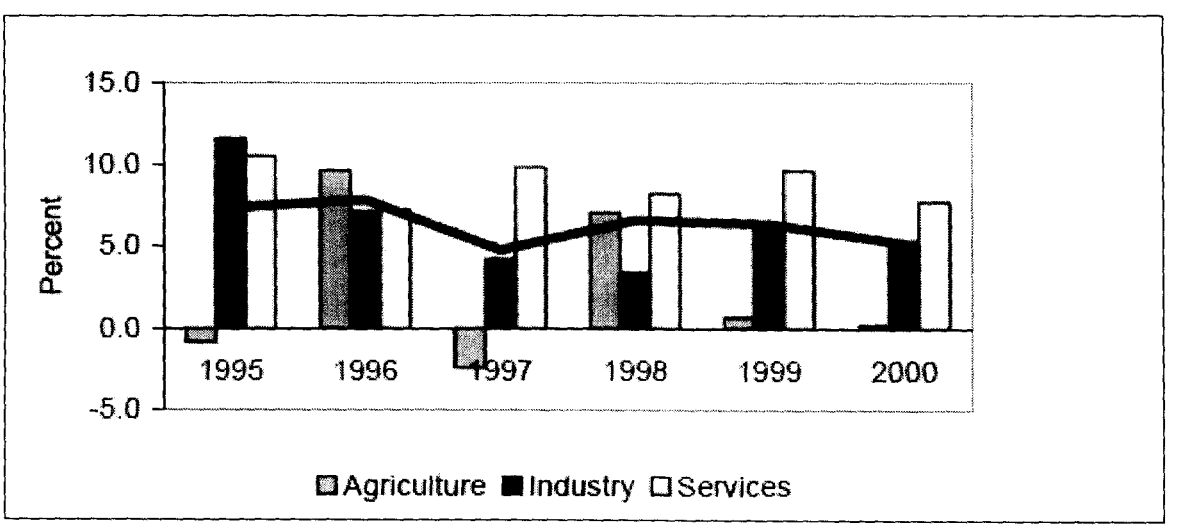
India's prospects for the medium term will depend on the prompt implementation of these reforms, and key reforms of industrial exit policies. Substantial progress on the reform agenda should allow India to move to growth above 6 percent in 2002 and toward the higher growth path of 8 percent envisaged in the Approach Paper to the Tenth Five-Year Plan for the medium term.

3.2.2: RECENT ECONOMIC DEVELOPMENTS OF INDIA

The Indian economy has been experiencing a significant slowdown starting from the second half of 2000. Current official estimates for 2000 place the growth of gross domestic product (GDP) at factor cost at 5.2 percent (FIG. 3.2).

Therefore, the economy was already at low ebb at the time of the September 11 attack on the United States. The September 11 attack contributed to undermining the prospects for early recovery of the weak global economy, which is now expected to grow at only 2.6 percent in 2001.2 The heightened uncertainty and dimmer prospects for a revival in global demand in the wake of September 11 may have an impact on the Indian economy, but this impact is likely to be fairly modest. India's economic problems are essentially homegrown. Large fiscal deficits, infrastructure bottlenecks, factor market distortions, and other obstacles to economic competition and to free trade are taking their toll on the economy. They need to be addressed through appropriate policy responses. In the first quarter of 2001, official estimates indicate that the GDP grew by a mere 4.4 percent over its level in the same quarter in 2000. Growth in the second quarter picked up to 5.3 percent. We project the Indian economy to be growing at 5.0 percent for the whole of 2001.

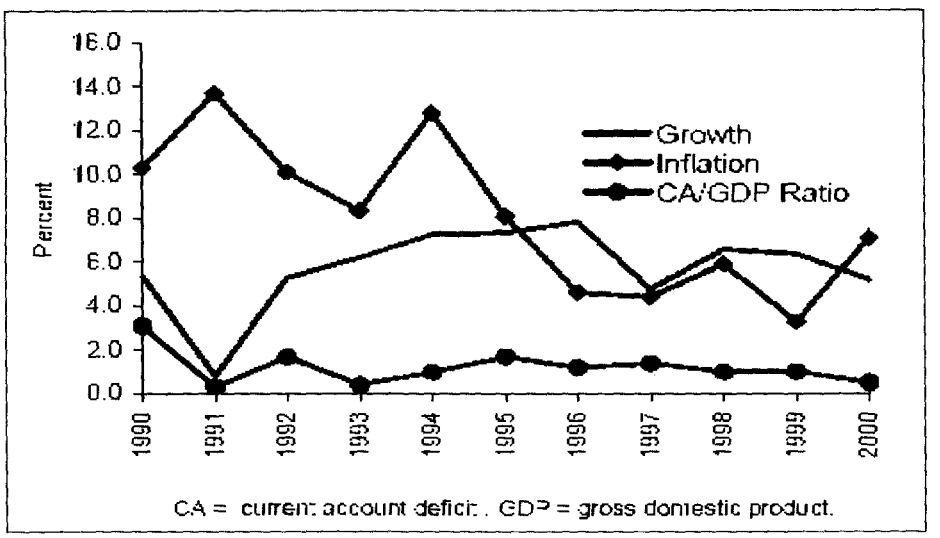
FIG.3. 1: INDIA'S GDP GROWTH RATES AND COMPONENTS
Source : World Development Report(2002)



The economic slowdown, however, should not be seen in isolation. Despite the somewhat disappointing growth outcome vis-à-vis expectations, the Indian economy remains one of the best performing developing economies in 2001. This is a remarkable achievement, considering the weak external demand environment and the dampening impact on India's economic performance of shocks such as the devastating earthquake in Gujarat in January 2001. However, economic growth at 6 percent between 1998 and 2000 appears lackluster compared with India's strong economic performance in the mid-1990s. Following the introduction of a comprehensive policy reform program in the aftermath of the 1991 balance-of-payment crisis, the Indian economy grew at rates higher than 7 percent during 1994-1996. As economic growth slowed down in the latter part of

the decade, inflation continued to beat a downward path and current account deficits remained moderate, generally around 1 percent of GDP (Figure 3.2).

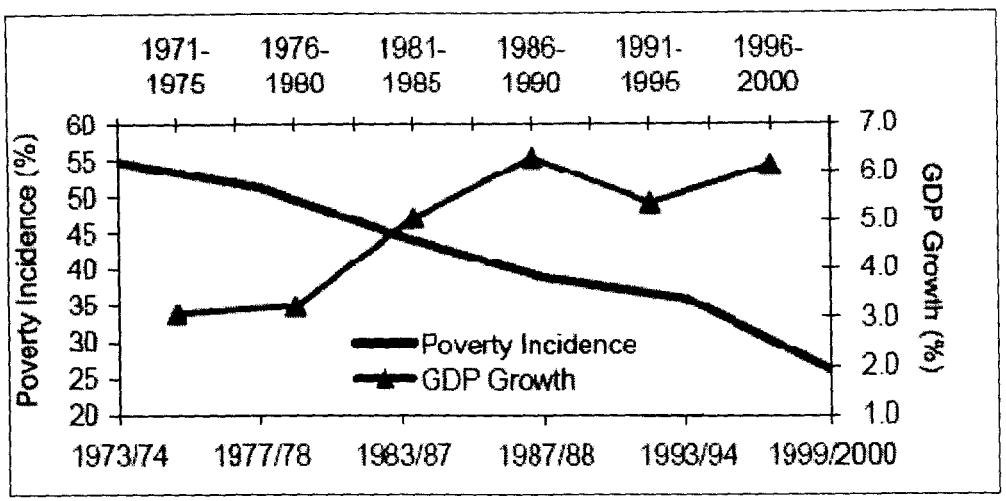
FIG3.2: INDIA'S GDP GROWTH RATE, INFLATION AND CURRENT ACC. DEF. /DGP
Source : World Development Report(2002)



Throughout its post-independence planning experience spanning the last 50 years, India has considered economic growth as a tool to achieve wide and equitable access of its citizens to necessary economic and social resources rather than as an end in itself.3 Practical results, however, have been mixed. While poverty and social indicators have improved, they have done so at a slower pace than in other developing countries originally in a comparable position (e.g., People's Republic of China, East and Southeast Asian countries). Also, even within India, achievements have been widely divergent, with some states—e.g., Gujarat, Goa, Kerala— achieving substantial progress and others—e.g., Bihar and Orissa—being left behind.

Overall, data clearly shows that poverty5 has been reduced the most, and at a more rapid pace, during periods of faster economic growth6 (Figure 3). For example, the post-1991 reform period, during which growth accelerated significantly, also exhibits a faster drop in poverty incidence.

FIG. 3. 3: POVERTY INDICATOR
Source : World Development Report(2002)



The liberalization of the economy under the "first-generation" reforms has beensubstantial. Most industries previously under state monopoly were opened to the private sector. The role of industrial licensing and small-scale industry reservations was curtailed. The insurance business was opened to the private sector. Imports were substantially liberalized with the abolition of import licensing, removal of quantitative restrictions (QRs) in fulfillment of World Trade Organization (WTO) obligations, and lower tariff rates.

Norms relating to ceilings to foreign direct investment (FDI) and foreign institutional investment (FII) were substantially eased. However, a lot still remains to be achieved, particularly in terms of fiscal consolidation efforts, divestiture and privatization, and creating an enabling environment for private sector growth. The 1991 reform program had included a review of industrial exit policies aimed at easing existing barriers to exit such as laws and regulations on bankruptcy, labor

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NOTE: [1. For an assessment of India's record in social development, see Dreze J. and A. Sen, 1995. *India Economic Development and Social Opportunity*, Oxford University Press.

2. The current poverty level in India is defined based on consumer expenditure. The per capita per month cut-off point was Rs327.56 in rural areas and Rs454.1 in urban areas in 1999-2000. The latest National Sample Survey has put the number of people below the poverty line at a level of 26 percent.

3. The poverty-reducing impact of economic growth is confirmed by several econometric studies. For example, a recent study by the International Monetary Fund (IMF), "Interstate Differences in Rural Poverty in India," part of the IMF Country Report 01/181 (October 2001), finds that economic growth has helped reduce poverty in most Indian states over the last 20 years, except in the early years (1990-1992) of the reform period. The study attributes the widening poverty differential across states in the 1990s to nongrowth

structural factors, such as policies on redistribution and expenditures for the development of human resources.

4. *Poverty in India: An Assessment and Analysis and Implication for Country Strategy and Program*, November 2001— Study carried out for the Asian Development Bank by K. S. and Suresh D. Tendulkar.]

retrenchment, and transfer of land. However, little if any progress was achieved on all these accounts due to the complex political economy dynamics impeding the actual reform process. Current economic woes experienced by the Indian economy can be traced back to the unfinished reform agenda.

In the post reform decade, the Indian economy recorded higher rates of GDP growth—on average, 5.7 percent—than in the 1980s (around 3.2 percent). Overall economic performance was remarkably more stable in the nineties, with fewer and milder cyclical downturns, and exhibited less dependence on agricultural outcomes. In the years immediately preceding the 1991 crisis, however, the economy had also recorded substantial growth of over 7.5 percent per year. Several factors had contributed to this growth performance. These included an exceptionally good agriculture output in 1988, but also pump-priming of the economy. Economic expansion in the late 1980s was financed through high levels of domestic and external indebtedness and the consolidated fiscal deficit of center and states reached 9.4 percent of GDP in 1990.

Between 1990 and 1995, efforts were made at fiscal consolidation, mainly at the center. During this period, the combined fiscal deficit of center and states declined by 2.9 percentage points. Fiscal discipline helped to free resources for investment, and, together with the positive impact of trade and industrial reforms, contributed to the rapid economic growth of the mid- 1990s. Unfortunately, in the latter half of the decade, these initial accomplishments in fiscal consolidation were quickly eroded by the impact of government salary hike under the Fifth Pay Commission and by the rapidly deteriorating fiscal position of the states. As public savings turned negative, the overall quality of public expenditure worsened, with a decrease in the share of capital expenditure and an increase in revenue deficits as a percentage of fiscal deficits. These negative developments in public finances and a slowing down of the reform process are the main structural factors behind the subdued economic performance in of the second half of the 1990s.

Widening fiscal deficits and high interest rates contributed to a mounting debt stock. In turn, the high interest payments on outstanding debt, combined with rising current expenditures on salaries, pensions, and subsidies, narrowed the fiscal room for public capital expenditures. During the 1980s, the public sector was contributing a fairly stable portion of gross capital formation, even though its relative share vis-à-vis the private sector dropped during the latter half of the decade (Figure 6). In the 1990s, following the reforms, the contribution of the public sector to gross capital formation in the economy ebbed as the private sector's rose. This was partly the deliberate result of the liberalization process, which encouraged the public sector to withdraw from economically viable productive sectors. Partly, it was the result of the narrowing fiscal space for

public capital expenditure. However, private sector investment did not effectively substitute for public sector capital expenditure, in both type and sector composition. A significant gap emerged in the infrastructure sector, as the government's privatization program under the first-generation reforms stalled and the expected private sector investment in key infrastructure services did not materialize. The drop in public capital investment combined with lack of progress in restructuring and privatizing public sector undertakings (PSUs) seriously undermined the quality of the infrastructure base of the economy during the 1990s. This created the infrastructure bottlenecks that constrain economic growth today.

The reforms improved the management of the external sector and opened new opportunities for Indian producers in export markets. Trade liberalization led to exports surging to double-digit levels in the late 1990s, and trade as a percentage of GDP went up from around 15 percent in the late 1980s to over 25 percent in the late 1990s. On the capital account, the softening of FDI and FII norms led to increasing and relatively stable foreign capital flows. In an environment of relatively moderate inflation, these positive trends contributed to an increasingly comfortable foreign exchange reserve position.

Despite these achievements, the degree of openness of the Indian economy remains limited. India together with other South Asian countries is still at the bottom of the spectrum in terms of conventional indicators of external openness (trade, FDI, protection). As for the implementation of capital account convertibility, since the early 1990s, gradual steps have been taken in relation to more liberal norms for FDI and FII and repatriation of funds by foreigners and NRIs. However, of the three preconditions laid down by the Tarapore Committee in 1997 for full capital account convertibility, i.e., fiscal consolidation, low inflation rate, and a stronger financial sector, progress has been made on the latter two accounts. Fiscal profligacy still remains a problem.

The Indian economy achieved a gross domestic product (GDP) growth rate of 8.1% in FY2005 (1 April 2005–31 March 2006). On the expenditure side, the economy was lifted by broad-based domestic demand growth. While aggregate expenditure data have not yet been released, consumption growth is estimated at 8.0%, driven by a good monsoon, which supported rural incomes. Gross fixed capital formation grew at an estimated rate of 8.5%, reflecting rising investor confidence (Figure 4.) in the face of strongly entrenched demand growth and as a consequence of the expansion in credit and companies' initial public offerings. The rate of gross fixed capital formation in GDP has increased to 25.9% and that of gross domestic capital formation to 30.1%. Meanwhile, public consumption grew less rapidly than GDP as the central Government set the target to reduce its overall deficit to 4.3% of GDP for FY2005. The Government has announced that it expects to have surpassed this target, reducing the deficit to 4.1% of GDP. The boom in domestic private demand, combined with rising oil import costs,

widened the trade deficit and pushed the current account further into a deficit equivalent to 2.5% of GDP.

Figure 3.1. shows the decomposition of growth by sector. The importance of the services sector was reaffirmed in FY2005. This sector accounts for 54% of economic output and grew by an unprecedented 9.8%. This was mainly the result of significant increases in the demand for domestic services. The export-oriented information technology (IT) and business process outsourcing (BPO) sectors also continue to perform very well due to growing international demand for skilled, low-cost, English-speaking Indian workers, although these sectors constitute only a small portion of total services output. Indian competitiveness in IT and BPO has been aided by substantial investment in telecommunications infrastructure and the phased liberalization of the communications sector

3.2.3 ESTIMATE OF CAPITAL FLIGHT FROM INDIA (1987-2004)

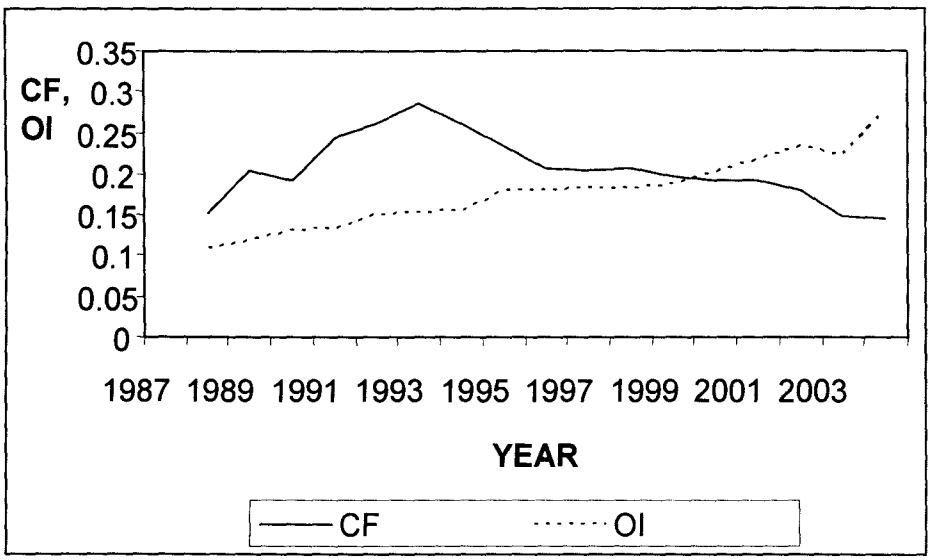
The estimate of capital flight from India over the period 1987-2004 (18 YEARS) is done following the residual method stated above.

Here we present the Capital Flight and Openness index for India over the period.

TABLE: 3.1 CF & OI FOR INDIA

YEAR	CF	OI=TRADE/GNI
1987	0.154877329	0.101841252
1988	0.15345074	0.107538179
1989	0.204625231	0.118661599
1990	0.192192968	0.130401978
1991	0.243790096	0.132210713
1992	0.260890745	0.149265434
1993	0.286972463	0.152109784
1994	0.262344198	0.155918364
1995	0.234573851	0.179513471
1996	0.207788557	0.178795905
1997	0.205282841	0.181684149
1998	0.206629314	0.181253914
1999	0.197134585	0.18782767
2000	0.193155981	0.201689595
2001	0.192837916	0.217920005
2002	0.179698329	0.233032274
2003	0.147522816	0.22158743
2004	0.144915726	0.277071904

FIG.3.4 CF AND OI FOR INDIA (GRAPHICAL REPRESENTATION)



3.2.4: Regression Analysis: CF versus OI (INDIA)

The Statistical analysis is shown below:

The Polynomial regression equation is

log (CF) = 3.49422 +20.9052 log (OI) + 32.3921 log (OI) **2 + 15.8613 log (OI) **3

S = 0.0453816 R-Sq = 77.9 % R-Sq(adj) = 73.1 %

Analysis of Variance

Source	DF	SS	MS	F	P
Regression	3	0.101452	0.0338173	16.4203	0.000
Error	14	0.028833	0.0020595		
Total	17	0.130285			

Source	DF	Seq SS	F	P
Linear	1	0.0040915	0.5188	0.482
Quadratic	1	0.0823010	28.1260	0.000
Cubic	1	0.0150595	7.3122	0.017

The linear regression equation is

CF = 0.248 - 0.254 OI

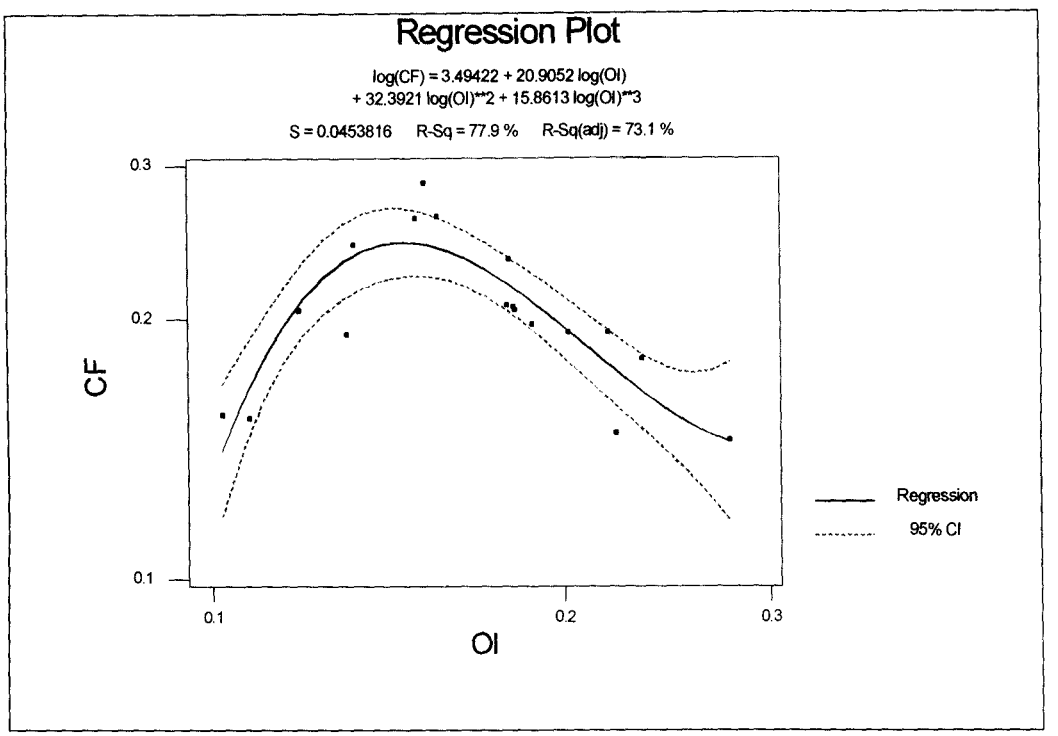
Predictor	Coef	SE Coef	T	P
Constant	0.24772	0.03759	6.59	0.000
OI	-0.2542	0.2105	-1.21	0.245

S = 0.04057 R-Sq = 8.4% R-Sq(adj) = 2.6%
PRESS = 0.034978 R-Sq(pred) = 0.00%

Analysis of variance (linear)

Source	DF	SS	MS	F	P
Regression	1	0.002401	0.002401	1.46	0.245
Residual Error	16	0.026333	0.001646		
Total	17	0.028734			

Durbin-Watson statistic = 0.39



In case of India over the period we have a significant amount of CF. But the most notable fact is that from 1991 to 1995 the burden of CF was severe. These were the initial years of economic and structural reforms. Several Macroeconomic adjustment measures were taken along with a number of trade reforms measure. The positive result of such measures was started coming from 1997-98. From this year India has begun to experience somehow a reverse trend regarding CF and OI. Up to 1997-98 the correlation between CF and OI was highly positive but after that a negative trend was emerging. The emergence of negative trend is mainly due to the rapid growth of the economy. Indian economy has achieved 8-9%annual growth on an average after 1999-2000 and thereafter. The growth has marked a reversing trend in outward investment of the capital flight, as the home economy grows and the internal environment is becoming favorable to investment as well as for healthy return and gradual loosening the tariff and tax

barriers in subsequent budgets encouraged people to follow the reverse trend. The internal changes are widely discussed in the earlier chapter.

Now we consider the Poverty trend along with the CF data. It is seen that after the liberalization there is an achievement in overall domestic growth and at the same time inequality has also risen. The poverty trend is not following the natural growth trend so the obvious factor is that the inequality is rising over the years. But the highlighting fact is that up to 1997-98, where CF and OI had a positive trend, poverty level was not falling as rapidly as it fell in the years with a negative trend. Thus it can be said that CF had an adverse impact on the poverty level and on raising the inequality. [This is analyzed in Chapter 7]

3.3 PAKISTAN:

3.3.1 THE ECONOMIC OVERVIEW

Pakistan's macroeconomic indicators have significantly improved over the last three years. The fiscal deficit has declined, inflation is low, exports have started to grow, the balance-of-payments deficit has declined and foreign exchange reserves are increasing. However, these gains need to be consolidated by continuing the ongoing structural adjustment and stabilization programs with a view to attaining long-run sustained growth and reduction in poverty levels. However, despite the improvement in the economic fundamentals and successful implementation of the International Monetary Fund (IMF) program, the investment rate has continued to decline, as has foreign private investment. Consequently during fiscal year (FY) 1999 to FY2001, economic growth has failed to recover. The average growth rate of gross domestic product (GDP) was constrained to 3.5 percent per year, with agriculture and manufacturing sectors expanding at 1.8 percent and 4.2 percent per year, respectively.

InFY2001, agriculture has suffered, mainly because of drought, but the manufacturing sector has tended to revive on the basis of improved export performance. Real per capita income increased marginally, but in dollar terms it declined because of the sharp depreciation in the Pakistan rupee.

Pakistan' s labor force is growing at a rate of 2.4 percent, while employment is growing much more slowly, and as many as 1.5 million people were added to the ranks of the unemployed in 1998-2001. Declining economic growth, shrinking public sector development spending, and increasing unemployment have led to widespread poverty. While data on the current incidence of poverty are not available, in 1998/99 about one third of the population lived in absolute poverty, and in 1996 31 percent were below the dollar a day poverty line, while 85 percent were below two dollars a day.

Over the three-year period,(1996-97 to 2001-02) the fiscal deficit has fallen from 7.7 percent of GDP to 5.2 percent, primarily as a result of the decline in public expenditure, including defense expenditure, which has declined from 5.1 to 4.5 percent of GDP. However, development expenditure also shows a steep fall, from 3.9 percent of GDP in FY1998 to 2.7 percent in FY2001, which has implications for poverty reduction and social sector expenditures. Public revenues also declined slightly as a percentage of GDP, but the structural changes in the tax system that shift the focus onto domestic taxes from taxes on international trade, replacement of the system of variable petroleum surcharges with a fixed levy, and the restructuring of the Central Board of Revenue hold promise for increase in tax revenues in the future.

Exports, after declining sharply in FY1999, have grown by 11.0 percent and 7.4 percent in the last two years. The depreciation of the exchange rate by 18 percent in real terms over the last three years has encouraged the export-oriented sector, especially non-traditional industries. Over the three years, the trade deficit has declined from $1,867 million to $1,245 million, and the current account deficit from $1,921 million to $508 million. Because of debt rescheduling, as well as aggressive buying in the open market, the own foreign exchange reserves of the State Bank of Pakistan have increased, from $1,122 million in June 1998 to $1,688 million in June 2001, i.e., equivalent to over 7 weeks of imports of goods and services.

Total debt as a percentage of GDP increased from 100 percent in FY1998 to 115 Percent in FY2001. External debt accounted for 55.5 percent of the total debt in FY2001.Because of the large depreciation in the rupee in FY2001, the share of external debt in the total has increased sharply. As a result of debt rescheduling, the external debt servicing burden has fallen from 55.4 percent of total export earnings in FY1998 to 37.4 percent in FY2001. Public debt service as a proportion of tax revenue also declined from 78.4 to 68.9 percent. However, despite debt rescheduling and improved tax revenues the burden of debt is still very high. Events since the 11 September attacks in the United States have adversely impacted Pakistan's economy. Exports are badly affected because international shipping and airline companies have to carry war risk insurance and quite a few airlines have stopped their service to Pakistan, resulting in an increase in freight charges and a sharp reduction in air cargo capacity. Many orders are being canceled and obtaining new orders has become difficult. If the conflict is prolonged, export earnings may fall by as much as $1.4 billion. The planned privatization efforts and expected private investment inflows are also likely to be adversely affected. Thus the external financing gap will widen significantly. Public expenditures will have to increase because of the increased burden of refugees and higher expenditures for defense and law and order. At the same time, tax revenues will be lost because of reduced imports and the economic slowdown. Thus, Pakistan will have difficulty meeting the previous target of fiscal deficit set at 4.9 percent of GDP. The growth rate of GDP may fall

to 3.0 percent, with attendant consequences for employment generation and poverty reduction.

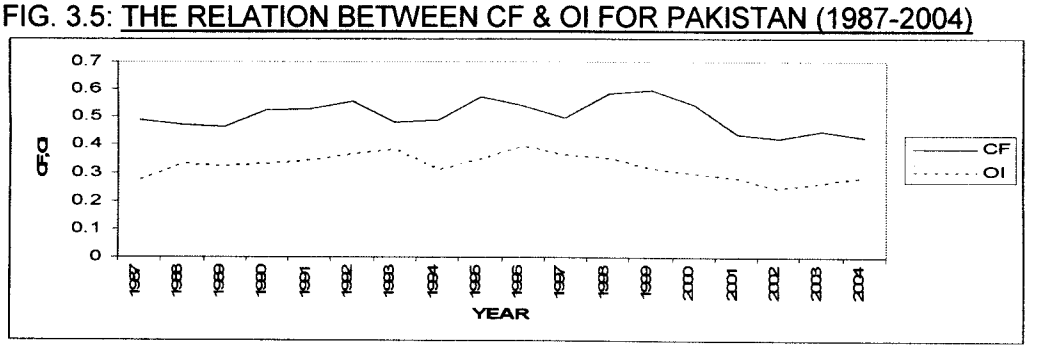
The short-run impact may be recouped over the medium term. By FY2004, the investment rate will likely rise to 16.8 percent of GDP, and the economic growth rate will increase to 5.2 percent. The fiscal deficit is expected to continue to fall, and is projected to be 3.2 percent of GDP in FY2004. Exports are projected to increase more rapidly than imports, resulting in a declining trade deficit. There will also be a significant improvement on the current account of the balance of payments. Net public debt as a proportion of GDP is expected to decline by almost 10 percentage points, to 82.4 percent of GDP. During this three year period, the process of restructuring is expected to be completed and the basis for high, sustainable economic growth and accelerated poverty reduction to have been established.

3.3.2 ESTIMATE OF CAPITAL FLIGHT FROM PAKISTAN (1987-2004)

TABLE: 3.2 CF & OI FOR PAKISTAN

YEAR	CF	OI=TRADE/GNI
1987	0.490210729	0.274676724
1988	0.472277715	0.328926418
1989	0.466657433	0.322223046
1990	0.526945502	0.328887175
1991	0.527887854	0.343087154
1992	0.555581825	0.364376329
1993	0.481862169	0.383072272
1994	0.490469702	0.310747419
1995	0.571368934	0.346496306
1996	0.540932061	0.395465081
1997	0.497870943	0.361594761
1998	0.584274224	0.349526405
1999	0.595903724	0.315700939
2000	0.546163754	0.294170238
2001	0.438129231	0.278180883
2002	0.422185029	0.242394896
2003	0.448371613	0.261316896
2004	0.426747613	0.282438474

FIG. 3.5: THE RELATION BETWEEN CF & OI FOR PAKISTAN (1987-2004)



The capital Flight data for Pakistan shows an upward rising trend over the years. Just after 2000-01 the magnitude of CF begun to reduce as form that time fiscal deficit showed a declining trend after adopting some economic reform and structural adjustment measures. The magnitude of CF was severe when it is seen as a proportion of GNI (measured in $).

3.3.3: Regression Analysis: CF versus OI (PAKISTAN)

The Statistical analysis is shown below:

The Polynomial regression equation is

log (CF) = -3.99450 - 21.4936 log (OI) - 40.2890 log (OI) **2 - 24.2450 log (OI) **3

S = 0.0373182 R-Sq = 46.6 % R-Sq(adj) = 35.1 %

Analysis of Variance

Source	DF	SS	MS	F	P
Regression	3	0.0169944	0.0056648	4.06765	0.028
Error	14	0.0194970	0.0013926		
Total	17	0.0364914			

Source	DF	Seq SS	F	P
Linear	1	0.0139096	9.85545	0.006
Quadratic	1	0.0025737	1.92947	0.185
Cubic	1	0.0005111	0.36701	0.554

The Linear regression equation is

CF = 0.271 + 0.725 OI

Predictor	Coef	SE Coef	T	P
Constant	0.27137	0.08281	3.28	0.005
OI	0.7252	0.2556	2.84	0.012

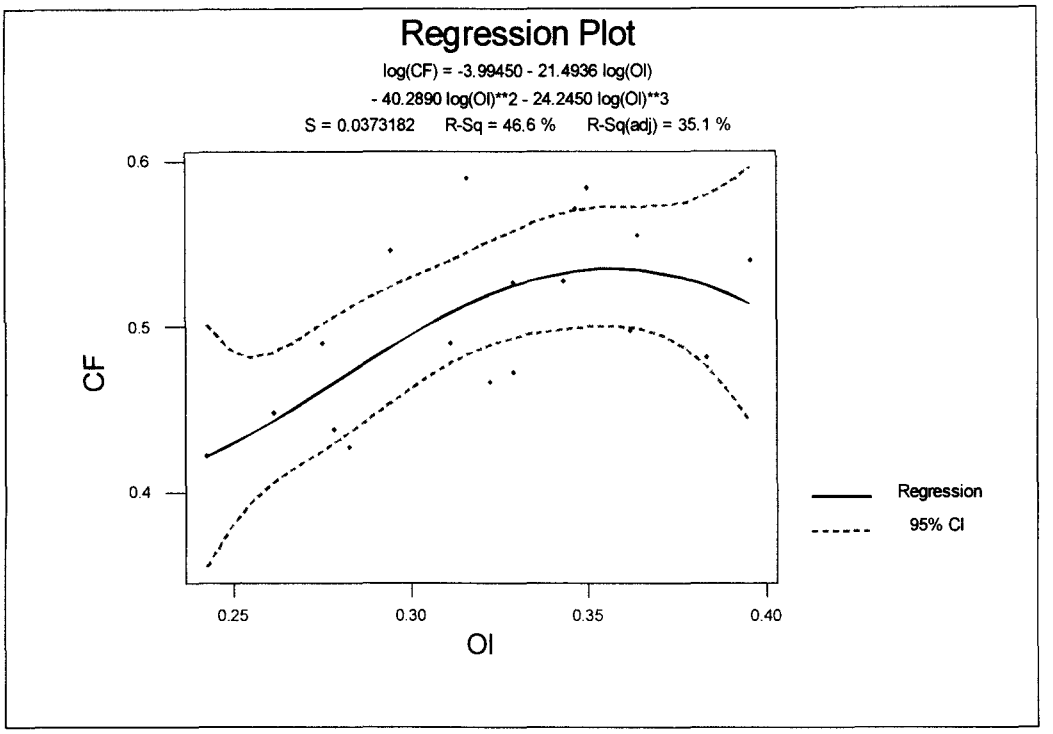
S = 0.04502 R-Sq = 33.5% R-Sq(adj) = 29.3%
PRESS = 0.040046 R-Sq(pred) = 17.83%

Analysis of Variance

Source	DF	SS	MS	F	P
Regression	1	0.016309	0.016309	8.05	0.012
Residual Error	16	0.032427	0.002027		
Total	17	0.048737			

Durbin-Watson statistic = 1.46

No evidence of lack of fit (P > 0.1)



3.4 BANGLADESH

3.4.1 *ECONOMIC OVERVIEW*

During FY2001 (ending 30 June), Bangladesh maintained robust economic growth with record low inflation despite lingering external and fiscal pressures. Successive bumper harvests and a rebounding industry sector contributed to the strong economic growth during FY2001. During the previous two years, the country succeeded in breaking the 5 percent growth barrier that persisted in the 1990s. Economic growth in Bangladesh over past two years exceeded the average of South and Southeast Asian countries. However, per capita income in Bangladesh is at the lower end among these countries, and extensive poverty continues to afflict around half of the population.

The gross domestic product (GDP) growth rate from FY2001 to FY2005 was about 6 percent on the average, close to the 5.9 percent achieved in FY2000. As in last few years, the agriculture sector accounted for 25 percent of GDP and continued to show strong performance particularly the food grain sub-sector. The industry sector grew by 8.7 percent in FY2001 compared with 6.2 percent in FY2000, due mainly to a surge in manufacturing output. The recovery in manufacturing output from prolonged recession is encouraging, given the lingering political disruption and mounting infrastructure constraints in the country. During FY2001-2005, growth in the services sector was 5.2 percent as against 5.5 percent in the previous year. In this sector, transport,

communications, financial, public administration, defense, health, and social work services recorded notable progress.

TABLE: 3.3 SECTORWISE ECONOMIC GROWTH IN BANGLADESH

Growth Rate (%)	FY1996	FY1997	FY1998	FY1999	FY2000	FY2001[a]
GDP Growth	4.6	5.4	5.2	4.9	5.9	6.0
Agriculture	3.1	6.0	3.2	4.8	7.4	5.0
Industry	7.0	5.8	8.3	4.9	6.2	8.7
Services	4.0	4.5	5.0	5.2	5.5	5.2

GDP = gross domestic product.
[a] Provisional.

Source: Bangladesh Bureau Of Statistics(2001)

Despite the strong revenue outcomes for FY2001, the budget deficit of the central Government remained high at 6.0 percent of GDP on account of a surge in expenditure. Monetary policy remained expansionary during FY2001 due to a spurt in domestic credit, notwithstanding deceleration in broad money (M2) growth to 16.6 percent in June 2001 from 18.6 percent in June 2000. Although the growth of government credit from the banking system declined, it still remained high and crowded out private sector access to credit at lower interest rates. The inflation rate, based on the consumer price index, declined from 3.4 percent in FY2000 to 1.5 percent in FY2001. A decline in food prices due to increased availability of food grains and somewhat depressed demand for nonfood items contributed to this decline. Food inflation declined from 4.1 percent in FY2000 to 0.95 percent in FY2001, while nonfood inflation remained unchanged at around 2.7 percent. Declining food prices outweighed the inflationary impact of monetary expansion. Although the relationship between broad money and inflation is complex in Bangladesh, the expansionary monetary policy may ultimately imperil price stability.

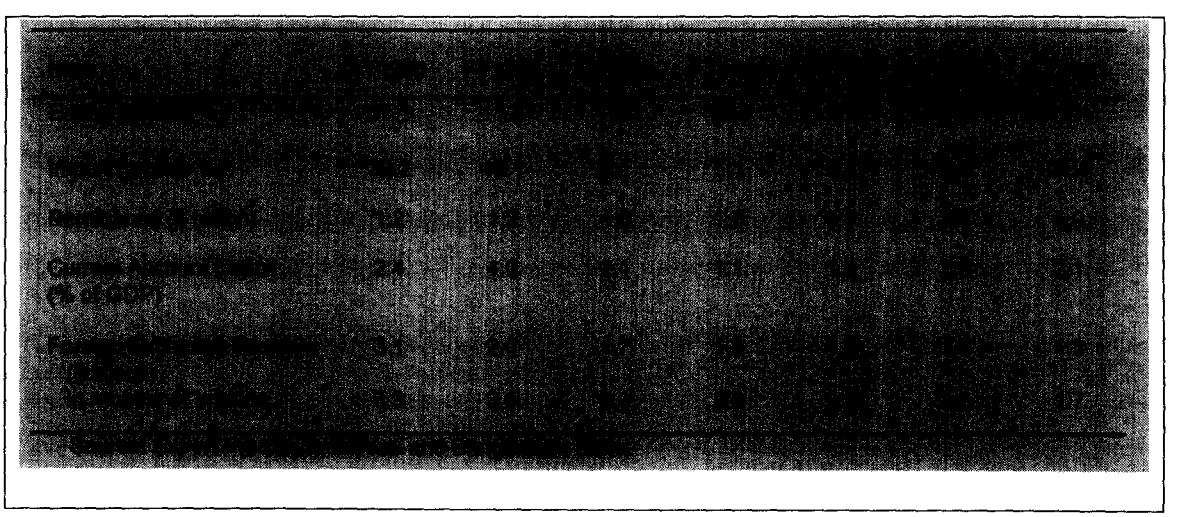
Exports grew at a rate of 12.4 percent in FY2001 compared with 8.2 percent in the previous year. However, export growth decelerated sharply as the year progressed. The export structure of Bangladesh is narrow–concentrating on ready-made garments and knitwear for around 75 percent of total exports. For maintaining a high level of exports, especially after the phase-out of the Multi Fiber Arrangement by the end of 2004, the Government needs to adopt appropriate policy measures to diversify the export base as well as markets; maintain external competitiveness; and improve infrastructure including transport, telecommunication, and port facilities. In FY2001, import growth increased to 11.4 percent from 4.8 percent in the previous year. Trade deficit increased by 9.3 percent in FY2001 over the previous fiscal year. Along with this, a decline in private current transfers including remittances created a current account deficit of $1,034 million (2.1 percent of GDP) compared with $441 million (1 percent of

GDP) in FY2000. Despite mild improvement in the capital account, the overall balance deteriorated, resulting in an erosion of foreign exchange reserves, which were only $1.3 billion (1.7 months' equivalent of imports) at the end of FY2001 compared with $1.6 billion (2.3 months' equivalent) at the end of FY2000.

During the 1990s, major progress was made in trade policy reforms by significant elimination of quantitative restrictions and reduction of tariff rates. However, the pace of trade liberalization witnessed in the early part of the 1990s became more gradual and moderate in the later part of the decade. Although the procompetitive effects of liberalization could bring substantial benefits to an economy, the policy stance reflected a concern for protection of domestic industries. In FY2001, the four-slab duty structure of FY2000 was kept unchanged. Duty rates on raw materials and intermediate goods were generally reduced, evidently to increase protection to value added. For supporting local industries, duty rates on certain items were raised. The average (unweighted) tariff rate stayed at around 17 percent. As in the previous fiscal year, no major trade policy changes were introduced in the FY2002 budget, and an identical rate structure and approach to rate adjustments were followed.

TABLE: 3.4: KEY BOP INDICATORS FOR BANGLADESH

Source: Export Promotion Bureau and Bangladesh Bank (2002)



Portfolio investment after recording an outflow $132 million in FY1997 following a stock market boom and bust has not returned in subsequent years. However, the Dhaka Stock Exchange's all shares price index remained steady during FY2001, recording an increase of 27.6 percent over FY2000. The capital market is still at a nascent stage, with market capitalization amounting to only $1.27 billion at the end of FY2001 compared with $1.05 billion in the corresponding period of FY2000. Investors' confidence in the stock market needs to be restored by further strengthening the regulatory framework and market infrastructure (trading, settlement, clearing, and depository systems), corporate governance of listed companies, issuers of listed securities, and other market institutions.

The slowdown in the global economy and heightened external pressures have aggravated Bangladesh's macroeconomic performance since the beginning of FY2002. In addition, the tragic incident of 11 September 2001 and subsequent developments have added further to the downside risks. The weakening external environment has considerably undermined the country's short- and medium-term prospects for economic growth and consequent poverty reduction. The decline in exports and erosion in confidence of domestic and foreign investors point to a continuing economic downturn.

Given the weakening global environment and emerging domestic developments, the GDP growth rate during FY2002 is expected to be around 4.0-4.5 percent compared with 6 percent achieved during FY2001, mainly due to mounting external pressures and lower growth in the agriculture sector. Heightened external pressures will particularly affect export-oriented manufacturing production, export trade-related services, remittances, and foreign direct investment. During FY2002, the current account deficit is likely to increase to 2.3 percent of GDP from 2.1 percent last year on the assumption of an 8 percent decline in exports, a 5 percent decline in imports, and tapering off of the recent spurt in remittances. The budget deficit is expected to remain high at 6 percent of GDP, mainly on account of shortfall in revenue collection. Over the medium term, i.e., in FY2003 and FY2004, the economic growth prospects of the country should improve, depending on recovery in the global economy, development in the external environment, and progress in the country's structural and economic reforms. Bangladesh is confronting considerable external and domestic risks over the short to medium term which could imperil macroeconomic stability, thereby seriously undermining economic growth prospects and consequent poverty reduction. If the downturn in the global economy lingers, the adverse impact on the country's real and external sectors could be severe. The overall balance of payments situation may deteriorate substantially with a rapid slide in foreign exchange reserves. There could be more severe pressures on the fiscal balance as a result of lower economic activity and reduced imports. The policy measures announced by the Government may prove inadequate to address the slippage in the external and fiscal balances.

Fiscal deficits, which remained largely contained for the greater part of the decade, began to show rising trends during the last couple of years (Figure 4). While revenue growth tapered off, public expenditure increased rapidly. The recent years have witnessed changes in the financing pattern of fiscal deficit. Over the years, the proportion of deficit financed from external resources has decreased and, correspondingly, the proportion of domestic borrowing has increased. The costly domestic borrowing has pushed up the domestic interest payment obligations of the Government. The interest payment on domestic debt as a ratio of revenue— indicating debt-servicing capacity, has been rising— reaching 13.6 percent in FY2001. Borrowing from the banking system, especially the central bank, has also been the prime cause of monetary expansion.

On the domestic front, there are considerable risks that political instability and law and order problems, as in the past few years, may continue to undermine the economic growth prospect in the country. Consensus between the ruling and opposition political parties on substantive national issues will be extremely important if the Government is to carry out much-needed critical reform measures.

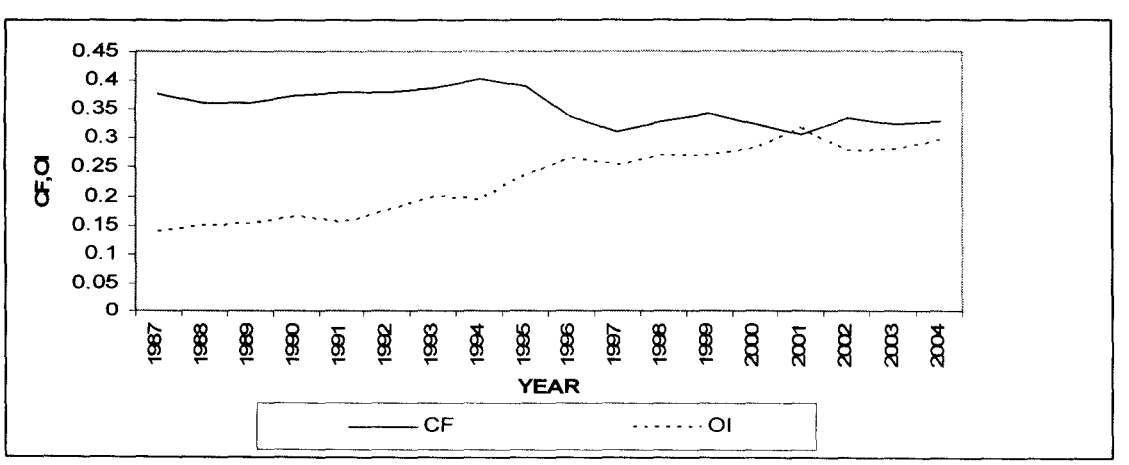
Bangladesh is confronting considerable external and domestic risks over the short to medium term that could imperil macroeconomic stability, thereby seriously undermining economic growth prospects and consequent poverty reduction. If the downturn in the global economy lingers, the adverse impact on the country's real and external sectors could be severe. The overall balance payments may deteriorate substantially with a rapid slide in foreign exchange reserves. If the foreign exchange reserves reach a critically lower level, the Government may face difficulty in servicing its external debt. There could be more severe pressures on the fiscal balance as a result of lower economic activity and reduced imports. The fall in revenue may force the Government either to borrow more from the banking system to meet both current and development spending or to cut the size of the development budget. The policy measures announced by the Government may prove inadequate to address the slippage in the external and fiscal balances. On the positive sides, the Government is discussing balance of payments support with the World Bank and the International Monetary Fund to address the emerging macroeconomic concerns. If oil prices continue to be low, oil imports payments will decline, with some respite for the balance of payments. On the domestic front, there are considerable risks that political instability and law and order problems, as in past few years, will continue to undermine economic growth prospects. A consensus between the ruling and opposition political parties on substantive national issues would be extremely important if the Government is to carry out much-needed critical reform measures.

3.4.2 ESTIMATE OF CAPITAL FLIGHT FROM BANGLADESH (1987-2004)

TABLE: 3.5 CF & OI FOR BANGLADESH

YEAR	CF	OI
1987	0.377025599	0.138939354
1988	0.361410204	0.150098415
1989	0.362040791	0.152806273
1990	0.374551404	0.164203007
1991	0.380600885	0.155264132
1992	0.379628009	0.175596774
1993	0.386612994	0.198294753
1994	0.401865383	0.193649291
1995	0.390671376	0.238514044
1996	0.338639039	0.264291992
1997	0.312482939	0.253663143
1998	0.330465646	0.269509598
1999	0.343461075	0.269999551
2000	0.323373376	0.281435262
2001	0.306436012	0.315821168
2002	0.335273157	0.276045918
2003	0.325218547	0.278664866
2004	0.329737771	0.294762063

FIG.3.6: THE RELATION BETWEEN CF & OI IN BANGLADESH (1987-2006)



The CF estimate for Bangladesh also shows a growing trend up to 1995, and then it declined slightly and continued to be a serious problem for the economy. Large amount of fiscal deficit, foreign borrowing, high rate of inflation have influenced a huge proportion of CF. This was most intense during the period 1991-95.

3.4.3: Regression Analysis: CF versus OI (BANGLADESH)

Polynomial Regression Analysis: CF versus OI (BANGLADESH

The regression equation is

```
log (CF) = -0.879824 - 0.297877 log (OI + 1.70148 log (OI) **2 +
1.69629 log (OI) **3

S = 0.0199813        R-Sq = 75.0 %        R-Sq(adj) = 69.6 %
```

Analysis of Variance

Source	DF	SS	MS	F	P
Regression	3	0.0167298	0.0055766	13.9676	0.000
Error	14	0.0055895	0.0003993		
Total	17	0.0223193			

Source	DF	Seq SS	F	P
Linear	1	0.0124045	20.0176	0.000
Quadratic	1	0.0042764	11.3768	0.004
Cubic	1	0.0000489	0.1224	0.732

The Linear regression equation is
CF = 0.440 - 0.385 OI

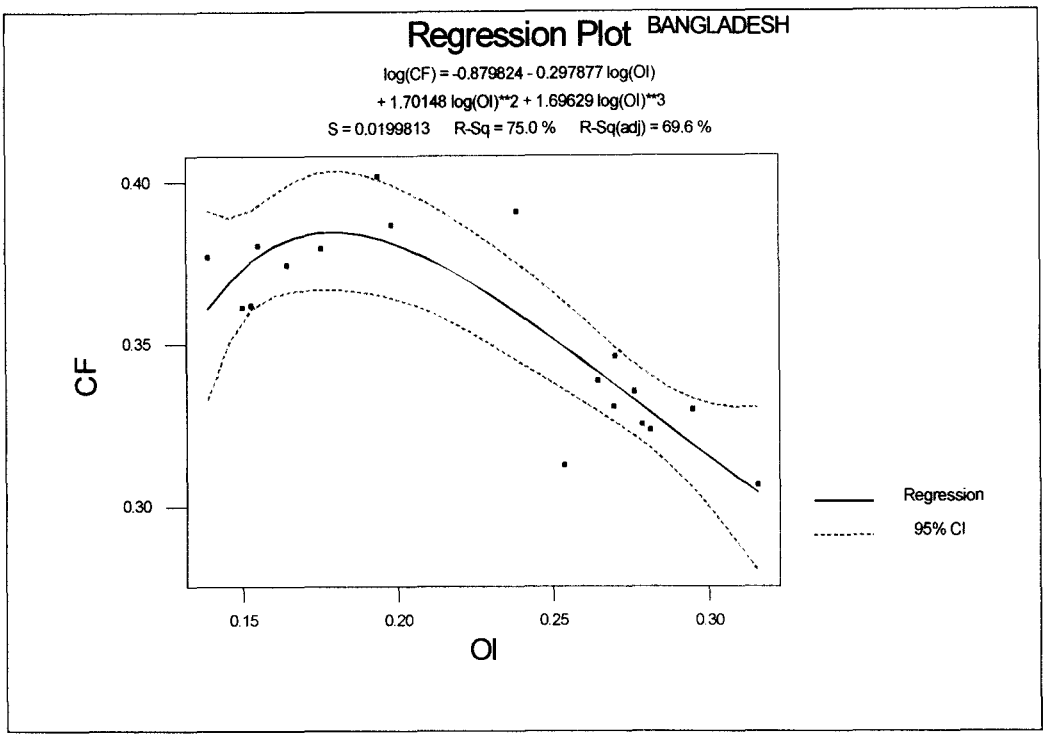
Predictor	Coef	SE Coef	T	P
Constant	0.44047	0.01842	23.91	0.000
OI	-0.38470	0.07895	-4.87	0.000

S = 0.01921 R-Sq = 59.7% R-Sq(adj) = 57.2%
PRESS = 0.007094 R-Sq(pred) = 51.66%

Analysis of Variance

Source	DF	SS	MS	F	P
Regression	1	0.0087672	0.0087672	23.75	0.000
Residual Error	16	0.0059072	0.0003692		
Total	17	0.0146744			

Durbin-Watson statistic = 0.88



3.5 NEPAL

3.5.1: *ECONOMIC OVERVIEW*

The economic performance of Nepal was exceptionally weak in FY2002, registering a negative growth rate for the first time in the past two decades. Real gross domestic product growth fell precipitously to -0.5% in 2002—the lowest in South Asia—from 4.6% in 2001. A series of domestic and external shocks, especially the continued escalation of the insurgency, irregular monsoon, and weak external demand, have exacerbated the economic downturn that began in mid–2001. Agricultural output slipped to 2.2% in 2002 due to the irregular monsoon, after strong performance in 2000 and 2001. Industry and tourism were hit hard by the insurgency and weak external demand.

After exceptional expansion of 8.7% in 2000, and for the first time since 1990, industrial growth was lower than agricultural growth, plummeting to -3.3% in 2002 after expanding to 2.7% in 2001, largely due to –10% growth in manufacturing, the sharpest contraction in two decades .Service sector growth was kept down by domestic security problems and declined by 1.4% in 2002 after expanding by 5.3% in 2001. Tourist arrivals have declined by 28%, resulting in an estimated 34% reduction in receipts from tourism.

Given the high annual population growth of 2.24%, the country faces a huge challenge of absorbing about 300,000 persons entering the labor force each year on top of the large number of the existing underemployed, estimated at 47% of

the total employed labor force. Consistent with an economy dominated by subsistence agriculture, labor force participation is high and unemployment low. The 1999 Labor Force Survey showed that about 86% of the working-age population was economically active, and unemployment less than 2%. Labor market conditions deteriorated further in 2002, given the weak performance of the agriculture sector and a sharp downturn in the service and industry sectors.

The sharp economic downturn had a major negative impact on the Government's fiscal position. While the budget deficit after grants was contained at 3.3% of GDP in 2002, down from 4.5% in 2001, it was at the expense of development expenditure, which had to be cut sharply. Despite the Government's intensified revenue collection measures, including the introduction of voluntary disclosure of income scheme and raising of special fees on imports and surcharges to income tax, domestic revenue increased only by 4.5% in 2002, down sharply from 13.2% in 2001. To contain the fiscal deficit, in 2002 development expenditure was curtailed drastically by 40% of the budgeted target. The Government was unable to cut regular expenditure due to a steep rise in security spending.

The growth of broad money (M2) decelerated sharply to 6.3% in 2002, much lower than target rates of 12–14%. An abrupt slowdown in the growth of net foreign and domestic assets prompted by income verification efforts of the tax and anti-corruption authorities as well as by the weak economy resulted in acute deceleration. Because the exchange rate is pegged to the Indian rupee, and trade is active across the relatively open border between the two countries, Nepal's inflation rate generally follows India's. Inflation stood at 2.9% in 2002, compared with 2.4% in the previous year. The decrease in nonfood prices helped counteract price increases of rice and rice products, meat, oil, and beverages.

Nepal's current account deficit widened significantly to 7.0% of GDP in 2002 from 5.4% in 2001, below the average deficit of 8.5% that prevailed during the 1990s.1 Despite an increase of 11.8% in the dollar value of net transfers mainly due to rising remittances from out-of-country workers, a steep decline of 62.5% in the dollar value of net service receipts increased the current account deficit. The trade sector was severely set back in 2002. While the trade deficit was reduced to 14.1% of GDP in 2002 from 14.7% in 2001, exports and imports declined acutely. Growth in the dollar value of merchandise exports dropped by 18.0% in 2002, continuously falling from marginal growth of 4.6% in 2001 since substantial growth of 38.0% in 2000. [1]

In response to the fiscal crisis and critical need to improve delivery of basic public services, the Government approved the Immediate Action Plan (IAP) on 3 June 2002, to prioritize and expedite reform programs in the short term, and monitor reform progress.

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1. The officially recorded remittance from abroad is known to be a significant underestimation of total actual valueThe current account could be surplus at 2.5% of GDP in 2002 if informal remittance were taken into account.

In line with the objectives of the Tenth Plan and MTEF, the IAP focuses on improving public expenditure management, delivery of basic services, and governance and accountability. A key element is to prioritize development expenditure and to drop low-priority projects. The IAP also proposes allocation of resources consistent with the Government's decentralization policy; no cuts were made in the allocation of block grants to local bodies in the 2003 budget.

Governance reform is one of the four strategies of the Tenth Plan and a key element in the Government's broad economic and structural reform program. In particular, the civil service is being made more efficient and streamlined with a pay increase for civil servants and downsizing through a voluntary early retirement scheme. The Government eliminated 7,500 unnecessary vacant positions of 17,000 in September 2002. The computerized civil service personal information system is being installed to improve accountability and transparency of the civil service. Progress was mixed in decentralization. Under the IAP, progress was made in devolving responsibility for key service areas (primary education, agriculture extension, and health service delivery) to local bodies. The Government approved the Decentralization Implementation Plan in January 2002 and charged the line ministries with its implementation.

Over the next few years, economic performance will depend on domestic security and the political scenario, the weather conditions, and the global and Indian economy. While the breakthrough announcement of a cease-fire on 29 January 2003 is a welcome development, any positive impact on the economy is likely to take time. The economy is projected to grow by 1.5% in 2003 and about 3.5% in 2004, assuming that (i) law and order will be restored in 2004 to allow private and public sector investment, (ii) global economic recovery will continue, (iii) the Indian economy will grow by about 6.0%, and (iv) the weather in Nepal and neighboring regions in India will be normal. Agricultural growth may slow to about 2% in 2003, but may recover to about 3% in 2004, depending on the weather and security. This reflects a large cut in the 2003 development budget for agriculture. The irregular monsoon in July-August 2002 adversely affected the production of summer crops such as paddy, maize, and vegetables. Industry is likely to grow by 0.2% in 2003 and may recover to 3.5% in 2004.

However, its recovery will be determined by export growth and domestic political stability. A major upturn in the service sector is unlikely unless the cease-fire leads to significant improvement in security and the political environment. The service sector's growth rate is expected at 0% for FY2003, but 3.5% for FY2004, which is lower than the 6-7% during 1990s, assuming that tourism and trade recover.

Monetary policy is geared to supporting the exchange rate peg with the Indian rupee. Given the projections for real growth and inflation, targets for broad money growth need to be in the range of 12–14% in the medium term. This will

support the central bank's efforts to control inflation and maintain the exchange rate peg to the Indian rupee. Government securities market should be developed to break the link between budget deficits and monetary expansion.

The Government's overdraft with the central bank needs to be kept within prudent limits. The current account deficit may rise to as high as 7%, as the dollar value of net transfers continues to increase. While economic recovery in the Nepal's major export markets such as India, the United States (US) and European Union offers some prospects, domestic security problems continue to be a challenge. India has enjoyed impressive growth of 39% during the past five years and largely benefited from the bilateral trade treaty, which allows Nepal essentially free access to the Indian market. However, export growth is now being adversely affected by non-tariff barriers imposed under the renewed bilateral trade treaty signed in March 2002. Garment exports have rebounded in FY2003 to some extent by US's initiative in providing duty- and quota-free access to Nepali garments until 2005. However, other items remain depressed. Exports of Carpets and Pashmina shawls have declined sharply and export prospects are uncertain due to uneven quality and marketing, and intensified competition with other low-cost producers.

Addressing the root causes of the insurgency—persistent rural poverty and failure to spread the fruits of development more widely, particularly in rural areas—is a prerequisite for effective development. The Government must pursue reconciliation, rehabilitation and reconstruction measures through (i) rural development, especially in conflict-ridden and impoverished areas; (ii) improvements in basic social services and infrastructure; (iii) empowerment of disadvantaged groups, including women; and (iv) governance and fiscal reform in the public sector.

Given the Government's fiscal problems, drastic public resource management reform is needed to ensure the macroeconomic stability and effective use of limited public resources. Major improvements are needed in budget planning, domestic and external resource management, and expenditure management. Development expenditures based on the Tenth Plan should be prioritized to raise the efficiency of public sector investments. As most of the poor depend on agriculture for their livelihood, the Government's continued commitment to improve the performance of agriculture within the framework of the Agriculture Perspective Plan is also important. Improved governance in the public sector will be critical to make development most effective. Civil service reform, which aims to improve efficiency, predictability, transparency, and accountability, is critical to deliver public service effectively and keep recurrent expenditure in check.

Financial sector reform needs to be accelerated to increase the country's savings rate and funnel the funds efficiently into productive investments. While difficult in the short- term, continued efforts are needed to mobilize domestic resources and reduce the fiscal deficit to lessen dependence on foreign assistance for

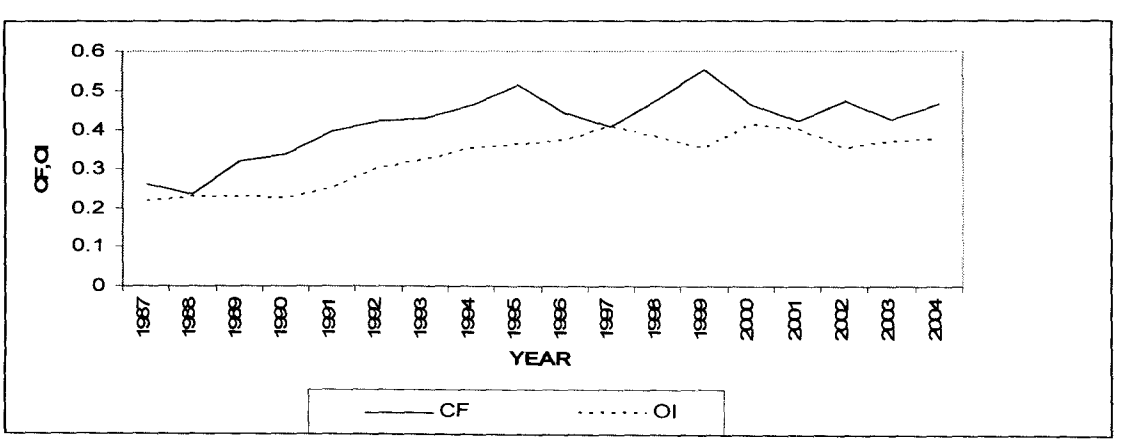
development expenditures over the medium-term. Private sector development and alternative basic service delivery mechanisms through decentralization and involvement of community-based organizations/NGOs should also be listed as part of important reform measures.

3.5.2 *ESTIMATES OF CAPITAL FLIGHT FOR NEPAL*

TABLE 3.6: CF & OI FOR NEPAL (1987-2004)

YEAR	CF	OI
1987	0.259716452	0.216653603
1988	0.233477768	0.229160827
1989	0.317607649	0.226275684
1990	0.334489626	0.222885619
1991	0.397556434	0.249875527
1992	0.422950188	0.299909986
1993	0.430242814	0.323410664
1994	0.462286404	0.348851749
1995	0.514278811	0.363039751
1996	0.444073306	0.373635035
1997	0.410174865	0.407433383
1998	0.478698938	0.379691726
1999	0.552253645	0.349093413
2000	0.466851746	0.410326734
2001	0.423208023	0.400901755
2002	0.472234357	0.349923252
2003	0.427009937	0.368934261
2004	0.465894065	0.372900563

FIG. 3.7: RELATION BETWEEN CF & OI FOR NEPAL (1987-2004)



For Nepal we have a highly positive correlation between CF & OI. The amount of CF remained very high throughout the period. Several macroeconomic maladjustments and political unrest was responsible for this

as discussed in the brief economic history of the country. Here trade becomes a means of transporting capital away from the country through various loopholes of economic policy. The statistical analysis confirms this comment.

3.5.3: Regression Analysis: CF versus OI (INDIA)

Polynomial Regression Analysis: CF versus OI (NEPAL)

The regression equation is
log(CF) = -3.03310 - 13.9643 log(OI) - 22.3203 log(OI)**2 - 10.3710 log(OI)**3

S = 0.0483767 R-Sq = 80.2 % R-Sq(adj) = 75.9 %

Analysis of Variance

Source	DF	SS	MS	F	P
Regression	3	0.132591	0.0441968	18.8851	0.000
Error	14	0.032764	0.0023403		
Total	17	0.165355			

Source	DF	Seq SS	F	P
Linear	1	0.109206	31.1189	0.000
Quadratic	1	0.023072	10.4625	0.006
Cubic	1	0.000313	0.1338	0.720

The Linear regression equation is

CF = 0.107 + 0.950 OI

Predictor	Coef	SE Coef	T	P
Constant	0.10675	0.06445	1.66	0.117
OI	0.9500	0.1932	4.92	0.000

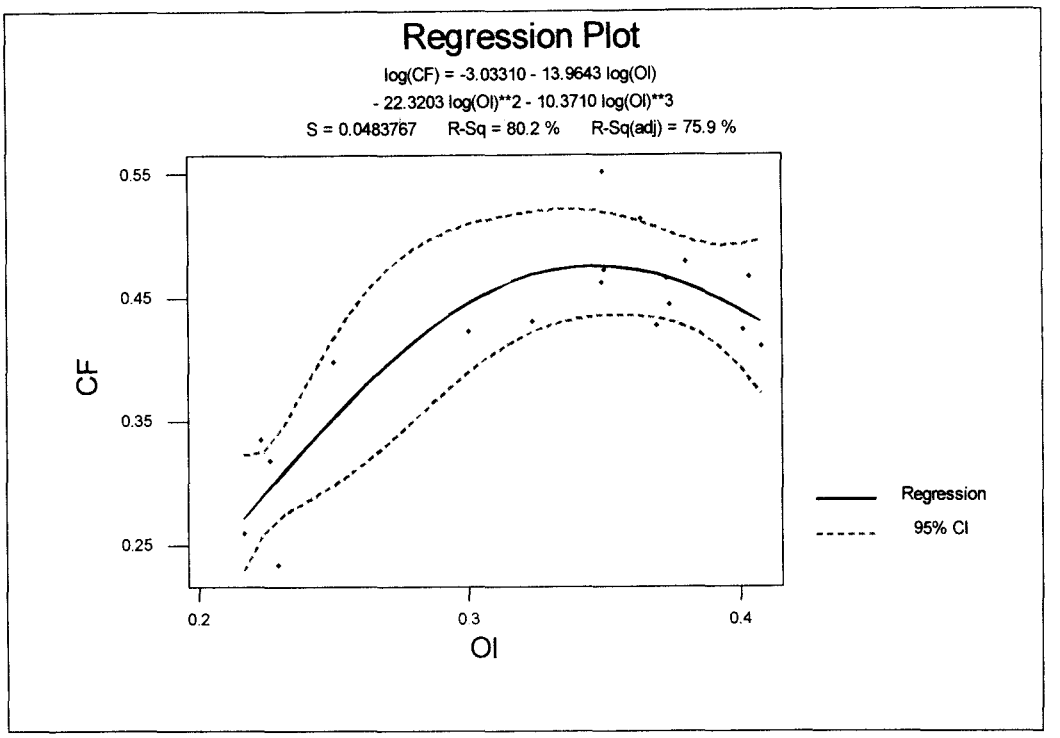
S = 0.05423 R-Sq = 60.2% R-Sq(adj) = 57.7%
PRESS = 0.060646 R-Sq(pred) = 48.67%

Analysis of Variance

Source	DF	SS	MS	F	P
Regression	1	0.071100	0.071100	24.18	0.000
Residual Error	16	0.047050	0.002941		
Total	17	0.118151			

Durbin-Watson statistic = 1.67

Fitted Line Plot: CF versus OI (NEPAL)



3.6: BHUTAN

3.6.1 *ECONOMIC OVERVIEW*

During the past 5 years, Bhutan's real average gross domestic product (GDP) grew by 6.7% per annum. In this period, the agriculture sector grew by 3.7% per annum, industry sector by 9.6%, and services sector by 7.2%. In recent years, the main drivers of GDP growth have been the hydroelectric power, construction, and transport sectors. The hydroelectric sector accounts for some 12% of GDP and 45% of the Government revenues.

The average per annum savings rate over the past 5 years is 17% of GDP, whereas gross domestic investment rate is 42%. Tax revenues, which have exhibited an average annual growth rate of 19%, have not shown corresponding buoyancy. Direct tax collections during 2002 recorded a 7% growth over the previous year and accounted for 61% of tax revenues and 32% of total revenues. The overall budget deficit rose from 3.9% of GDP in FY2000 to 11.1% of GDP in FY2002, before declining to 5.5% of GDP in the following year. As measured by the consumer price index, inflation continued to decline, falling to 2.3% in December 2002 from 2.7% at the end of June 2002. This is the lowest inflation rate in the past 3 years. To enhance the domestic revenue base, effective 1 January 2002, the Government instituted the personal income tax (PIT) applicable on six sources of income.

Over the past 5 years, Bhutan's trade balance has been negative. The composition of Bhutan's merchandise trade shows that India remains its largest trading partner accounting, on average, for some 90% of Bhutan's exports and about 70% of imports. Power exports are the largest export item to India. Bhutan's stock of external debt outstanding increased by 23.2% to $292 million at the end of FY2002. Corresponding to the growth in total debt, the ratio of outstanding debt to GDP rose to 55% in FY2002, while the debt service ratio rose to 5%.

According to Government estimates, over 60% of the soft loans (both convertible currency and rupee) were disbursed to the power sector, while another 25% were shared by the agriculture, education and industry sectors. As of June 2002, India had provided most soft loans to Bhutan, with cumulative gross disbursements totaling $216 million primarily for the development of the hydropower sector.
During FY2002, growth in commercial bank deposits with the Royal Monetary Authority (RMA) led to an increase in reserve money by 27.9%. Thus, managing excess liquidity remains a key financial sector challenge. Fortuitously, the exchange rate policy—which pegs the ngultrum at par with the Indian rupee—and capital controls ensure that excess liquidity does not act as a destabilizing factor for balance of payments, price stability, and monetary policy. RMA has taken steps to reduce excess liquidity by issuing RMA bills and raising the cash reserve ratio. Nonetheless, as of June 2002, commercial banks were holding excess reserves with RMA equivalent to about 40% of their assets.

The cost of financial intermediation in Bhutan appears high, given the prevailing 4-6% spread between the lending and deposit rates (Royal Monetary Authority Annual Report 2001/02, December 2002). At the same time, the financial system has excess liquidity and the banking system continues to hold some 40% of its assets in non-interest earning deposits with RMA. The high intermediation costs and continued excess liquidity (also reflected in the proportion of non-performing loans, which at end-2002 was some 10%) reflect inefficiencies of the banking system, which are further exacerbated by the lack of competition. The high lending rates and collateral requirements, generally around three times the amount of financing being sought, act as effective barriers for the private sector to access credit from financial institutions.

With a labor force participation rate of 56.5%, the Government estimates the overall open unemployment rate at 1.9% compared with 1.4% in 1998. Within the Ninth five-Year Plan (NFYP), the Government prepared a Human Resource Development (HRD) Master Plan for Private and Corporate Sectors and assigned 50% of NYFP's HRD allocation for implementing this master plan. To make private sector employment more attractive, the Government drafted labor laws that will be presented to the National Assembly for approval. In addition, an Apprenticeship Act was drafted whereby the Government and the private sector, on a 50:50 cost-sharing basis, will train new entrants in the labor market.

In 2002, effective measures were undertaken to deepen the decentralization process. District and village development committees were vested with greater administrative and financial powers, including the authority to retain and spend rural taxes for local development. During the implementation of the NFYP, the

Government plans to maintain the pro-poor focus of its development objectives. The primary school gross enrollment rate increased from 67% in 1990 to 72% in 2000. Although health care coverage is high—90%—the Government plans to improve delivery of health services. Inflows of external assistance as grants and concessional loans are the primary source of financing for capital expenditures.

Given growing pressures on global official development assistance, the quantum of external assistance available to Bhutan may possibly decline in the future. Should this happen, the Government may have to increasingly rely on domestic borrowings or adjust the scope of the NFYP. The NFYP explicitly acknowledges that the private sector will be the engine of growth and prime source of employment. To promote private sector development, a number of incentives were announced as part of the national budget for 2002/03. They included time based tax holidays and incentives for establishing businesses in rural areas.

Private sector representatives have submitted to the Government recommendations for boosting private sector activity in the country. Almost all pertain to the need for reform of financial institutions existing policies and practices for extending credit to the private sector. Foreign exchange revenues of $10.5 million from the tourism sector reached their peak value in FY2000. Thereafter, they have been reflecting a declining trend and were $9million for FY2002. In the NFYP, the Government's objective is to increase tourist arrivals to 15,000 per year by 2007.

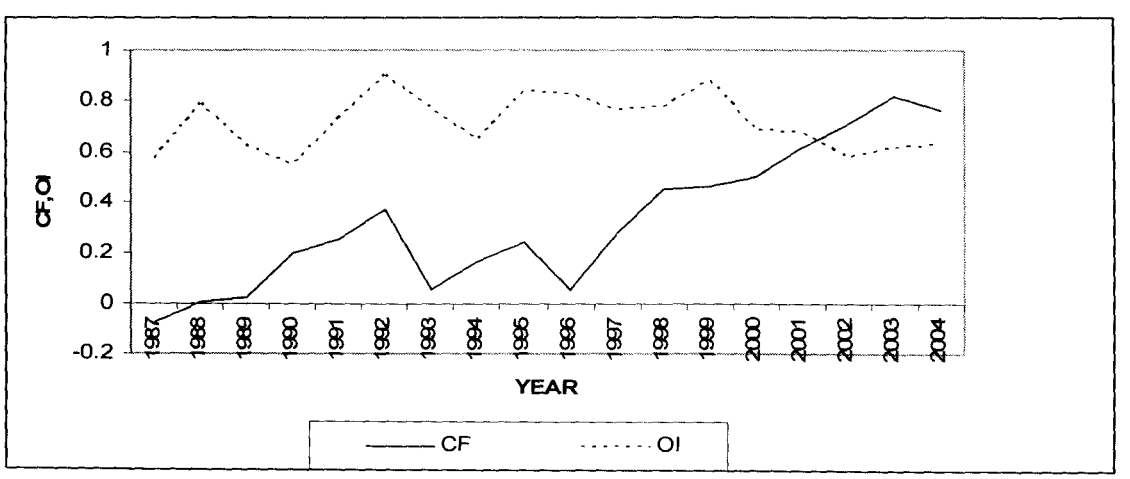
Over the past years, domestic resources financed only 15% of the average annual development budget, making Bhutan highly dependent on external assistance to fund its development programs and initiatives. The Bhutanese economy is overly dependent on hydropower (accounting for 11% of GDP in 2003), whose exports account for some 45% of Government revenues. While this is not likely to change in the near term, given the high capital intensity and low employment elasticity of this sector, alternative sources of employment and income generation would have to be explored to reduce the incidence of poverty, increase per capita incomes, and reduce the economy's current high dependence on the one-country-one export-commodity framework.

3.6.2: ***ESTIMATE OF FAPITAL FLIGHT***

TABLE 3.7: CF & OI FOR BHUTAN (1987-2004)

YEAR	CF	OI
1987	-0.073051607	0.574283395
1988	0.007293401	0.788851209
1989	0.026272655	0.622841512
1990	0.201520313	0.549772395
1991	0.253574832	0.734370856
1992	0.371766272	0.899519573
1993	0.061289277	0.773061917
1994	0.167899764	0.647326032
1995	0.243424196	0.837988157
1996	0.058883216	0.825693699
1997	0.277459946	0.768487063
1998	0.454590395	0.777671198
1999	0.463140356	0.881891399
2000	0.501411468	0.689199225
2001	0.616084224	0.679342757
2002	0.710899464	0.580365116
2003	0.819007639	0.618131319
2004	0.768635182	0.628576216

FIG.3.8: RELATION BETWEEN CF & OI FOR BHUTAN (1987-2004)



Bhutan shows somehow irregular trend regarding the correlation between CF & OI over the period. From 1998 onwards there was a high burden of capital flight in Bhutan. Negative trade balance, high rate of domestic inflation, huge current account deficit and excessive dependence on foreign capital are the primary cause of such severe capital flight.

3.6.3: Regression Analysis: CF versus OI (INDIA)

Polynomial Regression Analysis: CF versus OI

The regression equation is

Log(CF) = 1.30760 + 52.5514 log(OI) + 378.258 log(OI)**2 + 791.801 log(OI)**3

S = 0.575644 R-Sq = 16.7 % R-Sq(adj) = 0.0 %

Analysis of Variance

Source	DF	SS	MS	F	P
Regression	3	0.86211	0.287369	0.867227	0.483
Error	13	4.30776	0.331366		
Total	16	5.16987			

Source	DF	Seq SS	F	P
Linear	1	0.182934	0.55024	0.470
Quadratic	1	0.087866	0.25109	0.624
Cubic	1	0.591309	1.78446	0.205

The Linear regression equation is

CF = 0.916 - 0.778 OI

Predictor	Coef	SE Coef	T	P
Constant	0.9163	0.4444	2.06	0.057
OI	-0.7782	0.6079	-1.28	0.220

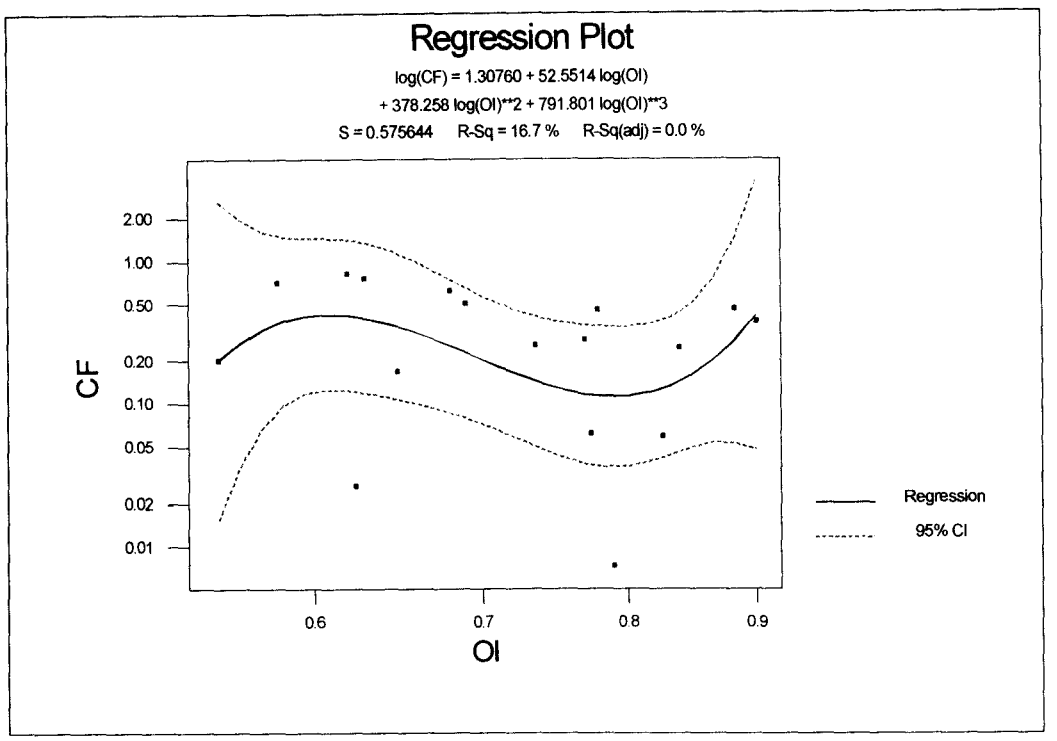
S = 0.2588 R-Sq = 9.8% R-Sq(adj) = 3.8%
PRESS = 1.32033 R-Sq(pred) = 0.00%

Analysis of Variance

Source	DF	SS	MS	F	P
Regression	1	0.10978	0.10978	1.64	0.220
Residual Error	15	1.00494	0.06700		
Total	16	1.11472			

Durbin-Watson statistic = 0.50

Fitted Line Plot: CF versus OI [BHUTAN]



3.7: SRI LANKA

3.7.1 *ECONOMIC OVERVIEW*

The Sri Lankan economy started to recover in the second half of 1999, and the recovery accelerated in 2000. Both internal factors such as weather conditions and political uncertainties, and external factors such as overall economic fluctuation in the wake of Asian financial crisis and high oil prices were key elements in determining the movement of the economy. However, another key factor that constrained the economy was the civil conflict that started in 1983 and intensified since April 2000.

In 1999, unfavorable external conditions slowed Sri Lanka's economic growth to 4.3 percent, lower than the 4.7 percent achieved in 1998; however, the economy started to recover in the second half of the year. The agriculture sector showed its highest growth since 1993. The annual growth rate of the industry sector was not high but, reflecting the recovery of industrial exports, performance in most industrial categories improved during the second half of the year.

Output in the services sector grew even more slowly because of the continued slump in the wholesale and retail trade. In the production structure, the share of

the services sector in gross domestic product (GDP) continued to increase. An increase in corporate and household savings and a reduction in Government dis-savings contributed to the higher domestic savings. While public investment remained at about the same level as in the previous year, the higher private investment led to higher domestic investment. The gap between domestic investment and domestic savings widened. Fiscal performance improved significantly despite the ongoing conflict in the north and the east. The overall deficit declined to 7.5 percent of GDP from 9.2 percent in 1998. This partially reflects the Government effort to reestablish the fiscal consolidation path achieved during 1995-1997. On the revenue side, the declining trend observed in the total revenue-GDP ratio in the recent past was arrested in 1999 with higher mobilization of tax revenue. On the expenditure side, non interest current expenditure was maintained at about the same level as in 1998, growth of the wage bill was contained at a lower rate, and expenditure on purchases of goods and services declined. In particular, defense expenditure continued to decline at 4.4 percent of GDP, compared with 5.0 percent in 1998. Capital expenditure did not reach the originally expected level owing to significant shortfalls in expenditures in several major projects in ports, agriculture, railways, and energy. The stock of Government debt as a percentage of GDP increased to 95 percent from 91 percent in the previous year.

The monetary policy continued to focus on maintaining stability in the financial market, and further efforts were made to enhance the market orientation of the instruments of monetary policy. Except for a temporary instability in the financial market in April as a result of elections and labor unrest, both the call market and the exchange market exhibited considerable stability. A slight decline in short-term market interest rates reflected a low inflation rate and flexible monetary policy. Although there were some reductions in interest rates, they were much less than the fall in inflation, resulting in an increase in real interest rates. Faster growth in domestic assets was partly offset by a decline in net foreign assets, reflecting the deficit in the balance of payments. Monetary growth was higher than in 1999.

The inflation rate of 4.7 percent was the lowest since 1985. It was the outcome of improved monetary controls and fiscal discipline, rationalized tax and tariff structures, greater agricultural production, and improved domestic marketing network and dissemination of price information systems using modern communication media. In addition, the drop in the world market prices of major imported consumer items compensated for the upward pressure on prices through the currency depreciation.
External sector developments were dominated by the lagged effects of the depressed global demand and the resultant decline in commodity prices. Exports decreased by 3.9 percent, but imports increased by 1.5 percent because of the import of three aircraft by Sri Lankan Airlines. Consequently, the trade deficit widened. The current account deficit increased from 1.4 percent of GDP in 1998 to 3.6 percent. Coupled with a declining surplus in the capital and financial

accounts, the overall balance of payments registered a deficit of 1.7 percent of GDP from a surplus of 0.2 percent in 1998. Exchange markets remained stable during the year in contrast to the high volatility in 1998. The Sri Lanka rupee depreciated by 8.2 percent against the dollar during 1999. Total external assets at the end of the year were equivalent to 4.6 months of imports of goods and services, while total official reserves were equivalent to 2.9 months of imports.

The external debt stock increased and 94.8 percent of the total was medium- and long term debts consisting mainly of concessional assistance. The total external debt-GDP ratio increased from 55.5 percent in 1998 to 57.4 percent. The debt service payments as a percentage of receipts from exports and services also increased.
During the first half of 2000, GDP grew by 7.0 percent helped by a favorable external trade environment that continued from the second half of 1999. While the high growth was broad-based, the industry sector outperformed the agriculture sector and the services sector. The inflation rate was higher than expected at 6.8 percent due to a high increase in food and energy prices. Exports continued to grow by 19.7 percent maintaining the growth momentum achieved in late 1999. The high export growth was accounted for by the strong economic growth in the United States (US) and European countries, and the recovery of the East Asian countries including Japan and the Republic of Korea. Reflecting the export-dependent import structure of Sri Lanka, imports also increased by 38.1 percent. Trade deficit was $1,139 million compared with $549 million in the same period in 1999.

In the second half of 2000, the economic trend of the first half is expected to continue. The real GDP growth rate is projected at 6.0 percent in 2000 and 4.5 percent in 2001. Exports are expected to increase by 19.8 percent, and imports by a higher rate, 22.4 percent due to higher oil prices. The ratio of the current account deficit to GDP is expected to be 6.0 percent in 2000 and 3.8 percent in 2001. High foreign direct investment, private capital flows and Government short-term capital flows will partially offset large current account deficit. The deficit in the overall balance of payments is projected to widen from 1.7 percent of GDP in 1999 to 3.4 percent in 2000. Despite continuing fiscal consolidation efforts, an increase in defense expenditure will reverse the downward budget deficit ratio to GDP. The ratio is expected to reach 8.7 percent in 2000, and only a small improvement is expected in 2001. Inflation will return to a higher level of 6-8 percent.

For sustainable and high economic growth, the Government needs to take the initiative in various areas. A consensus has emerged that a solution to the civil conflict which is estimated to lower GDP by 6 percentage points is a prerequisite to improve economic growth and poverty profiles. Mitigating the high fiscal deficit and public debt is imperative for flexible implementation of both fiscal and monetary policies. The Government must promote the private sector to meet the economy's expanding resource requirements while developing the appropriate

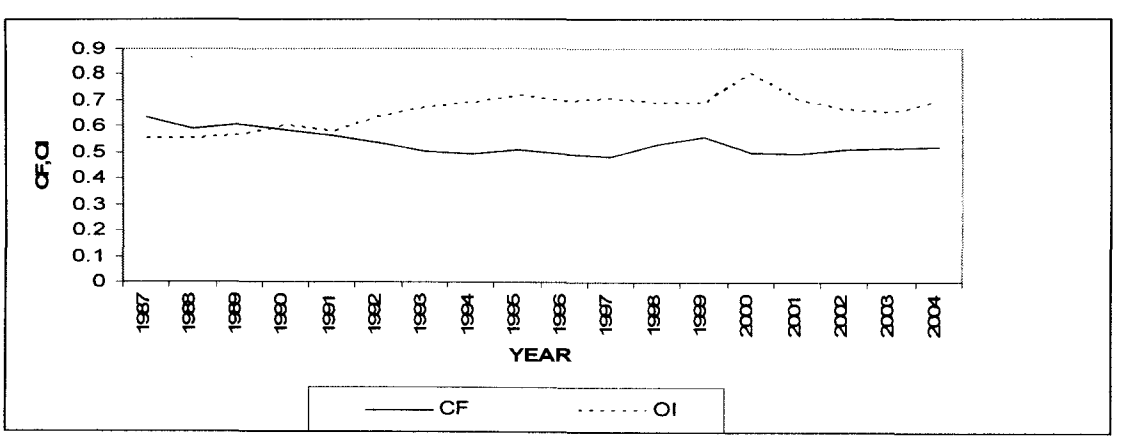
market environment to promote efficiency. More efforts for generating demand should be made in the agriculture sector, an important foreign exchange-earning sector. To link highly developed human capital to high economic welfare, a more flexible labor market and narrowing down the gap between skills demanded and skills supplied are required.

3.7.2: ESTIMATE OF CAPITAL FLIGHT FOR SRI LANKA

TABLE 3. 8: CF & OI FOR SRI LANKA (1987-2004)

YEAR	CF	OI
1987	0.633487865	0.555015522
1988	0.592615564	0.553788273
1989	0.608276374	0.562504284
1990	0.583708283	0.601202889
1991	0.565196479	0.579572981
1992	0.535649514	0.631730894
1993	0.503022286	0.672868015
1994	0.492015218	0.690095333
1995	0.510754754	0.713125859
1996	0.494984928	0.696232547
1997	0.481393725	0.703424124
1998	0.529710647	0.688437767
1999	0.557213234	0.687404198
2000	0.500143101	0.801024496
2001	0.490907027	0.697153134
2002	0.507315406	0.663537904
2003	0.516520377	0.653108692
2004	0.523099782	0.693029884

FIG.3.9. RELATION BETWEEN CF & OI FOR SRILANKA (1987-2004)



Throughout the estimated period the proportion of CF was very high. For Sri Lanka trade remained a major component of GNI and we have a very significant relation between CF and OI. The statistical table shows the estimated result.

3.7.3: Regression Analysis: CF versus OI (INDIA)

Polynomial Regression Analysis: CF versus OI (SRI LANKA)

The regression equation is
log(CF) = -0.178382 + 2.32311 log(OI) + 12.3219 log(OI)**2 + 14.7694 log(OI)**3

S = 0.0169903 R-Sq = 81.3 % R-Sq(adj) = 77.3 %

Analysis of Variance

Source	DF	SS	MS	F	P
Regression	3	0.0176200	0.0058733	20.3463	0.000
Error	14	0.0040414	0.0002887		
Total	17	0.0216614			

Source	DF	Seq SS	F	P
Linear	1	0.0158814	43.9623	0.000
Quadratic	1	0.0017119	6.3120	0.024
Cubic	1	0.0000268	0.0927	0.765

TheLinear regression equation is

CF = 0.914 - 0.577 OI

Predictor	Coef	SE Coef	T	P
Constant	0.91427	0.06186	14.78	0.000
OI	-0.57723	0.09361	-6.17	0.000

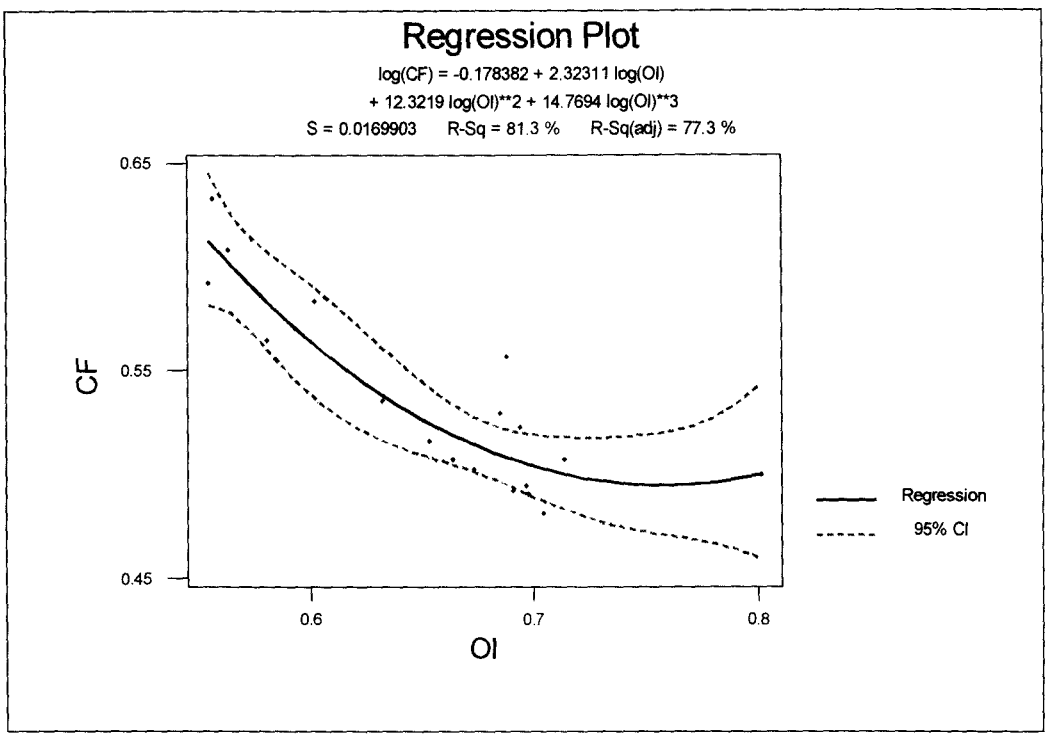
S = 0.02534 R-Sq = 70.4% R-Sq(adj) = 68.5%
PRESS = 0.015256 R-Sq(pred) = 56.03%

Analysis of Variance

Source	DF	SS	MS	F	P
Regression	1	0.024422	0.024422	38.02	0.000
Residual Error	16	0.010277	0.000642		
Total	17	0.034700			

Durbin-Watson statistic = 1.23

Fitted Line Plot: CF versus OI (SRI LANKA)



3.8: AGGREGATE ANALYSIS FOR CF AND OI FOR THE SIX COUNTRIES

Now we consider the average amount of CF and Total Trade as a proportion of GNI over the study period (1987-2004) for the six sample countries. Table 3.9 summarizes the result. It shows a highly significant relation between CF and OI . The F test is satisfied at 95% limit and the t-value also signifies the corresponding relation between the variables.

TABLE 3.9: AVERAGE PROPORTION OF CF & OI OVER THE PERIOD (1987-2004)

COUNTRY	AVG. CF	AVG. OI
INDIA	0.203	0.172
PAKISTAN	0.504	0.322
BANGLADESH	0.353	0.226
NEPAL	0.417	0.326
SRI LANKA	0.534	0.657
BHUTAN	0.398	0.605

STATISTICAL ANALYSISOF THE ABOVE DATA

1. Dependent variable: CF Method: LINEAR

Listwise Deletion of Missing Data

Multiple R	.65717
R Square	.43187
Adjusted R Square	.28984
Standard Error	.09976

Analysis of Variance:

	DF	Sum of Squares	Mean Square
Regression	1	0 .03026113	0.03026113
Residuals	4	0.03980837	0 .00995209

F = 3.04068 Signif F = .1562

Variables in the Equation -

Variable	B	SE B	Beta	T	Sig. T
OI	0.388511	222801	657170	1.744	0.1562
(Constant)	0.252053	0.094889		2.656	0 .0566

–

2 .Dependent variable: CF Method: QUADRATIC

List wise Deletion of Missing Data

Multiple R	.82912
R Square	.68743
Adjusted R Square	.47906
Standard Error	.08544

Analysis of Variance:

	DF	Sum of Squares	Mean Square
Regression	2	.04816819	.02408410
Residuals	3	.02190131	.00730044

F = 3.29899 Signif F = .174

Variables in the Equation -

Variable	B	SE B	Beta	T	Sig T
OI	2.694703	1.484821	4.558118	1.815	.1672
OI**2	-2.702682	1.725668	-3.933567	-1.566	.2153
(Constant)	-0.144844	0.266132		-0.544	0.6241

–

3. Dependent variable: CF Method: CUBIC

Listwise Deletion of Missing Data

Multiple R	.97124
R Square	.94332
Adjusted R Square	.85829
Standard Error .	04456

Analysis of Variance:

	DF	Sum of Squares	Mean Square
Regression	3	.06609768	.02203256
Residuals	2	.00397182	.00198591

F = 11.09443 Signif. F = .0838

Variables in the Equation --

Variable	B	SE B	Beta	T	Sig T
OI	13.109456	3.551592	22.174779	3.691	0.0662
OI**2	-32.933859	0.101409	-47.932961	-3.260	0 .0826
OI**3	25.916841	8.625379	26.630062	3.005	0 .0952
(Constant)	-1.214854	0.382205		-3.179	0 .0864

If we consider the primary determinants of CF for these sample countries formally it is seen that, CF is directly related to risk-averse behavior of the private individual that diversifies the wealth for maximizing asset returns. In this way he holds a part of his asset in abroad by the process of portfolio diversification. The main determinants of CF are:

1. Macroeconomic instability,
2. Political instability,
3. Rate of return differential,
4. Public policy uncertainty.

The portfolio decision of the private individual is directly influenced by these key determinants. The economic review of the sample countries also supports this. Among these the macroeconomic instability and political unrest plays the most significant part in determining the amount of CF. There are a number of other factors which essentially influenced CF, like the amount of capital inflow, the stock of capital flight, domestic rate of inflation, the growth rate of GNI, trading relation with the foreign countries, the size of external debt, etc. The individual and joint impact of these factors needs a rigorous study. In this paper we only estimated the amount of CF and showed some indication on which the amount of CF is depending upon. On the whole the figures of CF shows that there may be potentially large resources available for development financing if countries are able to conduct policies that contribute to the reversal of CF.