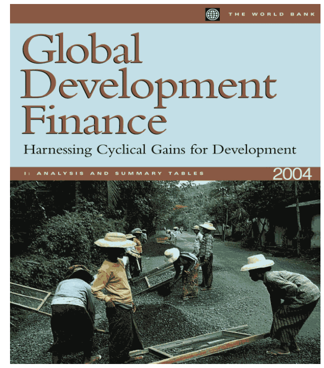
# South Asia

## GDF 2004 Summary




**Global Themes**

- The global economic environment affecting capital flows to developing countries improved in 2003. Global growth gained momentum in the second half of the year as the locus of economic activity shifted towards business investment spending. Renewed confidence in international financial markets led to a considerable decline in risk spreads in bond markets and fueled a strong rally in equity prices. Worldwide, GDP growth increased from 1.8 percent in 2002 to 2.6 percent during 2003; it is projected to rise to 3.7 percent in 2004. But the global economy is emerging from the pervasive slowdown of recent years facing major macroeconomic challenges – including large fiscal deficits in many advanced economies and a large current-account deficit in the United States - which could have a critical bearing on the outlook for developing countries and the availability of external capital to finance their development.

- Developing countries as a group are markedly outperforming the high-income countries. Developing countries' GDP grew 4.8 percent in 2003, compared to a 2.1 percent advance in the high-income countries. The low-and middle-income countries are on track this year to match, or even surpass, the record 5.2 percent growth achieved in 2000, before the global slowdown. Since 2000, the developing world has been a net exporter of capital to the advanced economies. For developing countries as a whole, foreign-exchange reserves rose about $276 billion in 2003, bringing total reserves to $1,227 billion—equivalent to nearly four times their short-term external debt. This buildup reflects a precautionary reaction to the costly crises of the 1990s, as well as broader factors related to trade and exchange rates. It underlines the strong financial interdependence between developed and developing countries.

- Official development assistance is still an important source of external finance for many countries. But, as private capital flows have grown, official aid flows have risen only slightly, and remain below the levels needed to achieve the Millennium Development Goals (MDGs). Political developments and changes in attitudes are dramatically altering the landscape for official flows. Net official development assistance did increase to $58 billion in 2002, but half of the $6 billion rise reflects debt relief donor agencies, rather than increased resources provided directly to developing countries. Moreover, the increase represents little progress toward meeting the commitments for higher aid made at the 2002 Monterrey conference.

- From 1992 to 2003, total international investment in developing countries' infrastructure is estimated to have been $622 billion—an average of $52 billion a year or 3.8 percent of total gross domestic investment in the developing world. Infrastructure needs in developing countries remain largely unmet—1.1 billion people lack access to safe drinking water, 2.4 billion are affected by inadequate sanitation, 1.4 billion have no power, and telecommunication links are five times less dense than in the developed world. Worldwide, future demand for infrastructure is likely to come mainly from the developing world. The bottlenecks in assuring a healthy flow of capital from international markets to developing-country infrastructure are related to policies, institutions, and regulation. Multilaterals can play a crucial role in providing risk-mitigation instruments (including guarantees and political risk insurance) and promoting the development of local capital markets. Efforts also need to be taken to develop a strong institutional framework for the protection of creditors' rights, effective covenants, and reliable avenues of legal enforcement and remedy. No single solution will fit all sectors and all countries.

- Developing countries' international trade is equivalent to about one-half of their gross national income. Trade finance supplies the liquidity needed to conduct trade, and governments can support it by ensuring a sound and efficient financial system. Finance linked to trade transactions may hold up better during crises than other forms of foreign borrowing for several reasons - lenders can rely on security arrangements linked to traded goods; supplier's information on their borrowers may limit contagion; suppliers have an incentive to support their customers during cyclical downturns; and, in some cases, governments have provided preferential treatment to trade finance in the context of rescheduling agreements. Trade credit from suppliers and customers appears to have held up better during crises than bank lending.

- The development community should view remittances as a welcome source of external finance and strive to improve the financial infrastructure supporting them. Workers' remittances have become a major source of finance for many developing countries. On an aggregate basis, they increased by more than 20 percent during 2001–03, reaching an estimated $93 billion in 2003, with more remittances being diverted to formal channels from alternatives—a result of efforts to curb money laundering. The increased focus on remittances resulted in better reporting of data in many developing countries.

**Regional themes**

- South Asian GDP rose 6.5 percent in 2003, a sharp pick-up from the 4.3 percent registered in 2002. On the demand side, growth was driven by rising domestic demand, especially fixed investment – the investment rate has consistently increased in the region to reach nearly 25 percent of GDP currently. Relief from drought was an important factor on the supply side.

- GDP growth is expected to be 7.2 percent in 2004, boosted by IT exports from India and the growing practice of outsourcing from the OECD economies. Peace talks between India and Pakistan, coupled with the regional trade initiatives of the South Asian Association for Regional Cooperation (SAARC) may further boost international confidence. Continued reforms in India – including tax cuts early in 2004 and capital account liberalization – will contribute to future growth.

- Sustaining such high level of growth in future is possible, but there are significant challenges. Infrastructure bottlenecks remain pervasive in the region. India remains saddled with a large government fiscal deficit. Recent tax cuts may raise the deficit further, especially if accompanied by populist spending in this election year. The smaller economies in the region will face difficulty from the impending phase-out of the international multifiber arrangement in 2005.

- International reserves rose to a record $114 billion in 2003, more than double the size in 2002. India accounted for most of this increase, but other economies, notably, Pakistan, also experienced sharp increases in reserves. A decline in the current account deficit – a noteworthy development in the face of rising oil prices for this region is a net oil importer – and rising inflows in the capital account contributed to the increase in international reserves.

- Workers' remittances to the region rose further to $18.2 billion in 2003 from $13.1 billion in 2001. India remained the second largest recipient of remittances (after Mexico) with $8.4 billion. In Pakistan, remittance receipts tripled between 2001 and 2003, to reach $4.2 billion last year. During the same period, remittance flows to Bangladesh also increased nearly 50 percent.

- India joined the top 5 developing country recipients of FDI ($4.1 billion in 2003). FDI to South Asia expected to rise from $5 billon in 2003 to over $7 billion in 2005, assuming that India's reform program continues and it continues to attract FDI into call centers and other outsourced businesses. FDI in India is understated because, unlike many other countries, India excludes from its records on FDI: (i) earnings reinvested by foreign investors; (ii) other direct investments between investors and subsidiaries, branches, and associates; and (iii) investments by offshore and domestic venture-capital funds set up by foreigners. Including these flows would raise FDI from $2-3 billion currently reported to as much as $8 billion.

- The region, led by India, became the largest recipient of portfolio equity flows with $7 billion net inflows in 2003. In India, stocks surged and reached record highs towards the end of the year. India has continued to modernize its stock exchanges and introduced new instruments for stock trading. It is, for example, one of the few emerging markets that have exchange-traded funds.

- Taking advantage of rising reserves and portfolio equity flows, the region repaid both public and private sector debt. Net inward debt flows were $-2.3 billion in 2003.

- The region's creditworthiness improved significantly in 2003, backed by strong growth, rising reserve levels, continued policy reforms and progress in peace talks between India and Pakistan. India was upgraded to investment grade. India's long-term foreign currency rating was upgraded to investment grade by Moody's in January 2004. Pakistan's rating was also upgraded last year. In February, S&P assigned a 'B' rating to Pakistan's issuance of $500 million fixed rate bonds due 2009.

- Aid flows to the region, especially to Pakistan, rose in 2002. Pakistan received $2.1 billion, up sharply from $0.7 billion in 2000.

- Bangladesh, and to a lesser extent Pakistan, continue to rely heavily on trade finance. These two countries were among the top 10 recipients of loans and guarantees – over 10 percent as a share of imports – from export credit agencies.

## South Asia outlook in summary, 1981-2004

| | 1981-90 | 1991-00 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004f |
|---|---|---|---|---|---|---|---|---|---|
| **Real economy** | | | | | | | | | |
| *(percent change, unless stated)* | | | | | | | | | |
| Real GDP growth | 5.8 | 5.2 | 5.4 | 6.4 | 4.2 | 4.7 | 4.3 | 6.5 | 7.2 |
| Private consumption per capita | 2.3 | 2.3 | 2.9 | 4.0 | 1.2 | 3.2 | 2.1 | 4.6 | 4.6 |
| GDP per capita | 3.5 | 3.2 | 3.6 | 4.7 | 2.5 | 3.0 | 2.7 | 4.8 | 5.5 |
| Population | 2.2 | 2.0 | 1.8 | 1.7 | 1.6 | 1.6 | 1.6 | 1.6 | 1.5 |
| Gross Domestic Investment / GDP /a. | 20.2 | 21.6 | 22.1 | 22.3 | 22.5 | 22.3 | 23.3 | 24.4 | 25.3 |
| Inflation /b. | 8.9 | 8.1 | 7.3 | 4.4 | 3.9 | 3.8 | 3.5 | 4.1 | 3.6 |
| Central Gvt budget balance / GDP | -12.6 | -10.3 | -11.4 | -12.3 | -9.1 | -8.5 | -9.7 | -9.3 | -9.1 |
| Export Market Growth /c | 5.0 | 7.5 | 3.0 | 6.2 | 13.4 | 0.1 | 3.4 | 5.3 | 8.2 |
| Export Volume /d. | 6.4 | 11.1 | 9.1 | 12.5 | 21.2 | 7.3 | 17.3 | 16.4 | 11.2 |
| Terms of Trade / GDP /e. | 0.0 | 0.1 | 0.8 | -1.2 | -0.8 | -0.4 | -1.1 | -0.8 | -0.2 |
| Current Account / GDP | -2.0 | -1.5 | -1.8 | -0.9 | -0.7 | 0.5 | 1.4 | 0.7 | 0.5 |
| Workers Remittances ($ billion) | – | 10.6 | 13.3 | 15.1 | 12.8 | 13.1 | 16.9 | 18.2 | -- |
| Memorandum item: | | | | | | | | | |
| GDP growth: South Asia (excluding India) | 5.5 | 4.4 | 3.7 | 4.2 | 5.1 | 3.1 | 3.4 | 5.4 | 5.9 |
| **External Financing and Debt** | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003e |
| *(billions of dollar unless stated)* | | | | | | | | | |
| Net inward FDI | 2.9 | 3.5 | 4.9 | 3.5 | 3.1 | 3.4 | 5.0 | 4.2 | 5.1 |
| Net inward portfolio equity flows | 1.6 | 4.1 | 2.9 | -0.6 | 2.4 | 2.8 | 1.9 | 1.0 | 7.0 |
| Net inward debt flows | 2.5 | 2.7 | 0.7 | 4.7 | 0.5 | 3.4 | -0.7 | 0.4 | -2.3 |
| From public sources | -1.2 | 1.0 | 0.3 | 2.3 | 2.5 | 0.5 | 2.2 | -2.4 | -0.6 |
| From private sources | 3.7 | 1.6 | 0.4 | 2.4 | -2.0 | 2.9 | -2.8 | 2.8 | -1.7 |
| Gross Market Based Capital Inflows | 7.4 | 10.5 | 12.7 | 5.1 | 4.2 | 4.5 | 3.3 | 2.7 | 6.2 |
| Total External Debt | 151.7 | 149.6 | 149.6 | 157.6 | 162.0 | 159.9 | 156.3 | 168.3 | 171.3 |
| Medium and Long Term | 142.6 | 139.3 | 141.4 | 150.5 | 154.9 | 153.9 | 151.4 | 161.1 | 162.9 |
| Short Term | 9.0 | 10.3 | 8.2 | 7.1 | 7.0 | 6.0 | 4.9 | 7.2 | 8.4 |
| Owed by Public Sector Borrowers | 134.3 | 129.9 | 129.7 | 139.3 | 144.6 | 138.5 | 137.2 | 147.2 | 150.4 |
| Owed by Private Sector Borrowers | 17.3 | 19.8 | 19.9 | 18.3 | 17.4 | 21.4 | 19.1 | 21.1 | 20.9 |
| Owed to Public Sector Creditors | 108.9 | 104.1 | 98.9 | 104.6 | 113.3 | 102.8 | 101.1 | 106.3 | 112.1 |
| Owed to Private Sector Creditors | 42.8 | 45.5 | 50.7 | 53.0 | 48.7 | 57.2 | 55.2 | 62.0 | 59.2 |
| Gross Foreign Exchange Reserves | 24.2 | 24.8 | 30.0 | 32.9 | 37.9 | 42.6 | 52.8 | 79.8 | 114.4 |

-- Not Available

*Note: e* = estimate, *f* = forecast.

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 non-factor services.

e. Change in terms of trade, measured as a percentage of GDP.

**External financing: South Asia, 1997-2003**
*(billionsof dollars)*

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003e |
|---|---|---|---|---|---|---|---|
| Current account balance | -5.4 | -9.4 | -5.2 | -4.1 | 2.8 | 8.9 | 5.3 |
| as % GDP | -1.0 | -1.8 | -0.9 | -0.7 | 0.5 | 1.4 | 0.7 |
| **Financed by:** | | | | | | | |
| Net equity flows | 7.8 | 2.9 | 5.5 | 6.2 | 6.9 | 5.2 | 12.1 |
| Net FDI inflows | 4.9 | 3.5 | 3.1 | 3.4 | 5.0 | 4.2 | 5.1 |
| Net portfolio equity inflows | 2.9 | -0.6 | 2.4 | 2.8 | 1.9 | 1.0 | 7.0 |
| Net debt flows | 0.7 | 4.7 | 0.5 | 3.4 | -0.7 | 0.4 | -2.3 |
| Official creditors | 0.3 | 2.3 | 2.5 | 0.5 | 2.2 | -2.4 | -0.6 |
| World Bank | 1.1 | 0.8 | 1.0 | 0.7 | 1.5 | -1.0 | -0.8 |
| IMF | -0.8 | -0.4 | -0.1 | -0.3 | 0.3 | 0.1 | -0.2 |
| Others | 0.0 | 2.0 | 1.6 | 0.1 | 0.4 | -1.4 | 0.4 |
| Private creditors | 0.4 | 2.4 | -2.0 | 2.9 | -2.8 | 2.8 | -1.7 |
| Net M-L term debt flows | 2.5 | 3.7 | -2.1 | 3.9 | -1.8 | 0.5 | -2.9 |
| Bonds | 2.3 | 4.2 | -1.2 | 5.4 | 0.0 | -0.5 | -4.1 |
| Banks | 1.3 | 0.7 | -0.5 | -2.0 | -1.4 | 1.0 | 1.1 |
| Others | -1.1 | -1.1 | -0.4 | 0.5 | -0.3 | -0.1 | 0.2 |
| Net short-term debt flows | -2.1 | -1.3 | 0.1 | -1.0 | -1.1 | 2.3 | 1.2 |
| Balancing item * | 2.1 | 4.8 | 4.2 | -0.9 | 1.2 | 12.4 | 19.5 |
| Change in reserves (- = increase) | -5.2 | -3.0 | -5.0 | -4.7 | -10.2 | -27.0 | -34.6 |
| Memo items: | | | | | | | |
| Bilateral aid grants (excluding technical co-operation grants) | 2.1 | 2.1 | 2.3 | 2.1 | 3.2 | 2.5 | 2.6 |
| Net private flows (debt+equity) | 8.2 | 5.3 | 3.5 | 9.2 | 4.0 | 8.0 | 10.4 |
| Net official flows (aid+debt) | 2.4 | 4.5 | 4.8 | 2.6 | 5.3 | 0.1 | 2.0 |
| Workers' remittances | 14.6 | 13.3 | 15.1 | 12.8 | 13.1 | 16.9 | 18.2 |

*Note* : e = estimate

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