South Asia

Recent developments

GDP growth in the South Asia region registered 8.2 percent in 2007, moderating from a 25-year high of 9 percent in 2006.[4] Slackening of growth was evident across all countries of the region, except Afghanistan and Bhutan. Regional growth reflected continued—albeit softening—strength in domestic activity, dampened by tighter credit conditions. An easing in demand from key export markets contributed to waning export growth and a widening in the regional current account deficit. Into the first half of 2008, surging food prices, higher petroleum prices, and an overall deterioration in the external environment linked to the subprime crisis in the United States, are straining regional government coffers and external positions. Early indicators for 2008 point to a sharper slowdown in growth and a challenging adjustment path ahead, aggravated by widespread subsidies for food and fuels, large investment demands, and rising inflationary pressures.

GDP growth in India eased to a still strong 8.7 percent in 2007, from 9.7 percent in 2006, and is projected to slow further to 7 percent in 2008, as monetary tightening in 2007 led to a softening in domestic demand. Though slowing, consumption has maintained a strong tone resulting from healthy wage growth and large remittance inflows, with the latter primarily fueled by increased demand for migrant work in the oil-exporting countries of the Middle East. Buoyant capital inflows, high capacity utilization, and reinvestment of corporate profits served to underpin investment growth in 2007. The more restrictive monetary policy helped prevent an acceleration in inflation in 2007 but contributed to an appreciation of the rupee (on a trade-weighted basis, and particularly against the dollar), leading to a loss in competitiveness for India's exporters. Combined with rising import prices and a largely resilient domestic demand, this led to deterioration in the country's current account deficit. Starting in 2008, inflationary pressures began to build. There are growing signs of a cooling economy, with a deceleration in industrial production to 3 percent in April 2008, year over year (table A.13).

In Pakistan, output growth also slowed during 2007, moderating half a percentage point to 6.4 percent. Heightened political uncertainty in the lead-up to elections in early 2008 undermined overall confidence and led to weaker investment and private consumption outlays. Output was also disrupted by growing power shortages. And, in part because of high fuel costs, Pakistan's current account deficit deteriorated substantially in 2007

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

Indicator	1991–2000[a]	2005	2006	2007	Forecast 2008	2009	2010
GDP at market prices (2000 $)[b]	5.2	8.7	9.0	8.2	6.6	7.2	7.6
GDP per capita (units in $)	3.1	7.0	7.3	6.7	5.2	5.7	6.2
PPP GDP[c]	6.4	8.8	9.2	8.3	6.7	7.2	7.7
Private consumption	4.0	7.2	6.3	6.0	5.1	5.7	6.4
Public consumption	3.9	8.8	10.1	5.7	8.1	8.5	8.4
Fixed investment	5.5	23.5	14.6	15.1	9.2	10.0	10.6
Exports, GNFS[d]	9.0	19.1	17.6	6.1	5.6	9.2	10.6
Imports, GNFS[d]	7.9	21.7	22.5	6.3	5.8	9.4	11.4
Net exports, contribution to growth	−0.1	−1.0	−1.7	−0.3	−0.3	−0.5	−0.7
Current account bal/GDP (%)	−1.6	−1.2	−1.5	−1.9	−3.4	−3.1	−2.9
GDP deflator (median, LCU)	8.0	5.0	6.6	7.0	9.2	10.1	7.8
Fiscal balance/GDP (%)	−7.7	−6.5	−6.7	−6.5	−6.5	−6.5	−6.2
Memorandum items: GDP							
South Asia excluding India	4.4	6.7	6.7	6.3	5.2	5.8	6.1
India	5.5	9.2	9.7	8.7	7.0	7.5	8.0
Pakistan	3.9	7.7	6.9	6.4	5.0	5.5	6.0
Bangladesh	4.8	6.0	6.6	6.4	5.7	6.5	6.6

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 $.
c. GDP is measured at PPP exchange rates.
d. Exports and imports of goods and nonfactor services.

and has continued to further deteriorate into 2008. To cover the widening current account deficit, about $3.4 billion in foreign exchange reserves have been drawn down since July 2007, bringing the merchandise import cover below three months, as of May 2, 2008—an unsustainable trend. The fiscal deficit has also widened substantially. This deficit primarily reflects a rise in government borrowing on the domestic market, as foreign lending has largely halted, the privatization program has stalled, and Pakistan's spreads on international markets have risen. Surging food and fuel prices are contributing to rising inflationary pressures. Consumer price inflation was up 17.2 percent year over year in April 2008, from 14.1 percent in March; that is the fastest pace in at least 25 years.

GDP growth in Sri Lanka dropped to 6.8 percent in 2007, from 7.4 percent in 2006. The deceleration is attributable in large measure to ongoing civil strife, continued inflationary pressures that squeezed household incomes, and a falloff in growth from the sharp recovery posted in the wake of the December 2004 tsunami. Inflation accelerated sharply since 2006, rising to an average of over 15 percent during 2007, and to nearly 24 percent in March 2008. Rising food prices in combination with strong credit growth—tied to both large fiscal deficits and negative real interest rates (to aid budget financing)—have fueled inflationary pressures. However, this macroeconomic stimulus has not yet resulted in a deteriorating current account. Sri Lanka's trade deficit narrowed in 2007, given strong export growth and a deceleration in import growth.

In Bangladesh, growth slowed from 6.6 percent in 2006 to 6.4 percent in 2007. This moderation mainly reflects a falloff in export growth, which was partly offset by a firming in domestic demand, particularly private consumption. Growth decelerated in the interim, following the losses from two consecutive natural disasters in the second half of the year—severe flooding in July and a devastating cyclone in November—which resulted in the deaths of 4,400 people and displaced an estimated 8.7 million people. The impact from these disasters will be captured in the 2008 growth figures (fiscal 2007–08). Damage from the disasters is estimated at $2.7 billion, or the equivalent of about 3.7 percent of GDP. Despite these sharp negative impacts to growth, domestic demand is being supported by strong, record-high remittance inflows. Remittance inflows have cushioned the impact of surging import prices but have not prevented a narrowing of the current account surplus and a projected shift to deficit in 2008. Further, a concerted drive against corruption and tax evasion, combined with a crimping of purchasing power caused by rising inflationary pressures, has dampened economic activity.

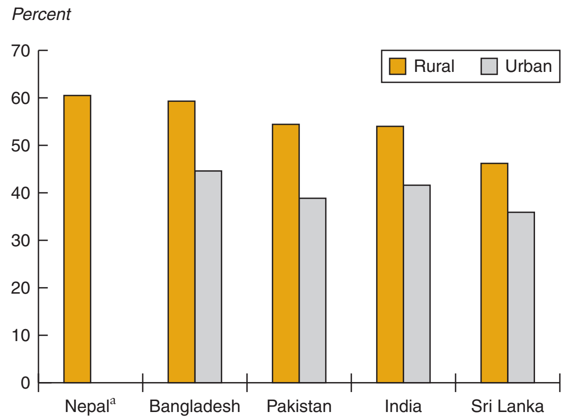
In Nepal, GDP growth decelerated to 2.5 percent in 2007, from 2.8 percent in 2006, amid election-related disturbances (including frequent blockades and strikes) that disrupted economic activity, labor unrest, power shortages, and high inflation. Early indicators are for a firming of growth in 2008 on the strength of the recuperated agricultural sector and high tourism growth, as well as improved confidence following the peaceful April 2008 elections.

The Maldives experienced a slowing of growth to 6.6 percent in 2007, retreating from the double-digit rebound that occurred in 2006 following the tsunami-related disruptions of 2005. Growth was supported by a revival in tourism but was partly offset by a particularly low fish catch, resulting in a sharp decline for the fisheries industry. Given that the small island economy is dependent on imports, rising international price pressures were quickly transmitted into higher domestic inflation.

In contrast with developments in the rest of South Asia, growth in Afghanistan and Bhutan accelerated during the year, tied in part to special circumstances. In Afghanistan, GDP growth increased to an estimated 14 percent, up from 6 percent in 2006, buoyed by recovery in agricultural output following the 2006 drought. Security, however, continued to deteriorate throughout 2007 and early 2008, with a sharp rise in incidents. Associated deaths have reached the highest levels since 2001. The Tala hydroelectric power project in Bhutan, which led to a sharp rise in power exports to India and boosted government revenues, supported a vigorous expansion in GDP to an estimated 17 percent gain in 2007, more than double the 8 percent advance of 2006. Growth has also been bolstered by vibrant tourism activity, as well as by improved confidence. Bhutan held its first multiparty election in March 2008, which generated a high turnout and marked the advent of a democratic, constitutional monarchy in the country.

By early 2008 surging food prices had become a serious concern in South Asia, where food insecurity is relatively high and food represents close to 50 percent of total consumption in most countries (figure A.13).[5] The extreme poor spend even a greater proportion of their budgets on food. The rapidly rising gap between food prices and wages indicates a sharp reduction in the purchasing power of the poor. The situation has become increasingly acute across the region—especially in Afghanistan and Bangladesh. Among other factors, rice producers, such as China, India, and Vietnam have introduced export restrictions to keep stocks for domestic use and to prevent sharp domestic price increases; these policies have contributed to the increase in international grain prices. Food supply difficulties are prevalent across the region, affecting Afghanistan, where fighting continues; Bangladesh, where the November 2007 cyclone affected an estimated 8.7 million people and reduced the 2007 paddy production; and Nepal, which is experiencing sustained political instability despite the successful postwar elections. India is self-sufficient, but grain stocks are low and crop production has been in decline. Bhutan and the Maldives are also vulnerable, as they import over 30 percent of their grains. In Pakistan, the U.N. World Food Programme estimates that nearly half of the country's 160 million people are at risk of running short of food due to rising grain prices. The poverty impact of the surge in food prices could be high and in some areas could wipe out years of gains in poverty reduction.

Figure A.13 Food consumption as a share of total consumption across South Asian countries



Sources: U.N. Food and Agriculture Organization and World Bank.

Note: Unweighted average for Germany, United Kingdom and United States is 17 percent. Ranked by rural data.

a. Urban data is not available for Nepal.

High international commodity prices, especially oil prices, combined with increasingly sluggish external demand, contributed to deterioration in the region's current account deficit, despite sustained strong inflows of worker remittances. The current account deficit of the region widened from $17 billion in 2006 to $27 billion in 2007. Foreign reserves increased by a record $100 billion in 2007 compared with an increase of $40 billion in 2006; most of the increase resulted from a $96 billion increase in India's reserves.

Capital Flows. The turmoil in international financial markets, which commenced in the second half of 2007 and has continued through the first months of 2008, has affected the region primarily through a falloff in portfolio flows and weakness in equity markets. The latter has been most pronounced in India, particularly during the first quarter of 2008. In contrast, Pakistan's bourse rose by close to 10 percent in the quarter, with a short-term improvement in confidence in the wake of elections. Net portfolio equity inflows to the region more than tripled, from $10 billion in 2006 to $35 billion in 2007, almost all of which ($34 billion) went to India where the stock market enjoyed a boom. Given the volatile nature of portfolio equity flows, the large inflows also pose risks, especially amid increased risk aversion and volatility as credit market turmoil continues and global growth prospects weaken for 2008. The sell-off in the Indian stock market in the first quarter of 2008, stemming from concerns over a possible U.S. recession, was a warning sign.

In contrast with strong equity flows, net FDI registered a small increase of $6 billion, reaching $29 billion in 2007, with three-fourths of the total going to India. This compared with a more than doubling of net FDI inflows in 2006 to $23 billion from $10 billion in 2005. Net private debt flows to the region increased to $33 billion in 2007 from $12 billion in 2006, led by a large increase in net inflows of cross-border bank lending to $25 billion in 2007, from $5 billion in 2006. In aggregate, net capital flows to South Asia jumped to $102 billion in 2007, from $50 billion in 2006. The increase resulted entirely from a rise in net private flows to $98 billion in 2007 from $46 billion in 2006; net official flows remained at an inflow of $4 billion (table A.14).

Medium-term outlook

South Asia appears poised for a significant slowdown in GDP growth to 6.6 percent in 2008, from 8.2 percent in 2007 (table A.14). Private consumption and investment are expected to decelerate

Table A.14 Net capital flows to South Asia

$ billions

Indicator	1999	2000	2001	2002	2003	2004	2005	2006	2007p
Current account balance	−5.3	−6.3	2.2	11.4	12.5	−1.0	−12.2	−16.9	−26.8
as % of GDP	−0.9	−1.1	0.4	1.8	1.6	−0.1	−1.2	−1.5	−1.9
Net equity flows	5.5	6.7	8.8	7.8	13.4	16.6	22.4	33.3	64.2
Net FDI inflows	3.1	4.4	6.1	6.7	5.4	7.6	10.0	22.9	28.9
Net portfolio equity inflows	2.4	2.4	2.7	1.0	8.0	9.0	12.4	10.4	35.4
Net debt flows	0.5	3.5	−0.7	−0.4	0.3	8.6	5.8	16.8	37.7
Official creditors	2.5	0.5	2.2	−2.4	−1.8	1.0	3.1	4.3	4.3
World Bank	1.0	0.7	1.5	−1.0	−0.2	2.0	2.2	1.7	1.9
IMF	−0.1	−0.3	0.3	0.1	−0.1	−0.3	0.0	−0.1	−0.1
Other official	1.6	0.0	0.4	−1.5	−1.6	−0.7	0.9	2.7	2.6
Private creditors	−2.0	3.0	−2.8	2.0	2.0	7.6	2.7	12.5	33.4
Net medium- and long-term debt flows	−2.1	3.9	−1.9	0.2	1.3	4.9	1.1	8.9	29.4
Bonds	−1.2	5.4	−0.4	−0.7	−3.1	4.1	−2.9	4.3	4.2
Banks	−0.5	−2.0	−1.1	1.0	4.4	1.1	4.1	4.6	25.2
Other private	−0.4	0.5	−0.3	−0.1	0.0	−0.3	−0.1	0.0	0.0
Net short-term debt flows	0.1	−0.9	−0.9	1.8	0.7	2.6	1.6	3.6	4.0
Balancing item[a]	4.3	0.8	−0.1	8.2	8.8	3.1	−9.6	7.3	26.0
Change in reserves (− = increase)	−5.0	−4.7	−10.2	−27.0	−35.0	−27.2	−6.3	−40.5	−101.2
Memorandum item									
Worker's remittances	15.1	17.2	19.2	24.1	30.4	28.7	33.1	39.8	43.8

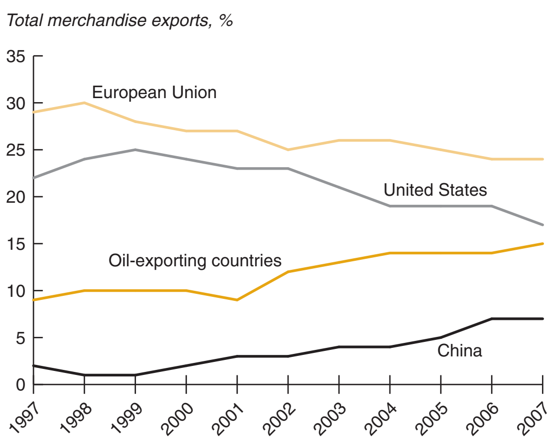
Source: World Bank.
Note: p = projected.
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.

because of tighter international and domestic credit conditions in combination with weakened external demand. Rising inflationary pressures, particularly for food, will reduce the purchasing power of the urban poor. A moderation in domestic growth will contribute to a slowdown in import volume, including capital goods imports. This, however, will be insufficient to prevent further widening of the region's current account deficit—given a falloff in export growth and continued high international commodity prices. High grain, oilseed, and energy prices, in particular, will represent the greatest challenge for regional policy makers. The challenge is to protect the poor, while keeping fiscal positions manageable and preventing second-round inflationary spirals. Ongoing volatility in international financial markets and decreased risk appetite among international investors are expected to lead to lower capital inflows.

Effects on South Asia's external demand stemming from turbulent financial markets and potential recession in the United States are expected to be relatively small compared with other developing regions. Of note, the importance of the United States and Western European trade partners for South Asia has declined over the last decade, while China and oil-exporting economies have come to represent a larger portion of their markets (figure A.14). And while South Asia's integration with the global economy advanced rapidly in recent years—with openness (measured by exports and imports of goods and services as a share of GDP) increasing by more than 15 percentage points since 2000 to 47 percent by 2007—it remains the least integrated of developing regions. From this perspective, the impact of the slowdown in external demand should be somewhat less pronounced than in other regions.

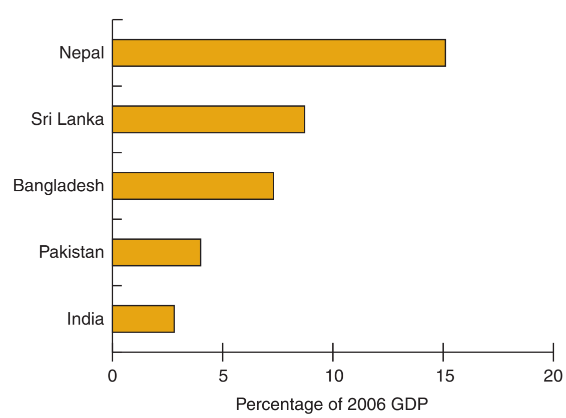
For South Asia's poor, one of the more direct impacts from the deterioration in the external environment could come through the international remittances channel. In a number of countries, such as Bangladesh and India, remittances have risen rapidly in recent years, posting record levels. A falloff in growth in countries where migrants are employed, combined with the sharp depreciation of the dollar, could lead to lower remittance inflows in local currency terms. This could in turn lead to weaker consumer demand. For the poor, whose incomes are already being squeezed by higher food and fuel prices, lower remittance inflows could make the situation still more difficult. For most South Asian countries, remittances represent a major source of hard currency, and for some countries, the inflows significantly offset deficits on trade. In Nepal, remittances inflows were equivalent to 15.1 percent of GDP in 2006, while in Sri Lanka and Bangladesh they represented close to 9 percent and 7.3 percent, respectively (figure A.15). Data on the countries of origin for remittances is sparse, but important sources include the Persian Gulf economies outside of the region and India within the region, in particular for Nepal. Nepal's economy is strongly linked to India's, and shifts in growth in India could have a major impact there.

Figure A.14 Shifts in South Asia's export partner composition



Sources: International Monetary Fund and World Bank.

Figure A.15 Worker remittances as a share of GDP in South Asian countries, 2006



Source: World Bank.

Growth for the region in the latter years of the forecast, in 2009 and 2010, is projected to pick up incrementally to 7.2 percent and 7.6 percent, respectively, well above the 5.2 percent average of the 1990s (table A.15). The projected weakening in world demand in 2008 is expected to lead to a softening of oil and non-oil commodity prices, manifested more clearly in 2009, allowing some easing of monetary conditions, which should contribute to a firming in domestic demand. Easing monetary policy should provide a fillip to regional investment, which in turn is expected to be supported by anticipated recovery in external demand in 2009 and 2010. Similarly, private consumption growth is expected to be underpinned by easing credit conditions and rising incomes, and as a reduction in inflation pressures raises disposable incomes. In line with the pickup in domestic demand, import growth is projected to revive, in part because of South Asia's high capital requirements. Hence, despite rising external demand and export growth, the current account deficit is expected to show only modest improvement as a proportion of GDP.

Risks and uncertainties

The degree and duration of the growth slowdown in the United States, and the extent of its impact on other countries, could represent downside risks to prospects for South Asia. A disorderly adjustment, including a hard landing of the dollar, would bring about a sharper deterioration in external demand and larger financial market repercussions, as well as further upward pressure on international commodity prices. Volatile and declining equity prices in the region, particularly in India—just as ownership of stocks and other financial assets is beginning to take hold among the burgeoning middle class—could hamper both consumer and business outlays, while depressing overall confidence levels in the economy.

A number of South Asian economies have been able to reduce their fiscal deficits in recent years, though these deficits remain large in some cases. As food and fuel prices are widely subsidized, the growing gap between domestic and international prices could lead to significant fiscal deterioration, aside from creating problems in incentives. In Pakistan, high subsidies that have kept wheat prices relatively low have led to smuggling. More broadly, slower growth outcomes will compress government revenues and make further consolidation more difficult, providing policy makers with less maneuverability to stave off potential effects of deterioration in the external

Table A.15 South Asia country forecasts
annual percentage change unless indicated otherwise

					Forecast		
Country/indicator	1991–2000[a]	2005	2006	2007	2008	2009	2010
Bangladesh							
GDP at market prices (2000 $)[b]	4.8	6.0	6.6	6.4	5.7	6.5	6.6
Current account bal/GDP (%)	−0.4	−0.3	1.5	1.0	−0.5	−0.6	−0.7
India							
GDP at market prices (2000 $)[b]	5.5	9.2	9.7	8.7	7.0	7.5	8.0
Current account bal/GDP (%)	−1.2	−1.0	−1.1	−1.5	−2.9	−2.6	−2.6
Nepal							
GDP at market prices (2000 $)[b]	5.0	3.1	2.8	2.5	3.5	4.5	5.0
Current account bal/GDP (%)	−6.4	2.0	2.2	0.5	1.2	0.6	−0.3
Pakistan							
GDP at market prices (2000 $)[b]	3.9	7.7	6.9	6.4	5.0	5.5	6.0
Current account bal/GDP (%)	−3.7	−3.4	−5.5	−6.1	−8.9	−8.1	−7.6
Sri Lanka							
GDP at market prices (2000 $)[b]	5.2	6.0	7.4	6.8	5.0	5.6	5.6
Current account bal/GDP (%)	−4.6	−3.1	−5.1	−4.2	−4.6	−4.4	−4.1

Source: World Bank.
Notes: 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 $.

environment. Given tight domestic supplies, a poor crop year could sustain or reignite inflationary pressures and put remote regions at particular risk.