South Asia

GNI per capita, 2000: $440

Recent developments

Gross domestic product (GDP) in the South Asia region increased by 4.3 percent in 2001, up from 4 percent growth recorded in 2000, yet well below the 5.8 percent growth of 1999. The slowdown in world trade and the regional tensions after September 11 slowed merchandise exports from the region to merely 1.1 percent growth in 2001 compared to a robust 12.3 percent posted in 2000. There was also a sharp fall in growth rates of industrial production.

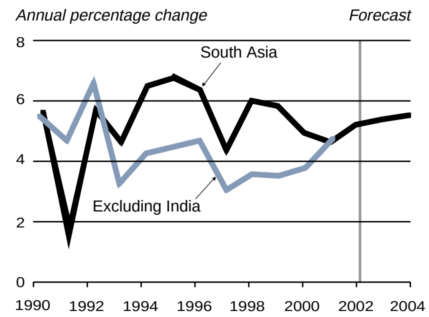
Importantly for growth, the agricultural sector recovered in the second half of 2001, after drought-induced stagnant output in the first half of 2001, with a bumper cotton crop in Pakistan and a good harvest in the Indian kharif season. Bangladesh showed around 6 percent growth in gross agricultural output (about the same growth as in recent years), reflecting government policies of encouraging the cultivation of high-yield crops. The service sector in India (50 percent of the Indian economy and about 35 percent of regional GDP), increased by almost 7 percent in 2001. Software exports from India grew 25 percent, despite the malaise in the global high-tech markets.

The external positions of major countries remained comfortable. Declines in key commodity prices (cotton prices fell by 20 percent) were balanced by the fall in oil prices, and the regional current account deficit deteriorated only marginally, to –1.3 percent of GDP compared with –0.8 percent in 2000. Pakistan, as a frontline state against terrorism, will receive ample financial support from the international community. Pakistan's reserve position improved significantly during 2001 to about three months of import coverage from a low of one month import coverage in September 2000. Also, India has substantial foreign reserves, and with the relatively closed nature of its capital market, it is unlikely to face a financing problem in the near term.

Chronically high fiscal deficits are the Achilles heel of the region and they increased across the region in 2001. There was a steep decline in tax collections as a result of lower imports and stagnant corporate incomes in the manufacturing sectors. In Pakistan, overall tax collection was more than 3 percent below target in the third quarter of 2001, while collections from customs were 12 percent below target. In India, both import duties—more than 25 percent of total tax revenues—and corporate tax revenues are projected to be 8 percent below target in 2001. It is unlikely that the Indian central government will meet its deficit target of 4.7 percent of GDP for fiscal 2001–02, as it had already reached 50 percent of the deficit target by the first quarter of the fiscal year. The consolidated public sector deficit in India remained unchanged at 10.6 percent of GDP.

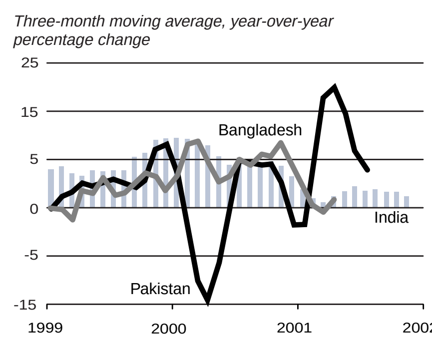
Inflation, as measured by the consumer price index, averaged 3.4 percent for the region. As in earlier years, government subsidies through the public distribution system cushioned the impact of poor crop production and higher oil prices (in the first part of the year) on consumer prices—which in turn is being reflected in a low rate of consumer inflation and growing fiscal and current account deficits. Responding to the slowdown in the economy and helped by global monetary easing and subdued domestic inflation, the Reserve Bank of India lowered the bank rate to 6.5 percent, the lowest rate since 1973. By contrast, interest rates in other countries

Gross domestic product growth rates, 1990–2004



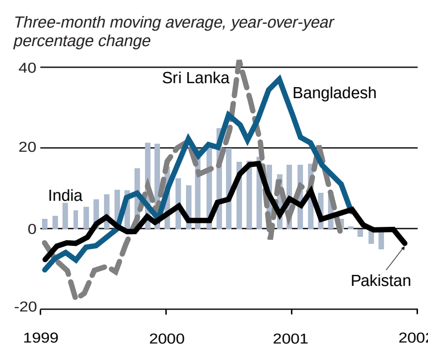
Source: World Bank Economic Policy and Prospects Group.

Industrial production index, 1999–2002



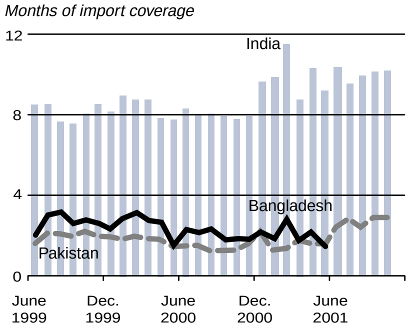
Source: Datastream.

Merchandise exports, 1999–2002



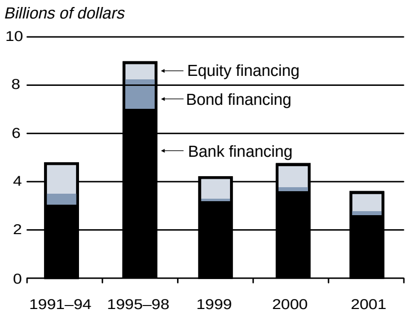
Source: Datastream

International reserves, 1999–2001



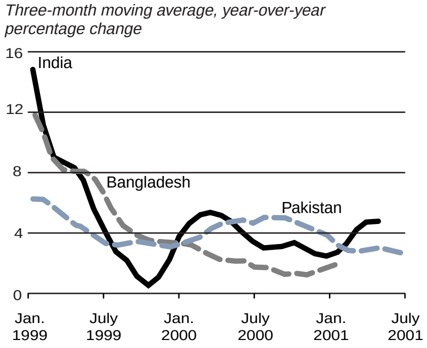
Source: World Bank.

Gross capital market flows, 1991–2001



Source: Euromoney.

Consumer price index, 1999–2001



Source: World Bank.

in the region were stable or slightly rising (for example in Pakistan.)

Capital flows

FDI to South Asia rose to $4.2 billion in 2001, a 35 percent increase from the previous year. Nevertheless, FDI to the region remains small, only 0.5 percent of GDP. South Asia produces 9 percent of developing countries' GDP but attracts only 2 percent of FDI flows to developing countries. The relatively small FDI flows into the region in part reflect little progress in privatization, glacial industrial regulations, and slow reforms in the labor market. Notwithstanding the recent successful sale of two highly profitable public enterprises in India, Videsh Sanchar Nigam Limited and IBP, privatization of other, often money losing, public companies remains a huge challenge. Nonetheless, FDI in India increased by a full $1 billion in the year, to reach $3.3 billion. But in Pakistan, privatization of the Pakistan Telecommunications Company and the United Bank has been delayed. The distribution of FDI flows within the region is more or less proportional to GDP, with 75 percent going to India and roughly 10 percent going to Pakistan and Bangladesh. This amount represents an impressive increase for Pakistan, which attracted only 0.5 percent of regional FDI inflows in 1996.

Lending by foreign banks, which accounts for the bulk of external private capital market commitments to the region, declined by more than $1 billion in 2001. Equity placement, which was hit hard due to heightened uncertainty created by the global economic slowdown and the September 11 events, declined by almost 50 percent. However, because these flows are relatively small and official aid increased, the decline in equity placement did not prevent a general improvement of reserves in the region, despite the slight deterioration in the current account.

Prospects and risks

The region is expected to recover modestly in 2002, with an average growth rate of 4.9 percent, and thereafter remain at a rate around 5.3 percent. Domestic factors will be the immediate impetus to an up-tick in growth during the first half of 2002, while a recovery in the developed economies in the second half of 2002 will further accelerate growth. Agricultural output is expected to improve in the first half of 2002. This improvement should have a stimulating effect on the industrial sector, particularly the durable goods sector, because traditionally farmers tend to buy big ticket items (such as furniture, motorcycles, and bicycles) during periods of good harvest and consequently increased incomes. The war-related aid for Pakistan, especially to the export sector, is expected to quicken the recovery of its economy.

Assuming that the countries in the region follow their declared policies, the average fiscal deficit is expected to decline from 10.3 percent of GDP[1] in 2001 to 9.2 percent in 2004. In Pakistan, the International Monetary Fund–supported program is expected to result in a significant fall in the fiscal deficit and in the public debt burden. Following the Eleventh Finance Commission and Expenditure Reform Commission reports, the Indian central government has proposed medium-term fiscal policy reforms[2] that aim to cut the revenue deficit to zero by fiscal 2005–06, mainly by reforming the tax system, rationalizing expenditure, and reducing the number of central government employees by 10 percent. Realization of this program will be an imposing challenge, however. In India, efforts to reduce subsidies and spur privatization of public industries have had mixed success. In addition, the recent increase in regional tensions may put pressure on the budgets of the region.

The current account deficit is expected to improve marginally to 1 percent of GDP in 2002 and continue to decline steadily thereafter. In the early part of 2002, export growth is likely to be slow given sluggish growth in the region's major export markets (the United States and Europe). Recovery of the export sector should begin in earnest during the second half of 2002. Removal of sanctions by the United States and Japan on India and Pakistan will benefit the two countries in the medium term. However, continuation of military activity in the region is likely to have a depressing impact on exports due to an increased risk perception by Organisation for Economic Co-operation and Development–area importers. A major source of gains in the medium term will be exports of services, especially software, data, and business services, from India. The region is not expected to cut import tariffs in the near term and, therefore, import growth is expected to remain slow.

This forecast faces significant downside risks. As of the time of this writing, tensions between India and Pakistan remained at high levels. Even if recent moves toward peace bear fruit, the potential for additonal terrorist attacks cannot be ruled out. The war in Afghanistan appears to be drawing to a close, but that country may still be a source of regional instability. Over the longer term, the success of efforts to restrain fiscal deficits while continuing to achieve high growth rates remains uncertain. And the entry of China into the World Trade Organization creates a major competitive challenge for the manufacturing industries of the region.

Notes

1. For India we have used the consolidated public sector deficit.

2. As of the writing of this report, the proposed Fiscal Responsibility and Budget Management Bill is yet to be ratified by the Indian Parliament.

South Asia forecast summary

(percent per year)

Growth rates/ratios	1991–2000	1999	2000	Estimate 2001	Baseline forecast 2002	2003	2004
Real GDP growth	5.2	5.8	4.0	4.3	4.9	5.3	5.2
Consumption per capita	2.6	6.1	1.2	2.2	1.8	2.0	1.9
GDP per capita	3.2	3.9	2.1	2.6	3.2	3.6	3.6
Population	1.9	1.9	1.9	1.7	1.7	1.6	1.6
Gross domestic investment/GDP[a]	21.9	22.6	24.0	24.7	25.4	25.8	26.4
Inflation[b]	8.1	4.6	5.8	6.1	5.0	5.1	5.1
General government budget balance/GDP	–10.3	–9.8	–9.7	–10.3	–10.3	–9.7	–9.2
Export market growth[c]	7.3	7.2	12.7	1.1	2.6	7.3	6.9
Export volume[d]	9.3	1.8	7.7	3.8	5.3	10.0	8.1
Terms of trade/GDP[e]	–0.1	–0.5	–0.7	0.4	–0.1	0.2	0.1
Current account/GDP	–1.5	–0.9	–0.8	–1.3	–1.1	–0.8	–0.4
Memo items							
GDP growth: excluding India	4.3	3.6	4.2	3.8	3.9	4.8	5.2

a. Fixed investment, measured in real terms.
b. Local currency GDP deflator, median.
c. Weighted average growth of import demand in export markets.
d. Goods and nonfactor services.
e. Change in terms of trade, measured as a proportion of GDP (percent).
Source: World Bank baseline forecast, February 2002.