to stronger domestic demand that would be offset by even higher imports—and as a result only limited additional GDP growth. Inflationary pressures and a tendency for flexible exchange rates to appreciate would accentuate, while current account balances could be expected to improve. For oil importers the effects would be more complex. To the extent that they benefit from additional leakages in the form of exports and FDI, their growth rates might actually pick up, even as government deficits and current account balances deteriorate. In the case of weaker oil prices, domestic demand among oil exporters would weaken, but the GDP impact would be less severe because import demand would also likely weaken. Lower oil prices would result in reduced government and foreign currency revenues, resulting in deterioration in both government and current account balances.

The possibility of increased political tension is a further risk for the region. Events in Lebanon illustrate how serious an economic impact even a short-lived conflict can have. Even an increase in uncertainty can generate significant global impacts if it affects financial market confidence, interest rates, and investment intentions.

On the positive side, a number of countries in the region have made substantial efforts at reforms: Egypt, Tunisia, and among oil-exporting countries, Algeria and Oman. A number are enjoying the benefits in the form of increasing FDI, more vibrant private sector activity, and broader reductions in the "cost of doing business." And to the extent that oil-financed government investment projects succeed in improving potential supply, these too could have long-term benefits.

South Asia regional prospects

Recent developments

GDP for the region is estimated to have expanded at a very rapid 8.2 percent pace in 2006, marking the fourth consecutive year that regional GDP has advanced by more than 7.5 percent (table A.10). A group of factors have contributed to this trend, including progress in promoting private sector–led growth, improved macro management, and greater integration. Loose monetary and fiscal policies and strong remittance inflows also played a role, providing a boost to domestic demand, while the reimposition of restrictions on Chinese exports of textiles and clothing, combined with strong external demand, kept export growth strong. Throughout much of the region, supply was unable to keep up with demand, resulting in rising inflation and rapidly growing imports. As a result, despite very strong export growth, net exports actually reduced GDP growth by 1.7 percentage points. Growth in some of the smaller countries of the region has been supported by strong remittance inflows as well as recoveries from natural disasters (including the December 2004 tsunami in Sri Lanka and the Maldives, and floods in Bangladesh).

India, the largest economy in the region, led the way with GDP expanding by an estimated 8.7 percent in 2006—backed by nonagricultural growth in excess of 10 percent. Very low real interest rates combined with an improved business climate and rising household savings have enabled higher investment rates, helping to sustain stronger growth. Elsewhere in the region, growth was less rapid but nevertheless robust at 6.5 percent. Output in Pakistan is estimated to have slowed from 7.8 to 6.6 percent, following a return to more normal agricultural production in the wake of a bumper harvest in 2005. In Bangladesh, growth rebounded owing to stronger remittance inflows and the waning impact on agricultural output and incomes from last year's floods, and by vibrant services and manufacturing sector output. Economic activity in Nepal slowed because of the intensified conflict, a weather- related decline in agricultural production, and a trend decline in clothing exports. In Sri Lanka growth picked up to an estimated 7 percent, thanks to a good harvest, post-tsunami recovery, and reconstruction activity (including tourism, despite increased political uncertainty). Bhutan's GDP

Table A.10 South Asia forecast summary

Annual percent change (unless otherwise indicated)

					Estimate	Forecast	
	1991–2000[a]	2003	2004	2005	2006	2007	2008
GDP at market prices (2000 US$)[b]	5.0	7.8	8.0	8.1	8.2	7.5	7.0
GDP per capita (units in US$)	3.2	6.1	6.3	6.4	6.7	5.9	5.6
PPP GDP[c]	5.6	8.0	8.1	8.2	8.3	7.5	7.1
Private consumption	3.8	6.7	6.3	8.2	7.8	7.0	6.3
Public consumption	5.1	4.6	8.4	4.4	5.3	4.2	4.2
Fixed investment	5.8	11.5	8.2	10.9	12.6	12.1	10.3
Exports, GNFS[d]	9.4	11.5	12.9	19.0	22.3	15.5	13.8
Imports, GNFS[d]	10.2	11.3	21.9	19.6	23.6	16.9	13.3
Net exports, contribution to growth	−2.4	0.4	−1.1	−1.3	−1.7	−2.2	−2.2
Current account balance/GDP (%)	−1.6	1.4	−0.8	−1.4	−2.2	−2.5	−2.5
GDP deflator (median, LCU)	8.1	4.5	7.6	6.3	8.1	7.4	6.5
Fiscal balance/GDP (%)	−7.6	−7.8	−7.2	−7.1	−7.1	−6.7	−6.1
Memo items: GDP							
South Asia, excluding India	3.9	5.1	6.1	6.9	6.5	6.6	6.4
Bangladesh	4.5	5.3	6.3	6.2	6.7	6.2	6.5
India	5.4	8.6	8.5	8.5	8.7	7.7	7.2
Pakistan	3.4	5.0	6.4	7.8	6.6	7.0	6.5

Source: World Bank.

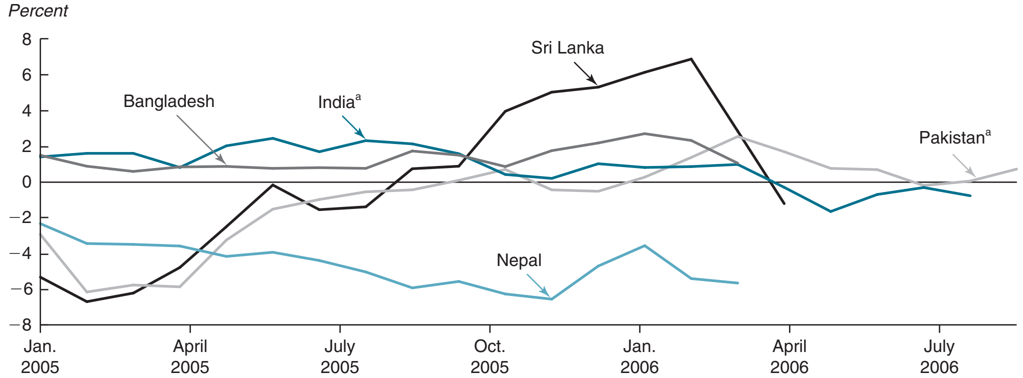
a. Growth rates over intervals are compound averages; growth contributions, ratios, and the GDP deflator are averages.
b. GDP is measured in constant 2000 U.S. dollars.
c. GDP is measured at PPP exchange rates.
d. Exports and imports of goods and nonfactor services.

growth is expected to post strong gains of 14 percent in 2006, largely as a result of capacity expansion following the coming on stream of the Tala hydroelectric plant. In the Maldives, a rebound in tourism, post-tsunami reconstruction, and new resort construction helped increase GDP by nearly 18 percent, while a drought and increased fighting are expected to slow growth in Afghanistan to a still robust 12 percent.

Despite higher nominal interest rates, rising inflation has kept real interest rates close to zero or negative (see figure A.10). This, plus strong capital inflows (predominantly in the form of portfolio investment) has led to a substantial expansion of credit throughout the region. At the same time, despite rapidly rising tax revenues, fiscal deficits remain elevated at 7.1 percent of GDP overall (about 7.5 percent in India) because of increased implicit subsidization of energy costs and major public-sector investment programs. Higher government expenditures for reconstruction tied to natural disasters has also contributed to government deficits, notably in Bangladesh, the Maldives, Pakistan, and Sri Lanka. These factors have contributed to very rapid investment growth (over 13 percent in India and 8 percent in Pakistan). Strong remittance inflows—especially among smaller countries—contributed to a 7.8 percent increase in consumer demand.

Reflecting very strong demand, inflation in the region has risen from an average of 3.8 percent in 2003 to 7.8 percent in September (and from 4.3 to 6.8 percent in India). This has occurred despite the failure of most governments to pass through much of the increase in world oil prices. In 2006, inflation was up in Bangladesh, India, and Nepal. Tighter monetary policies in Pakistan are expected to bring inflation down to about 8 percent from 9.1 percent in 2005. In Sri Lanka, inflationary pressures have reemerged since April 2006, reflecting adjustments in fuel prices and rapid money supply growth, despite increases in policy rates and open market

Figure A.10 Real interest rates remain close to zero or negative

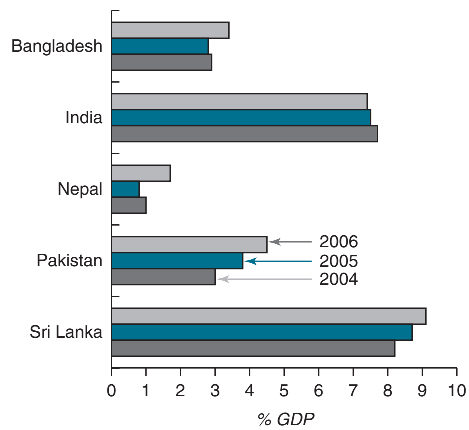


Sources: World Bank; IMF.
a. Policy rate minus CPI.

operations. In October, the annual rate of inflation (year-over-year) was 17.2 percent. Ample international and domestic liquidity has also contributed to a strong runup in asset prices, with the stock markets in India and Pakistan rising by roughly 45 percent (in both dollar and local-currency terms, as of mid-November).

The influence of excessive domestic demand was also reflected in the strength of import volumes, which are estimated to have grown by 24 percent in 2006. As a result, notwithstanding a record 22 percent increase in exports, the external sector made a −1.7 percent contribution to regional growth. These developments, in combination with further oil-price hikes, caused the regional current account deficit to deteriorate from −1.4 to −2.2 percent of GDP, despite strong remittance inflows in many of the regional economies. The largest deterioration was recorded in Sri Lanka, where the current account deficit is projected to reach about 4.9 percent of GDP in 2006 compared with 2.8 percent in 2005, owing to a sharp rise in import growth combined with weaker export growth. India and Pakistan witnessed more modest increases in their deficits. In the Maldives, a significant easing of import demand—which had spiked in 2005 because of the massive reconstruction effort—is expected to translate into a sharp reduction in the current account deficit, from about 40 percent of GDP in 2005 to an estimated 20 percent in 2006. Substantial remittance inflows and weak domestic demand are estimated to have supported Nepal's current account surplus at more than 2 percent of GDP, while in Bangladesh, remittances and strong export growth are expected to bring the current account to a surplus of nearly 1 percent of GDP. (See figure A.11.)

Figure A.11 Budget deficits



Source: World Bank.

Medium-term outlook

Real GDP in South Asia is projected to slow gradually from 8.2 percent in 2006 to a still robust 7 percent in 2008 (5.5 percent in per capita terms). Weaker external demand, reflecting slower growth in the United States in 2007 (a major trading partner for the region), tighter domestic monetary and fiscal policies, and tighter international monetary conditions are all factors contributing to the expected slowdown.

This projection assumes a modest tightening of fiscal policy over the next two years, following several years during which increased subsidy spending on heavy fuel and heating oil kept deficits elevated despite rapid growth and rising revenues. A notable exception is Pakistan where higher deficits are anticipated because of earthquake reconstruction efforts and subsidies. The stance of monetary policy in the region is also expected to tighten, and higher borrowing costs should cause investment growth (which is already anticipated to have reached its cyclical peak) to slow to single-digit rates in 2008. Overall, the initial weakening and then strengthening of export demand, in line with the slowdown and recovery projected for the United States, combined with an easing of energy prices and weaker domestic demand is projected to result in a modest deterioration in the regional current account balance in 2007, followed by a similarly small improvement in 2008.

Despite somewhat weaker prospects, domestic demand is projected to continue expanding at the same rate as—or faster than—supply. This, combined with emerging capacity constraints and the expectation that past increases in international energy prices will be gradually passed on to consumers, should preclude any significant easing of inflationary pressures.

Prospects for individual countries will be affected by weather, political developments, and earlier outturns. In India, slower investment growth in response to tighter financial conditions and weaker consumer and government consumption (as fiscal policy tightens) are expected to contribute to a moderation of GDP growth to about 7.2 percent over the forecast horizon. In Pakistan, neither fiscal nor monetary policy are likely to turn restrictive in the run up to the 2007 presidential election. As a result, GDP in Pakistan is expected to pick up in 2007, bolstered by an expansion in agricultural production and increased capacity following government infrastructure investments and private sector investments in the textile sector. Growth is expected to tail off in 2008 as more restrictive macroeconomic policies begin to restrain domestic demand.

Among the smaller regional economies, growth in Sri Lanka is projected to be sustained at current rates, supported by a number of post-tsunami infrastructure and reconstruction projects (ports, roads, buildings) and by an expected recovery in tourism. In Nepal, growth is projected to strengthen, owing to diminished political uncertainties following the recent restoration of Parliament and the cessation of fighting with insurgents. Bhutan's economic expansion is expected to remain strong, at about 12 percent in 2007, as the impacts of the Tala hydropower project continue to be felt. In the Maldives, the construction of 46 new resorts will contribute to growth of about 7 percent.

Risks and policy challenges

Governments in the region will need to strike appropriate policy stances if the projected soft landing is to be achieved. The incomplete pass-through of past energy price increases to consumers suggests that significant latent inflationary pressures remain. In the baseline scenario, a relatively aggressive policy tightening is assumed, which allows overheating tensions to dissipate smoothly. Should policy not tighten and demand continue to expand well in excess of supply, inflation outturns will be higher, current account deficits larger, and the subsequent slowdown more pronounced and disruptive. Most vulnerable are countries such as Pakistan, where the current account and fiscal deficits are large (both projected at 4 percent or more of GDP for

Table A.11 South Asia country forecasts

Annual percent change (unless otherwise indicated)

					Estimate	Forecast	
	1991–2000[a]	2003	2004	2005	2006	2007	2008
Bangladesh							
GDP at market prices (2000 US$)[b]	4.5	5.3	6.3	6.2	6.7	6.2	6.5
Current account balance/GDP (%)	−0.4	0.3	−0.4	−0.9	0.9	0.4	−0.6
India							
GDP at market prices (2000 US$)[b]	5.4	8.6	8.5	8.5	8.7	7.7	7.2
Current account balance/GDP (%)	−1.2	1.1	−0.8	−1.3	−2.2	−2.5	−2.4
Nepal							
GDP at market prices (2000 US$)[b]	4.4	3.1	3.8	2.7	1.9	3.7	4.5
Current account balance/GDP (%)	−6.3	2.1	2.9	2.2	2.4	3.9	2.9
Pakistan							
GDP at market prices (2000 US$)[b]	3.4	5.0	6.4	7.8	6.6	7.0	6.5
Current account balance/GDP (%)	−3.7	4.3	−0.8	−3.1	−3.9	−4.4	−5.3
Sri Lanka							
GDP at market prices (2000 US$)[b]	4.7	6.0	5.4	6.0	7.0	6.5	6.0
Current account balance/GDP (%)	−4.6	−0.6	−3.2	−2.8	−4.9	−4.1	−3.5

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.
a. Growth rates over intervals are compound averages; growth contributions, ratios, and the GDP deflator are averages.
b. GDP is measured in constant 2000 U.S. dollars.

2006) and hard currency reserves are relatively low (with import cover down to about 3.5 months in 2006 from over 9 months in 2003).

Higher-than-anticipated international oil prices due to a significant interruption of supply also are an important risk for the region. Higher prices would have a direct impact on inflation, the current account deficit, and the government balance because of increased government spending on fuel subsidies. At the same time, reduced exports due to slower global growth would weaken government revenues and export earnings, thereby exacerbating direct impacts on government and current account deficits. A simultaneous rise in both fiscal and current account imbalances could undermine the perceived creditworthiness of countries in the region, resulting in significantly higher interest rates that could undermine growth prospects.

Political tensions, both domestic and external, also pose risks. The simmering domestic conflict in Sri Lanka and the international tensions on Pakistan's borders generate instability and reduce confidence, acting as drags on growth, particularly of investment. An escalation of these situations—or the emergence of political conflict elsewhere in the region—could lead to a fall in output, with potentially serious consequences for the most vulnerable members of society. Externally, heightened tensions in the Middle East—the source of the majority of migrant remittances flowing to South Asia—could result in a sharp fall-off in transfer payments (in addition to the above-mentioned rise in oil prices).

Sub-Saharan Africa regional prospects

Recent developments

GDP in Sub-Saharan Africa is estimated to have increased an impressive 5.3 percent in 2006, down marginally from 5.5 percent in 2005 and marking the third year of more than 5 percent growth (table A.12). The deceleration in growth is mainly explained by a moderate slowdown in South Africa, the region's