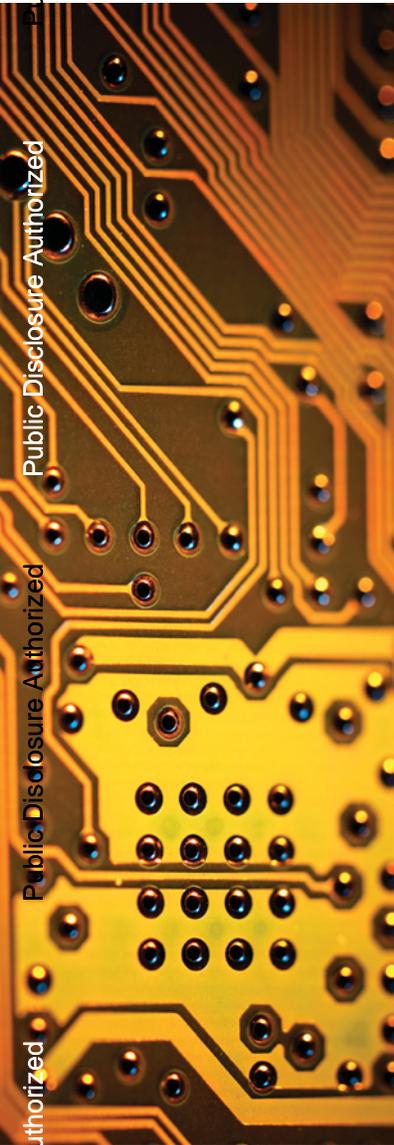


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# Moving Up, Looking East



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WORLD BANK SOUTH ASIA ECONOMIC UPDATE 2010

# Moving Up, Looking East



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## ABBREVIATIONS

ACFTA	ASEAN-China Free Trade Association	HIPC	Highly Indebted Poor Country
ADB	Asian Development Bank	HS	harmonized system
ASEAN	Association of South East Asian Nations	IMF	International Monetary Fund
ASEAN-3	Association of South East Asian Nations Plus Three: China, Republic of Korea, and Japan	IT	information technology
ASEAN-6	Association of South East Asian Nations Plus Six: Australia, China, Republic of Korea, India, Japan, and New Zealand	kg	kilogram
BB	Bangladesh Bank	<i>kharif</i>	main monsoon season crop
BIMSTEC	Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation	kWh	kilowatt hours
BOI	Board of Investment	LPI	Logistics Performance Index
BPO	business process outsourcing	MFN	most favored nation
bps	basis points	MLA	mandated lead arranger
call rate	interbank call money rate	Mmt	million metric tons
CBSL	Central Bank of Sri Lanka	MNA	Middle East and North Africa region
CECA	Comprehensive Economic Cooperation Agreement between India and Singapore	MW	megawatts
CGE	computable general equilibrium	NAFTA	North American Free Trade Agreement
CRR	cash reserve ratio	PPI	Private Participation in Infrastructure
EA	East Asia	PPP	Private Participation Project
EAP	East Asia and Pacific region	RBI	Reserve Bank of India
EU	European Union	RCA	revealed comparative advantage
EU-25	European Union 25 Expanded Countries	REER	real effective exchange rate
FDI	foreign direct investment	ROW	rest of the world
FTA	free trade agreement or association	RREPO	reverse repurchase rates
FY	fiscal year	RTA	regional trade agreement
G-7	Group of Seven industrialized countries	SA	South Asia
G-20	Group of Twenty countries	SAAR	seasonally adjusted annual rate
GATS	General Agreement on Trade in Services	SAFTA	South Asian Free Trade Agreement
GDP	gross domestic product	SAPTA	South Asian Preferential Trade Agreement
GM	genetically modified	SBP	State Bank of Pakistan
GVC	gross value chain	SITC	standard industrial trade classification
		SLR	statutory liquidity ratio
		TFP	total factor productivity
		TWh	terawatt hours
		VAT	value-added tax
		VOA	vote on accounts

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## SUMMARY

**South Asia's rebound since March 2009 has been strong and is comparable to that in East Asia.** South Asia is poised to grow by about 7 percent in 2010 and nearly 8 percent in 2011, thanks to the strong recovery in India, good performances in Bangladesh, postconflict bounce in Sri Lanka, recovery in Pakistan, and turnarounds in other countries, including Afghanistan, Maldives, and Nepal. The region's prospective growth is close to precrisis peak levels and faster than the high rates of the early part of the decade (6.5 percent annually from 2000 to 2007). The recovery is being led by rising domestic confidence and is balanced in terms of domestic versus external demand, consumption versus investment, and private demand versus reliance on stimulus.

**Government policy, external support, resumption of private spending, and global recovery are driving the rebound.** Strong government fiscal and monetary stimulus packages and, in some cases, external assistance are helping stimulate recovery. Improved optimism is helping the recovery in private spending in India, Bangladesh, Bhutan, and Sri Lanka. World trade and demand recovery are also supporting the rebound in exports and tourism, as are capital inflows. Not everyone is doing equally well, with slower recovery in countries with weaker fundamentals, those with unresolved conflict or postconflict issues, and those that were heavily exposed to the global downturn (Maldives, Nepal, and Pakistan). Some significant risks are ahead in the global environment—slowing worker remittances and exports in a still hesitant and uncertain global recovery (which recent events in Europe have highlighted), volatile commodity prices, and continuing volatility in global capital flows.

**Strong, timely policy interventions were and are key to confidence and recovery.** Monetary policy was eased and interest rates sharply lowered during the crisis, cushioning private demand. Fiscal stimulus amounted to more than 3 percent of GDP in India and helped revive confidence and optimism, assisted by preelection spending and civil service salary raises. Bangladesh was similarly placed to take fiscal action. Other countries had more limited room, and they tightened policies initially to shore up macrostability, before easing policies to strengthen their recoveries (Pakistan and Sri Lanka).

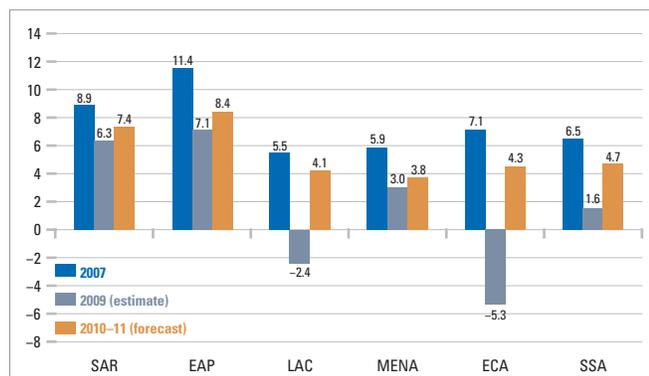
**South Asia's particular strengths and forms of global integration—not the lack of them—were key reasons that allowed greater resilience.** The view that South Asia is relatively less integrated with the outside world, and that this helped protect it from the global recession, is outdated. Over the past 15 years the region has become much more open—and it appears that the form of openness it has chosen has provided resilience in the face of recent shocks:

- Financial systems proved relatively robust, with limited financial integration and exposures to overseas subprime markets, while long-standing capital account restrictions lessened, but not altogether avoided, vulnerability to sudden capital outflows
- Remittance inflows proved surprisingly resilient, as opposed to trends elsewhere, as workers from South Asia kept remitting earnings and savings from abroad even as they faced job losses and downturns in main migration centers
- Exports proved relatively resilient, especially given the types of specialization such as in the IT services sector (India), and in the garment and textile sectors (Bangladesh and Sri Lanka) where the region maintained competitiveness
- Foreign direct investment (FDI) flows proved more buoyant and resilient than in other parts of the world

**As a result, South Asia weathered the global shocks much better than expected.** The slowdown in regional GDP growth of nearly 3 percentage points—from a peak of 8.9 percent in 2007 to 6.3 percent in 2009—was the least pronounced of that for all developing regions. The effects were nevertheless significant—large negative output shocks, job losses, wealth and confidence losses, stock market declines, indirect contagion effects propagated by domestic financial markets, losses in exports and tourism,

**Figure 1 South Asia: smallest decline in growth from global financial crisis and recovering**

GDP growth (annual percentage change)



Sources: Staff estimates; *Global Economic Prospects 2010*, World Bank.

Note: SAR (South Asia), EAP (East Asia and Pacific), LAC (Latin America and the Caribbean), MENA (Middle East and North Africa), ECA (Europe and Central Asia), SSA (Sub-Saharan Africa).

needed to deal with unexpected future shocks, not crowd out the private sector, and permit governments to finance crucial public investment. Managing inflationary pressures will also benefit from gradually tighter fiscal and monetary demand management to contain core nonfood inflation which has risen to a relatively high level of 7–10 percent, surpassing the precrisis average of 4–6 percent. Food prices have been rising especially sharply in recent months, because of poor weather in India compounded by delayed adjustment to higher global prices; they should moderate in the near-term, but a renewed focus on agriculture is also vital, especially given the persistently high rural populations and poverty.

**Sustaining inclusive and faster growth—new drivers of growth.** The challenge now is to also make this regional recovery more durable, inclusive, and sustained, looking not just to cement its past successes, but to future drivers. The world that the region is facing after this crisis is different—with slowing growth in high-income countries and faster growth in emerging markets—offering both opportunities and challenges. The model that has served the region well in the past, the growth of increasingly sophisticated service sectors, should continue to serve it well. But it will be useful to add to that in order to create more jobs and help realize the demographic potential of the region.

**One of the key new drivers is likely to be the rise of a globally competitive manufacturing sector.** South Asia in recent years has attracted greater investor attention, because of faster growth, its large size of domestic markets, and as an increasingly attractive location for labor-intensive manufactures given low-wage costs. And paradoxically, its growing prowess in exports of sophisticated services as it became more open and integrated with global markets is also enhancing its possibilities in industrial and other sectors. Such services will serve as critical inputs to the growth of manufacturing. This set of endowments and interest of investors can now be turned to decisive advantage by stepping up policy support to manufacturing, with a focus on new entry and growth of the “missing-middle” of more dynamic mid-sized firms and more “sophisticated” manufactures. Policies that might support such goals are: greater export-orientation and trade links, reduced behind-the-border costs, better infrastructure, and a differentiated strategy of industrial support—such as industrial clusters and export-processing zones in late or new industrializing areas, and accelerated skills-training, infrastructure, and a deregulated business environment (land, labor) in already established areas.

The process has already started. Rapid spread of mobile telephony and financial services is boosting domestic markets and productivity growth. Private sector investment is also addressing critical bottlenecks. In the first three quarters of 2009, South Asia remarkably attracted some 40 percent of total investment commitments in private participation in infrastructure projects in the developing world worth some record US\$26 billion, much of it going into the crucial energy and transport sectors, mainly in

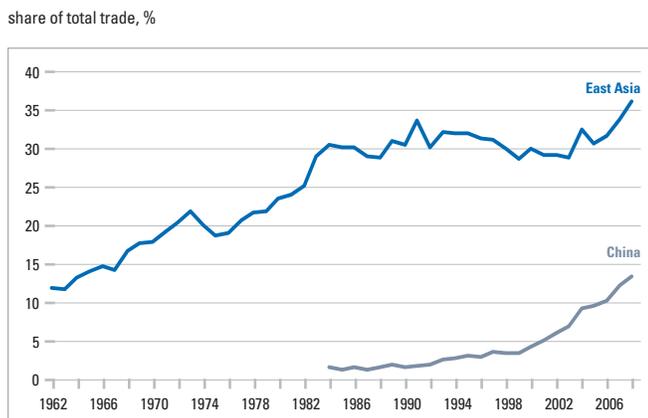
India, but spreading to other countries. Foreign direct investment has been surging, much of it directed to the new manufacturing and services sectors. In the first six months of 2009, India exported more small cars to the rest of the world than did China, thanks to the relocation of car manufacturing from Korea and Japan. Sri Lanka has started exports of sophisticated optical equipment, electronics, and high-end garments, and become a transshipment hub. And Bangladesh is beginning to attract investment in sophisticated ship-building and newer manufacturing, in addition to its traditional specialization in low-cost garments, jute, and ship-breaking.

**Taking advantage of three levels of growing integration: with East Asia, within the region, and with the rest of the world.** There is a significant consensus now that what will come after this crisis in the global economy will not be simply a return to precrisis conditions, but a “new normal.” Developed countries are starting to save more and spend less, are burdened with large fiscal and financial adjustment after the crisis, and are likely therefore to grow at a much slower pace, especially in Europe and North America, whereas Asia and emerging markets will become much bigger drivers of global growth. As a special topic for this Update, the report examines and recommends three principal directions to reposition South Asia’s trade and investment integration policies and profitably expand its domestic economies in both manufacturing and services.

**Intensify their Look East strategy to integrate faster with East Asia, a region with a combined GDP of US\$6 trillion and South Asia’s natural trading partner.** Look East integration is already happening, with quite remarkable results, and South Asia is well on its way to integrating rapidly with East Asia (with trade potentially tripling to some US\$450 billion annually in terms of gravity model results). One of the largest copper mines is being established in Afghanistan by investment from China. The biggest FDI project in India is an integrated steel plant investment from Korea. Financial services are being deepened by investments from Singapore, as are electronics with investments from Asian newly industrialized countries (NICs). Energy and food imports from Malaysia and Indonesia are reducing domestic constraints. Imports of sophisticated capital goods are helping the productivity climb of large segments of manufacturing, including consumer electronics and capital goods. The recovery of tourism in Maldives, as well as other countries, is being driven by increased flows from East Asia. Given complementary economic structures and specialization possibilities, such trade and investment integration will help boost domestic manufacturing and services output and productivity further, and provide significant gains for growth and welfare—provided policies improve and attract investment in trade logistics and other backbone services and help integrate South Asia faster into global manufacturing value chains. Reducing tariffs to

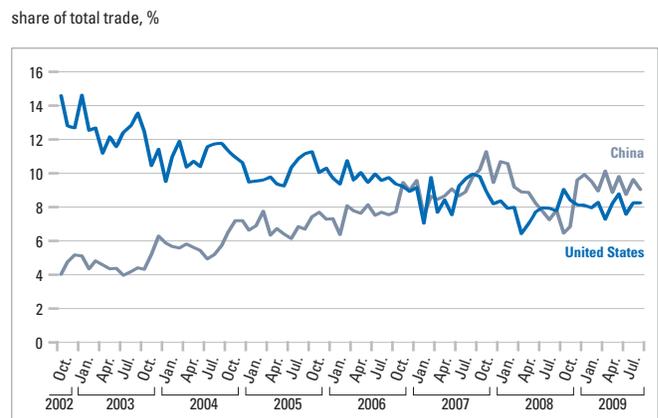
**Figure 2 South Asia’s rising trade with East Asia, and India’s trade with China and the United States**

A. South Asia’s rising trade with East Asia



Sources: CEIC Data Ltd.; World Trade Indicators.

B. Share of India’s bilateral trade with China and the United States



Source: CEIC Data Ltd.

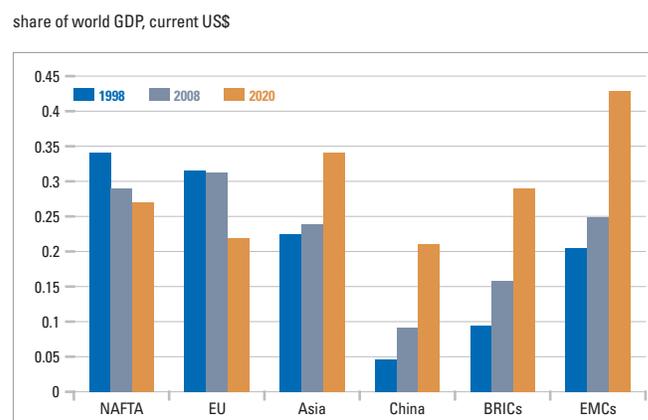
East Asian levels, liberalizing foreign direct investment into services sectors, and reducing behind-the-border administrative and regulatory trade barriers will be important to achieve these gains.

**Integrate more closely with each other within the South Asia region as a key complementary driver.** The potential for closer integration within South Asia is large (with annual trade potentially increasing by some US\$50 billion), similar to the experience in the EU, East Asia, and other regional trading arrangements. The gains from a Look East strategy will be even stronger with such an expanded regional market. Such a larger regional market will allow bigger scale economies, induce greater competition and technology spillovers, improve trade logistics, and attract greater private investment from East Asia and the rest of the world. The role of India will be central to improve integration opportunities for smaller neighbors as they respond. While the gains for India are smaller, the gains for smaller neighbors are much bigger. Growing bilateral hub-and-spoke trade, in both manufacturing and in services, with private investment as the driver, is likely to be the most promising route (complementing regional initiatives). Again, there are increasingly prominent gains happening on the ground. Sri Lanka–India trade has boomed following the bilateral trade agreements, extending to services, such as an open-skies agreement that has brought new carriers and tourism, while Sri Lanka’s exports to India have quadrupled. Nepal’s access to India’s labor markets has increased remittances dramatically. Bhutan’s power projects are providing a surge in export earnings and growth, while helping supply critical power. The recent 2010 Bangladesh-India trade agreement promises to open similar avenues to growth, not just to the two countries, but also boost transit trade for land-locked Nepal and Bhutan and India’s Northeast. Afghanistan-Pakistan border trade is booming with large benefits to both countries.

**Finally, preserve links to high-income markets in Europe and North America, and others, as these will continue to be important for labor-intensive exports, services, and as sources of capital and know-how.** High-income markets are already vital for growing information technology and outsourced business process services (the United States accounts for over half of India’s service exports) and labor-intensive manufactured exports, even if at a slower pace than in the past. Other emerging markets and regions, such as the Middle East, Africa, and Latin America, are also fast growing and are increasingly important partners. In their pursuit of a Look East and accelerated regional integration strategy, South Asian countries will therefore stand to gain by pursuing a unilateral opening of their merchandise and services trade and direct investment—in an “open regionalism” fashion—to improve their access to all markets, and increase inflows of capital and know-how for manufacturing and backbone infrastructure services at home. These, in turn, will complement and sustain the domestic engines of productivity and growth. The effects of lowering real trade costs could be as powerful as increasing trade impacts by a factor of two or more.

**Concerns about security, including day-to-day insecurity, will need to be addressed if the region is to fulfill its full potential.** For some countries in the region, and some regions in all countries, economic growth and development have been hobbled in the past decade by rising conflict and insecurity. As peace returns, the postconflict peace dividends can be large but are not automatic; policy settings need to be supportive—potentially raising growth by 2 to 3 percentage points annually in the countries and more in the sub-regions severely affected. The postconflict bounce in growth and optimism in Sri Lanka is an example and could

**Figure 3** The growing share of emerging markets



Source: Staff estimates.

be possible in Nepal, if policies sustain the dividend. On the other side, in protracted conflict-affected regions, although it is a very complex issue, one factor that might help is more jobs for a fast-rising young population. Winning the peace and ensuring security there will require the successful creation of jobs, as well as strengthening the role of the state to deliver better services and good governance. Expanding the private sector, including in agriculture, will require vast improvements in public infrastructure, sustaining and scaling up of successful national programs, and strengthening economic governance.

**Increased trade among neighbors might help.** One example of this is the possibility of a larger regional energy ring trade that might bring large regional benefits. Bangladesh, India, Pakistan, and Sri Lanka all have a demand for energy that is in excess of their domestic capacity to varying degrees, and the gap will only become larger with future growth. Conversely, Bhutan and Nepal in the region; the Islamic Republic of Iran and Qatar in the Middle East and North Africa region; Kyrgyzstan, Tajikistan, and Turkmenistan in the Central Asia region; and Myanmar in the East Asia region all have resource endowments considerably in excess of domestic demand. The tapping of this potential with regional energy links by some estimates could generate benefits valued at US\$12–15 billion annually. But this potential would only be realized with improved security and regional cooperation, including at the ground level and with discernible benefits to the local populations.

## I. SOUTH ASIA RECOVERING FROM THE GLOBAL CRISIS

South Asia is a relatively small geographic region of eight countries with a large combined population (1.5 billion people), second only to East Asia (2 billion), and with great diversity in size and circumstance. India (1.13 billion), Bangladesh (160 million), Pakistan (166 million), and Sri Lanka (20 million) compose the diversified economies. By contrast, the region also contains two very small, relatively specialized economies: Bhutan (0.7 million) and Maldives (0.3 million). The remaining two economies consist of the relatively undiversified and landlocked economies of Nepal (28 million) and Afghanistan (28 million).

With an average per capita gross national income (GNI, by Atlas method) of US\$963 (2008), South Asia remains a low-income region that is on the verge of becoming middle-income—in contrast to a decade ago. Nearly 80 percent of the region’s GDP originates in India, South Asia’s fastest-growing and biggest economy, with Pakistan and Bangladesh accounting for another 10 and 7 percent, respectively, and with the remainder divided among the others. Although intraregional trade is the lowest in the world—about 5 percent of total external trade—informal and unrecorded border trade is significant. Domestic food and other commodity prices converge across borders, in part because of such trade. Bhutan and Nepal enjoy unrestricted trade, capital flows, and labor migration access to neighboring Indian markets.

**Backdrop: Faster Precrisis Growth, 2000–07.** Economic growth in South Asia accelerated during 2000–07 (continuing the trend since the 1980s) to reach 6.5 percent a year, and it reached a peak of about 8.9 percent in 2006–07, making South Asia the second-fastest-growing developing region after East Asia. From a growth accounting perspective, the proximate drivers were an acceleration of factor productivity growth and capital accumulation, while much less was gained in education (Collins 2007). From a policy point of view, the engines were investment deregulation, lower foreign trade restrictions, and lower tariff barriers. Reforms sparked a private sector–led boom in investment and productivity, rises in household incomes provided fast growth in domestic consumer markets, and demographics favored a rise in household savings (indirectly through a rise in corporate profitability and savings).

Labor-intensive manufactured export sectors such as ready-made garments and textiles continued to play important roles. They gained market shares (from the dismantling of the Multi-Fiber Agreement) and attracted buyers at both low (Bangladesh) and high (Sri Lanka) ends, as did other sectors, such as leather, gems and jewelry, carpets, and frozen foods. Bigger gains came from modern services—especially telecommunications, information technology (IT), tourism, transport, retail, and finance (Ghani 2010). Mobile telephony achieved rapid penetration and attracted large investments. Information technology and outsourcing grew rapidly in India and was spreading to Bangladesh, Pakistan, and Sri Lanka. Modern tourism grew in Bhutan, Maldives, Nepal, and Sri Lanka. Financial services deepened. Industry also gained—in sectors such as ship-breaking, shipbuilding, and steel in Bangladesh; automobiles, steel, pharmaceuticals, and light engineering in India; fertilizer and cement in Pakistan; and hydropower in Bhutan and Nepal. Overall, these nonagricultural sources underpinned more dynamic growth and rising investor confidence in South Asia. Agriculture continued to decline in importance for output growth.

**Varying Country Circumstances.** There were some differences, however (see table 1.1). India grew by nearly 9 percent annually in 2002–07, reflecting overall investment rates that climbed to 37 percent of GDP (compared to 25 percent in the 1990s), and financed by rising domestic savings. Investment rates elsewhere remained at about 25 percent of GDP. Bangladesh saw a pickup but smaller rise in growth and private investment, and it financed its growth easily with growing remittances and exports. Bhutan’s growth was led by large hydropower projects, with little external vulnerability because long-term external inflows (from India) financed such projects. Nepal was the only country with large savings and external surpluses, but it was unable to achieve faster growth and investment dynamism; rising remittances went into nontraded housing and land markets. In contrast, the sources of faster growth in Maldives, Pakistan, and Sri Lanka were relatively well grounded, but the economies saw increasing reliance on foreign savings (external deficits) and experienced greater vulnerability (reflecting growing fiscal deficits). Insecurity and conflict

**Table 1.1 South Asia: recent growth, outlook, and macroeconomic indicators**

	1991–00	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10 P	2010/11 F	2011/12 F
<b>South Asia (GDP growth)</b>	<b>5.3</b>	<b>7.6</b>	<b>7.8</b>	<b>8.9</b>	<b>8.9</b>	<b>7.8</b>	<b>6.3</b>	<b>7.0</b>	<b>7.8</b>
Bangladesh (GDP growth) <sup>1</sup>	4.8	6.0	6.6	6.4	6.2	5.7	5.5	5.9	6.4
Current A/C balance	-1.4	-0.9	1.3	1.4	0.9	2.8	2.1	1.5	1.8
Budget balance (% of GDP)	-4.7	-3.5	-3.4	-3.1	-3.6	-3.6	-4.0	-4.0	-3.4
Inflation (annual %)	5.7	6.5	7.2	7.2	9.9	6.7	6.5	6.1	6.0
Bhutan (GDP growth)	5.1	7.5	6.7	13.2	11.7	6.2	8.1	7.7	6.9
Current A/C balance	-5.2	-30.4	-4.3	14.3	-2.1	-4.5	-11.5	-11.7	-10.5
Budget balance (% of GDP)	-6.3	-7.0	0.2	7.1	3.9	2.3	-4.7	-4.2	-2.5
Inflation (annual %)	8.5	3.3	4.8	5.2	5.1	4.6	4.0	8.3	4.0
India (GDP growth) <sup>2</sup>	5.6	7.5	9.5	9.7	9.2	6.7	7.4	8.5	9.0
Current A/C balance	-1.1	-0.4	-1.2	-1.0	-1.4	-2.5	-2.4	-2.4	-2.3
Budget balance (% of GDP)	-8.1	-7.3	-6.8	-5.4	-5.0	-8.8	-9.5	-8.5	-7.4
Inflation (annual %)	8.7	4.0	4.2	6.4	6.2	9.1	11.3	8.5	6.0
Nepal (GDP growth)	5.0	3.5	3.4	3.3	5.3	4.7	3.0	4.0	4.2
Current A/C balance	-2.9	1.6	2.1	-0.1	2.7	4.3	-2.0	0.1	0.0
Budget balance (% of GDP)	-5.8	-3.2	-3.6	-4.1	-4.6	-5.4	-6.3	-7.1	-7.0
Inflation (annual %)	9.6	4.5	8.0	6.4	7.7	13.2	11.8	8.0	5.5
<b>Externally Vulnerable:</b>									
Pakistan (GDP growth)	4.0	9.0	5.8	6.8	4.1	2.0	3.7	3.0	4.0
Current A/C balance	-4.0	-1.4	-3.9	-4.8	-8.4	-5.6	-3.8	-4.0	-3.9
Budget balance (% of GDP)	-5.9	-3.3	-4.3	-4.3	-7.6	-5.2	-4.6	-3.9	-3.0
Inflation (annual %)	9.2	9.3	7.9	7.8	12.0	20.8	11.5	7.5	6.5
Maldives (GDP growth) $\Delta$	8.3	9.5	-4.6	18.0	7.2	6.3	-3.0	3.4	3.7
Current A/C balance	-5.7	-15.8	-36.4	-33.0	-41.5	-51.4	-28.5	-23.4	-13.1
Budget balance (% of GDP)	-5.9	-1.8	-11.3	-7.2	-4.9	-13.8	-26.1	-17.8	-4.2
Inflation (annual %)	7.5	-1.7	1.3	2.7	6.8	12.0	4.5	6.0	6.0
Sri Lanka (GDP growth) $\Delta$	5.2	5.4	6.2	7.7	6.8	6.0	3.5	5.5	6.0
Current A/C balance	-4.7	-3.1	-2.7	-5.3	-4.3	-9.3	0.7	-2.2	-2.5
Budget balance (% of GDP)	-8.1	-7.5	-7.0	-7.0	-6.9	-7.0	-9.7	-7.5	-6.0
Inflation (annual %)	9.7	9.0	11.0	10.0	15.8	22.6	3.5	8.1	8.7
<b>Memo: Externally Aid Reliant</b>									
Afghanistan (GDP growth)		8.8	16.1	8.2	14.2	3.4	22.5	8.6	7.0
Current A/C balance *	...	...	-2.8	-4.9	0.9	-1.6	-3.6	...	...
Budget balance (% of GDP)	...	...	...	-2.9	-1.8	-3.7	-0.7	-1.4	-1.5
Inflation (annual %)	...	14.9	9.4	4.8	20.7	3.2	-2.2	5.0	4.0

Sources: World Bank staff estimates for GDP growth. World Bank 2010.

<sup>1/</sup> Bangladesh Bureau of Statistics.

<sup>2/</sup> India: Based on NAS with 1999-2000 as base year.

Note: South Asia refers to starting calendar years. Inflation is consumer price inflation.

$\Delta$  Maldives & Sri Lankan Economic Authorities record data in calendar years. Maldives & Afghanistan budget balance includes grants.

\* Includes official transfers.

also rose in the region, especially after 2001, and it affected countries in South Asia to varying degrees (Iyer 2009). Natural disasters took their toll, such as the tsunami (affecting India, Maldives, and Sri Lanka in 2004); earthquakes (affecting Pakistan in 2005); floods (affecting Bangladesh, India, and Nepal in 2007); and droughts (affecting India in 2009 and Pakistan in 2001).

**Growth Slowdown, Recovery, and Outlook, 2008–11.** A sharp growth slowdown punctuated 2008 and 2009 as a result of the global financial crisis; the slowdown was more marked in some countries than in others. The region is now recovering rapidly. From 2007 to 2009, growth fell by close to 3 percentage points. It is now expected to recover to 7 percent in 2010 and nearly 8

percent in 2011—close to precrisis levels, and more quickly than earlier anticipated. The strengths of the domestic economies, resilience in key sectors, and strong domestic policy responses contributed to the rebound, as did the emerging global recovery. There remain some significant risks in the global economy, however. The rest of this chapter focuses on the factors involved in South Asia’s recovery from the global financial crisis.

## THE GLOBAL FINANCIAL CRISIS’ IMPACT

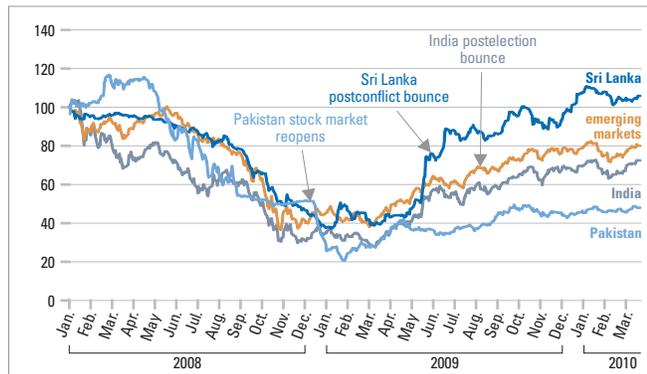
The first external shock to the South Asian economies was the global commodity price shocks starting in late 2007. The September 2008 global financial crisis deepened the impacts. The commodity price shocks were the first channel, and they initially caused (1) very large terms-of-trade losses (about 9 percent of GDP until May 2008, bigger than in any other developing region), (2) a widening of external deficits, and (3) a loss in foreign reserves.

Starting September 2008, the financial crisis impacts deepened. Propagation was through the second channel in domestic financial markets. It was more severe in the more externally vulnerable countries, Pakistan and Sri Lanka, but also in India, as was evident in the stock market fall (see figure 1.1). South Asian countries and banks had limited financial integration, had little exposure to subprime markets, and had relatively closed capital accounts that, in principle, limited vulnerability to short-term capital outflows.

**Figure 1.1A Large drops in stock markets...**

Morgan Stanley Capital International Indices

index of equity prices (\$), January 1, 2008 = 100



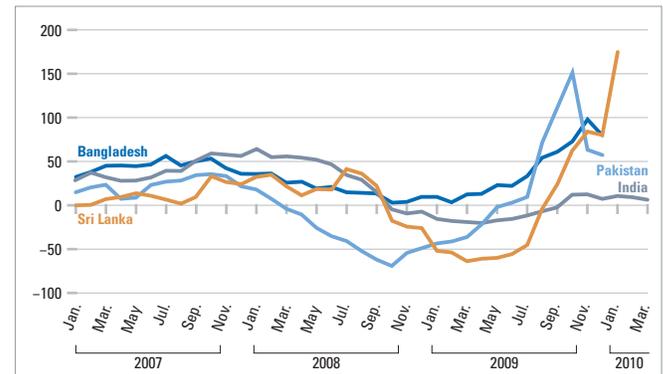
Sources: Bloomberg; World Bank 2010.

Note: Data are for the first month of each date shown.

**Figure 1.1B ...and loss in foreign reserves**

Total foreign reserves, excluding gold

annual percentage change



Sources: Global Economic Monitor; World Bank.

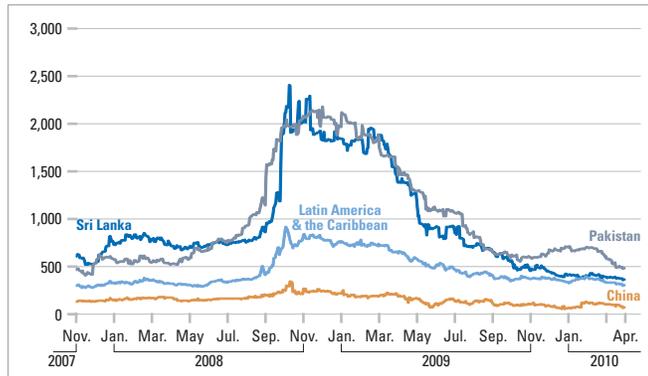
Nevertheless, with contagion and with reversal of portfolio and external commercial credit inflows, secondary market spreads on sovereign bonds spiked dramatically (see figure 1.2). The interbank market in India effectively froze, and overnight call money rates rose to unprecedented levels (as banks feared others’ exposure to overseas subprime markets). Trading in the Pakistani stock market had already been suspended, and trading continued to be halted for several weeks after September (reopening in December); Indian and Sri Lankan markets further declined from already low levels.

The third channel was the subsequent real sector negative effects of falling global output and trade. The fall in tourism affected Maldives most severely—and to a lesser extent Bhutan and Nepal (see figure 1.3). Falling merchandise exports affected the

**Figure 1.2 Spike in spreads in Pakistan and Sri Lanka and interbank call money rates in India**

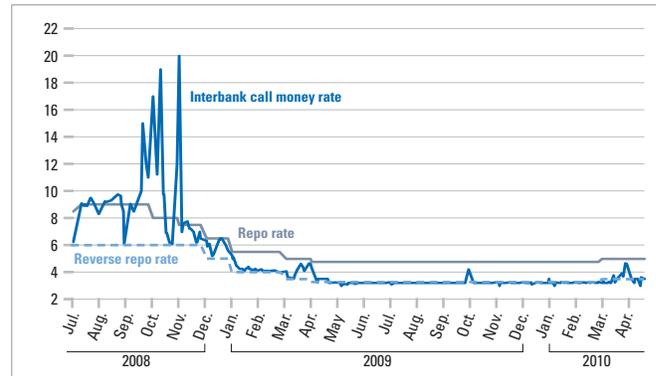
Sovereign bond interest spreads over U.S. treasuries

basis points



Sources: JP Morgan; Global Economic Monitor.

repo rates and interbank call money rates

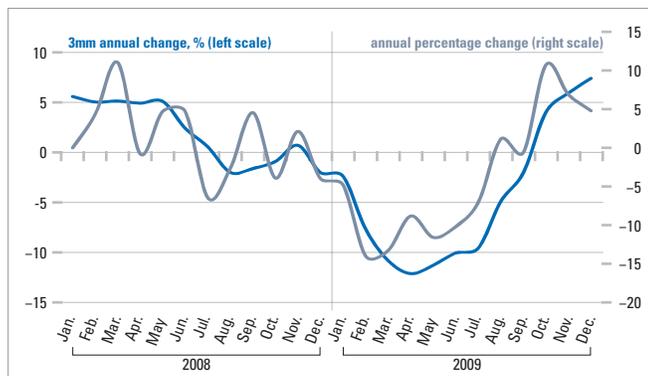


Sources: Bloomberg; CEIC Data Ltd.

Note: Data are for the first day of each month shown.

**Figure 1.3A Real sector impacts: collapse in tourism...**

Maldives tourism

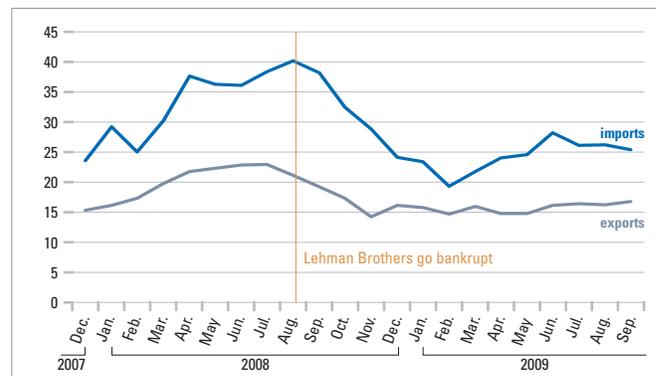


Source: Maldives Monetary Authority.

**Figure 1.3B ...and trade**

Trade of South Asian countries

US%, billions



Source: CEIC Data Ltd.

Note: The sample countries are India, Bangladesh, Pakistan, and Sri Lanka.

others. Export sectors such as textiles and garments, tourism, and diamond processing also laid off workers, in a limited fashion relative to the size of the labor force.

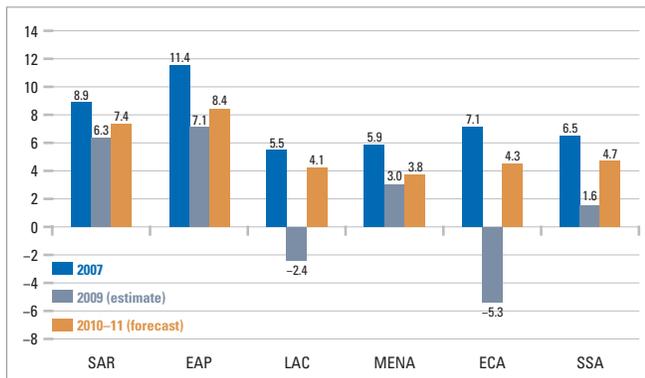
This brief review of developments during the crisis suggests some lessons: (1) the domestic financial propagation channel was the most important through the loss in consumer and investor confidence; real sector effects quickly followed, as by December 2008, investment growth in India, Pakistan, and Sri Lanka had collapsed, domestic consumer spending had slowed, and industrial production in Bangladesh, India, Pakistan, and Sri Lanka had plummeted from rates of about 10 percent a year earlier to negative levels by January 2009 (see charts in the Outlook section), and (2) South Asia remained especially vulnerable to global commodity price shocks. Looking forward, policies might seek to strengthen the domestic financial system (reduce fiscal deficits, improve domestic capital markets) and build more buffers between global commodity shocks and domestic prices (set domestic energy prices at more sustainable levels, reduce food and energy subsidies, and help build alternative regional and domestic supplies).

## RESILIENCE AND RECOVERY

South Asia weathered this crisis better than expected, and it has been recovering strongly since March 2009. Four reasons stand out: resilience of remittances, particular key exports, foreign direct investment (FDI) and recovery of global capital flows, and adroit policy responses.

**Figure 1.4 South Asia: smallest decline in growth from global financial crisis and recovering**

GDP growth (annual percentage change)



Sources: Staff estimates; *Global Economic Prospects 2010*, World Bank.

Note: SAR (South Asia), EAP (East Asia and Pacific), LAC (Latin America and the Caribbean), MENA (Middle East and North Africa), ECA (Europe and Central Asia), SSA (Sub-Saharan Africa).

South Asia, as a whole, has weathered this crisis better than most analysts had expected (see figure 1.4). The overall effect has been to reduce the region’s growth by about 3 percentage points—from 8.9 percent per year in 2007 to 6.3 percent per year in 2009. This was the smallest growth decline among all the developing (and developed) regions of the world—attributable to the relatively low levels of financial integration with the global economy and to domestic sources of growth. The recovery is now well under way. Expected GDP growth of more than 7 percent per year on average between 2010 and 2011 is only slightly behind East Asia and is better than South Asia’s own historical average (6.5 percent annually between 2000 and 2007 and 5.3 percent between 1991 and 2000). The macro-impacts of the crisis were most severe on countries with weaker fundamentals and greater external vulnerabilities going into the crisis, such as Maldives, Pakistan, and Sri Lanka.

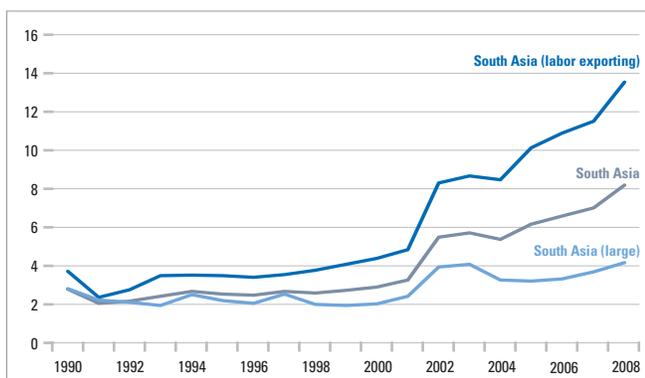
The crisis also affected India because of domestic contagion effects on spending, but it had much more limited negative effects in other countries, such as Bangladesh, Bhutan, and Nepal.

Four key factors cushioned South Asia’s growth during the crisis and are helping in the strong recovery. The first is the resilience in remittances (see figure 1.5). Remittances play a crucial role in South Asia, bigger than in most other regions. Migration takes place to increasingly diversified sources of recipient regions: to high-income OECD and non-OECD countries, to the nearby Gulf and the Middle East, and within South Asia itself.

**Figure 1.5 Resilience of remittances**

A. South Asia exporting labor: workers’ remittances

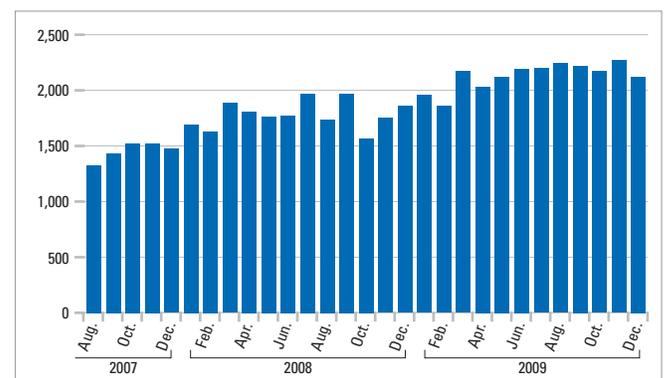
% of GDP



Sources: World Development Indicators; World Bank 2010.

B. Total remittance inflow for Bangladesh, Nepal, Sri Lanka, and Pakistan

US\$, millions



Source: CEIC Data Ltd.

The rise in workers’ remittances in South Asian countries has been dramatic since 1990. Total annual receipts now average about 10 percent of GDP. For Bangladesh, Nepal, and Sri Lanka, the average receipts were nearly 14 percent of GDP in 2008 and tripled in size from about 3 percent of GDP in 1990. However, for the very large countries (India, Pakistan), annual receipts have risen from about 3 percent in 1990 to an average of about 4 percent of GDP by 2008. Workers’ remittances exceed capital inflows and are five times bigger than net FDI inflows—financing household consumption, financial savings and investment, imports, and the balance of payments.

During the global crisis, remittances held up much more strongly and continued to grow in South Asia compared to other regions (where they fell by 6 percent), and remittances are doing better than expected—partly because of the large stock of workers abroad in the Gulf and other regions and because of higher incomes and education in the stock in high-income countries that have been less adversely affected by loss of jobs. In Nepal, the reliance on remittances is the highest, and without those flows, growth in consumption might have collapsed.

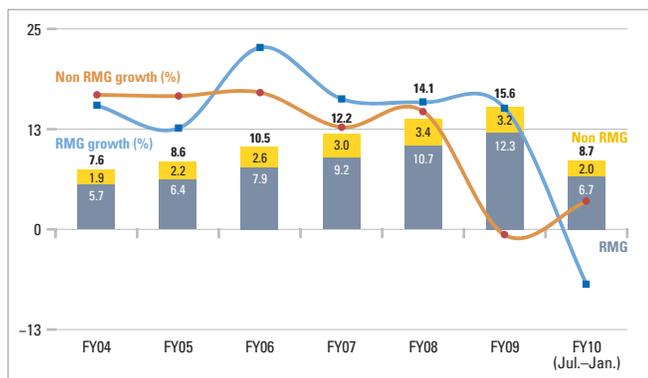
A second reason has been the resilience of some key export-oriented sectors. Exports make up a relatively smaller share of national output in South Asia than in most other regions: about 22 percent of GDP (compared to 12 percent in 2000), against 35 percent of GDP in East Asia and the Pacific (EAP). On average, the share is more than 30 percent of GDP in all low- and middle-income countries.

Nevertheless, exporting sectors play an important role, in part because they are concentrated in labor-intensive sectors and services. Some exports of goods and services during this crisis proved more resilient when compared to, for example, EAP, whereas imports, as expected, dropped sharply because of weak demand. Indeed, net trade actually supported growth in South Asia during the crisis.

Export resilience can be traced to the types of merchandise specialization and competitiveness of South Asian countries (trade issues are discussed in more detail in chapter 3). Garments in Bangladesh and IT software exports from India are two good examples. In garments, a so-called Walmart effect was evident as Bangladesh became the preferred supplier because of its competitive strength in the lowest-cost segments and as it gained market shares. The peak-to-trough decline in the key garments sector is expected to be only about 3–4 percent.

**Figure 1.6A Bangladesh: growth of garments...**

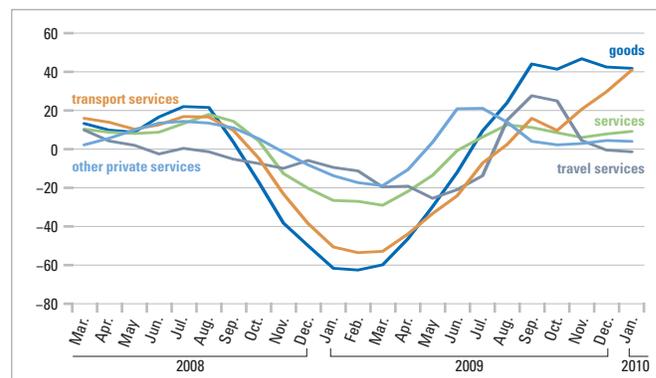
RMG and non-RMG exports, US\$, billions



Source: Bangladesh country source.

**Figure 1.6B ...and U.S. import of services**

rolling 3 month on 3 month average (%)



Source: CEIC Data Ltd.

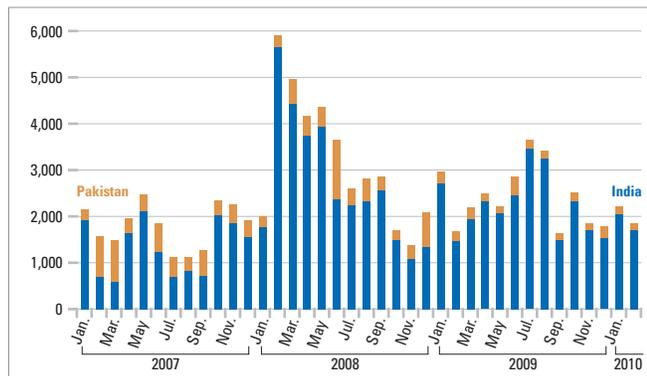
At the other end, in India, where service exports make up close to one-third of the country's total exports, such exports fell but were less affected by the global trade downturn, because even in a deep recession, such business processes continued to be important (see figure 1.6). As Borchert and Mattoo (2009) indicate, "The gloom and doom about goods trade has obscured the quiet resilience of services trade. Countries like India, relatively specialized in business process outsourcing and information technology services, suffered much smaller declines in total exports to the U.S. than [did] countries like Brazil or regions like Africa, which are specialized in exports of goods, transport services, or tourism services." Although world trade and overall exports plummeted elsewhere, these export-oriented sectors in South Asia held up relatively well.

A third key reason was the resilience of FDI inflows to South Asia during this crisis. FDI inflows to South Asia had earlier soared between 2000 and 2007: net inflows rose from about 0.7 percent of GDP in the 1990s to nearly 3 percent of GDP by 2007. The recent surge was marked by some important differences: inflows took off only after 2004, lagging the rise in trade integration. In addition, they went primarily to the larger and more diversified economies: India and Pakistan, and, to a much lesser extent, Bangladesh<sup>1</sup> (see figure 1.7).

**Figure 1.7 Foreign direct investment inflows relatively resilient in South Asia**

A. FDI inflows in India and Pakistan

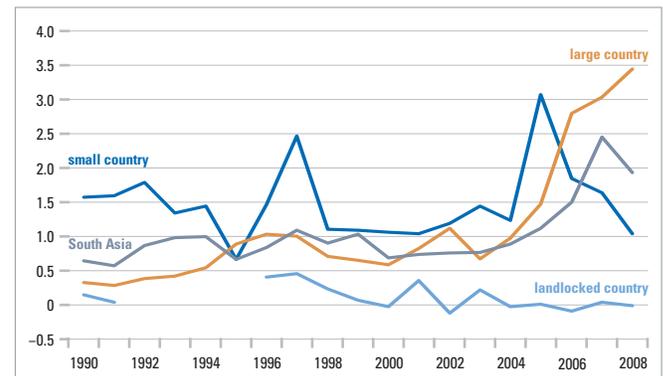
US\$, millions



Sources: CEIC Data Ltd.; World Development Indicators, World Bank 2010.

B. South Asia FDI inflows by size and geography

percent of GDP



Sources: World Development Indicators, World Bank 2010.

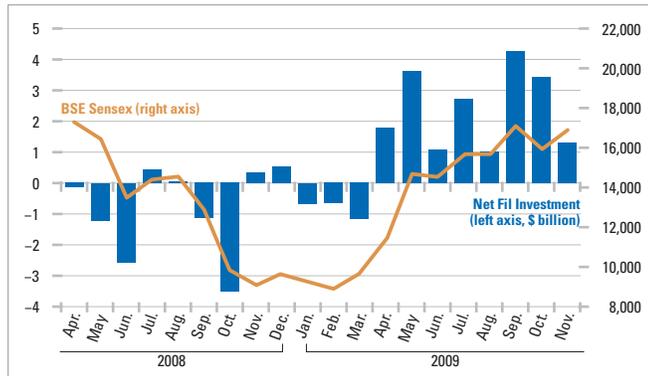
Small or island countries (Bhutan, Maldives, and Sri Lanka) received higher levels of starting inflows, but inflows were more volatile (characterized by lumpiness of investments, such as hydroelectric power in Bhutan or resort development in Maldives), when compared with the steadier rise in larger countries. In contrast, flows to the landlocked countries (Afghanistan and Nepal) remained low throughout, benefiting neither from size nor from global integration potential.

During this crisis, although FDI inflows fell significantly from their peak in 2007–08, which was common to all regions, the fall was less pronounced. Flows have since picked up in India but less so in Pakistan. In contrast, FDI flows to all developing countries in 2009 were expected to have come in at only 30 percent of their 2008 values.

The early recovery of global capital markets also helped in the resilience and recovery of South Asia. Capital inflows started to resume quickly, given the longer-term potential of the region—especially in India but also in other countries (see figure 1.8).

<sup>1</sup> Bangladesh saw limited FDI inflows compared to the other two countries, and inflows fell sharply during FY10.

**Figure 1.8 India: recovery of portfolio capital inflows and stock markets**



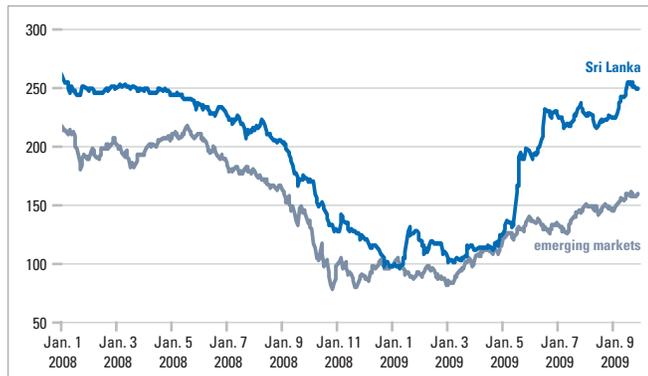
Sources: Reserve Bank of India; IMF IFS.

Confidence and stock markets also gained from domestic developments, even as global equity markets recovered earlier than the GDP and as trade rebounding started in mid-2009. Indeed, (1) the Sri Lankan stock market became the best-performing stock market in 2009, especially as confidence lifted following the end of conflict in May (see figure 1.9); (2) the Indian stock market also jumped dramatically in May, following the successful elections that returned the previous government to power, with reforms expected to continue and strengthen (see figure 1.9); (3) Pakistan's stock market, too, showed a smart recovery; and (4) the Bangladesh market experienced an unexpected bounce as investors discovered the biggest new initial public offering of Grameen Phone.

**Figure 1.9A Postconflict bounce in Sri Lanka...**

Morgan Stanley Capital International Indices

equity prices (\$), December 31, 2008 = 100

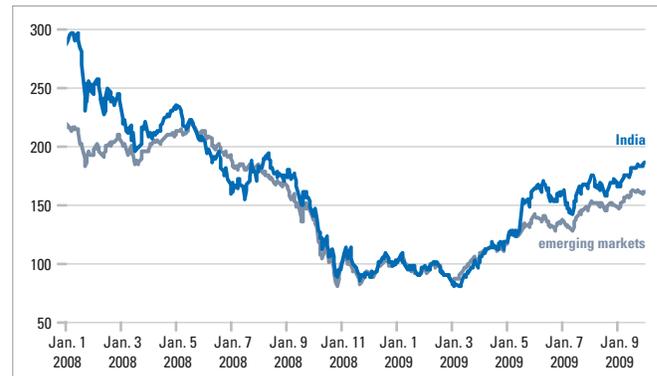


Sources: Bloomberg; World Bank.

**Figure 1.9B ...and the postelection bounce in India**

Morgan Stanley Capital International Indices

equity prices (\$), December 31, 2008 = 100

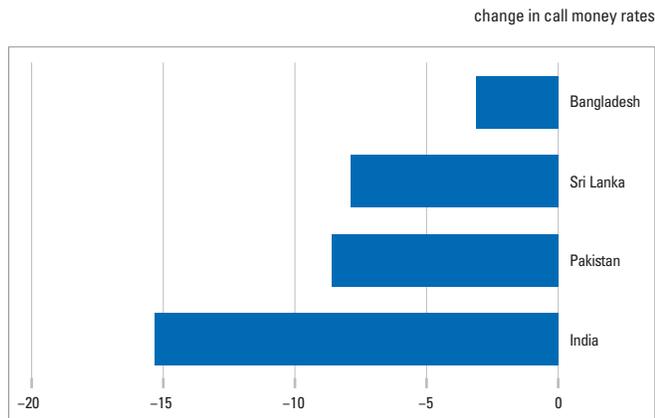


Sources: Bloomberg; World Bank.

Capital flows to South Asian economies now became second only to EAP. Increased capital flows and optimism in South Asian economies was also echoed in a recovery of the Indian rupee (12.5 percent from September 2008 to August 2009), after an earlier steep fall and after rising foreign reserves (from US\$247.7 billion in November 2008 to US\$288 billion in November 2009).

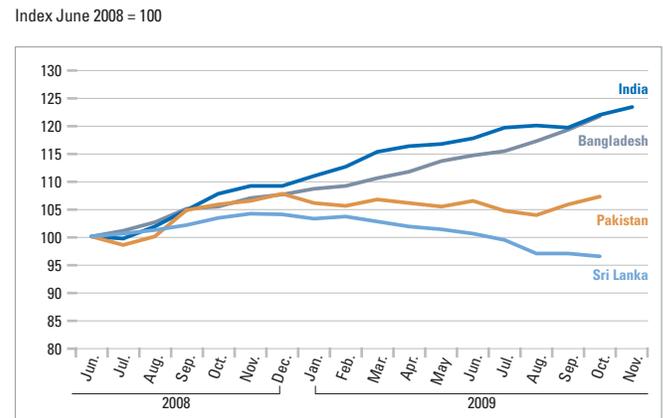
The fourth key reason was strong policy responses early in the crisis, helped by domestic factors such as pre-election fiscal spending increases in India. As in other regions, the policy responses from South Asian policy makers have been swift and timely to contain the global economic slowdown. Policy interest rates, for example, were lowered sharply in most South Asian countries as in India (and subsequently in other countries), faster than in other comparable regions of the world. Similarly, the size of the fiscal stimulus announced was over 3 percentage points of GDP in India and was also significant in Bangladesh and Sri Lanka. As a result, domestic demand has been maintained steadily, with private consumption leading the way. With the help of substantial stimulus and rise in private confidence, South Asians are spending again.

**Monetary Policy Easing.** The easing of monetary policy was a crucial step in which the central banks took aggressive actions. Sharply lower commodity prices, falling inflation, and the decline in advanced country policy rates to near-zero levels allowed

**Figure 1.10A** Change in call money rates since October 2008...

Source: CEIC Data Ltd.

Note: For India and Pakistan, the latest period is February 2010. For Sri Lanka and Bangladesh it is December 2009.

**Figure 1.10B** ...and domestic credit growth

Source: CEIC Data Ltd.

most of South Asia's central banks to adopt accommodative macropolicies, particularly in Bangladesh and India. Pakistan and Sri Lanka continued to have some inflationary pressures, although not nearly as much as would have occurred had the commodity price spikes been sustained. The South Asian policy rates, on average, have dropped by 350 basis points since September 2008. Overnight call rates, in turn, have dropped by an average of 850 basis points (see figure 1.10). Lending rates have, however, declined by smaller amounts in Bangladesh, India, and Pakistan, in part reflecting the stickiness in monetary transmission mechanisms.

However, there were important country differences in circumstances, and hence policies. With large foreign reserves, strong balance of payments, and manageable fiscal settings, Bangladesh and India particularly had more choices. In India, the main issue was providing adequate liquidity in the interbank credit market. The Reserve Bank of India (RBI) aggressively reduced the key policy rates (the repurchase and the reverse repurchase rates), while the cash reserve ratio and the statutory liquidity ratio were both cut sharply. Fresh bond issuances under the market stabilization scheme (MSS) were ceased, and the RBI also bought back existing MSS securities so as to inject liquidity into the system. Foreign exchange liquidity was eased by loosening restrictions on external commercial borrowings and short-term trade credits, while interest rate ceilings on nonresident deposits were raised to attract more foreign funds into the country.

The RBI, which had allowed the rupee to depreciate until September 2008, released foreign exchange into the markets to manage volatility. The monetary policy operations and the extension of liquidity facilities released liquidity amounting to more than Rs4.9 trillion (or about 9 percent of India's GDP) from mid-September 2008 to March 2009.

Bangladesh initially was largely sheltered from the global financial crisis effects. Bangladesh Bank (BB) did not need to alter its monetary policy stance, given stable liquidity and credit conditions in the domestic financial market. However, as the crisis deepened in real sectors (a drop in export performance and a slowdown in migrant workers going abroad), BB eased monetary policy (from July to December 2009).

In countries with weaker settings (higher inflation, loss in reserves), however, as in Pakistan and Sri Lanka, the central banks responded initially by tightening liquidity to contain accelerating inflation and stem losses in reserves. As the global financial crisis effects on their real economies subsequently deepened, the State Bank of Pakistan (SBP) and the Central Bank of Sri Lanka (CBSL) both reverted focus to growth. Policy easing in Sri Lanka commenced in late 2008 and continued into 2009: the benchmark interest rates of repurchase (REPO) and the reverse repurchase (RREPO) were lowered by 225 and 125 basis points

**Table 1.2** Fiscal stimulus measures in South Asia

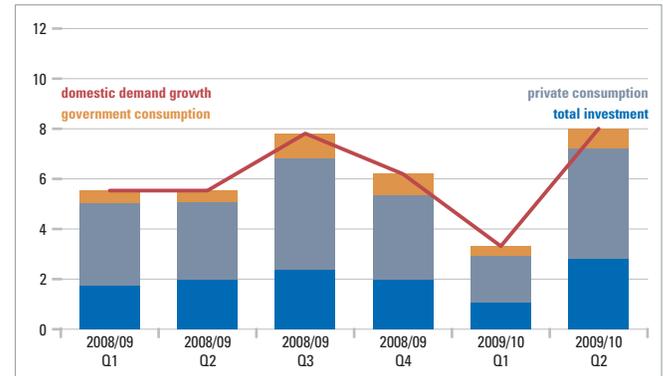
Fiscal stimulus measures taken by Bangladesh		Fiscal stimulus measures taken by Sri Lanka		Fiscal stimulus measures taken by India		Fiscal stimulus measures taken by India	
Stimulus package of Tk34.2 billion (0.6% of GDP) [Apr 09]	Increased subsidies in agriculture; increased cash incentives for recession-affected sectors (jute, leather and frozen food); and further allocations for social safety net programs.	1st Stimulus Package of SLRs16 billion (0.4% of GDP) [Dec 08]	Incentives to tea, rubber, cinnamon and garments export sectors (including fertilizer subsidy).	India 1st Stimulus Package [Dec 08]	Additional plan expenditure up to Rs200 billion in FY2008 for rural infrastructure and social security.	India 2nd Stimulus Package [Jan 09]	State governments allowed to borrow an additional 0.5% of GSDP.
Additional measures [May 09]	Export subsidy (or, cash subsidy) raised for the recession-affected sectors.	2nd Stimulus Package of SLRs8 billion (0.2% of GDP) [May 09]	Rewards under the Export Development Reward scheme, including 5% export incentives.		Tax cut of CENVAT by 4%, and 2% in the service tax.	India 3rd Stimulus Package: [Feb 09]	Central Excise Duty general rate and Service Tax rate reduced.
Budget FY2010 [Jun 09] – stimulus package of Tk50 billion (0.9% of GDP)	Subsidies and incentives to be continued and expanded.				IIFCL raise Rs400 billion through tax-free bonds.		States allowed deviation from fiscal consolidation targets beyond March 2009.
					Full refund of service tax paid by exporters to foreign agents.	India Revised FY2009 Federal Budget [Jun 09] – fiscal deficit remains high (6.8% of GDP)	Accelerated public investment in infrastructure (Bharat Nirman, JUNNURM, NHDP, etc) National Rural Employment Guarantee Scheme

Source: Asian Development Bank 2010.

(bps), respectively, while the hitherto applicable “penal rate” on RREPO (applicable to banks that access the CBSL’s RREPO window more than three times a month) was successively lowered and was eliminated altogether in May. In addition, the statutory reserve requirement of commercial banks was cut twice in the last quarter of 2008 and lowered again in February 2009. As it did in Sri Lanka, the monetary stance in Pakistan was eased significantly, but this easing began even later, after fiscal and other actions to stabilize the balance of payments and reserves. The SBP started to reduce its policy rate (discount rate) in March 2009. Since then, the discount rate has been cumulatively reduced by 250 bps. The SBP also reduced the cash reserve requirement and exempted time deposits from the statutory liquidity requirement.

**Figure 1.11** Fiscal stimulus effects in India

annual percent change, (percentage share)



Source: CEIC Data Ltd.

**Fiscal Stimulus.** In countries with some room for fiscal expansion—Bangladesh and India—and in Sri Lanka to a more limited extent, authorities provided fiscal stimulus in response to the global crisis effects on the domestic economy (see table 1.2 for details).<sup>2</sup> Going into the crisis, India had fortuitously already announced large spending increases, especially in implementing civil service salary adjustments following the Sixth Pay Commission recommendations. Subsequently, India provided three successive rounds of additional fiscal stimulus. Altogether, the fiscal expansion between 2007–08 and 2008–09 amounted to some 3.5 percent of GDP (the largest in South Asia), with (1) a broad focus on indirect tax cuts on consumption; (2) an expansion of government expenditures, especially on the National Rural Employment Guarantee Act, which promised 100 days of guaranteed employment to at least one member of a rural household; and (3) an allowance for state governments to run additional fiscal deficits by 0.5 percent of their state GDPs (see figure 1.11 for fiscal stimulus impacts in India, directly through higher public consumption, and indirectly through tax cuts, which supported private consumption).

The government of Bangladesh similarly provided two principal rounds of fiscal stimulus in an amount close to Tk85 billion, or 1.5 percent of GDP (a third round was announced, but it was primarily about the specific design of measures, rather than about additional stimulus). The measures were focused on the ready-made garments industry. Sri Lanka also took more modest steps to provide some fiscal stimulus, with two rounds amounting to 0.6 percent of GDP, with a focus on helping strategic industries, such as tea and rubber, and with a focus on trade facilitation. In contrast, other countries affected by the downturn but with weaker fiscal settings were consequently forced to adopt relatively contractionary policies. For example, Maldives reduced expenditures sharply to stabilize the balance of payments and the loss in reserves following the fall in tourism receipts, and Pakistan adjusted public electricity prices and cut expenditures; however, their contractions were moderated by taking recourse to external financing from the International Monetary Fund (IMF) and others.

## OUTLOOK

*South Asia is rebounding to higher growth of 7.0 percent in 2010, rising to nearly 8.0 percent in 2011—slightly below precrisis levels. It is driven by a combination of return of greater “optimism” in private consumption and investment, as a result of the effects of the stimulus packages and of the global recovery, especially in capital flows, trade, and tourism. Not every country is, however, doing equally well: some are starting with weak fundamentals, insecurity and conflict, difficult postconflict settings, or a combination of these elements.*

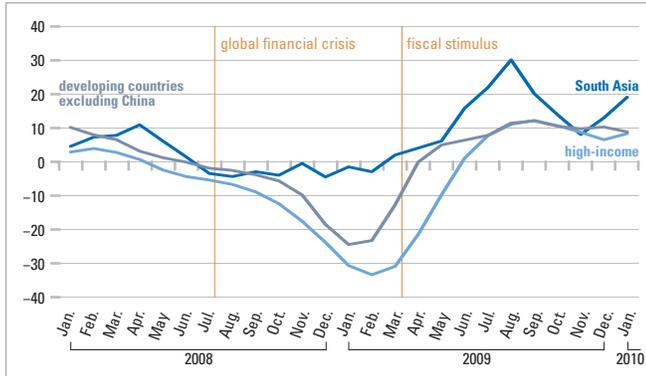
The recovery in South Asia that began in March 2009 has been strong and is comparable to the rebound in China, for example. In terms of the three-month moving average of industrial production as a leading indicator (seasonally adjusted annual rate, or SAAR), South Asia saw a more prolonged but shallow trough between September 2008 and March 2009, when industrial

<sup>2</sup> Table 1.2 is a broader classification and includes immediate precrisis spending measures that had been announced earlier (but implemented more vigorously), as well as infrastructure lending by specialized publicly owned financial institutions (IIFCL) for India, to illustrate the range of measures.

**Figure 1.12 Growth in industrial production**

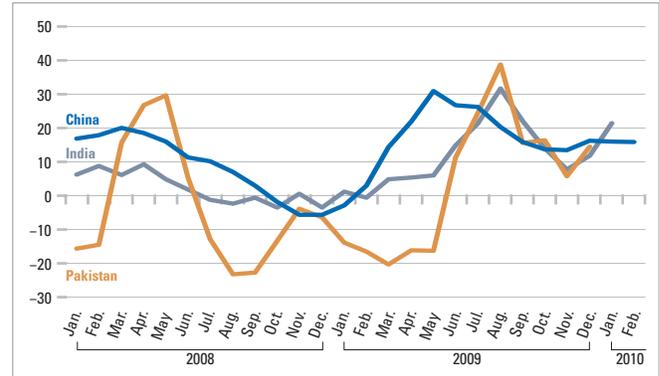
A. South Asia, high-income and developing countries excluding China

rolling 3 month on 3 month percentage change (seasonally adjusted rate)



Sources: Global Economic Monitor and World Bank.

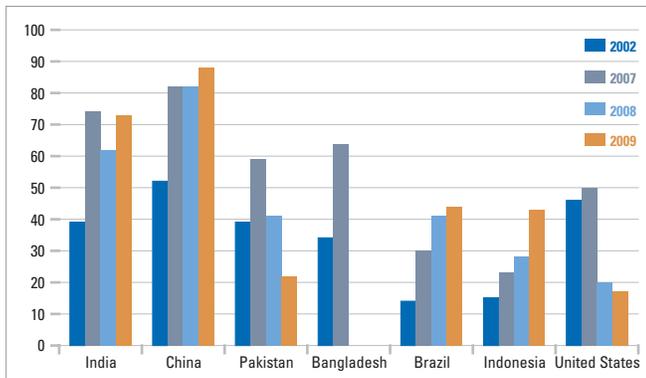
B. India, Pakistan, and China



**Figure 1.13 Relative optimism in South Asia**

Is the current economic situation in your country good?

% of respondents

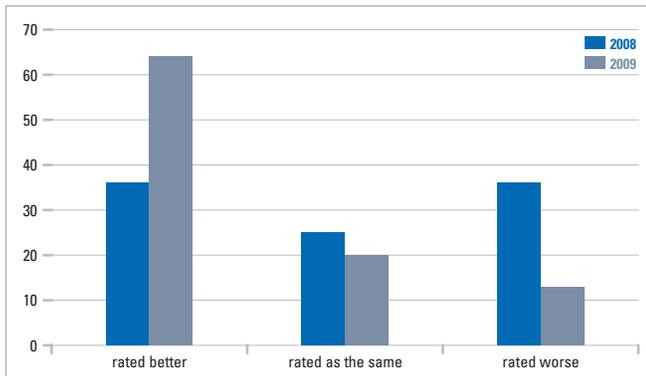


Source: Pew's Global Attitudes Project.

**Figure 1.14A Sri Lanka rising...**

Are economic conditions better?

% of respondents

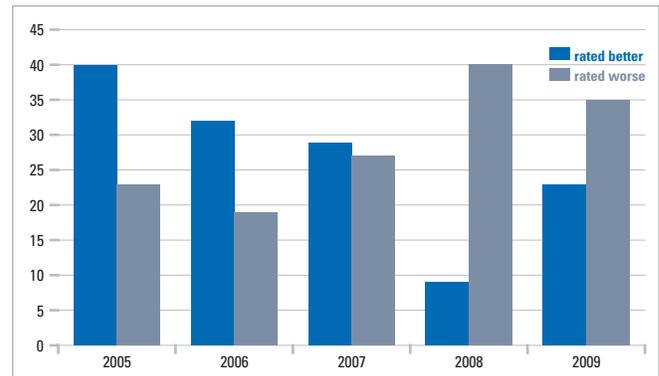


Source: Gallup poll.

**Figure 1.14B ...and Pakistan improving**

Is the next year better?

% of respondents



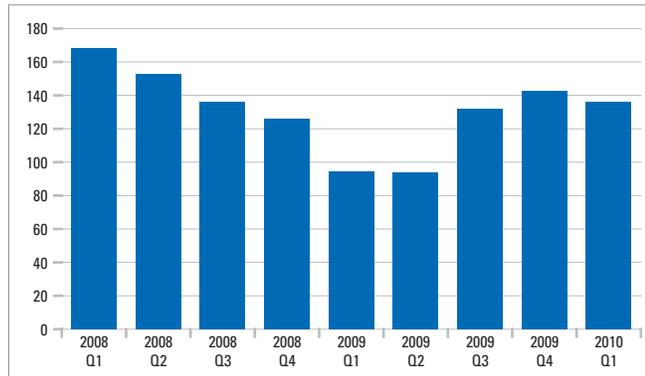
Source: Gallup poll.

production averaged a negative 3–5 percent annualized rate, which was down from a previous level of a positive 8–10 percent growth (see figure 1.12). In contrast, most developing countries (excluding China) and industrial countries experienced much steeper falls, reaching the bottom of the trough in March 2009, with falls in industrial production of negative 25–30 percent. China shows a shallower downturn, which is similar to that in India and South Asia. It reached bottom earlier (December 2008) and is recovering rapidly.

The size of the recovery in China, India, and South Asia is similar—and in some respects recovery is even faster in South Asia, although it started a little later. Pakistan's industrial production shows large volatility, even though it has been recovering strongly in the past few months. The reason appears to be greater shocks and more limited institutional

**Figure 1.15 Outlook improving for firms in India**

optimism index, June 1999 = 100



Sources: Dun and Bradstreet.

capacity to deal with them. Overall, South Asia's recovery in industrial production appears to have settled down to a recent performance (January 2010) of about a 20 percent, 3-month-over-3-month, annualized growth in industrial production, which is very high and correlates well with GDP growth recovering strongly.

What factors help to explain the strong recovery? One set of factors probably has to do with increased optimism in South Asia, especially in Bangladesh, Bhutan, India, and now Sri Lanka (see figures 1.13, 1.14, and 1.15). This optimism can be seen from recent public opinion surveys about the region,

and the results suggest relatively strong expectations when compared to elsewhere and results comparable to China's in some respects. The strong expectations are also borne out by many other recent indicators, especially investor confidence and business expectations. In Pakistan, a turnaround of falling confidence is beginning.

A second key factor, part of which the optimism reflects, is undoubtedly the strong support that government stimulus packages and, in some cases, external assistance have been providing to help stimulate recovery. The easing of monetary policies and the low-interest-rate environment have also been helped by the low-policy-rate circumstances in developed countries.

A third key factor has been the recovery in world production and trade. As a result, and as depicted in earlier figures, tourism is recovering strongly, as are exports and capital flows—thus boosting South Asia's prospective recovery. Given those factors, the outlook for South Asia is a continuation of the strong recovery to about 8 percent GDP growth in 2011, nearly matching the precrisis peak levels. Nevertheless, policy makers in South Asia need to be vigilant about some significant risks and uncertainties in the global environment.

## EXTERNAL RISKS AND UNCERTAINTIES

The policy challenges ahead will be to move to higher, sustained, and more inclusive growth beyond the near term. These challenges are discussed in the next chapter. At the same time, there are potential risks ahead, including the following:

- The global recovery reflects a range of stimulatory fiscal and monetary policies, as well as a turn in the inventory cycle. However, with the effects of recent events in Greece and Europe, the recovery is expected to continue to be hesitant and uneven. In that context, exports from South Asia are also slowing in the most recent months, especially some key exports such as garments.
- Workers' remittances, which have so far been a key strength, are showing some signs of slowing as the number of returning workers rises, and outflows start to fall—as in Bangladesh and Nepal.
- Commodity prices were beginning to become firm, especially oil prices, and are volatile, which pose special challenges for South Asia as a largely import-dependent region.

- Global capital inflows, although currently strong (and still lower than precrisis levels), pose some risks of volatility, including possible reversal if interest rates turn higher and provide better returns in developed countries or if there is a renewed flight to safety after events in Europe.

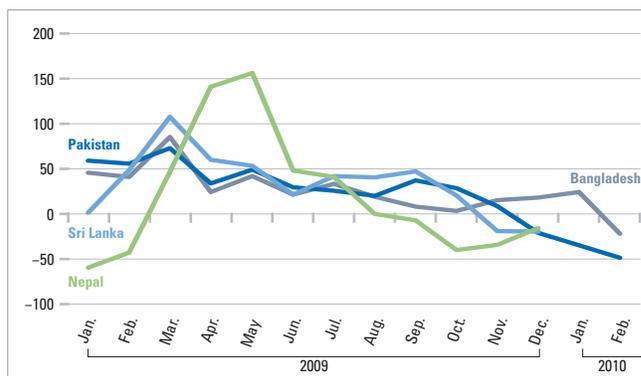
**Hesitant Recovery.** The recovery has been hesitant in developed countries but stronger in East Asia and emerging markets, as global rebalancing occurs (see chapter 3 for details). Indeed, there has been some easing of the very robust rates of industrial production growth posted in the second half of 2009, and although world export orders—which have lagged—have also increased, this was on the strength of developing country performances, which has more than offset weakening export orders for high-income countries. Moving forward, the strength of a demand-led recovery will be supported by rising demand from developing countries, which has grown to represent a larger share of world GDP (up from 19 percent in the 1990s to 25 percent in 2009) and a larger share of world demand (up from 20 percent in the 1990s to 28 percent in 2009). This process is projected to continue, as GDP growth in developing countries continues to grow twice as fast as that of high-income countries.

The recovery will nevertheless be partially muted as fiscal stimulus measures need to be withdrawn and employment growth remains insipid in developed countries. The recent events of sovereign stress in highly indebted European countries are also a reminder of the uncertain outlook and the dilemmas and risks of large fiscal imbalances in the recovery. While the immediate effects are likely to be limited for South Asia given the region's limited reliance on foreign financing and diversified export markets, and may even provide some offsetting gains because of the decline in commodity prices, in particular, oil, they underscore the uncertainties with global demand, with a broadening recovery in the United States and Japan offset by slower growth in Europe. Moreover, households in countries that suffered asset-price busts will seek to rebuild savings, dampening a recovery in household expenditures. Global output is estimated to have contracted by 2.1 percent in 2009, but it is projected to expand by 3.3 percent in 2010 and 2011.<sup>3</sup> Over the short term, the global economy will be characterized by substantial spare capacity, continued high employment, and prolonged weakness.

**Remittances Weaker.** Over the short term, continued high unemployment—notably in high-income countries—will also dampen prospects for migration and remittance flows. Aggregate remittance flows to developing countries are estimated to have fallen by more than 6 percent in 2009. In contrast, remittances to some South Asian countries, such as Bangladesh, Nepal, and Pakistan, continued to record positive growth into 2009, until very recently, when momentum slowed (see figure 1.16).<sup>4</sup> However, to some extent, this slowing may reflect efforts (notably in Pakistan) to increase the flows through formal (and hence measurable) channels. In addition, some migrants may be repatriating, thus bringing accumulated savings with them. Therefore, the consequences of the global downturn on remittance flows to South Asia may be observed with a lagged effect. On a global basis, migration and remittance flows are expected to recover in 2010 and 2011, and the recovery is likely to be gradual, climbing back to 2008 levels in 2010–11.<sup>5</sup> For all developing regions, and for South Asia, prospects are improving in oil-producing countries and in higher-

**Figure 1.16 Momentum of remittance growth slowing**

seasonally adjusted 3 month on 3 month average growth in remittances



Source: CEIC Data Ltd.

<sup>3</sup> See also Global Economic Prospects 2010: Crisis, Finance and Growth, [www.worldbank.org/globaloutlook](http://www.worldbank.org/globaloutlook).

<sup>4</sup> Full year data for 2009 are not yet available.

<sup>5</sup> See Ratha, Mohapatra, and Silwal, "Migration and Remittance Trends 2009," and "Outlook for Remittance Flows 2010–11," Migration and Development Briefs 11 and 12, World Bank, <http://www.worldbank.org/migrationandremittances>.

income East Asia, but remittance flows are likely to face three downsides in OECD countries: a jobless economic recovery, tighter immigration controls, and unpredictable exchange rate movements.

**Commodity Prices to Remain Volatile and Relatively High.** International commodity prices, which fell dramatically in 2009, are expected to be relatively volatile with respect to their current levels over the next two years. The crude oil price is forecast to remain in a band around US\$80 per barrel—recent prices crossed US\$85 per barrel in April, as market conditions tightened with demand recovery, but have fallen back sharply to US\$70 per barrel after recent events in Europe. As stocks of food have recovered since 2008, food prices are not expected to rise further. However, it should be noted that the dollar price of internationally traded food is already twice as high as it was at the turn of the century.

Rice prices averaged \$555 per ton during 2009—16 percent lower than the 2008 average (\$650 per ton), but more than three times higher than in 2000/2001.<sup>6</sup> Despite the weather-related production shortfall this season, the global rice market appears well supplied. End-of-season stocks of the past and the current season averaged 90.5 million tons, 17 percent higher than in 2003–07. Thus, rice prices are projected to fall to \$460 a ton during 2010. Even so, at that level, real prices would average 70 percent higher in 2010–12 than in 2000–07.

Sugar prices averaged 40 cents per kilogram in 2009, almost 42 percent higher than in 2008, and they averaged more than 50 cents per kilogram during the last five months of 2009. Sugar is among the few commodities with prices rising continually during 2009. The rally began when it became clear that global supplies in 2008–09 would be limited, due to a production shortfall of 44 percent in India, induced by weather, among other factors. India's 2009–10 crop-year output is expected to be equally disappointing. The shortfall has made India the world's largest sugar importer (it imported 2.8 million tons in 2008–09 and is projected to import 6 million tons in 2009–10). In view of the current global sugar balance and crude oil prices, sugar prices are projected to average 35 cents per kilogram in 2010, down from 40 cents per kilogram in 2009, with some further declines expected in 2011 and 2012. These price levels are more than double those of the early 2000s.

**Managing Volatile Capital Flows.** Policy interest rates across the globe remain very low; some central banks have begun tightening or have signaled their intention to begin to do so soon, but may now defer after events in Europe. The unprecedented steps that have been taken by policy makers in both developed and developing countries following the onset of the global financial crisis in 2008 have gone some way toward normalizing financial markets and restoring capital flows to developing countries. As a result, a large number of emerging market exchange rates have recovered to their precrisis levels relative to the U.S. dollar, and equity markets have recovered, on average, between one-third and one-half of their initial losses. Capital flows to developing countries—which peaked at close to 9 percent of their GDP in 2007—fell to 2.5 percent of GDP in 2009. Flows are expected to recover modestly in 2010 to somewhat more than 3 percent of developing-country GDP in 2010. However, recent events in Europe have brought back volatility and uncertainty to global financial markets, whose effects will continue to play out in the near-term. In contrast to the recovery in bond and equity markets, cross-border bank lending remains weak, as global banks continue to consolidate and deleverage in an effort to rebuild their balance sheets. Overall, net private capital flows to developing countries in 2009 are estimated to have fallen by almost 70 percent. Even with recovery on the horizon, projected flows in 2010 will remain well below their precrisis levels. Lower-income countries and those perceived to present greater investor risk will suffer the most from this shrinkage—even as India and other fast-growing emerging markets may face better prospects (see table 1.3).

<sup>6</sup> See “Commodity Markets Briefs” from Global Economic Prospects 2010 at <http://go.worldbank.org/JLUJ1U4IR0>.

The challenge will be on managing the risks of large and growing but volatile capital inflows. During an upswing, countries potentially face sharply rising inflows and the risks of appreciating currencies, rising asset prices, and complications to domestic monetary policies (with the need to sterilize such inflows through growing reserves). Conversely, and as the recent global crisis showed—and continues to show with current investor nervousness about fiscal indebtedness in Europe—a sudden change in sentiment may cause a flight to safety from individual countries or countries judged to be in similar positions, causing a sudden fall in reserves, exchange rates, and asset prices. To avoid the risks of such boom-bust episodes—in a still-fragile global financial setting—developing countries such as those in South Asia may want to consider complementary options: (1) They may wish to seek to encourage more longer-term and stable sources of capital inflows such as FDI and discourage shorter-term debt inflows through taxes or tighter regulatory approaches, as well as to examine more carefully the composition of their inflows; Brazil, for example, has recently instituted capital controls to reduce future volatility. (2) Simultaneously, countries may need to accelerate improvements in their domestic macroeconomic policies, especially fiscal balances; return to more normal monetary policies; and reduce domestic demand inflationary pressures and expectations (as discussed in chapter 2), which will lessen their reliance on external financing and its volatility. Managing external volatility with domestic stability is a complicated issue and will benefit from more careful consideration of options and instruments than is possible in this brief discussion here, highlighting risks (Dasgupta, Uzan, and Wilson 2001).<sup>7</sup>

**Table 1.3 Global assumptions and South Asian outlook**

Percentage change from previous year, except interest rates and oil price

	2007	2008	2009 <sup>a</sup>	2010 <sup>b</sup>	2011 <sup>b</sup>
<b>Global conditions—assumptions</b>					
World trade volume	7.2	3.2	-11.6	11.2	6.8
Consumer prices, G-7 countries <sup>c,d</sup>	2.0	3.1	-0.2	1.5	1.6
United States	2.9	3.8	-0.3	2.0	2.2
Commodity prices (US\$ terms)					
Non-energy commodities	17.1	0.0	-21.6	16.8	-4.0
Oil price (US\$ per barrel) <sup>e</sup>	71.1	97.0	61.8	78.1	74.6
Oil price (percentage of change)	10.6	36.4	-36.3	26.4	-4.5
Manufactures unit export value <sup>f</sup>	5.5	5.9	-4.9	0.0	-3.7
Interest rates					
US\$ 6-month (percent)	5.2	3.2	1.2	0.8	2.2
<b>Real GDP growth<sup>g</sup></b>					
World	3.9	1.7	-2.1	3.3	3.3
Memo item: world (PPP weights) <sup>h</sup>	5.0	1.3	-0.4	4.2	4.0
<b>Major trading partners</b>					
OECD countries	2.5	0.3	-3.4	2.2	2.3
Euro area	2.7	0.4	-4.1	0.7	1.3
United States	2.1	-1.2	-5.2	2.5	2.1
East Asia and Pacific	11.4	8.5	7.1	8.7	7.8
China	13.0	9.6	8.7	9.5	8.5
<b>South Asia forecasts</b>					
South Asia	8.9	7.8	6.3	7.0	7.8
India <sup>i</sup>	9.2	6.7	7.4	8.5	9.0

Sources: World Bank and staff estimates and staff working assumptions; "OECD Economic Outlook," No.87, May 2010; World Bank East Asia Economic Update, Vol. 1, May 2010.

Note: G-7= Group of Seven; PPP = purchasing power parity.

a. Figures are estimates.

b. Figures are forecasts.

c. Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

d. In local currency, aggregated using 2005 GDP weights.

e. Simple average of Dubai, Brent, and West Texas Intermediate.

f. Unit value index of manufactured exports from major economies, expressed in USD.

g. Aggregate growth rates calculated using constant 2005 U.S. dollar GDP weights.

h. Calculated using 2005 PPP weights.

i. In keeping with national practice, data for India are reported on a fiscal year basis.

<sup>7</sup> See also IMF, May 2010, "Regional Economic Outlook: Western Hemisphere Taking Advantage of Tailwinds."

## II. ECONOMIC POLICIES SUPPORTING RECOVERY

As recovery happens, all South Asia countries face some challenges to sustaining their recovery from this crisis and accelerating growth in the medium term. These challenges are more immediate on the demand-management side—to create more fiscal space and to manage rising inflation, while ensuring that the exit from fiscal and monetary stimulus is gradual and in tune with the recovery of private demand. But the solutions are also likely to be important in addressing the supply side—in renewing agricultural growth, stepping up infrastructure investment, encouraging growth in the manufacturing sector, and reducing conflict. All are interlinked to achieve faster growth with inclusion, and more and better jobs to realize the demographic gift potential of the region.

### DEMAND MANAGEMENT

**Timing the Exit from Stimulus.** As their economies recover and as private demand picks up, governments are starting to plan for the gradual exit from fiscal and monetary stimulus policies. This crucial issue is facing all countries, both developed and developing. Past history, as in South Asia, suggests unwinding stimulus cautiously so as not to stall the recovery. But high deficits and rising inflation (see further discussion that follows) complicate the picture in South Asia. Nevertheless, the ongoing recovery in South Asia is still in its early stages, thereby warranting a slow, gradual pace of exit. India has already started on this path with small steps. Individual country authorities know best their own circumstances and will be monitoring a few key high-frequency indicators to guide their decisions—especially inflation, credit growth, asset prices (real estate, stock markets), consumer spending, and industrial production.

**Creating Fiscal Space.** One of the urgent demand-management challenges facing South Asia in the wake of this global crisis is to create fiscal space to allow each government room to address three objectives: (1) improve macroeconomic stability, including building more room to run countercyclical policies to deal with unexpected future shocks;<sup>8</sup> (2) do not crowd out the private sector and growth as economies recover by reducing their deficits and borrowing needs; and (3) permit governments to increase the financing of crucial expenditures for public goods, especially infrastructure and social safety nets.

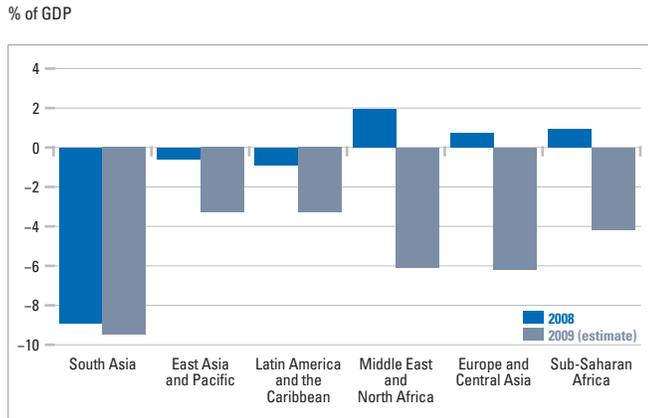
Entering the global financial crisis, South Asia's economies were a large outlier in having inadequate fiscal space to accommodate countercyclical policies to counteract the fall in aggregate demand (see figure 2.1). In this crisis, South Asia showed less ability to inject additional countercyclical demand to counteract the global shock. Although some did, such as Bangladesh and India, others such as Maldives, Pakistan, and Sri Lanka bound themselves to conservative fiscal stances to control expenditures. The reasons were structural: high starting fiscal deficits and high public debt, highest in the developing world (and closer to levels prevailing in the G-7 countries). How might South Asian countries create more fiscal space? Lessons from other countries suggest some options, including faster growth itself.

**Raising Revenues.** South Asia economies' tax-GDP ratios are low in comparison to many similarly placed developing and emerging market economies, and they are low relative to the region's development needs. Thus, the focus should be on efforts to raise the revenue-GDP ratio. The assumption, of course, is that, at the margin, the reduction in deficits or debt will result in better returns than the alternative and will require relatively nondistortionary taxes. In some countries, external grants are financing significant expenditures, as in Afghanistan and Bhutan. Clearly, they provide more fiscal space and defer revenue-raising needs, but the downside of external grants is that typically they are not sustained over long periods, eventually requiring domestic revenue sources to sustain fiscal space. The evidence seems to be that relative to income, tax levels in South Asia are below expected levels—

<sup>8</sup> A key lesson is to build more fiscal space in good times (Blanchard, Dell'Ariccia, and Mauro 2010).

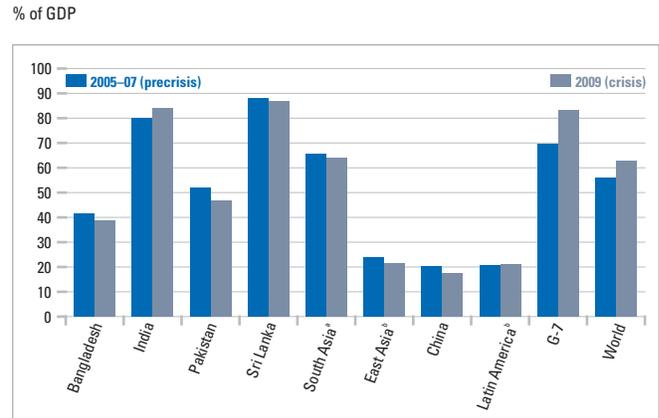
**Figure 2.1 Fiscal balances and debt in South Asia**

A. Fiscal balance



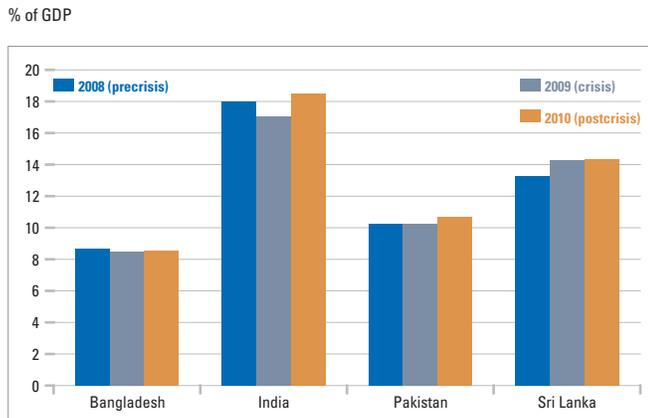
Source: World Development Indicators.

B. Public debt



Sources: Economic Intelligence Unit; the World Bank's Unified Survey.  
 a/ South Asia is a simple weighted average of Bangladesh, India, Pakistan, and Sri Lanka.  
 b/ The data only include developing countries in the region.

**Figure 2.2 Tax revenues**

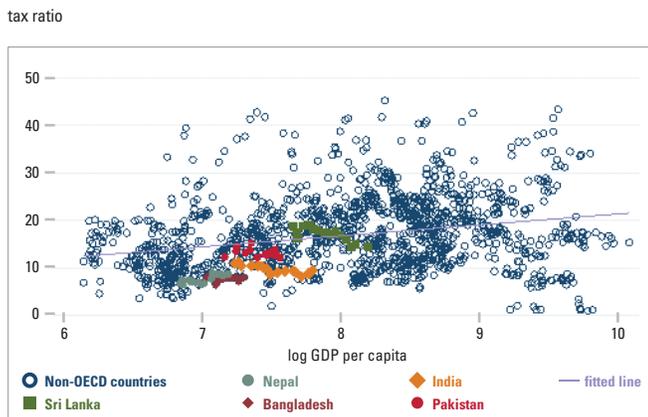


Source: The World Bank's Unified Survey.

averaging around 8–12 percent of GDP in countries other than India and about 19 percent in India (see figures 2.2 and 2.3). India is a good example of successful implementation of more efficient and relatively nondistortionary taxes: (1) the value added tax (VAT) at the state level (raising some 2 percentage points of additional revenue to GDP); (2) a more efficient and nationally uniform general sales tax on goods and services (GST) that might yield an additional 1.5 percent gain in revenues; and (3) a broadening of the income tax base by introducing electronic taxpayer information bases, thereby reducing rates and improving compliance. Structural constraints to raising revenues in South Asia are, nevertheless, significant—in particular, the higher shares of the informal sector in the region.

**Figure 2.3 Revenue ratios lower in South Asia**

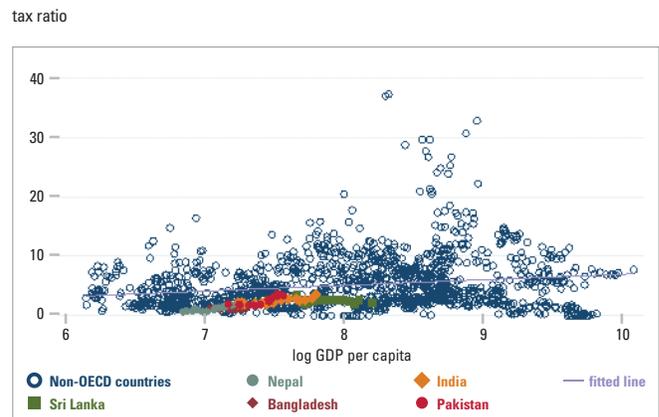
A. Tax revenue—GDP and PPP per capita from 1975 to 2000



Source: Author calculations.

Note: India revenues are understated in the tax revenue in the figure because they reflect central government only.

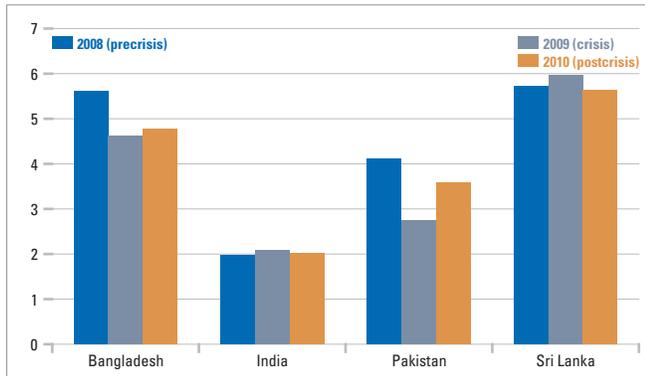
B. Income tax revenue—GDP and PPP per capita from 1975 to 2000



**Figure 2.4 Capital expenditures and current expenditures**

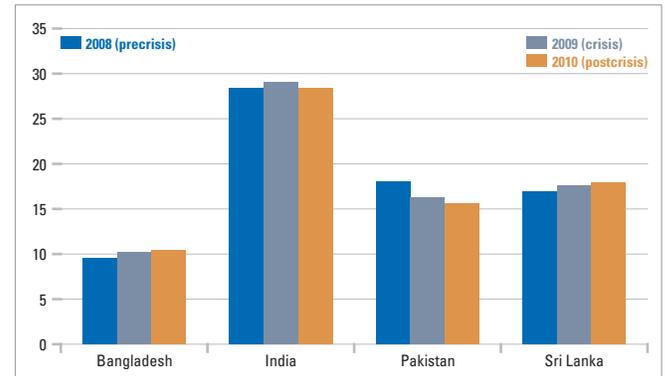
A. Capital expenditure and net lending

% of GDP



B. Current expenditure

% of GDP



Source: The World Bank's Unified Survey; country sources.

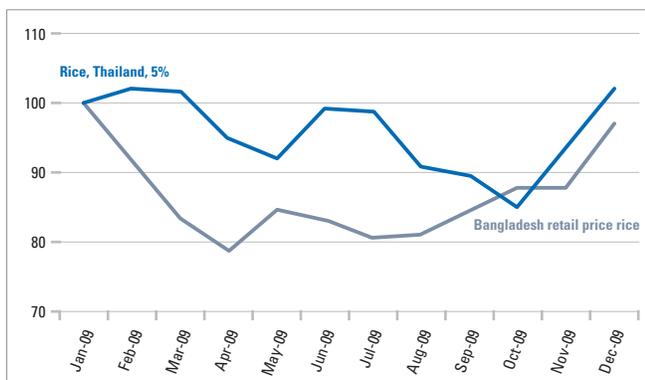
Note: Capital spending in India as reported in the figure is understated because of falling net lending. If net lending is taken out, capital spending is about 4–5 percent of GDP, similar to Bangladesh levels.

**Reprioritizing Expenditures.** Focusing on more productive spending is another important option (see figure 2.4, on expenditures). Although considerable gains in prioritizing spending on primary health and education are being made, large and escalating budget and off-budget subsidies still remain on petroleum, electricity, fertilizer, and food that can drain as much as 4–6 percent of GDP by some estimates—with large leakages to the better-off. More carefully targeted and designed schemes would save resources, better protect the poor, and help raise growth. Agricultural subsidies, for example, now exceed capital investment in agriculture in many South Asian countries. Higher public wage bills without gains in service delivery are another issue, as are escalating military and security expenditures. These areas are complex and political economy sensitive, especially for citizens who receive higher spending but ineffective public services.<sup>9</sup> The challenge will be to improve services and to reprioritize spending.

**Inflation and Food Prices.** A more immediate demand-management challenge is inflation. Global commodity prices fell in the crisis and have since risen, contributing to higher inflation in South Asia (see figure 2.5) compared to the rest of the world, which is still facing very low rates of inflation. The price rises have been led by food items, raising additional concerns given large numbers of the population at or near the caloric deficiency levels. Farmers are benefiting, but poor households, even in rural areas,

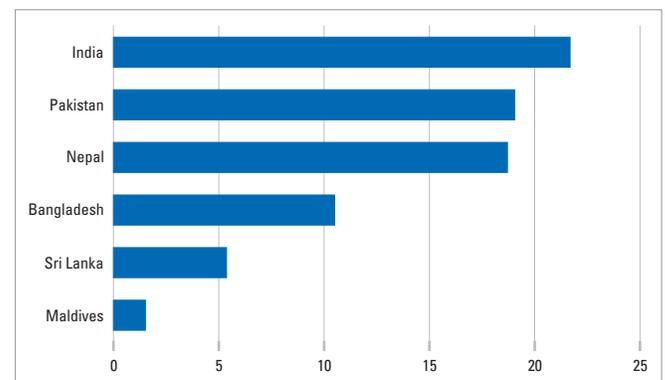
**Figure 2.5 Rising food prices and inflation**

January 2009 = 100



Sources: Department of Agricultural Marketing and The World Bank's Global Economic Monitoring Database.

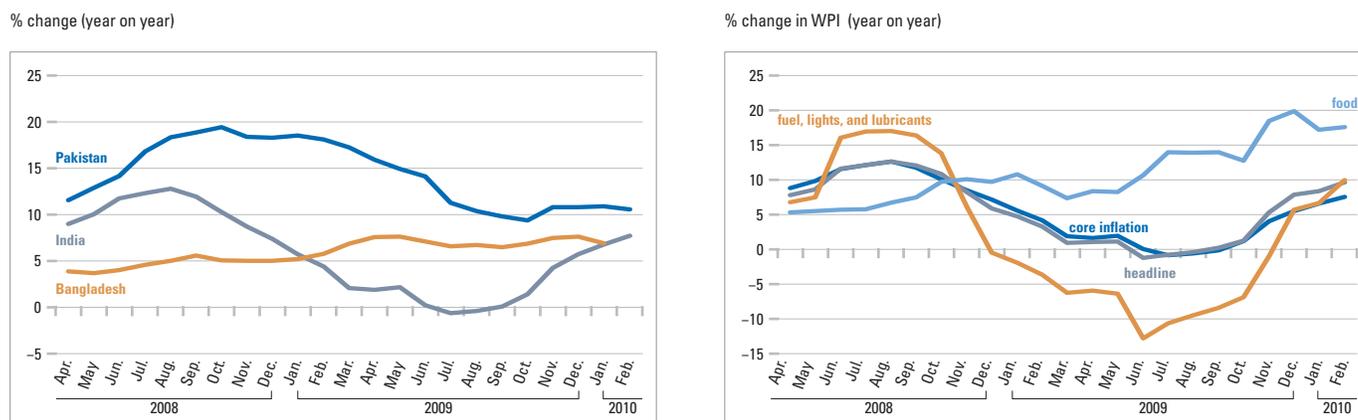
percentage change in food prices since June 2009



Sources: Respective countries monetary authorities; CEIC Data Ltd.

Note: Most recent months are Bangladesh (March 2010); India (May 2010); Pakistan (April 2010); Sri Lanka (May 2010); Maldives (April 2010) and Nepal (April 2010).

<sup>9</sup> Improved governance is also likely to be important to creating better services and more fiscal space. New initiatives in South Asia include the Freedom of Information Act in India, Bhutan's Anti-Corruption Commission, and Bangladesh's strengthening of public expenditure programs.

**Figure 2.6 Core inflation is edging up since fourth quarter 2009, along with food and fuel prices, as in India**

Source: Central banks for respective countries.

are net buyers of food, and this puts a strong political economy premium on managing food price inflation in South Asia—unlike elsewhere (e.g., where land is more abundant and surplus-producing farming households dominate in rural areas, as in Latin America).

**Food Prices.** In part, the rise in prices reflects the lagged effects of higher food prices in global markets last year and the severe drought in India in 2009—exacerbated by El Niño weather patterns. Box 2.2 describes the consequences and implications. In the medium-term, raising agricultural productivity will be important (see below).

**Core Inflation.** The danger is that of rising inflation expectations, spilling over to the broader economy beyond food prices. Core inflation in South Asia is now rising to a distinctly higher level of 7–10 percent, surpassing the previous decade’s precrisis average of 4–6 percent (see figure 2.6). India’s increase is correlated not just with the food price shocks, but also with fuel prices. Pakistan’s core inflation fell from high levels during a contractionary phase and is now rising; in Bangladesh, it is rising steadily upward (independent of commodity price shocks).

The issue that monetary authorities now face in South Asia as economies recover is whether the rise in core inflation needs more aggressive steps to moderate demand-side pressures: with a return to more normal monetary policies—in a phased manner. The RBI has already started raising policy rates and reserve ratios in India from very low levels. Other countries face similar choices. In Nepal, liquidity-management pressures were growing even earlier, and overheating land and real estate markets were notable, as a result of very large remittance inflows (and fixed exchange rates). Fiscal adjustment will also help reduce inflation and aggregate demand pressures. The global context, too, faces similar choices with the timing of pace and exit from monetary stimulus, although inflation rates there remain much more benign.

## SUSTAINING FASTER GROWTH: SUPPLY-SIDE MEASURES

**Improving Agriculture Productivity and Climbing the Value Chain.** A big part of managing rising food prices will be a refocus on agricultural productivity. Box 2.2 argues that food price inflation should moderate in the course of the next few months, as more normal weather returns, farmers respond to higher prices, and global prices ease. Still, food prices are expected to remain high globally in the medium-term, providing an opportunity to focus on policies in agriculture, with a second “green revolution.” Part of that will be a shift to the lagging states and regions of South Asia, where yield potentials for foodgrains remain large. Another part will benefit from the increasing adoption of better seeds and fertilizers through new means. Although still controversial,

### Box 2.1 Deficits, debts, and impacts on inflation and growth

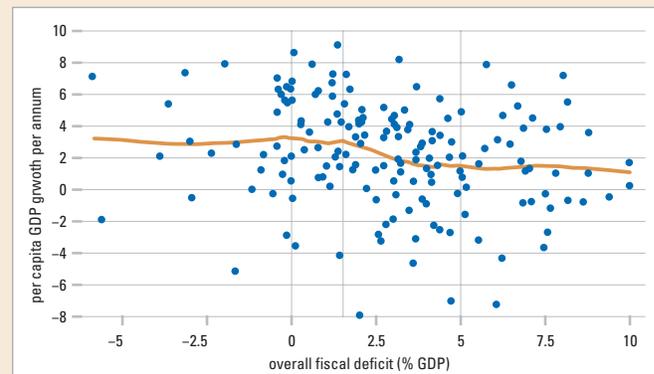
Reducing fiscal deficits will help lower inflation pressures and the conduct of monetary policy during up-cycles in managing aggregate demand. Evidence suggests that after controlling for other factors, fiscal deficits and inflation appear to be strongly correlated (Easterly and Schmidt-Hebbel 1993; Reinhart and Rogoff 2010).

The crowding-out effects of deficits and debt are intermediated by effects on interest rates facing the private sector. Domestic interest rates are, however, affected by other factors, including financial markets depth, global interest rates, external capital flows, exchange rates, and household savings behavior. As a result, the effects are weak in most advanced economies: a rise in U.S. federal debt by 1 percent of GDP, for example, was estimated to raise long-term interest rates by only about 3 basis points (Engen and Hubbard 2004); and a rise in fiscal deficit to cause a rise in long-term interest rates by an estimated 25 basis points (Laubach 2007). In developing countries, the relationship is stronger or is negatively impacted by financial repression (Easterly and Schmidt-Hebbel 1993).

A more direct look at the effects of debt and deficits reduction on growth suggests a virtuous relationship: higher growth occurs when deficits are lower, and faster growth in turn helps reduce deficits. The effects can be large: deficits lower by 2.5 percent points of GDP are associated with 1.5 percentage points higher growth—until a threshold level of lower deficits is reached (Adam and Bevan 2002, see figure below); the stock of debt also matters: very high debt levels reduce growth sharply (Reinhart and Rogoff 2010).

Sources: Easterly and Schmidt-Hebbel 1993; Adam and Bevan 2002; Reinhart and Rogoff 2010; Engen and Hubbard 2004; Laubach 2007.

**Box figure 1 Reducing fiscal deficits raises growth—up to a threshold level of 1.5 percent**



Note: The plotted line in the figure is derived from a semi-parametric model of the form  $y = Z\beta + f(x) + \epsilon$ , where  $Z$  denotes a vector of control variables,  $x$  is the fiscal deficit after grants and interest on debt, and  $f(x)$  is a potentially nonlinear function.

the adoption of genetically modified (GM) seeds, for example, is rising rapidly in South Asia, with large gains—as in cotton production and exports. The private sector is also turning its focus toward the potential in agriculture and rural areas (Rosegrant and Hazell 2001).

One of the broader critical challenges in rural areas in South Asia, is to create faster growth and employment opportunities (Bhalla and Hazell 2003). Despite out-migration, rural populations and agricultural work forces have continued to grow in much of the region, and the share of the total workforce engaged in agriculture remains obstinately high (Headey, Bezemer, and Hazell 2010). This has led to increasing pressure on land, and a decline in the average farm size (to less than 2 hectares). Apart from the potential for increasing foodgrain production and improving food security as well as safety nets, two opportunities to revitalize rural areas with associated policy support are the following:

- (i) Diversification of agriculture into higher value-added production of nonfoodgrain activities to match changing patterns of domestic and export demand (Joshi, Gulati, and Cummings 2007). Greater diversification from cereals to higher-value

### Box 2.2 Rising food prices in South Asia

Domestic food prices have tracked the upsurge in global food prices, exacerbated by droughts. Global food prices fell steadily until 2005 but then rebounded sharply, reaching a peak in 2008. This change has been a major driver of South Asian food inflation, which responded with a lag and then reached an 11-year peak, accelerating to almost 20 percent by the end of 2009 in India (Bloomberg). The price hike was evident for rice, sugar, pulses, and oil seeds. The Indian food price inflation is spilling over to its neighbors (Bangladesh, Bhutan, Nepal, and Sri Lanka). Erratic monsoons resulted in reduced crop-sown area during July to September 2009. The *kharif* (summer crop) season area sown under paddy and oilseeds in 2009 was 16.1 percent and 5.4 percent, respectively, lower than in 2008. *Kharif* food grain production in 2009–10 fell by 15 percent, whereas domestic demand for food rose, thus driving food prices higher.

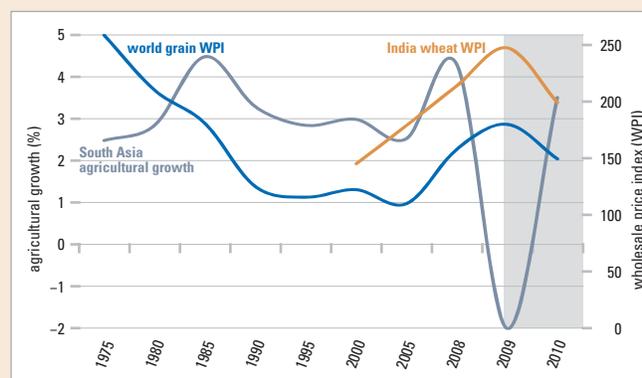
(1) *Producers that will respond, moderating near-term food prices.* Agricultural growth responds to output prices. Growth fell between 1985 and 2005 from 4.5 percent to 2.5 percent with lower prices. With better prices and improved weather, agricultural output is expected to bounce back, thus moderating food prices.

(2) *Food policy.* Procurement by government in 2009 may have led to shortage of cereals in open markets, influencing the rise in food prices. Public stocks held for food security purposes were at 24.3 million metric tons (mmt) at the beginning of January 2010, more than double the norm of 11.8 mmt (Institute of International Finance). Government intervention with safety nets, food security rations, and market sales will help consumers.

(3) *In the medium-term, agricultural output should benefit from strategically targeting yield gains in lagging states.*

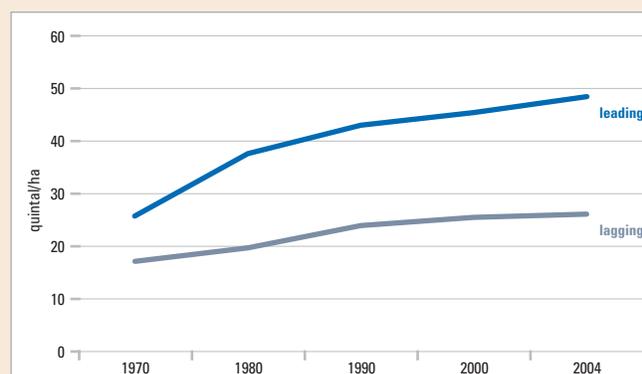
Sources: Goyal, Bloomberg Economic Update, available publicly at <http://www.bloomberg.com/apps/news?pid=20601091&sid=a7M37Y1.sXjQ>; Kumar, Vashisht, Kalita, and Gunajit 2009; Dasgupta 2010.

### Box figure 2 Agricultural growth and output prices



Sources: World Development Indicators, World Bank 2010. World Bank staff estimates for World WPI. Indiatat for India WPI. Agricultural Statistics at a Glance 2008.

### Box figure 3 Rice yield in India in lagging and leading regions



Sources: World Development Indicators, World Bank 2010. World Bank staff estimates for World WPI. Indiatat for India WPI. Agricultural Statistics at a Glance 2008.

crops such as fruits and vegetables and to livestock and fisheries would not only help to increase employment but would also provide opportunities for exports. Rising per capita incomes and changing food consumption behavior are already becoming important drivers of this process in India and South Asia, as in China. Public investment in improved water use efficiency has considerable potential to reduce water use and improve yields, both in rain-fed areas and in irrigated

### Box 2.3 Private participation in infrastructure (PPI) bouncing back

South Asia accounted for around 40 percent of total PPI investment commitments in developing countries in the first three quarters of 2009, a record for the region. Investment in new PPI projects in the region has grown every year since 2005, reaching a record US\$26.2 billion in the first three quarters of 2009. South Asia has had the most resilient investment during the financial crisis. In the first three quarters of 2009, investment was 72 percent higher than in the same period in 2008, and the number of new projects was 41 (28 percent more than in the same period in 2008).

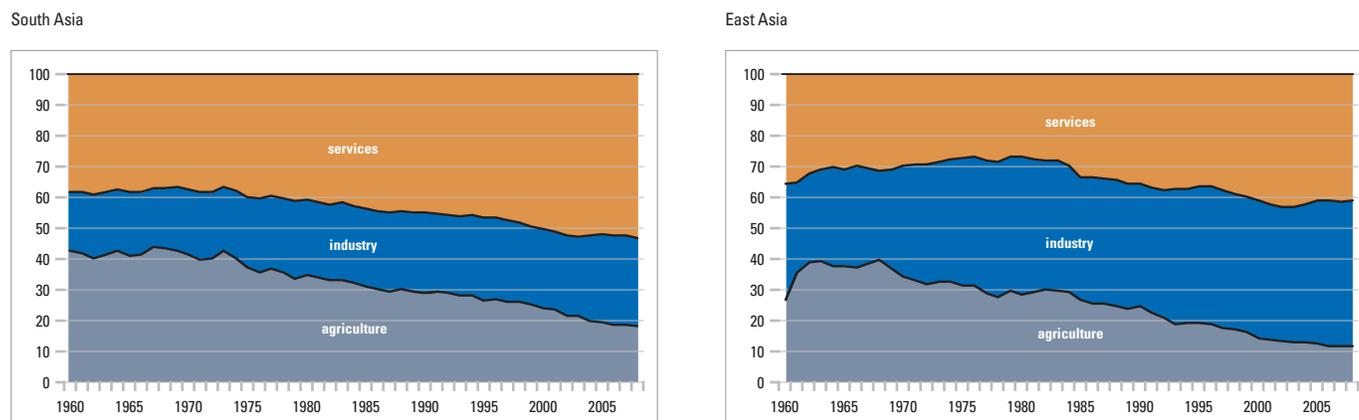
The growing activity in private infrastructure, however, is not a regionwide trend. Instead, India explains most of it. India accounted for almost all the PPI activity in the region in the first three quarters of 2009, registering US\$25 billion of investment and 33 new projects in this period. Larger projects have been implemented in India since 2006. The average size of new projects tripled from US\$211 million in 2006 to US\$638 million in 2009. The growth of private infrastructure activity was facilitated by the national and state government policies to encourage private sector investment in infrastructure, as well as depth and liquidity in India's local capital market. In 2009, the top four initial mandated lead arrangers (MLAs) for project loans in the Asia-Pacific region were Indian banks.

Excluding India, investment in new PPI projects in the rest of South Asia amounted to US\$1.4 billion in 2008 and US\$1.1 billion in the first three quarters of 2009. The latter activity was confined to eight power plant projects in three countries: Pakistan (three projects, US\$852 million); Bhutan (one project, US\$205 million); and Bangladesh (four projects, US\$52 million).

The energy sector has driven investment in PPI projects, growing from US\$1.3 billion in 2005 to US\$19.4 billion in the first three quarters of 2009. Investment in transport projects has remained in an annual range of US\$4.6–5.8 billion since 2007. Investment in telecoms remained in the US\$12–14 billion range between 2005 and 2008 (2009 data were not yet available), but there has been minimal investment in new water projects in the region. There is also a large pipeline of new projects coming to the market. As of September 2009, 96 projects, with associated investment of US\$48.5 billion in total, were at one of the following stages: “awarded”; “looking for financing”; or “advanced stage of tender.” Of those projects, India accounted for 55, with an associated investment of US\$44.5 billion.

systems, as demonstrated by success in China (Gulati and Fan 2008). Crop insurance is another important initiative that has started to make inroads. Trade liberalization also has a greater role to play, given still high levels of protection.

- (ii) Expanding agroprocessing and rural manufacturing also offers important opportunities for productive employment in rural areas. The input, output, and consumption linkages provided by higher agricultural growth should help create the right climate for fostering these activities. Stepping up public investment, especially on agricultural research, education, health, and rural roads, is likely to be more effective than, say, spending on fertilizer or irrigation subsidies. Domestic deregulation, such as restrictions and licenses for private agribusiness, would help foster agroprocessing. Vertical integration will help: contract farming has already begun to take off in India, with amendments to the agriculture produce marketing acts and the permitting of entry of larger businesses, and it will produce benefits, provided small farmers have adequate bargaining power (Armah and Plotnick 2010). Such vertical integration would provide more assured markets, reduce transaction costs and risks, and encourage greater investment (Gulati and Fan 2008).

**Figure 2.7 Differences in sectoral shares of GDP, South Asia versus East Asia**

Source: World Development Indicators 2010.

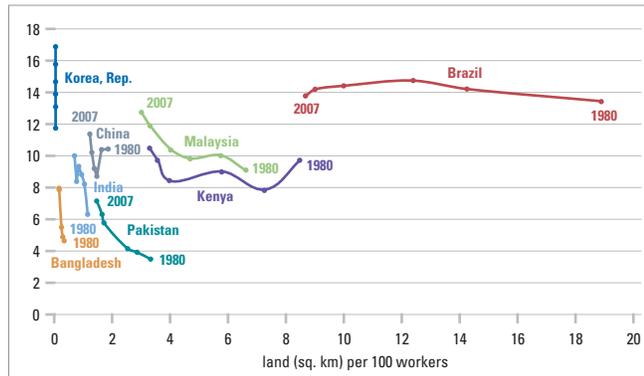
**Accelerating Infrastructure Provision.** A second key factor in sustaining higher growth in South Asia will be accelerated infrastructure development. The biggest gaps are in energy, transport, ports, and urban development. Firms face rising power shortages throughout South Asia, and some 40 percent have standby generators; in Bangladesh, they face frequent power cuts (as the peak gap between demand and supply of power is about 2000 mw, half of its generating capacity), and in Nepal, such cuts occur almost daily. Road transport is choking everywhere, and inefficient transport and port congestion exacts a high cost. In most major cities, water supply is restricted to a few hours a day, while the unserved population is growing. Given large fiscal deficits, financing accelerated infrastructure investment is proving to be difficult. In the near-term, it is essential to crowd in private investment. South Asia is already on its way (see box 2.3) and will benefit from supporting such private provision of an even larger set of investments—with transparent and appropriately managed institutional frameworks, including intraregional coordination and cross-border investments.

**Supporting Faster Manufacturing Growth.** The faster development of a more dynamic outward-oriented manufacturing sector in South Asia is important for creating more and better jobs, especially in the “missing middle” of medium-size firms (Page 2010). During the past decade, services growth has been the biggest driver of overall growth and employment in South Asia—in some contrast to East Asia, where manufacturing and industry have been the main drivers (see figure 2.7). In the coming years, South Asia will need to grow its manufacturing sector faster—but will need to do this in the context of ongoing global rebalancing, a process that has hastened after the crisis, where developed country markets will grow more slowly and developing countries will grow faster, especially in Asia and other large developing regions and countries. Chapter 3 discusses in more depth the opportunities for growing trade with East Asia and other markets that may allow for the faster and more efficient development of the manufacturing sector in South Asia, as it benefits from increased trade and investment with East Asia, especially in global production chains, and as East Asia starts to shift out of labor-intensive manufacturing.

The biggest reason for the rapid shift away from agriculture in both regions has been, of course, the highly constrained land-labor ratios in Asia, relative to elsewhere (see figure 2.8, which shows the relative endowments of education and land-labor ratios). But given starting much lower human capital endowments (as proxied by expected years of schooling) especially compared to East Asia, the latter’s more open and export-oriented structures, and the paucity of physical capital accumulation, South Asia was constrained to shift to services (even as East Asia developed its manufacturing sectors). Over time, with increased openness in South Asia, its services are increasingly driven by modern services and exports, including IT, business process services, trade, transport, tourism, and finance. The result has been faster productivity growth.

**Figure 2.8 Land and human capital endowments that drive comparative advantage**

expected years of schooling



Sources: World Development Indicators; World Bank 2010.

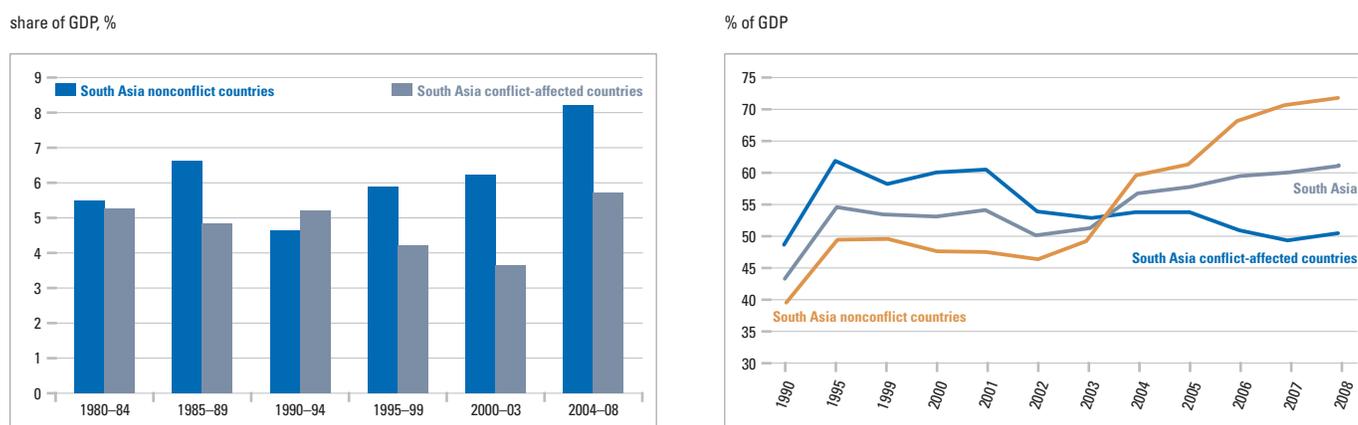
Now, the potential is for the transformation of the manufacturing sector in South Asia—with East Asia transiting to more skill-intensive manufactures, with rising wages there, and with faster accumulation of human and physical capital in South Asia. South Asia’s manufacturing will remain more labor intensive, with differences between countries depending on their endowments—Bangladesh will become more labor intensive, Pakistan will become more natural-resource oriented, and India will start to move into higher skills and become oriented to a larger scale of domestic markets, while the smaller countries will find more specialized niches. This process is beginning. In garments and textiles, Bangladesh is

emerging as a competitive supply alternative to China in lower-cost segments, Sri Lanka is becoming competitive in higher-end niches, and India is scaling up with larger factories. Similarly, India is emerging as a competitive producer of small cars (over 230,000 units exported in the first six months of 2009, overtaking China), with the relocation of scale production to Chennai from Korea. Faster trade and investment integration is thus an important element to realize this potential, which is discussed in chapter 3 of this report. Over time, there will be opportunities to climb the ladder of industrial sophistication in all, similar to East Asia.

*Expanded trade integration* will help. Export and trade opportunities, if successfully exploited, will achieve greater “learning by exporting” to raise the productivity of the manufacturing sector as a whole—complemented by greater domestic manufacturing “churning” (entry and expansion of more productive firms). Indeed, the biggest difference between the East Asian and South Asian experience in manufacturing appears to be the latter’s inability to develop more “sophisticated” (UNIDO 2009)<sup>10</sup> manufacturing exports and its subsequent growth. Between 2000 and 2005, for example, both China and India experienced, as a whole, little change in the measured sophistication of their manufacturing sectors, but exports tell a different story: China had dramatically increased its export sophistication, but India’s structure changed little relative to its income levels. The ability to increase its sophistication of exports may be central to a country’s achieving future rapid growth potential.

*Domestic industrial policy improvements* will also help achieve this transformation. Improvements in infrastructure investments are key (see earlier discussion). Industrial policies may also gain from attention to spatial transformation and to allow the faster growth of more dynamic medium-size firms, addressing the problem of the “missing middle” (Page 2010): (1) for late-industrializing regions in South Asia, export processing zones remain one option to provide a clear focus for government infrastructure and other investments and institutional reforms to encourage firms in a cluster and allow them to gain access to pooled technical, marketing, and managerial know-how, access to international distribution channels, and access to links with larger international firms to facilitate their entry to international markets, and (2) in already developed and more industrialized areas, government support may be important by investing more heavily in education and skills and generating technical and management skills specific to the agglomerations that already exist, and by embracing substantially more liberalized deregulation, in areas such as labor markets, to encourage entry of more dynamic firms. These are only some options, and a research agenda lies ahead to identify best practice policies and solutions to encourage faster growth of a more dynamic manufacturing sector in South Asia.

<sup>10</sup> This report develops an index of relative sophistication of a country’s export and manufacturing production that essentially measures the extent to which lower-income countries produce and export a higher proportion of products that are produced in richer economies; when they do, they tend to grow faster.

**Figure 2.9 Growth and trade in countries with and without conflict**

Source: World Development Indicators 2010.

**Building Peace.** A rise in insecurity and conflict is evident in the region, especially since 2001 (Iyer 2010), as in Afghanistan and elsewhere, even as countries grapple with difficult postconflict situations in Sri Lanka and Nepal. Providing a faster pace of increase in jobs, in agriculture, services and especially in manufacturing, may be crucial. The good news is that peace building can also provide large dividends for growth and trade that are mutually reinforcing. Efforts at encouraging faster growth and trade and investment integration, both with other regions of the world and within South Asia itself, are discussed later in chapter 3 and will be important to reduce, in part, the sources of such conflicts, as they help provide more and better jobs for a young and growing labor force (Mesquida and Wiener 1999; Beck, King, and Zeng 2000).<sup>11</sup>

In the interim, winning the peace and ensuring security will require an accelerated creation of jobs and sources of such jobs domestically, as well as strengthening the role of the state in that connection to deliver better services and good governance.<sup>12</sup> Expanding the private sector will be a key, especially in agriculture, and will require improvements in public infrastructure, sustaining and scaling up of successful national programs, and strengthening governance.

What might such reduced insecurity and conflict deliver in turn? First, the “peace dividend” or bounce-back potential is large, and recent faster regional growth could accelerate. For example, countries in past or current heightened conflict (Nepal, Pakistan, and Sri Lanka) have tended to show slower growth—with a differential of 2–3 percentage points of annual GDP growth.<sup>13</sup>

Second, countries would integrate faster and trade more (see figure 2.9). When differentiated by two groups—conflict-affected versus others—the former showed sharply slowing trade-to-GDP ratios throughout the past decade, becoming markedly less open, whereas the opposite was the case for the others. The transition was especially marked after 2003, when the average trade-to-GDP ratio climbed to over 70 percent for the nonconflict countries (unweighted average), whereas that for the conflict-affected group fell to about 50 percent by 2008—a 20 percentage-point gap. There are several reasons why conflict reduced trade, including rising risk aversion of trade partners, higher transaction costs (higher insurance risk premiums on international shipping, for example), and reduced trade financing. This is consistent with others’ broader findings in the literature, which suggests that conflict has a powerful negative effect on trade (using a gravity model for a large set of countries for trade in 1999–2000, and an internationally comparable Heidelberg conflict-intensity index (Pasteels, Fontagné, and Brauer 2003). The effect of conflict in

<sup>11</sup> Mesquida and Wiener (1999) suggest that a demographic bulge may often be accompanied by rising conflict. Beck, King, and Zeng (2000) suggest the importance of duration dependence (peace years) and the pacific effect of democracy when the ex ante probability of conflict is otherwise high (such as between contiguous states and duration of previous conflicts).

<sup>12</sup> *Development Report 2011* (forthcoming) will cover more comprehensively the topic of conflict, security, and development.

<sup>13</sup> Insecurity and conflict affects all countries in the region to varying degrees, and the exact classification is debatable. These growth differentials emerge within countries as well, as in the lagging states in India.

that study (1) was calculated as being equivalent to a 33 percent tariff barrier, and (2) was additive to other factors. The evidence for the opposite is also the case: that increased trade between partners reduces the probability of conflict (O'Neal and Russett 1999). But the worst is when partners don't trade: one study, for example, finds that contiguity enhances conflict when contiguous states exhibit little trade (Chang, Polachek, and Robst 2004).

### III. GLOBAL REBALANCING AND INTEGRATION PROSPECTS

This chapter examines regional integration prospects and policies for South Asia—with East Asia and between countries within the region. This theme was selected, not to exclude other important topics that might be the subject of future outlooks, but because of its immediate relevance in the context of expected global rebalancing after the crisis and the expected shifts of global growth toward a more multipolar world. Growing trade between South and East Asia, and that within the region—supported by an increasing number of regional trade agreements—makes this a matter of increasing reality.

The challenge for the South Asia region, as set out in the previous chapter, will be to make its recovery more durable, inclusive, and sustained in the medium-term. Part of that will require policy makers to reposition the region's trade and investment integration strategies after this crisis to a “new normal” in the global economy.<sup>14</sup> The ongoing global recovery will likely involve a fundamental restructuring of the economic order, as described in chapter 1, where industrial country growth will be hesitant and slow to recover, whereas that in emerging markets will be much stronger. South Asia will correspondingly need to shift its market integration strategy, as developed countries start to save more and spend less and grow more slowly in North America and Europe, and as the East, especially Asia and emerging markets, overall look to become bigger drivers of global growth.

In that setting, the South Asia region faces three interrelated challenges, as well as opportunities: to enhance its Look East strategy, looking to integrate faster with East Asia (the gains are potentially large, some US\$450 billion of increased trade annually); to find opportunities among countries in the region to integrate more closely with each other (the gains also are potentially big, some US\$50 billion of additional trade); and to maintain its traditional links with industrial markets, which will continue to be important for labor-intensive exports and for the demand and supply of high-value services, capital, know-how, and foreign direct investment, in sectors (from manufacturing to infrastructure, finance, and logistics) that remain crucial to South Asia's growth.

The first section begins with an overview of the ongoing shift of global demand after this crisis to Asia and other emerging regions, and the relative decline of industrial country markets and its implications for South Asia's trade prospects. The second section then analyzes the opportunities of expanding trade and investment links with East Asia. With a combined GDP of US\$6 trillion, it is South Asia's fastest-growing natural trade partner. Given complementary economic structures and specialization possibilities, trade and investment integration would not only help expand South Asia's services trade, but also its domestic manufacturing base, as East Asia looks to shift out of labor-intensive sectors. Although there remains some skepticism about the gains from such faster regional integration for faster growth in South Asia, analysis suggests that the gains could be substantial. Exports and trade would rise in sectors important for South Asia, and benefit growth, jobs, and productivity. And among the most important side benefits for South Asia, in particular, would be a reduction in large behind-the-border barriers, especially in trade related services, transport, and logistics, that would benefit growth in the region's economies as a whole.

These gains will be even bigger if countries in South Asia succeed in integrating more closely with each other, as examined in the third section. A bigger and integrated regional market will attract greater investment, improve scale economies and efficiency in manufacturing, allow the development of more efficient services, and lower real trade costs within the region. Private investment is likely to lead the way. India, the largest economy, has a vital role to help carry its smaller regional neighbors with it, even as it grows faster and looks East, and as its neighbors respond (Kumar and Singh 2009; Francois et al. 2009). Growing bilateral hub-and-spoke trade, manufacturing specialization, logistics, and private investment flows offer the most promising prospects to increase such intraregional trade—as recent successes and potential suggest (as in the case of Bhutan-India, Sri Lanka-India,

<sup>14</sup> The “new normal” anticipates several fundamental shifts: muted growth (1–2%, not 3%) with a shift away from the G-7 to emerging markets; slower consumption with debt-laden consumers and governments; financial markets facing greater regulatory burdens; banking being a shadow of its old self; a longer path of unemployment; and rising inflation expectations, currency, and sovereign risks (El-Erian 2009; Davis 2009; Galston 2010). Many agree on a global recovery led by emerging markets, while households and governments struggle with higher debt and unemployment.

and emerging possibilities for Bangladesh-India trade and investment, including transit trade arrangements with Nepal, Bhutan, and India's Northeast). The strengthening of intra-regional trade will facilitate the growth of South Asian–East Asian integration as trade barriers within the region are lowered. There are also similar opportunities for Pakistan-India trade, regional trade with the Middle East, and improved regional energy trade and transit arrangements (Central Asia–Afghanistan–Pakistan–India, hydropower potential in Nepal and Bhutan, and in the East with Myanmar), as power shortages are a rising and critical bottleneck to growth.

A repositioning of trade and investment externally that is based on an accelerated regional and intraregional integration can therefore be an important part of the adjustment in South Asia to the “new normal” in the global economy in two important ways. First, as an instrument by which to achieve lower real trade costs, both at and behind the border, which will benefit producers and consumers throughout the economies, and overall trade more generally, Second, as a way to attract into South Asia accelerated investments in manufacturing and services and allow the region to specialize in particular niches and become more integrated with global value chains. The two are related: lower trade and input costs (including of services) are critical for improved competitiveness. The policy challenge will be to design regional cooperation and initiatives in ways that achieve these twin objectives.

## GLOBAL REBALANCING AND THE RISE OF ASIA

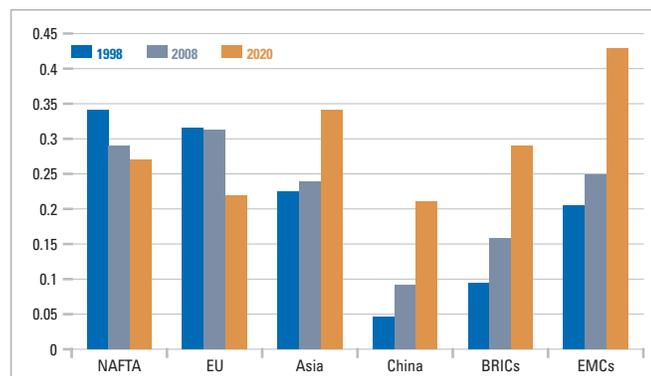
**Global Rebalancing after the Crisis.** Global rebalancing has two distinct connotations: one, the rebalancing of current account deficits between surplus and deficit countries; the other, the longer-term process whereby emerging countries are gaining much larger weights in the global economy as they grow faster. The concern with global rebalancing in this section is primarily with the latter process—although the former is also accelerating the latter after this crisis, as deficit developed countries such as the United States and others in Europe start to slow down and reduce their consumption, even as surplus countries, often developing ones such as China and India, grow faster from domestic sources after this crisis.

Forces were at work well before the crisis to increasingly question the sustainability of rising global current account imbalances. The global crisis has now sharply hastened the processes, marking a decisive change to a “new normal”—with the contraction of growth in advanced countries, an unwinding of global current account imbalances, and a shifting of centers of economic activity. Countries with large current account deficits, such as the United States, are now reducing imports because of depressed domestic demand and are seeking to raise exports by improving competitiveness and shifting to new export markets, and countries with large surpluses have stimulated domestic demand, raising imports and reducing their surpluses. As a consequence, the contribution to global GDP growth of developing countries, including China, India, Brazil, and other big emerging markets, has risen—with Asia the fastest growing region of the world—whereas that of high-income countries has diminished sharply, as their economies were the epicenter of this crisis. This process is expected to continue, as the high-income countries grapple with the long-lasting effects of the current crisis and with the recovery in capital flows to developing countries, as investors seek to raise returns by investing in countries with stronger fundamentals and growth outcomes.

By 2020, Asia could become the largest center of economic activity, with its share of world GDP projected to reach close to 35 percent. Correspondingly, the share of the United States and NAFTA would shrink from 35 percent posted in the wake of the East Asian crisis in 1998 to 27 percent in 2020 (see figure 3.1). Driving this change is the projected increase in weights of China and India, but also of other emerging markets. Indeed, under this scenario, by 2020, the share of all large emerging market countries in the global economy would account for close to one-half of the global economy.

**Figure 3.1** The growing role of emerging markets

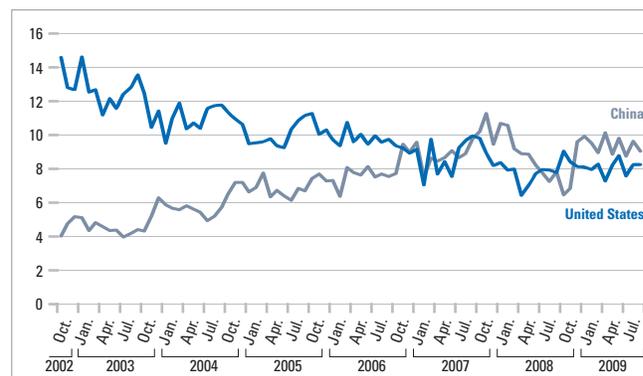
share of world GDP, in current US\$



Sources: Authors' estimates, extrapolated from IMF, World Economic Outlook to 2020.

**Figure 3.2** Share of India's bilateral trade with China and the United States

share of total, %



Source: CEIC Data Ltd.

**Global merchandise import-demand is shifting to China, East Asia, and other emerging markets.** Over the past few decades, the import share of China in world merchandise imports has increased rapidly, whereas the share of the United States has fallen—a consequence of differing growth rates and relocation of manufacturing. The secular decline in the share of world imports in high-income countries such as the United States has accelerated during this crisis and has been matched by the rise in import shares of emerging markets in Asia, such as China. This is also reflected in the relative importance of South Asia's main markets: during and after the crisis, East Asia has become the biggest merchandise trade market for South Asia, supplanting the markets in advanced countries. Together, developing countries currently account for close to 70 percent of South Asia's total merchandise exports, reversing the picture that prevailed only a decade ago in 2000.

**In South Asia.** As can be seen in figure 3.2, bilateral trade between India and China has been on the rise and has surpassed the bilateral trade between India and the United States since 2008. Furthermore, trade between India and China held up during the crisis, whereas that between India and the United States showed a declining trend. This provides initial evidence that South-South trade is becoming more important now (see box 3.1) and has recovered much faster than South-North trade. There is similar evidence from other South Asian countries. Share of exports from Pakistan to the United Arab Emirates plus Afghanistan, for example, has surpassed the corresponding share from Pakistan to the United States. It is also worth noting that all the top four importing countries from Pakistan are developing countries or Middle Eastern countries. Similarly, for Bangladesh and Sri Lanka, China and India are the two most important trading partners, accounting for 30 percent of their total imports for both countries.

**East Asia represents the greatest potential for growth in merchandise trade for South Asia.** Using an augmented gravity model, postcrisis medium-term estimates (with revised partner GDP growth estimates through 2014) of India's global merchandise trade potential, for example, suggests that the increase in India's trade potential will be highest with the Asia-Pacific region, followed by the European Union and NAFTA, and then by South Asia (De 2010).<sup>15</sup> Potential for expansion of India's trade in the postcrisis period is highest with countries such as China and ASEAN-6. However, India's trade has remained unrealized with other large parts of the world, which presents further opportunities for expanding trade, despite a slowdown in global demand. The estimates of the gravity model suggest that trade with developing East Asia has the potential to increase 32 percent per annum by 2014 (or an incremental US\$360 billion in exports by 2014, compared to an actual of US\$126 billion in 2008). This is twice as high as the potential increase in trade with the EU-25 group (15 percent per annum growth potential and an incremental gain of US\$190 billion), and three times as large as with NAFTA (21 percent annual growth potential and an incremental export potential

<sup>15</sup> The paper estimates trade potential between India and its partner countries for (1) the precrisis and (2) the postcrisis periods, using an augmented gravity model (Anderson–van Wincoop type), where bilateral trade is expected to be proportional to the product of economic sizes of country pairs and inversely related to the distance between them, among other factors.

### Box 3.1 Global rebalancing effects on developing country exports after the crisis

Two recent papers provide some analysis of the likely effects of global rebalancing on developing country exports after the crisis. The first (Canuto, Haddad, and Hanson 2010) suggests that a protracted contraction in final consumption in the United States and Europe, in light of global rebalancing after the crisis, will hurt exports from low-income developing countries, especially in labor-intensive exports such as garments. However, South-South trade could play a powerful offsetting role. Such imports had been growing strongly even before this crisis, especially in the BRIC countries (Brazil, Russia, India, and China). After this crisis, these countries will play an increasingly important role, exceeding the contribution of the United States and Europe. These middle-income countries could also drive export diversification over time, with low-income countries occupying labor-intensive manufacturing niches as higher middle-income countries shift out of these sectors, diversify, and specialize.

A second paper (Milberg and Winkler 2010) looks more closely at global value chains (GVCs). It first analyzes the rapid growth in developing country exports and trade prior to this crisis, driven in part by GVCs and cutting up the production chain. It goes on to attribute, like others, the large downturn in world trade to the increasing role of GVCs, which magnified the effects of this crisis. The paper suggests that the recent global downturn in trade has been deeper and different from previous downturns and that it will likely lead to significant shifts—especially consolidation in “buyer-led” global chains, but also to “greater diversity” in producer-led global chains. The former will reduce opportunities, but the latter may well create others. It concludes that there are promising prospects for rapid growth in South-South trade after this crisis, especially if there are closer production ties between developing countries and regions, but that the prospects are more limited if consolidation in global value chains dominates.

of US\$120 billion). Trade within South Asia also has strong potential to grow and is complementary to the above. If regional markets grow, it will attract greater trade and investment and improve scale economies and efficiency, especially in manufacturing. Estimates suggest fast potential of about 36 percent annual growth—the fastest for all of India’s trade partners—although the absolute incremental gain in exports would be relatively small (US\$50 billion annually), given the small starting base.

**High-Income Countries remain important for global services trade.** In contrast to merchandise trade, high-income countries in the European Union and North America will continue to play much bigger roles in world trade in services. There are several fundamental reasons: higher incomes that generate greater demand for services, higher wages and the shift to knowledge-intensive activities reflecting differences in relative skills and factor endowments, and demographics that favor the demand for services. Europe, for example, still accounts for about 50 percent of global service imports, followed by Asia with about 25 percent (of which Japan is a big contributor) and the United States with some 17 percent. The United States remains the primary market for India’s service exports to the OECD countries, accounting for 51 percent of total Indian exports to these markets, and an even larger 60 percent share of its exports of IT and IT-enabled services. With service exports constituting about one-third of South Asia’s exports—with information technology, business process outsourcing, and tourism and travel playing large roles—the potential markets in high-income countries remain the biggest, even as rising incomes in East Asia and elsewhere provide new, albeit smaller, sources of growth and dynamism. Services trade imports (and FDI) are also crucial for South Asia as it seeks to upgrade its own domestic manufacturing and services sectors, in transport, logistics, and financial services, among others. As a result, a nuanced approach will be useful: with merchandise trade shifting to neighboring Asia, the traditional high-income countries will remain important markets and sources of service sectors. Enhancing and opening FDI into service sectors is important to facilitate this process.

**The Gains to Growth and Welfare from Faster Regional Integration with East Asia.** A formal analysis using CGE modeling confirms that a broader South Asia–East Asia integration would provide large gains to exports and trade for South Asia and to overall welfare (Francois and Wignaraja 2008). Compared to a baseline scenario, exports from Bangladesh would be higher by 52 percent, from India by 23 percent, and between 6 and 7 percent from Sri Lanka and Pakistan. Sectorally, much of the gains from South Asia are in services, because no change is assumed for South Asia’s potential for rising manufacturing exports. The aggregate welfare gains would also be significant, between 2 and 4 percent of base income. Typically, as with all such CGE models, these static gains considerably understate the growth impacts because of limited dynamic effects of higher cross-border investment decisions that follow the static gains. Conversely, the CGE modeling result also suggests most crucially that it is India’s participation that provides most of the gains to East Asia. For the South Asian economies themselves, countries other than India gain significantly only if India carries its neighbors in South Asia with it. In its absence, the India–East Asia integration scenario produces significant trade and welfare losses for India’s neighbors. The paper also models the impact of a subregional FTA within South Asia itself. The results suggest that India gains modestly from a South Asian subregional FTA, compared to that from a larger trade agreement targeting East Asia, even as the gains are bigger for its neighbors—again suggestive of the argument that South Asia–East Asia trade gains, provided South Asian countries also open their markets to each other.

**Gains to Growth from Reduced Behind-the-Border Barriers.** The results above are only illustrative of the possible directions of static gains of trade. Dynamic gains from cross-border investment flows in support of trade would be much bigger. Moreover, the effects of such opening would potentially raise the economywide productivity and scale economies of domestic firms and industries, as suggested earlier. Finally, the biggest specific gain from a regional trade deepening with East Asia and within South Asia may well be to lower what are currently very high trade-related service, transport, logistics, regulatory, and institutional barriers, with impacts on economywide domestic growth in South Asia. Regional trade agreements by themselves would do little to address these constraints, because such trade agreements are limited to shallow tariff reductions, with often large nontariff barriers and restrictive rules of origin. Instead, the true gains would emerge if the Look East and related initiatives induced improved policies and institutions in individual South Asian countries through unilateral and accelerated liberalization of trade and investment within the context of a regional framework. Behind-the-border barriers are important: high freight costs, delays in customs, slow port processing, transport bottlenecks, and bureaucratic and regulatory bottlenecks. Not only do they impede trade, but they work backward throughout the economy and are one of the important reasons for the “missing middle” in South Asian manufacturing that was examined in chapter 2.

**Gains to Growth from Exploiting Niches and Potential in Global Value Chains.** As suggested in a recent paper (Sally 2010), unlike East Asia, South Asia has failed to insert itself into global manufacturing supply chains, processing trade supply chains, and other information and communication technologies (ICT) supply chains other than in textiles and garments. One of the principal reasons is such behind-the-border constraints. Regional services and cross-border investment in services can be a powerful engine for easing these constraints endogenously. The effects can be as powerful as increasing trade impacts by a factor of two or more (Hoekman and Nicita 2008). East Asia, in particular, has developed specific expertise—its cost to export (in US\$ per container in 2006–07) was 773, versus 1,180 for South Asia, for example—and it would provide competition and learning gains to South Asia (Brooks and Stone 2010). The lowering of trade costs is one of the reasons why East Asia has become closely integrated and has been able to capitalize on its manufacturing potential in global value chains. South Asia might be able to do the same by integrating faster with East Asia, and a lowering of barriers would help generate the investments that are needed for countries and locations to specialize more in niches and product varieties and to become more integrated in the global value chains.

**Repositioning South Asia’s Trade and Investment.** The overall picture for South Asia’s strategy for repositioning its trade and investment integration after this crisis and with global rebalancing thus suggests three major priorities: a shift to closer

integration with East Asia as its fastest-growing trading partner; still important trade and investment links with high-income countries, especially in services trade (and also as a source of longer-term capital flows and know-how in domestic services and manufacturing); and closer integration among the countries in its own region.

## SOUTH ASIA LOOKING EAST

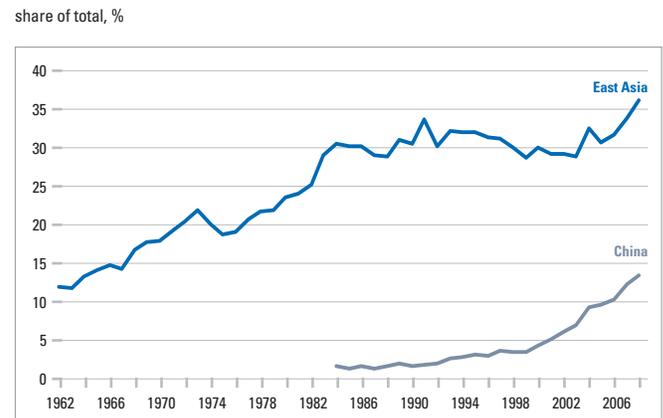
Against this setting, increasing trade with East Asia is becoming important (see figure 3.3). East Asia is now home to the third-largest regional market, with a combined GDP of US\$6 trillion (versus South Asia's combined GDP of US\$1.5 trillion). It has already become the biggest partner for South Asia. We examine first the past performance and its drivers, and then turn to future prospects and policies that will help determine future trade.

**Merchandise trade is growing rapidly.** As its natural trading partner,<sup>16</sup> East Asia's importance to South Asia (and the reverse) has grown since the 1970s, and especially in the past decade, even without formal preferential agreements.<sup>17</sup> By 2008, East Asia constituted the largest trading partner, accounting for approximately 36 percent of South Asia's merchandise trade. Total merchandise trade grew from US\$25 billion to US\$148 billion (still a small share, 2.5 percent, of East Asia's world merchandise trade) (table 3.1). There were no apparent displacement effects, as South Asia's trade with other regions continued to expand rapidly (and faster than East Asia's).

### Complementarity of South Asian and East Asian Exports.

Is the faster growth of South Asia trade with East Asia a result of being displaced in third-country markets, particularly in the United States and European Union? The answer seems to be no, as South Asia continued to export strongly to third-country markets and capture larger market shares of merchandise trade. And South Asia's exports to the rest of the world continued to diversify to industrial processed goods and parts and components, even as its industrial primary exports to East Asia rose. Following Freund and Ozden (2006), we more

**Figure 3.3** South Asia's rising trade with East Asia



Sources: CEIC Data Ltd.; World Trade Indicators.

**Table 3.1** South Asia trade expanding fastest with East Asia

	growth (% per annum)			
	1977–87		2002–08	
	Imports	Exports	Imports	Exports
<b>All</b>	<b>11.6</b>	<b>8.5</b>	<b>27.1</b>	<b>21.4</b>
East Asia	16.8	10.7	29.8	27.5
European Union (25)	13.8	7.6	21.9	20.2
South Asia	4.3	5.7	21	19.6
United States	7.1	17.2	26.5	11.3
Rest of the World	4.3	1.2	27.9	27.3

Source: Authors' calculations using UN Comtrade.

<sup>16</sup> Richard Lipsey (1960) has put forward the hypothesis of “natural trading partners,” suggesting that a regional agreement is more likely to raise welfare effects, the higher is the proportion of trade with the region and the lower the proportion with the rest of the world.

<sup>17</sup> East Asia is now home to the world's third-largest free trade association (FTA), with the launch of the ASEAN-China Free Trade Area (ACFTA) in 2002, and its full implementation since 2010. With its Look East policy, India also signed a free trade agreement with ASEAN in August 2009, which promises to expand the FTA further and deepen South Asia's trade with East Asia. Two prominent early RTAs were the Bangkok Agreement in 1975 by India, Bangladesh, Sri Lanka, Korea, and Lao PDR, and the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC)—comprising Bangladesh, Myanmar, India, Sri Lanka, Thailand, Nepal, and Bhutan—in 1997. Neither have provided significant market access due to unresolved issues with regard to “negative lists,” rules of origin, and dispute-settlement procedures (Pursell and Pitigala 2001).

formally test for these effects,<sup>18</sup> looking at the relationships between South Asia's exports and East Asia's exports in the same import markets.<sup>19</sup> Results are reported in annex table 3A.1. It allows a test of whether East Asia is affecting South Asian countries negatively or positively in third-country markets. The results suggest that South Asia's exports grew more slowly than the total imports in these markets (the export supply coefficient for all South Asian countries was lower than 1, around 0.4). This suggests losses in market share in third countries other than East Asia, which is partly to be expected, given that such market shares in goods include nonfuel commodities, where South Asia does not have a strong comparative advantage. By contrast, the positive coefficients on East Asia's specific exports to these same third-country markets suggest strong complementarities in manufacturing—India's export growth is higher when East Asian exports are large and growing. This is also true for Pakistan, Bangladesh, and Sri Lanka, whereas the impact is not significant for Nepal. Over time, the positive impact diminished during 2000–08, except for in India—suggesting the emergence of some competition at the margin (e.g., as in case of Bangladesh). This also highlights the importance of maintaining the competitiveness of export sectors (and real exchange rates), and reducing real trade costs at or behind-the-borders.

**Shifting Composition of Trade.** As we suggested in chapter 2, the growing trade between East Asia and South Asia is also enlarging the possibilities for domestic manufacturing. The composition of exports from South Asian countries to East Asia has, however, shifted toward industrial primary goods (see figure 3.4)—reflecting growing demand by China and other East Asian countries for such products in their manufacturing. They also reflect the effect of much higher trade costs in South Asia that prevent it from integrating with global value chains, as well as possible competitiveness issues. The major exports were metals, ores, and minerals (including petroleum products from India). The latter therefore requires closer attention and the discovery of possible ways to increase South Asia's ability to deepen its manufacturing trade potential with East Asia. The intensive margins (existing exports) still dominate for all major South Asian countries' exports to East Asia, although Sri Lanka, Pakistan, and Bangladesh have experienced limited success in extensive margins in industrial primary and processed goods.<sup>20</sup> Conversely, the composition of imports by South Asia shifted toward industrial processed goods, especially capital goods and machinery and parts. Evidence points to a significant impact on productivity improvements (Topalova 2007; Nataraj 2009).

**Rising Services.** Services trade for South Asia has been growing rapidly during the past decade. But this trade with East Asia so far has been a relatively small part. Bilateral data flows are dominated by Indian exports (exports of US\$2.4 billion in services to Japan, Singapore, and Hong Kong, China, equivalent to 16 percent of its total, in 2007). Transportation services, professional services, IT, financial services, and insurance services follow. The rest of South Asia's exports were in the traditional segments, mainly transport services. Sri Lanka shows a surge in exports as an emerging transshipment hub between the East and West.

**Tourism: The Brightest Spot?** South Asia's overall tourism receipts have grown at 13.5 percent per annum between 2002 and 2007, compared to 8.1 percent in all developing countries. The impact reaches beyond direct expenditures on lodging, restaurants, entertainment, and retail, to include indirect impacts<sup>21</sup> (ranging from 5.3 percent of GDP in India to as much as 66.6 percent

18 Estimating the following regression equation:

$$dexports_{jkt} = \alpha + \beta_1 dimports_{jkt} + \beta_2 dEastAsia_{jkt} + \beta_3 \epsilon_{jkt}$$

where  $dEastAsia_{jkt}$  is growth of East Asia's export in country  $j$  in sector  $k$ . The advantage of this specification is that we are exploiting both cross-section and time-series variation to estimate how South Asian countries are affected by East Asia. If East Asia has roughly the same effect on all exporting countries, then the coefficient yielded from the regression on imports will be close to 1, and the coefficient on East Asia will be 0. A negative coefficient on East Asia indicates that East Asian export growth is correlated with a decline in South Asian export growth in a given industry. We estimate this equation using data from 1990 to 2008, with the four-digit classification.

19 Only nonfuel products are included; we also distinguish between industrial products (technology-intensive, skilled labor-intensive, unskilled labor-intensive) and nonindustrial products (agricultural products, minerals, raw materials).

20 The intensive margin is typically thought to be more important for growth in exports between countries at similar levels of income (Brenton and Newfarmer 2007; Amurgo-Pacheco and Pierola 2008).

21 The World Travel and Tourism Council utilizes satellite accounting and input-output modeling to capture both direct and indirect impacts of travel and tourism.

of GDP in Maldives). East Asia now accounts for a significant and growing share of South Asia’s tourism. East Asian arrivals account for 26.5 percent of tourism arrivals in Nepal, 24.2 percent in India, 19.8 percent in Bangladesh, and 18.5 percent in Maldives (see table 3.2), and they are growing.<sup>22</sup>

**Prospects for deeper integration**

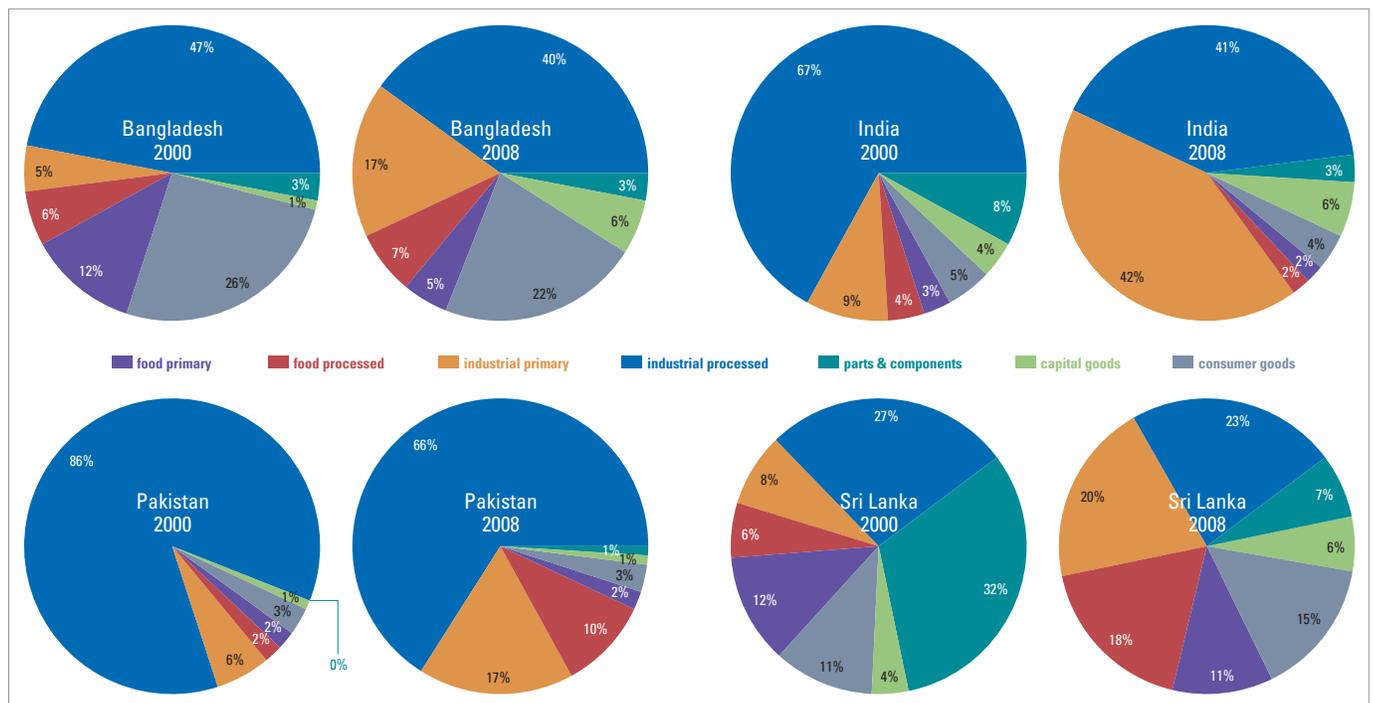
Given the size of the East Asian region and South Asia, the faster growth prospects in both, and the increasing trade with each other along with mutual benefits, major gains are clearly to be realized from deepening trade and investment. Such trade would be complementary to each region’s strengths and changing development patterns, and the evidence for this is suggested next. East Asia is exporting capital-intensive manufactures, is beginning to shift out of labor-intensive manufacturing, and is exporting transport, logistics, tourism, financial, health, and other services to South Asia—even as South Asia is exporting more industrial products, gaining in third-country markets, and is expanding its service exports, especially in tourism, transport, IT, and business processes. The pace of growth and the size of benefits are clearly large. Underpinning the prospects are fast-expanding cross-border investments, as well as formalization of free trade agreements (FTAs).

**Table 3.2 South Asia tourism, economic contribution, and role of East Asia**

	Share of GDP (2006)	Share of exports (2006)	Share of tourism arrivals	
			East Asia	South Asia
South Asia	5.5	5.4	n.a.	n.a.
Bangladesh	n.a.	n.a.	19.8	35.4
India	5.3	4.7	24.2	5.5
Maldives	66.6	65.9	18.5	4.5
Nepal	8.2	22.6	26.5	31.9
Pakistan	n.a.	n.a.	9.2	n.a.
Sri Lanka	9.6	14.9	10.4	36.4

*Sources:* Share of GDP and share of exports from World Travel and Tourism Council; share of tourism arrivals derived from available national tourism statistics (2006 for India and Pakistan, 2007 for others).

**Figure 3.4 South Asia’s composition of exports to East Asia**



Source: World Integrated Trade Solution (WITS).

22 Data from India show that arrivals from East Asia grew 37 percent per annum between 2001 and 2006.

**Rising Merchandise-Trade Complementarity.** Trade has greater potential to grow if neighboring regions start growing trade in similar product lines—as they deepen their production relations. One way to assess this is by measuring so-called complementarity indexes, which correlate the countries' exports in similar products. These indexes for the two regions suggest that trade complementarity is growing (see figure 3.5).<sup>23</sup> Current South Asian values with respect to East Asia are similar to those for countries such as the original European Union (6) members at the time of the formation of the European Economic Community—suggestive of the scope for further gains.

**Supportive Comparative Advantage.** An alternative measure of trade potential is the so-called revealed comparative advantage (RCA), which calculates the share of one region's exports to another partner region, relative to total world exports. If this is greater than unity, it means greater comparative advantages in the other's market. Table 3.3 summarizes the picture on calculated revealed comparative advantage (RCA) indexes for East and South Asia, where they have such advantages, based at a disaggregated product level.<sup>24</sup> The results again suggest strong complementarities. The key categories, where either region has a comparative advantage, comprise as many as 2,843 products, or 64 percent of total trade, suggesting strong prospects for trade between East Asia and South Asia. Drilling down further to identify where South Asia's comparative advantage lies suggests that (1) South Asia has outright comparative advantages in food, organic and inorganic materials, textiles, and metal products, and (2) the products where both regions' share positive revealed advantages in each other's markets, but where South Asia has greater advantages than East Asia are apparel, yarn and textiles, and other labor-intensive manufactures (footwear, parts, jewelry). Ultimately, the drivers of such advantages stem from relative factor endowments—and their changes over time—which we described in chapter 2. Similar analysis (UNCTAD 2006) supports growing differences in factor intensities between the two regions as one factor in trade driving this, and hence driving growing complementarity.

23 The trade complementarity, TC, between countries  $k$  and  $j$ , is defined as

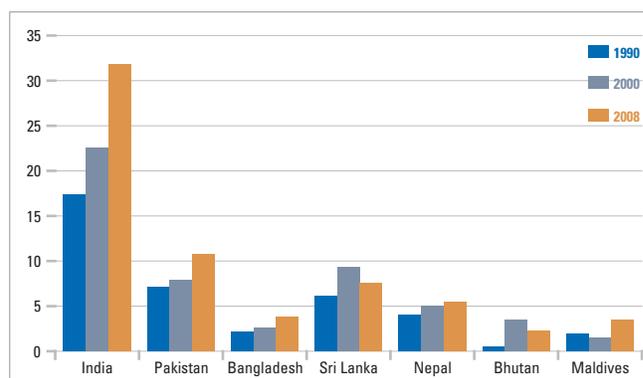
$$TC_{ij} = 100 - \text{sum}(|m_k - x_j|/2)$$

where  $x_j$  is the share of good  $i$  in global exports of country  $j$ , and  $m_k$  is the share of good  $i$  in all imports of country  $k$ . The index is 0 when no goods are exported by one country or imported by the other and 100 when the export and import shares exactly match. As such, it is assumed that higher index values indicate more favorable prospects for a successful trade arrangement between countries.

24 At HS-6 level. However, RCA growth at country level and relative compositions may be more informative than levels. It is important to note, however, that the RCA index, as a measure of comparative advantage, does not discriminate between "inherent" comparative advantages and policy-induced comparative advantages. Any attempt to apply the concept of RCA to South Asian countries must therefore acknowledge the influence of distortions created by their policy regimes.

**Figure 3.5 Growing trade complementarity with East Asia**

Complementarity index



Sources: Authors' estimates; World Bank 2010.

Note: Complementarity index correlates exports of South Asian countries with imports of East Asia at the HS-6 disaggregated level—with increasing values suggesting strong positive matches of the two over time. Intra-industry trade indexes could reinforce the qualitative conclusions here, but we choose TCI as a more relevant measure.

**Table 3.3 Revealed comparative advantage favorable: 2008**

Categories	Number of lines	Percentage of lines
1 Both East Asia and South Asia have positive RCA, but RCA in East Asia is greater than RCA in South Asia	540	12.3
2 Only East Asia has positive RCA	846	19.3
3 Both East Asia and South Asia have negative RCA but RCA in East Asia is greater than RCA in South Asia	800	18.3
4 Both East Asia and SA have positive RCA but RCA in South Asia is greater than RCA in East Asia	637	14.5
5 Only South Asia has positive RCA	820	18.7
6 Both East Asia and South Asia have negative RCA but RCA in South Asia is greater than RCA in East Asia	740	16.9
	<b>4,383</b>	

Source: Based on authors' calculations.

**Table 3.4 FDI inflows from East Asia**

	India (2008)		Pakistan (2007)		Bangladesh (2005)		Sri Lanka (2008)	
	Flow (US\$ millions)	Rank						
Cambodia	--	--	--	--	--	--	--	--
China	50.5	35	101.4	6	0.9	21	101.2	3
Hong Kong, China	493.7	19	156.1	5	47.4	9	--	--
Indonesia	72.9	29	--	--	5.4	15	--	--
Japan	3,481.1	6	74.3	10	22.8	10	26	8
Korea, Rep.	513.3	15	2.3	13	53.9	7	--	--
Lao PDR	240.9	24	--	--	--	--	--	--
Malaysia	3.2	75	--	--	44.5	12	162.6	1
Myanmar	1.4	80	--	--	--	--	--	--
Philippines	0.7	90	--	--	0	26	--	--
Singapore	9,146	2	--	--	35.9	13	20.6	10
Taiwan, China	33.2	37	--	--	2.4	19	--	--
	--	--	--	--	--	--	--	--
Thailand	55.5	34	--	--	0.1	25	--	--
Vietnam	0.1	100	--	--	--	--	--	--
Total	102,058.7	--	3,719.9	--	792.4	--	888.9	--

Sources: India: Ministry of Finance, Pakistan: Board of Investment, 2010, Sri Lanka: Board of Investment, 2010, Bangladesh: Board of Investment.

A more detailed look at China's imports from South Asia shows that products in which South Asia has both a comparative advantage, as defined by RCA, and a growing market share in China numbered some 166 (out of a total 1,594 products at Standard International Trade Classification five-digit level, exported by South Asia to China). Although small in number, those products together accounted for more than 47 percent of South Asia's merchandise exports to China. This finding bodes well for further export penetration. The exports remain concentrated in industrial primary products, with the exception of textiles.

**Large Production-Sharing Potential.** Beyond the static comparisons of complementarity and revealed comparative advantage, however, is the much greater potential for South Asia to integrate with global manufacturing (and services) value chains, by driving down real trade costs and trade and transport logistics barriers. The drivers of such trade go beyond relative factor endowments to factors such as complementary use of information and communication technologies and natural geographies (clustering, agglomeration, and scale effects). Manufacturing production sharing (or vertical specialization) is a key characteristic in East Asia's regional integration and export dynamism (Ng and Yeats 2008; Kimura 2006). So far, there has been a limited engagement with South Asia, but it is starting. Production-sharing in apparel and textiles is well established (Bangladesh and Sri Lanka with East Asia). India and Korea show greater production-sharing in automobiles and steel. A few projects in Sri Lanka supply truck parts, optical parts, telecommunications parts, and electrical parts manufactures that are exported to Japan, Korea, and Malaysia (Board of Investment, Sri Lanka). However, evidence suggests that the proportion of parts and components that constitute major activity in East Asia is only a small part of South Asia's trade with the East. By the same token, the room for growth is large if policies start to address the fundamental drivers, such as lowering the trade costs in South Asia.

**Rising Foreign Direct Investment.** Asian outward FDI is playing an important role in promoting South Asia's extraregional and interregional trade (see table 3.4). East Asian FDI was earlier key in transforming Bangladesh and Sri Lanka to labor-intensive textile and apparel exports. It is likely to prove equally important in fostering the shift to other sectors. The recent rise in FDI is already starting to do this. Time-series data of bilateral FDI flows (or stocks) between Asian economies is not readily available, but the data presented below provide some insights. First, the sources of FDI are diversifying: China, Malaysia, and Thailand joined

traditional high-income countries, such as Hong Kong, China; Korea; Japan; and Singapore. Second, service sectors are assuming increasing importance, helped by framework agreements, such as the Comprehensive Economic Cooperation Agreement (CECA) between India and Singapore; as a result, Singapore has climbed to become the second-ranked source in 2009, and India's service exports to Singapore have increased; there has also been a temporary movement of workers. Third, inflows of FDI are opening new sectors and directions. These are notable in sectors such as automobile manufacturing in India from Korea and Japan; electronics in India from Korea; Taiwan, China; and Singapore; infrastructure in India, Pakistan, Bangladesh, and Sri Lanka from China, Malaysia, and Singapore; and tourism and related aviation and freight and transshipping services across the region.

FDI outflows to East Asia, in services and overall, were minimal prior to 2004. By the end of 2005, more than 300 Indian IT companies had set up software development operations in Singapore. There are around 1,500 Indian companies currently based in Singapore; on average, approximately 150 Indian companies set up base in Singapore every year.<sup>25</sup> Anecdotal evidence also indicates that much cross-border investment from East Asia to South Asia has been in services (under Mode 3 of GATS). Recent trends also point to opportunities in transport services, including recent heavy investment by China in Pakistan's transport infrastructure following the implementation of their own bilateral agreement.

Findlay et al. (2009) point to a number of other growing opportunities to expand service exports from South Asia to East Asia, including health services (India), travel (Nepal), telecoms (Pakistan and Sri Lanka), financial services (Sri Lanka), and transport (Sri Lanka and Pakistan), among others. An established network of support services and a pool of trained workers (promoting agglomeration), along with lower-cost service links (to support fragmented activities), are crucial if South Asia is to encourage links "eastward" (Carruthers et al. 2003; Arvis et al. 2007).

**Lowering Real Trade Costs.** A critical link to the success of a Look East trade integration strategy for South Asia will thus be to attract sizeable investments from East Asia and the rest of the world to the Region to become integrated into global production chains in both manufacturing and services. But in order to do so, the Region will also need to improve its trade logistics and lower substantial barriers at and behind the borders. Indeed, high trade costs are the biggest deterrent to expanded integration (see box 3.2). Increased integration strategy with East Asia will help to attract these complementary investments (where East Asia has a decided comparative advantage) provided entry into services and trade logistics is encouraged by lowering policy and institutional barriers.

At the same time, closer intraregional integration within South Asia will be another critical instrument to enlarge market size and attract more investment, and lower the substantial within-region trade costs—given a long coastline that surrounds a very large geographic hinterland and the difficulties of land-locked countries and cross-border trade within South Asia. A

### Box 3.2 Improved logistics: a critical precondition

The World Bank's Logistics Performance Index (LPI) provides assessment of logistics performance of countries. In the latest 2010 index, India, Bangladesh, and Pakistan scored better than new low-income members of ASEAN (Lao PDR, Myanmar, and Cambodia), but much lower than ASEAN original members Malaysia, Thailand, and the Philippines, as well as China. Sri Lanka scored marginally lower than Lao PDR, Maldives, Bhutan, Cambodia, and Myanmar, all low-income countries. If South Asian countries are to exploit the marginal advantage of the transportation costs or wages to Europe and the east coast of the United States, improving logistics performance will be critical, given the increasing time sensitivity of vertically linked production networks, including higher value-added apparel, and there will be spillover benefits to promote trade more broadly.

25 India Brand Equity Foundation, CII, [http://www.ibef.org/artdispview.aspx?art\\_id=4267&cat\\_id=400&page=3](http://www.ibef.org/artdispview.aspx?art_id=4267&cat_id=400&page=3) (accessed July 15, 2009).

review of trade facilitation and transport logistics in the region illustrates weakness of South Asian countries in port and transport infrastructure, regulatory environments, and service-sector infrastructure (Wilson and Ostuki 2007). Delays at seaports due to congestion and outdated infrastructure raise costs for exporters throughout the region. Furthermore, landlocked countries in the region confront additional delays due to congestion in road and transit caused by the poor road infrastructure and networks (De, Chaturvedi, and Khan 2007; Roy and Banerjee 2007). The study finds that very large gains from improved trade facilities are possible—much of which will accrue from intra-regional efforts at and gains from lower trade costs. Continued reform in regulation and harmonization of standards, accelerating the diffusion of technology to lower transactions costs, and promoting efficiency in customs regimes within the region are thus needed. The next section discusses therefore the complementary approach to accelerate intra-regional integration as a critical instrument to lower these real trade costs within the region.

### BOOSTING INTRAREGIONAL TRADE IN SOUTH ASIA

While the fast-expanding trade with East Asia (and with other regions) will open new avenues for South Asian countries individually, they are likely to gain even more by expanding trade and cross-border investments with each other—enlarging the South Asia market. A larger South Asian integration, if policies and institutions needed to do so can be improved, could also provide an important platform to reduce real trade costs and behind-the-border barriers in the region, which would then attract greater investment and integration with East Asia—enlarging dramatically the gains. In a similar vein, more closely integrated South Asian markets would improve the scale economies of domestic firms, especially in manufacturing (where the small size of domestic markets has been one big constraining factor),<sup>26</sup> would increase competition, and hence efficiency; and would facilitate skills and technology spillovers (Kumar and Singh 2009), a process that is already starting in sectors such as IT and business process outsourcing. Industrial structures that are similar across the region (for example, apparel and textiles) would also gain from greater specialization and intraindustry trade, helping to strengthen comparative advantages with the rest of the world. Services, too, would gain, such as tourism, transport, energy, and shipping, with scale economies and competition. Such a bigger regional market would, in turn, attract greater trade and investment from East Asia (and the rest of the world), making the likelihood of gains even stronger. In reflection, quantitative studies (Francois et al. 2009) find consistently that the gains from greater trade integration for South Asia are much bigger and benefit all country members more, if countries of the region also trade more with each other, even as they integrate faster with East Asia and the rest of the world.

The potential for such intraregional trade is large—the current levels of about 5 percent share of intraregional trade, in total, could quadruple to about 20 percent with such supportive policies, by some estimates. The more likely and faster way to do so is by expanding bilateral trade and investment relations—helping support the eventual goal of formal intraregional trade cooperation arrangements (the SAPTA and its transition to SAFTA).<sup>27</sup> The latter has had some difficulties in reducing binding barriers to intraregional trade and in producing results because of political-economic and other constraints to obtaining significant reciprocal concessions across member states. At the bilateral level, however, the pace of liberalization can be much faster, can help build confidence, and can induce competitive spillovers across the region. Some of the reasons why such bilateral agreements work better and faster include the practical aspects of the broader scope of liberalization in such bilateral FTAs, less restrictive rules of origin, bigger and faster cuts in tariff and nontariff barriers, and features such as asymmetrical concessions (especially by larger

26 Evidence across the world suggests that exporting plants overwhelmingly tend to be larger, to have higher levels of productivity and shipments, and to be more capital intensive and technologically more sophisticated (Wagner 2001), even if this is not true of all industries. In assessments of firm size and performance in South Asia, this appears to hold. Scale effects are consistently positive in exporting, whether in (1) highly clustered network industries such as garments (Cawthorne 1995) or (2) vertically integrated and R&D-intensive sectors such as IT and pharmaceuticals (Pradhan 2002). Evidence from China also suggests that scale economies are strong, with exporting firms distinctly larger, even after controlling for sectoral, regional, and ownership factors (Kraay 1997).

27 SAPTA became operational in 1995, 10 years after the first SAARC summit, and it transitioned to SAFTA in 2004.

**Box 3.3 Bhutan-India cooperation**

Bhutan is well endowed with mountainous, glaciated peaks that feed its four main rivers with potential hydroelectric power—generating capacity estimated at 30,000 megawatts (MW), of which about 26,000 MW are commercially viable. Bhutan and India signed a series of four agreements in 2009 that include energy, educational, and vocational needs. The four agreements are for the preparation of detailed project reports for 10 hydropower projects. Of the 10 projects, 6 will be financed through an intergovernmental model, whereby India will supply 40 percent of the cost as grants and the remaining 60 percent as loans. A free trade regime exists between Bhutan and India that expired in March 2005 but has been renewed for 10 years. Bhutan experienced a notable rise in its exports to India.

countries to smaller ones) in the political-economic setting of the region (Aggarwal and Mukherji 2005). And, as the subsequent trade and business climate improves sharply in the wake of such bilateral trade, so do cross-border investments, helping to drive further gains faster and to build greater private-sector and business support. Sector-level agreements, as in energy, are another possibility, if they induce similar specificity and rapid mutual gains in confidence and cross-border investments.

There are signs that such bilateral trade and cross-border investment is starting to show greater vitality in South Asia—particularly in the post-2000 period, a time that saw key developments in growing trade relations between India and other member countries, and with East Asia. The latest developments in Indo-Bangladesh trade relations and Indo-Bhutan economic cooperation, along with the growth in Sri Lanka–India trade (and cross-border investment) and the potential for energy trade with neighbors, are some examples and possibilities described in boxes 3.3 to 3.6.

**Box 3.4 India–Sri Lanka Free Trade Agreement (ISLFTA)**

Sri Lanka’s regional trade, particularly with India, has undergone a significant increase compared to others. Sri Lanka’s share of intraregional imports rose from 11 percent in 2000 to 23 percent in 2008, while its export share rose proportionately faster from a very low 2.7 percent in 2000 to 8.5 percent in 2008 (Pitigala 2008). Traditionally, Sri Lanka’s exports to India have been relatively small, but since ISLFTA, Sri Lanka’s bilateral exports have soared compared to the other nonlandlocked countries, and relative to growth levels of Indian overall imports.

The reasons behind the success are (1) the ISLFTA, although principally an agreement in trade in goods, provided a boost to services trade and FDI—in air travel (the “open skies” agreement brought in several new carriers), in transshipment (70 percent from India), and in FDI (India joined the top five investors, with cumulative investment of US\$2.5 billion); (2) the scope of product coverage was enhanced through a “negative list” approach; (3) a faster pace of implementation was used—for example, duty-free access was granted by India within three years of signing on 81 percent of the agreed items, and similar reciprocity was pursued by Sri Lanka; and (4) rules of origin were simplified.

**Raising the game: policy directions**

In positioning the South Asia region in the “new normal” of the global economy, as highlighted in this chapter, the region needs to redirect its market integration strategy. What does this imply in terms of the changes in the direction of policies?

### Box 3.5 Bangladesh-India cooperation

Bangladesh and India have a long history of agreements to facilitate trade and economic cooperation. Although bilateral trade between the two countries has been growing steadily, exports from India far outweigh imports from Bangladesh, resulting in a wide and growing trade gap. Bangladesh and India signed a series of new agreements in January 2010 to address some of the barriers to bilateral trade through new trade and transit provisions:

- Greater market access for Bangladesh. India has extended duty-free access beyond its South Asian FTA commitments, broadening the scope of goods to benefit from duty-free access to India, with the aim of narrowing the large trade gap.
- Promotion of transit links between Bangladesh and India. India also agreed on transit rights for goods from India's northeastern state of Tripura to Chittagong, including a new rail link. The new links will benefit both countries by reducing transport costs for Indian exporters in the border regions and by gaining greater revenues for Bangladesh from transit and port fees.
- Regional trade facilitation. India also agreed to a long-pending request from Bangladesh to allow rail transit from Bangladesh to Nepal and Bhutan, thereby benefiting all three of India's regional trade partners as India expands its demand for underused port facilities and services, and as Bangladesh's, Bhutan's, and Nepal's landlocked regions gain greater market access for their exports.

Other agreements signed at the January meeting include India's extension of an infrastructure credit facility at highly preferential rates and new energy supplies to meet Bangladesh's shortfalls.

### Box 3.6 An energy ring trade for South Asia

Bangladesh, India, Pakistan, and Sri Lanka have a demand for energy that is in excess of their domestic capacity to varying degrees, and the gap will only become larger with future growth. Conversely, Bhutan and Nepal in the South Asia region; the Islamic Republic of Iran and Qatar in the Middle East and North Africa region; Kyrgyzstan, Tajikistan, and Turkmenistan in the Central Asia region; and Myanmar in the East Asia region have resource endowments considerably in excess of domestic demand.

The benefits from energy trade in South Asia can be enormous: The most obvious direct benefit would be in alleviating the energy constraint to growth for the potential energy-importing countries, India and Pakistan. In addition, transit countries would earn large fees, and grids could improve efficiency of supply and could attract private investment with better services, while potentially improving the environment. In India, the volume of unmet demand for electricity in 2007 is estimated to have been 55 terawatt hours (TWh), which can be valued at US\$12 billion on the basis of the short-term marginal cost in the Indian grid. The value of the forgone industrial value added would be considerably more. In Pakistan, unmet energy in 2007 is estimated to have been 18 TWh. When valued at the Pakistan system's average incremental cost of about US\$.07 per KWh, the direct cost of shortages is of the order of US\$1.9 billion. In Bangladesh, electricity shortages are forcing garment exporters to ship orders through chartered flights, while stoppages of production are reducing exports.

**The Look East Strategy.** The most important policy initiatives would be to accelerate the lowering of tariff and nontariff barriers with respect to East Asia and the rest of the world, and then to expand to the opening of services and foreign direct investment.

Individual South Asian countries are already relatively well positioned and are making good progress, as far as formal trade agreements are concerned. India, for example, has already signed an FTA with ASEAN, while bilateral agreements with member states are enlarging the scope and pace of its trade and investment integration. Others, too, have similar bilateral and regional agreements, although not as encompassing as India's. Although theory suggests that a single trade arrangement encompassing both South and East Asia may provide the optimal strategy within broader Asian integration, this is unlikely to happen, and a “noodle bowl” phenomenon of overlapping bilateral and regional agreements, with multiple rules of origin and market access provisions, is therefore likely to stay.

*To lower trade and transactions costs within this setting, South Asia would benefit by lowering trade barriers to levels similar to East Asia (annex table 3A.2) and extending them to all countries to reduce the potential for trade diversion. This would accelerate its South-South trade potential, in light of the global rebalancing. Relatively higher nominal tariffs above 15 percent still prevail; countries could decide to unilaterally reduce them closer to the norm in East Asia of below 9 percent (the rate that all developing countries face incidentally in high-income markets). Nontariff barriers, however, account for even bigger protection, and “paratariffs” are often large. Import restrictions have often increased after the crisis. Liberalizing such nontariff protection unilaterally could be an even more important component of such open regionalism,<sup>28</sup> including cutting import restraints, protracted customs clearance processes, and often complicated and redundant documentation requirements. Complementary and similar approaches would be needed to boost intraregional trade within South Asia.*

*South Asia could also more aggressively liberalize services trade and investment.* Such liberalization should not be limited to more visible champions, such as IT and BPO sectors, but should also extend to backbone services—in finance, domestic transport, wholesale distribution, and other professional services—permitting entry on an MFN basis and encouraging competition. Indeed, the success stories emerging from the agreements between India and Singapore, Pakistan and China, and Sri Lanka and India may have been triggered by the “credibility” of their FTAs, but they are largely a consequence of such unilateral measures.

Improvement of *trade logistics* will be especially crucial for South Asia to better exploit its manufacturing potential and may prove decisive in tapping into East Asia's global production sharing. South Asia countries, as a result, need to fast-track East Asian investment into the logistics chain: trucking, customs, brokerage, freight forwarding, shipping, aviation, port and airport operations, and others.

**South Asia's Intraregional Integration.** The acceleration of bilateral trade and investment arrangements will be central, where India plays an important role, and private-sector cross-border investments will be key.

Similar considerations, as in the case of South East Asian trade, apply regarding why bilateral trade and investment integration will lead the way. How might this come about? The challenge will be for the region's largest and fastest-growing economy, India, to extend quickly such bilateral benefits of closer trade and investment with all its neighbors and to ensure that implementation is faster. But these agreements can go only so far, and a key role will need to be played by *private-sector, business-to-business transactions*, in expediting and enlarging such intraregional trade, leveraging such bilateral agreements.

In a similar vein, within South Asia, too, *services complementarity* is expected to be greater than in just merchandise trade, such as in transport, travel, health, education, and other sectors, which will carry immediate and more visible benefits to people. Trade

<sup>28</sup> In principle, reducing barriers at a multilateral level reduces negotiation costs, minimizes the risk of trade diversion, permits countries to reap gains from trade with the rest of the world, increases transparency for exporters and importers, and gives recourse to the enforcement mechanisms of the multilateral system (e.g., dispute settlement).

liberalization within the region might also start to consider agriculture, which remains untouched despite its potential, as well as energy trade, given the constraints across the region.

Given the landlocked nature of some countries in the region, *facilitating transit trade* will also be critical. The new agreements between India and Bangladesh, signed in January 2010, suggest a promising breakthrough, and they will benefit the neighboring landlocked countries of Nepal and Bhutan (as well as the northeastern border regions of India). Much more can be done. A quantitative test (De 2010) supports the above: a 10 percent reduction in the ad valorem price (transport and tariff), for example, would raise trade within South Asia by as much as 6 percent, a larger impact than the effects of standard reduction of at-the-border tariffs.

**Maximizing Opportunities in High-Income and Other Markets.** The main imperative will be, again, services liberalization. The high-income markets will continue to provide critical markets for outsourced services (IT, BPO) and labor-intensive exports from South Asia, even if at a slower pace than in the past. Increasingly, the high-income countries will also provide bigger sources of longer-term capital and know-how—from manufacturing to backbone services critical to South Asia’s domestic growth. For both reasons, South Asian countries should accelerate liberalizing services on an MFN basis with all, including high-income countries, even as they pursue multilateral approaches in formal trade negotiations and agreements. While pursuing such market opportunities in high-income countries, South Asia would also do well to keep its trade and investment open to the rest of the world—to an increasingly multipolar world—including other regions and emerging markets that continue to be important, given long-standing and growing ties: the Middle East, Central Asia, Sub-Saharan Africa, and Latin America. Leveraging regional integration with these markets could also offer promising opportunities, as in energy, manufacturing, and services.

## ANNEX

**Table 3A.1** Displacement versus complementarity of South Asian and East Asian exports: regression results

	Export India		Pakistan		Bangladesh		Sri Lanka		Nepal	
Export supply effect (dimports)	0.4347a	0.4347a	0.3284a	0.3286a	0.4185a	0.4199a	0.4009a	0.4012a	0.2648a	0.2649a
	-89.89	-89.89	-26.98	-26.99	-15.59	-15.63	-22.12	-22.13	-7.28	-7.29
East Asia Export effect (dEast Asia)	0.0430a		0.0511a		0.0752a		0.0439a		0.0015	
	-20.94		-8.66		-5.1		-4.7		-0.09	
East Asia Export effect: 1990–99		0.0400a		0.0585a		0.1101a		0.0550a		0,0132
		-9.94		-5.39		-3.92		-3.07		-0.38
East Asia Export effect: 2000–08		0.0441a		0.0481a		0.0621a		0.0398a		-0,0026
		-18.48		-6.87		-3.6		-3.65		-0.12
Constant	0.1162a	0.1162a	-0.0065	-0.0063	0.0635a	0.0642a	0.0185a	0.0186a	0.0451a	0.0452a
	-53.1	-53.07	-1.46	-1.42	-8.48	-8.56	-3.47	-3.49	-4.93	-4.94
Observations	591,566	591,566	166,350	166,350	61,239	61,239	113,481	113,481	35,656	35,656
R-squared	0.19	0.19	0.28	0.28	0.33	0.33	0.31	0.31	0.32	0.32

Source: Staff calculations.

Note: The regressions include 2-digit product, importers and year effects. The estimates thus rely entirely on cross-market variation in East Asian import penetration in a given product. Robust t-statistics are shown in bracket. The symbol a denotes significance at the 1% level.

**Table 3A.2 Tariff barriers in Asia: 2007\***

Country/Region	Binding Coverage	Simple Mean	Weighted Mean	Primary	Manufactured
India	73.8	16.4	10.4	25.2	15.9
Pakistan	98.7	14.9	11.4	14.2	15
Bangladesh	15.9	14.5	11	15.2	14.4
Sri Lanka	38.1	11	7.1	17.8	10.6
Nepal	..	12.6	13.7	12.4	12.7
Bhutan	..	18.2	17.8	43.7	15.5
Maldives**	97.1	21.4	21.1	18.1	22.2
Cambodia	..	12.5	10	14.8	12.1
China	100	8.9	5.1	9	8.9
Hong Kong, China	45.6	0	0	0	0
Indonesia	96.6	5.9	3.9	6.6	5.8
Korea, Rep.	94.6	8.5	8	20.8	6.6
Lao PDR	..	5.8	8.3	9.9	5.3
Malaysia	83.7	5.9	3.1	2.8	6.5
Myanmar	17.4	4.1	3.9	5.8	3.9
Philippines	67	5	3.6	6	4.8
Singapore	69.7	0	0	0.2	0
Thailand*	75	10.8	4.6	13.6	10.4
Vietnam	..	11.7	10.6	14.5	11.3
Lower Middle Income	88.7	2.9	1.8	12.9	8.9

Source: World Bank, WDI

Note: \* Available for 2006. Primary products are commodities classified in SITC revision 3 sections 0-4 plus division 68 (non-ferrous metals). \*\*Manufactured products are commodities SITC revision 3 sections 5-8 excluding division 68.

## COUNTRY PAGES AND KEY INDICATORS

## AFGHANISTAN

Population	28.3 million
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GNI per capita	US\$370
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Capital	Kabul
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GDP growth in 2009–10 bounced back strongly to record levels.<sup>29</sup> The year of peak global crisis coincided with severe drought in Afghanistan, pulling GDP growth down to 3.4 percent in 2008–09. As agriculture swung back to bumper crops in 2009–10, GDP growth also bounced to 22 percent—a record for the reconstruction period, which began in 2002.

Large aid inflows for reconstruction needs and drops in import prices helped cushion the impact of the crisis. Official exports are a small 5 percent of GDP, compared to aid inflows, which are equal to 45 percent of GDP. Although Afghanistan was insulated from the financial crisis, the real crisis that followed had mixed effects. Whereas exports are expected to have fallen by less than US\$100 million, the saving on import payments on petroleum and wheat flour was more than US\$130 million. Official aid inflows increased three times as much as the fall in exports.

A strong rebound in the agriculture sector's GDP growth (53 percent), helped mainly by ample and well-distributed rainfall, contributed much to the record growth rate. Wheat production nearly doubled to 5 million tons compared to the preceding five-year average of 3.4 million tons. Services continued to grow in double digits, led by government services, the financial-sector, and transport services. Industrial growth continues to lag behind, pulled down by

<sup>29</sup> Lack of data on many aspects of the economy of Afghanistan limits detailed analysis and is complicated by ongoing conflict, which affects economic activity in the country.

modest manufacturing- and construction-sector growth rates that are much lower than in the early years of reconstruction.

Mining, however, is booming, with near 30 percent growth in the last two years in the run-up to the construction of the world-class Aynak copper mine.

Bank lending has turned cautious since the global crisis. Bank assets as a share of GDP rose to an all-time high of 23 percent by the end of 2009, but the loan-to-deposit ratio has fallen under 50 percent. Deposit growth continues to outpace loan growth, which is indicative of the difficulty of lending in a difficult private-sector environment. Microfinance has also started to slow down since mid-2009. Observance of prudent standards by commercial banks merits close supervision by the Central Bank, as some banks have breached minimum capital requirements.

Disinflation seems to have ended in December 2009. The fiscal year 2009–10 is likely to end with a negative inflation of 12 percent, mainly on account of the drop in cereal prices, which account for 28 percent of the consumer basket. Small nominal appreciation of the Afghani against the U.S. dollar (3 percent over a year) and imports

from regional partners may have also played a role in keeping prices low. The average price of wheat flour in March, for instance, was Afs14 per kg, a third lower than in the same month last year on the back of a bountiful harvest. Nonfood prices have been edging up slowly since December 2009, led by housing costs. The disinflation in food prices also ended in January, and prices have been recovering rapidly.

Fiscal performance improved in fiscal year 2009–10, with a dramatic surge in revenue collection and strong containment in operational expenditures. Afghanistan achieved a remarkable surge in domestic revenues during 2009–10, collecting 53 percent more than the previous year and 16 percent more



## Afghanistan

## Key Indicators

	2006–07	2007–08	2008–09	2009–10	2010–11e
<b>Output, Employment and Prices</b>					
Real GDP (% change y-y)	8.2	14.2	3.4	22.5	8.6
Industrial production index (% change y-y)	...	...	...	...	...
Unemployment (%)	...	...	...	...	...
Real wages (% change y-y)	...	...	...	...	...
Consumer price index (% change y-y) end of period	9.4	4.8	20.7	3.2	-2.2
<b>Public Sector</b>					
Government balance (% of GDP)	-2.9	-1.8	-3.7	-0.7	-1.4
Total government debt (% of GDP)	155	20.7	19.2	10	10.5
<b>Foreign Trade, BOP, and External Debt</b>					
Trade balance (millions of US\$)	...	...	...	...	...
Exports of goods (millions of US\$) (% change y-y)	2.9	11	13.5	-16.3	9.9
Imports of goods (% change y-y)	12.5	20.6	10.4	3.1	3.5
Current account balance (millions of US\$) (% of GDP)	-4.9	0.9	-1.6	-3.6	...
Foreign direct investment (millions US\$)	...	...	...	...	...
External debt (millions US\$) (% of GDP)	...	...	...	...	...
Short-term debt (millions US\$)	...	...	...	...	...
Debt service (% exports of g&s)	...	...	...	...	...
Foreign exchange reserves (millions US\$) (months of imports of g&S)	2,040	2,784	3,479	4,448	5,116
<b>Financial Markets</b>					
Domestic credit (% change y-y)	...	...	...	...	...
Short-term interest rate (% p.a)	...	...	...	...	...
Exchange rate ( /US\$, ave)	...	...	...	...	...
Real effective exchange rate (=100) (% change y-y)	-2	3.2	14.4	-17.7	...
Stock market index	...	...	...	...	...
Memo: nominal GDP (billions US\$)	7.7	9.7	11.8	14.5	17

Sources: World Bank country sources; IMF staff papers; World Development Indicators; CEIC Data Ltd.; Central Bank, Finance Ministry, and Statistical Bureau.  
Note: Official data is reported where available drawing on varied reliable published sources; e=estimate.

than budgeted. Improved tax administration underpins much of the revenue increase. Even as the revenues surged, strong containment of operational expenditures led to expenditures about 10 percent less than budgeted. As a net result, the fiscal sustainability indicator—percent of operational expenditures covered by domestic revenues—improved to 70 percent, up from 60 percent in the previous year.

The execution of a development budget continued to be a cause for concern, as the government managed to spend only

38 percent of what was budgeted. The low execution rate has multiple causes, attributable to the weak capacity of the government in formulating and executing investment projects and the weak alignment of donor priorities and funding cycles with that of local government. The commitment at the London conference in January 28, 2010, to increase donor spending through the budget to 50 percent in two years' time sets a laudable but ambitious target. An upcoming conference is scheduled for July 20, 2010, in Kabul to follow up.

Afghanistan reached a final milestone in debt relief. After completing a series of important reforms, agreed upon in 2007 under the most challenging of circumstances, Afghanistan reached the HIPC completion point and secured permanent debt relief from the Highly Indebted Poor Country Initiative and the Multilateral Debt Relief Initiative. The relief is in the form of debt service savings nominally valued at US\$1.6 billion. External debt, after applying the debt relief, is valued at a modest 10 percent of GDP—halved from the previous year. The improvements in external accounts notwithstanding, Afghanistan faces a high risk of debt distress because of the likelihood of shocks emanating from GDP growth or the grant element in borrowing.

The outlook for the current fiscal year 2010–11 is good, with GDP growth slightly higher than 8 percent and mild inflation under 5 percent. As agriculture falls back to normal growth, service sectors will once again provide much of the growth in the coming year and will benefit from government and donor spending. The mining sector will continue to grow vigorously, as the construction phase of the Aynak copper mine intensifies. On the inflation front, there appears to be little cause for worry, although disinflation appears to have ended. The prospects for cereal production are good, with winter and spring crops developing under generally favorable conditions per FAO assessments. Some susceptibility to imported prices remains, as even in a good year, about one-sixth of cereals are imported. Nonfood prices are rising, but at a modest pace, below 5 percent.

## BANGLADESH

Population	160 million
GNI per capita	US\$520
Capital	Dhaka

Real GDP is projected to grow at 5.5 percent in fiscal year (FY) 2010, down from 5.7 percent in FY 2009, driven by consumption and public development expenditures. Private consumption expenditures held up well because of strong growth in remittances and the non-rice agricultural sector. Public consumption expenditures rose because of increased public-sector pay and an additional stimulus package for the export-oriented sectors. Public investment has also picked up slightly in FY 2010. However, sluggish private investment is largely responsible for the projected decline in growth in FY 2010.



Reserves have increased due to strong remittance and foreign aid inflows. Despite a decline in exports, the nominal current account surplus rose in the first seven months of FY 2010 to US\$2.2 billion, compared with US\$0.38 billion in FY 2009 with rising services. Compressed import demand and strong remittance inflows in the first half of FY 2010 have led to this surplus. This has been complemented by a surplus

## Bangladesh

Key Indicators	2005–06	2006–07	2007–08	2008–09	2009–10f	2010–11f	2009			
							Q1	Q2	Q3	Q4
<b>Output, Employment and Prices</b>										
Real GDP (% change y-y)	6.6	6.4	6.2	5.9	5.5	5.7	...	...	...	...
Industrial Production index	327.1	359.8	384.8	413.4	...	...	422.6	417.7	429.9	...
(% change y-y)	11.0	10.0	6.9	7.4	...	...	6.5	5.5	2.5	...
Unemployment (%)	4.25	...	...	...	...	...	...	...	...	...
Real wages (% change y-y)	...	...	...	...	...	...	...	...	...	...
Consumer price index (% change y-y)	7.2	7.2	9.9	6.7	6.5	6.1	5.6	4.3	4.2	7.5
<b>Public Sector</b>										
Government balance (% of GDP)	-3.4	-3.1	-3.6	-3.6	-3.9	-4.0	...	...	...	...
Domestic public sector debt (% of GDP)	18.2	19.8	20.4	21.2	21.5	22.3	...	...	...	...
<b>Foreign Trade, BOP and External Debt</b>										
Trade balance (billions of US\$)	-2.9	-3.5	-5.3	-4.7	...	...	-1.1	-0.7	-0.7	-2.0
Exports of goods (billions of US\$)	10.5	12.2	14.1	15.9	16.9	19.4	3.9	3.9	3.9	3.4
(% change y-y)	21.6	15.7	15.9	10.3	8.6	14.5	5.9	-0.5	-11.7	0.9
Key exports (% change y-y)	23.1	16.6	16.2	15.4	...	...	12.6	3.9	-9.7	-4.8
Imports of goods (billions of US\$)	14.7	17.2	21.6	22.5	25.8	30.2	5.6	5.1	5.1	6.0
Current account balance (billions of US\$)	0.8	0.9	0.7	2.5	...	...	0.7	1.5	1.4	0.3
(% of GDP)	1.3	1.4	0.9	2.8	2.1	1.5	...	...	...	...
Foreign direct investment (billions US\$)	0.7	0.8	0.7	0.9	...	...	0.2	0.1	0.2	0.0
External debt (billions US\$)	17.8	18.5	21.0	21.5	22.2	23.3	...	...	...	...
(% of GDP)	28.7	27	26.4	24.1	22.3	21.7	...	...	...	...
Short-term debt (billions US\$)	...	...	...	...	...	...	...	...	...	...
Debt service (% exports of g&s)	5.8	5.3	4.8	4.6	...	...	...	...	...	...
Foreign exchange reserves (billions US\$)	3.5	5.1	6.2	6.7	10.9	...	6.0	7.5	9.4	10.3
(months of imports of g&s)	2.8	3.4	3.4	3.7	5.5	5.5	2.8	3.6	4.7	5.6
<b>Financial Markets</b>										
Domestic credit (% change y-y)	20.3	14.8	21.0	16.0	15.6	...	18.7	16.0	12.4	13.7
Short-term interest rate (% p.a)	6.5	7.9	7.9	7.5	...	...	8.2	5.7	3.6	3.5
Exchange rate (Taka/ US\$, ave)	67.2	69.1	68.6	68.8	69.5	70.5	68.9	69.0	69.1	69.1
Real effective exchange rate (FY01=100)	82.7	81.5	82.1	90.2	...	...	93.5	91.2	91.6	90.9
(% change y-y)	-5.2	3.2	-0.6	8.9	...	...	14.6	12.4	7.8	-0.1
Stock market index	1,340	2,149	3,001	3,010	...	...	2,967	2,795	2,447	3,010
Memo: nominal GDP (billions US\$)	61.9	68.4	79.6	89.4	99.5	107.2	...	...	...	...

Sources: World Bank country sources; IMF staff papers; World Development Indicators; CEIC Data Ltd.; Central Bank, Finance Ministry, and Statistical Bureau.

Note: The fiscal year for Bangladesh is from July to June; T-bills rate (182-Days); f=forecast.

of US\$418 million in the capital and financial accounts, leading to a US\$2.1 billion-plus surplus in the overall balance of payments. Reserves rose correspondingly to exceed \$10 billion (5.7 months of imports) in January 2010. In the face of these inflows, Bangladesh Bank was forced to accumulate additional reserves of US\$2.1 billion in the first seven months of FY 2010 in order to prevent the nominal taka value from appreciating.

Inflation rose to 9 percent in January 2010, up from 2.2 percent in June 2009. This sharp increase was driven by food inflation, arising from a shortfall in domestic rice production, rising world food prices, and high food inflation in India. Nonfood inflation also rose, from 3.7 percent in July 2009 to 6.6 percent in January 2010. While domestic agriculture output and world food prices are likely to have a strong bearing on inflation in the next few months, an incremental

tightening of monetary policy, as announced in the Monetary Policy Statement for the second half of FY 2010, can also help dampen inflationary pressures.

The fiscal deficit remains sustainable, underpinned by good revenue performance. It is projected to be contained at about 4 percent of GDP in FY 2010, which is well within the sustainable threshold. This is slightly higher than last year's fiscal deficit of 3.7 percent of GDP—and it derives from the implementation, retrospectively, of the public-sector wage increase, higher safety net expenditures, a likely further boost to the Annual Development Program (ADP) this year, and a potential increase in energy and fertilizer subsidies because of rising international prices.

The FY 2011 growth outlook is dependent on the easing of domestic supply constraints, particularly energy. Global recovery is off to a stronger start than was initially anticipated. Currently, supply issues are more problematic than those of demand; energy shortages will continue to stifle Bangladesh's recovery. The estimated demand-supply gap is currently one-third of demand (2,000 MW) in peak hours. Gas shortages account for nearly half of this gap. Maintaining growth at its recent 6 percent average over the medium-term will thus be a challenge for Bangladesh, given the current infrastructure and energy deficit. Redressing this will require domestic reforms and increasing trade integration with countries in the region and the rest of the world. The Bangladesh Prime Minister's visit to Delhi earlier this year helped to promote Indo-Bangladeshi cooperation in security, power, trade, connectivity, and water sharing, and to encourage resolution of other long-standing bilateral concerns. If fully implemented, these resolutions will lay the basis for higher investment and growth by improving energy security and connectivity.

## BHUTAN

Population	0.68 million
GNI per capita	US\$1,900
Capital	Thimphu

Growth slowed to about 6.2 percent in 2009, down from an average 9 percent in the preceding five years. Per capita gross national income was estimated to be the second highest in the South Asia region, after the Maldives.



Hydropower enabled Bhutan to maintain strong growth over the last few years. The kingdom's power-generating capacity trebled in the last three years. The government aims to use electricity and hydropower construction to sustain targeted growth of almost 8 percent over the next several years. It has tapped just 5 percent of its 23,760 MW potential and has plans to develop a string of new plants with assistance from India.

The economy was adversely affected by some shocks in 2009. Although hydropower was relatively unaffected by the global crisis, the downturn depressed tourism, a key source of convertible currency revenue, by US\$7 million in 2009, or nearly 18 percent compared to the year before. Earnings from tourism in the last quarter of 2009 were 33 percent below the

## Bhutan

Key Indicators	2005–06	2006–07	2007–08	2008–09	2009–10e	2010–11f	2009			
							Q1	Q2	Q3	Q4
<b>Output, Employment and Prices</b>										
Real GDP (% change y-y)	6.7	13.2	11.7	6.2	8.1	7.7	...	...	...	...
Industrial production index (% change y-y)	...	...	...	...	...	...	...	...	...	...
Unemployment (%)	...	3.7	...	4	...	...	...	...	...	...
Real wages (% change y-y)	...	...	...	...	...	...	...	...	...	...
Consumer price index (% change y-y)	6.2	5.9	8.8	...	...	...	7.21	2.96	3.42	4.05
<b>Public Sector</b>										
Government balance (% of GDP)	0.2	7.1	3.9	2.3	-4.7	-4.2	...	...	...	...
Domestic public sector debt (% of GDP)	10.8	3.5	2.7	2.1	1.6	1.2	...	...	...	...
Foreign trade, BOP and external debt										
Trade balance (millions of US\$)	-122.9	46.7	-72.4	-158.3	-197.7	-200.8	...	...	...	...
Exports of goods (millions of US\$) (% change y-y)	312.0	573.3	598.7	456.3	502.9	545.1	...	...	...	...
Imports of goods (millions of US\$)	-434.9	-526.6	-671.1	-614.6	-700.6	-745.9	...	...	...	...
Current account balance (millions of US\$) (% of GDP)	-37.9	145.2	-26.8	-54.9	-162.4	-184.8	...	...	...	...
Foreign direct investment (millions US\$)	6.1	73.3	30.1	17.9	21.4	23.0	...	...	...	...
External debt (millions US\$) (% of GDP)	668.5	739.1	763.8	631.7	818.0	1,011.2	...	...	...	...
Short-term debt (millions US\$)	...	...	...	...	...	...	...	...	...	...
Debt service (% exports of g&s)	5.1	3.3	13.7	14.3	14.2	13.9	...	...	...	...
Foreign exchange reserves (millions US\$) (months of imports of g&S)	478.8	600.4	645.7	758.2	791.5	844.6	...	...	...	...
<b>Financial Markets</b>										
Domestic credit (% change y-y)	42.5	12.3	29.9	19.2	...	...	...	...	...	...
Short-term interest rate (% p.a)	...	...	...	...	...	...	...	...	...	...
Exchange rate ( /US\$, ave)	44.7	44.2	40.4	47.9	46.7	46.8	...	...	...	...
Real effective exchange rate (=100) (% change y-y)	...	...	...	...	...	...	...	...	...	...
Stock market index	...	...	...	...	...	...	...	...	...	...
Memo: nominal GDP (millions US\$)	882.5	1,013.2	1,282.3	1,212.9	1,409.2	1,580.6	...	...	...	...

Sources: World Bank country sources; IMF staff papers; World Development Indicators; CEIC Data Ltd.; Central Bank, Finance Ministry, and Statistical Bureau.

Note: Fiscal year is July 1 to June 30; e=estimate; f=forecast.

corresponding 2008 figures, indicating that sector recovery is still some distance away. A further US\$67 million was lost to earthquake and cyclone damage.

Domestic credit growth has been curtailed by cautious monetary policy, although growth of credit to the private sector is high, accounting for about 97 percent of the total outstanding credit in June 2009, a 28.7 percent increase from 2008. Building and construction was the highest component,

at 25 percent, followed by trade and commerce at 17 percent, and services and tourism at 13 percent. With rapid credit growth, averaging about 30 percent in the last 10 years, financial-sector vulnerabilities are on the rise, and there are signs of deteriorating asset quality. Banks' nonperforming loans more than doubled to 18 percent of total loans between December 2008 and June 2009. Banks also have maturity mismatches due to the long-term structure of these loans and the short-term corporate deposits that dominate the funding

base. Strengthening the supervisory function of the central bank will be helpful in managing the loan issue and the entry of new financial institutions in the sector.

The authorities are taking important steps to promote private-sector development by improving policy and liberalizing the financial sector. Bhutan's Royal Monetary Authority, the central bank, has issued three new bank licenses and one additional insurance license, leading to the number of financial institutions more than doubling in the first quarter of 2010. A new economic development policy, approved by government in April 2010, is intended to enhance economic self-reliance, generate employment, add value to natural resources, raise import substitution, and increase diversified exports. The government has also released guidelines for external commercial borrowing, which is expected to ease financial constraints for the private sector.

In September, Bhutan initiated its first public-private partnership to develop an information technology park aimed at attracting foreign direct investment. The Oberoi Group has also indicated plans to build a 75-room luxury resort that would employ 150 people, mostly Bhutanese. FDI inflows are projected to increase at about 25 percent per year in the next few years as the government seeks to encourage further partnerships with foreign companies.

Consumer inflation has eased from the elevated levels of late 2008, but food inflation is resurging due to supply shocks from India, which provides three-quarters of all commodities. With the Bhutanese ngultrum pegged to India's rupee, prices have tracked India's inflation closely. The easing of inflationary pressure in India, due to a sharp drop in global oil and commodity prices, helped Bhutan's headline inflation drop to 3 percent in the second quarter of 2009, from over 9 percent in the third quarter of 2008.

A fiscal deficit of more than 4.5 percent is projected for 2009–10, although this is expected to decline over the next few years. Bhutan's debt is expected to rise significantly in coming years with the hydropower loans—with the debt-to-GDP ratio projected to reach 80 percent, up from about 54 percent in 2008–09. This is less of a problem than the numbers might

indicate, as nearly all of the country's debts are owed to India and are serviced automatically by hydropower receipts. The risk of debt distress will be limited in the medium-term, as hydropower projects boost real economic growth and electricity exports.

For the same reason, the current account is expected to weaken in the next few years due to a worsening trade balance and to loan interest payments, although capital transfers from India, foreign direct investment, and loans and grants from development partners should finance this. The overall balance of payments will continue to show a surplus through the short- and medium-terms, due to capital inflows. The ngultrum depreciated by about 11 percent against the U.S. dollar between 2008 and 2009 (following the Indian rupee), even though there was appreciation in the second and third quarters of 2009.

The attainment of fiscal goals will depend critically on the timely receipt of revenues from electricity and budgetary grants, which are the main projected sources of domestic revenue in the short- and medium-terms. Revenues from personal income tax and business income tax are projected to show modest increases of between 6 and 10 percent annually in this time. As a share of aggregate revenues, however, nonelectricity domestic revenues are expected to decline in importance from about one-third last year to about one-quarter by 2013.

As for domestic revenue distribution, the government plans to introduce a formula-based resource allocation mechanism for block transfers from the central government to district and subdistrict (gewog) governments. The formula includes poverty estimates at the gewog level, which are intended to strengthen the resource allocation framework in the coming year.

Bhutan's overall outlook looks bright, with real GDP growth projected at around 8 percent for 2010–11, but the country remains vulnerable to macroeconomic volatility on account of its heavy dependence on hydropower revenues and external assistance, and because of potential overheating from higher development spending and credit growth. There

are also resource constraints from uncertain donor support in the aftermath of the financial crisis, as well as domestic capacity constraints.

INDIA	
Population	1.13 billion
GNI per capita	US\$1,040
Capital	New Delhi

The Indian economy is recovering quickly from the global slowdown. Growth in the second quarter of fiscal year 2009–10 was an unexpectedly high 7.9 percent, compared to 6 percent in the two preceding quarters. Private demand growth has lately been the strongest in two years at the end of the third quarter of 2009–10, an early sign that a stronger platform for future growth is taking hold. Third-quarter growth was also hit by the weak monsoon and a waning fiscal stimulus, but industry continued to surge.



The recovery was broadly based. Capital goods, consumer durables, and intermediate goods led the resurgence of the manufacturing sector, expanding at 18.3 percent (seasonally adjusted annual rate, SAAR). Restocking of depleted inventories and catch-up of postponed purchases explains some of the resurgence in manufacturing. The Indian economy is emerging as a competitive producer of small cars. Hyundai and Suzuki already export half of their Indian vehicles, and Ford and Nissan will enter the fray shortly.

## India

Key Indicators	2005–06	2006–07	2007–08	2008–09	2009–10e	2010–11f	2009			
							Q1	Q2	Q3	Q4e
<b>Output, Employment and Prices</b>										
Real GDP (% change y-y)	9.5	9.7	9.2	6.7	7.4	8.5	6.1	7.9	6.0	8.6
Industrial production index	221.5	247.1	268	275.4	300.1	327	280.4	295.2	307.8	316.9
(% change y-y)	8.2	11.6	8.5	2.8	8.9	9.0	3.8	9.0	13.4	9.6
Unemployment (%)	5	...	...	...	...	...	...	...	...	...
Real wages (% change y-y)	...	...	...	...	...	...	...	...	...	...
Consumer price index (% change y-y)	4.2	6.4	6.2	9.1	11.3	6.0	8.9	11.6	13.2	14.7
<b>Public Sector</b>										
Government balance (% of GDP)	-6.8	-5.4	-5.0	-8.8	-9.5	-8.5	...	...	...	...
Total public sector debt (% of GDP)	80.6	77.3	74.5	75.1	77.1	74.1	...	...	...	...
<b>Foreign Trade, BOP and External Debt</b>										
Trade balance (billions of US\$)	-28.7	-32.3	-54.1	-69.6	-77.2	-86.3	-17.2	-24.7	-23.0	...
Exports of goods (billions of US\$)	105.2	128.9	166.2	175.2	161.8	191.8	37.9	41.9	44.6	...
(% change y-y)	23.4	22.6	28.9	5.4	-7.6	18.5	-34.0	-21.8	13.2	...
Imports of goods (billions of US\$)	157.1	190.7	257.8	294.6	270.4	323.4	64.8	73.8	75.4	...
(% change y-y)	32.1	21.4	35.2	14.3	-8.2	19.6	-21.7	-20.4	2.6	...
Current account balance (billions of US\$)	-10.1	-9.8	-17.3	-30.0	-30.9	-35.9	-6.4	-11.9	-12.0	...
(% of GDP)	-1.2	-1.0	-1.4	-2.5	-2.4	-2.4	-2.2	-3.9	-3.4	...
Foreign direct investment (billions US\$)	3.0	7.7	15.4	17.5	26.0	28.0	6.9	8.2	5.6	...
External debt (billions US\$)	138.1	171.3	224.6	229.9	255.0	267.1	...	...	...	...
(% of GDP)	16.6	17.3	18.1	21.0	19.0	17.7	...	...	...	...
Short-term debt (billions US\$)	19.5	28.1	45.7	43.4	45.8	...	...	...	...	...
Debt service (% exports of g&s)	84.8	84.5	87.6	83.2	105.4	92.0	...	...	...	...
Foreign exchange reserves (excl gold) (billions US\$)	145.1	191.9	299.2	241.4	260.4	279.3	255.3	271.0	265.2	...
(months of imports of g&S)	9.1	9.8	11.6	8.4	9.8	8.9	10.1	9.3	8.7	...
<b>Financial Markets</b>										
Domestic credit (% change y-y)	20.7	20.5	17.4	23.0	18.8	17.9	25.4	23.2	19.6	...
Short-term interest rate (% p.a)	5.5	6.0	6.0	3.5	3.5	6.0	3.25	3.25	3.25	3.5
Exchange rate (/US\$, ave)	44.3	45.1	40.1	45.9	47.5	47.0	48.5	48.3	46.7	46
Real effective exchange rate (1993-94=100)	102.4	98.5	104.8	94.4	91.3	...	89.0	89.8	93.2	...
(% change y-y)	2.3	-3.8	6.4	-10.0	-3.2	...	-10.0	-7.8	1.9	...
Stock market index	11,280	13,072	15,644	9,709	17,528	...	14,494	17,127	17,465	17,528
Memo: nominal GDP (billions US\$)	875.4	1,101.0	1,206.7	1,236.0	1,367.2	1,496.5	...	...	...	...

Sources: World Bank country sources; Economic Survey; IMF staff papers; World Development Indicators; CEIC Data Ltd.; Central Bank, Finance Ministry, and Statistical Bureau.  
Note: e=estimate; f=forecast.

Higher inflation mars the bright picture, but there are early indications of moderation. Inflation, as measured by the wholesale price index (WPI), was just under 10 percent in February 2010 and remains almost unchanged in March 2010. This is in sharp contrast to the negative inflation rates registered throughout much of 2009 because of the sharp drop in international commodity prices. While international oil prices have rallied strongly since the spring of 2009, the

largest contribution to inflation in India comes from food price increases, which reached 17–20 percent in the last three months. However, month-on-month SAAR indicates some moderation in the inflation rates because of a slight drop in food prices in February 2010, compared to January 2010.

In response to higher inflation, RBI raised its two policy rates, the repo and reverse repo, by 25 basis points to 5 percent and

3.5 percent on March 19, a month ahead of its next scheduled monetary policy review. The RBI raised all key policy rates by a further 25 basis points on April 20, 2010. This is a continuation of its gradual exit policy, which started with the withdrawal of liquidity measures in October 2009. The RBI had earlier raised the cash reserve ratio (CRR) by 75 basis points in January 2010.

Fiscal stimulus in the form of higher development and social expenditures has played a role in the rebound. In the Indian states, debt relief and restructuring initiated by the 12th Finance Commission had allowed interest payments to take up less fiscal space, and the ratio of development expenditure to GDP increased from 9.4 percent in 2007–08 to 11 and 10.7 percent in the two years of the slowdown, 2008–09 and 2009–10, respectively. Social-sector expenditures, in particular, received a boost, increasing by about 1 percentage point of GDP.

The 2010–11 union budget envisages fiscal consolidation and is well balanced between revenue improvements and expenditure restraints. The budget for FY 2010–11 cautiously rolled back some of the stimulus measures adopted in the second half of FY 2008–09. It targets a fiscal deficit of 5.5 percent of GDP in 2010–11, down from an estimated 6.7 percent deficit in the outgoing year (6.9 percent when off-budget financing of subsidies is included). Following recommendations made by the 13th Finance Commission, the states' fiscal deficit is also expected to narrow slightly to 2.8 percent of GDP, from a revised estimate of 2.9 percent of GDP in 2009–10.

Financial markets have shown robust signs of recovery. Credit growth remains low compared with previous years, but it is picking up as indicated by a fast drop in excess liquidity in the banking system recently. In the two weeks ending March 12, bank credit grew 16 percent year-on-year. In comparison, in the three years to March 2008, bank lending was growing at an average of 30 percent.

Indicators suggest growing optimism on the economy and policy extending into 2010, as evident from improved ratings, confidence indexes, and expectations surveys. After

the budget was announced, S&P revised its outlook for India from “negative” to “stable.” The NCAER Business Confidence Index for February 2010, at 153.8 points, was at its highest value since January 2008. The seasonally adjusted HSBC Market Purchasing Managers' Index also continued to increase for the third straight month in February 2010. The rise in confidence was also evident in the equity market, with both the BSE Sensex and the NSE posting increases.

India's balance of payments (BoP) recorded a small surplus of \$1.8 billion in the third quarter of FY 2010, smaller than the surplus of \$9.4 billion recorded in the previous quarter. On a cumulative basis, the current account deficit narrowed to \$30 billion in the first nine months of 2009–10, as compared with \$36 billion in the corresponding period of FY 2009. Capital inflows have surged from around \$15 billion during the first nine months of FY 2009 to around \$43 billion during the corresponding period in FY 2010. As a result, the overall balance of payments registered a surplus of \$11 billion between April and December 2009, as compared with a deficit of \$20 billion in the first three quarters of FY 2009. Export growth has weakened since November 2009, and recent data indicate a marginal contraction in January 2010 (SAAR).

India's recovery after the slowdown is well under way. Growth is projected to recover to 8–9 percent in the next two years. The recovery of Indian GDP could be even faster than what is projected, but rising interest rates, a small appreciation of the rupee, and continued low growth in high-income countries weigh on the recovery. Risks to the outlook come from volatility in capital inflows, global recovery, and inflation shocks.

## MALDIVES

Population	0.31 million
GNI per capita	US\$3,640
Capital	Malé

Real GDP growth fell by 3 percent in 2009. A deeper growth decline was avoided as tourism rebounded in the second half of 2009. Tourism is the lifeblood of the Maldivian economy, accounting for almost 30 percent of GDP. Tourist arrivals, earnings, and duration of stay fell in the first half of 2009, as the global recession took hold in Europe—the major tourist-sending region.<sup>30</sup> A rebound in arrivals started in August 2009 and has continued into 2010, with February arrivals up over 30 percent compared to a year earlier. Occupancy and duration of stay have also rebounded, but they have not yet reached precrisis levels.

Efforts are under way to reign in an unsustainable fiscal deficit. The estimated fiscal deficit for 2009 is 26.1 percent of GDP, which is down from mid-2009 projections of 30 percent, based on unchanged policies. Authorities have reduced wages in public service from 10 to 20 percent, depending on grade, and have begun implementing redundancies. They have also raised electricity tariffs by an average of 30 percent for Malé residents. These efforts, along with underspending of capital expenditures and a downward revision to overall expenditure outcomes, have helped contain expenditures in late 2009 and early 2010. The introduction of an airport tax has helped revenues that have been hard hit by a decline in tourism-related receipts due to the global economic slowdown.



Fiscal adjustment and external financing have taken the pressure off foreign exchange reserves. Until late 2009, the Maldives Monetary Authority was rationing foreign exchange, and premiums in the parallel foreign exchange market were building. Since the recovery that started in late 2009, foreign exchange reserves have grown to over 3.5 months of imports, rationing is no longer intensifying, and the premium in the parallel market has decreased significantly. External financing and proceeds from privatization have also contributed to these favorable results.<sup>31</sup>

The IMF approved a blended stand-by arrangement and an arrangement under the Exogenous Shocks Facility for a combined amount of about US\$92.5 million (or 700 percent of quota) on December 4, 2009.<sup>32</sup> The State Bank of India's Malé branch purchased \$50 million of dollar-denominated T-bonds in December 2009, and another \$50 million in February 2009. The bank disbursed \$13.7 million in early April, and the ADB is expected to disburse \$17 million in the second quarter of 2010. The recent Donor Forum successfully garnered commitments of external financing that should underpin the adjustment efforts this year, as well as foreign exchange reserves.

Inflation has moderated on falling food prices. Headline inflation in Malé eased for the second month, running in January to a record 3.7 percent (yoy) compared to 5.4 percent in December 2009. Food prices (which account for 27 percent of overall CPI) recorded a 3.3 percent decline in January (yoy) compared to a 0.8 percent increase in December 2009, which in turn has driven the depreciation of the real effective exchange rate (REER).

30 Cumulative arrivals as of June 2009 were 10.5 percent lower than in the corresponding period in 2008.

31 In January, the government obtained US\$16 million for a 20 percent stake of the Maldives Water and Sanitation Company (MWSA), acquired by the Hittachi Corporation of Japan.

32 The IMF completed its first review of the program on March 26, 2010, releasing the second tranche of the operation (approximately SDR9 million).

## Maldives

Key Indicators	2006–07	2007–08	2008–09	2009–10	2010–11e	2011–12f	2009			
							Q1	Q2	Q3	Q4
<b>Output, Employment and Prices</b>										
Real GDP (% change y-y)	18.0	7.2	6.3	-3.0	3.4	3.7	....	....	....	....
Industrial production index (% change y-y)	....	....	....	....	....	....	....	....	....	....
Unemployment (%)	....	....	....	....	....	....	....	....	....	....
Real wages (% change y-y)	....	....	....	....	....	....	....	....	....	....
Consumer price index (% change y-y)	3.1	10.3	9.1	4.0	4.5	6.0	7.5	3.9	0.8	4.0
<b>Public Sector</b>										
Government balance (% of GDP)	-7.2	-4.9	-17.1	-26.25	-17.4	-4.2	....	....	....	....
Domestic public sector debt (% of GDP)	23.4	26.4	31.2	48.1	55	47.7	....	....	....	....
<b>Foreign Trade, BOP and External Debt</b>										
Trade balance (billions of US\$)	-0.59	-0.74	-0.89	-0.69	-0.70	-0.70	-0.15	-0.16	-0.18	-0.19
Exports of goods (billions of US\$)	0.23	0.23	0.33	0.16	0.20	0.24	0.05	0.04	0.03	0.05
(% change y-y)	39.4	1.2	45.0	-50.7	23.3	20.9	(64.0)	(43.6)	(55.1)	(24.3)
Imports of goods (billions of US\$)	0.82	0.97	1.22	0.85	0.90	0.94	0.20	0.20	0.21	0.24
Current account balance (billions of US\$)	-0.30	-0.44	-0.65	-0.42	-0.36	-0.25	....	....	....	....
(% of GDP)	-33.0	-41.5	-51.4	-31.0	-24.9	-15.8	....	....	....	....
Foreign direct investment (billions US\$)	0.014	0.015	0.012	0.01	0.01	0.011	....	....	....	....
Total external debt (billions US\$)	0.57	0.84	0.97	1.06	1.19	1.20	....	....	....	....
(% of GDP)	62.8	79.7	76.9	77.8	81.4	75.4	....	....	....	....
Short-term debt (billions US\$)	0.09	0.18	0.21	0.20	0.25	0.27	....	....	....	....
Debt service (% exports of g&s)	8.6	12.1	12.5	14.9	17.4	17.1	....	....	....	....
Foreign exchange reserves (billions US\$)	0.232	0.310	0.241	0.262	0.305	0.339	0.268	0.226	0.207	0.262
(months of imports of g&s)	3	3.4	2.1	3.2	3.1	3.3	2.6	2.4	2.5	3.2
<b>Financial Markets</b>										
Domestic credit (% change y-y)	38.6	44.7	35.2	14	7.5	7.5	....	....	....	....
Short-term interest rate (% p.a)	6.5	6.5	6.5	6.5	6.5	6.5	....	....	....	....
Exchange rate (Rufyiaa/US\$, ave)	12.8	12.8	12.8	12.8	12.8	12.8	....	....	....	....
Real effective exchange rate (2000=100)	71.74	75.92	79.97	85.2	....	....	....	....	....	....
(% change y-y)	-9.51	5.83	5.33	6.54	....	....	....	....	....	....
Stock market index	....	....	....	....	....	....	....	....	....	....
Memo: nominal GDP (billions US\$)	0.92	1.05	1.26	1.36	1.46	1.59	....	....	....	....

Sources: World Bank country sources; Economic Survey; IMF staff papers; World Development Indicators; CEIC Data Ltd.; Central Bank, Finance Ministry, and Statistical Bureau.  
Note: e=estimate; f=forecast.

Import prices have been a key driver of the improvement in the current account deficit to an estimated 31 percent in 2009, down from 51.4 percent in 2008. The multiyear boom in food and fuel prices played an important role in the exceptional import growth of recent years, reaching 97 percent of GDP in 2008. But the subsequent decline in 2009 reduced imports to 63 percent of GDP, and with it, the current account deficit.

The renewed momentum in the tourism sector will help drive the rebound in growth to an expected 4 percent or more this year, but risks to continued macroeconomic stability remain. There is a risk that the public-service wage cuts may be undone, which would add an additional approximately 4 percent of GDP to the fiscal deficit. Delay risks also surround proposed new tax measures—particularly the business profits tax (BPT) and the goods and services tax on tourism, given the government's lack of majority in parliament. The recent rise

in international food and fuel prices could push the current account deficit to widen more than expected in 2010 and put pressure on foreign exchange reserves. Rising international commodity prices will also feed through to consumer price inflation, which could cause an appreciation of the REER.

## NEPAL

Population	28.5 million
GNI per capita	US\$400
Capital	Kathmandu

Nepal's real growth has averaged 4 percent since the end of the conflict and signing of the Comprehensive Peace Agreement in 2006. The global crisis is having a delayed impact on Nepal's economy and exposing its structural weaknesses. Real GDP growth has slowed down due to a poor monsoon, slower remittance growth, a steep rise in imports, and tighter monetary conditions that followed in turn. The government recently revised its GDP projection for FY 2010 down from 5.5 percent to 3.5 percent.



Due to high remittance inflows, Nepal has had abundant liquidity in recent years, but this fiscal year, monetary conditions are tightening. The slowdown in remittance growth (inflows in FY 2010 are around 12 percent year-on-year, compared to above 30 percent growth in past two years), combined with a widening current account deficit and episodes of capital flight, has led to a recent decline in reserves.

## Nepal

Key Indicators	2005–06	2006–07	2007–08	2008–09	2009–10e	2010–11f	2009			
							Q1	Q2	Q3	Q4
<b>Output, Employment and Prices</b>										
Real GDP (% change y-y)	3.4	3.3	5.3	4.7	3.0	4.0	...	...	...	...
Manufacturing production index (% change y-y)	104.74	107.43	106.4	106.6	...	...	...	...	...	...
Unemployment (%)	...	...	...	...	...	...	...	...	...	...
Real wages (% change y-y)	...	...	...	...	...	...	...	...	...	...
Consumer price index (% change y-y)	8.0	6.4	7.7	13.2	11.8	8.0	13.6	14.3	12.9	12.2
<b>Public Sector</b>										
Government balance (% of GDP)	-3.6	-4.1	-4.6	-5.4	-6.3	-7.1	...	...	...	...
Domestic public sector debt (% of GDP)	...	...	12.9	13.3	13.7	14.7	...	...	...	...
<b>Foreign Trade, BOP and External Debt</b>										
Trade balance (billions of US\$)	-1.5	-2.0	-2.3	-2.7	-3.9	-4.0	-0.7	-1.3	-1.8	-2.8
Exports of goods (billions of US\$) (% change y-y)	...	...	0.9	0.9	0.8	0.9	0.3	0.5	0.6	0.9
Imports of goods (billions of US\$)	2.4	2.7	3.2	3.6	4.7	4.8	0.9	1.7	2.5	3.7
Current account balance (billions of US\$) (% of GDP)	0.2	0.0	0.3	0.5	-0.3	0.0	0.1	0.2	0.4	0.5
Foreign direct investment (billions US\$)	...	...	0.0	0.0	0.0	0.0	...	...	...	...
External debt (billions US\$) (% of GDP)	...	...	3.4	3.4	3.5	3.5	...	...	...	...
Short-term debt (billions US\$)	35.6	30.2	27.4	27.0	23.8	21.6	...	...	...	...
Debt service (% exports of g&s)	...	...	3.5	3.5	3.5	3.2	...	...	...	...
Foreign exchange reserves (billions US\$) (months of imports of g&S)	1.8	1.9	2.4	2.8	2.5	2.7	...	...	...	...
6	5.9	6.5	5.9	5.0	5.0	...	...	...	...	...
<b>Financial Markets</b>										
Domestic credit (% change y-y)	12.5	15.7	19.9	26.8	17.4	...	...	...	...	...
Short-term interest rate (% p.a)	...	...	...	...	...	...	...	...	...	...
Exchange rate (NPR/ US\$, ave)	72.3	70.5	65	76.9	...	...	75.05	77.3	81.07	77.32
Real effective exchange rate (2004/05=100)* (% change y-y)	101.8	108.6	107.3	112.0	...	...	107.1	113.5	111.9	116.2
5.7	9.5	-4.2	7.3	...	...	...	0.4	8.2	4.4	8.0
Stock market index	386.83	683.95	963.4	749.1	...	...	998.2	733.9	664.0	696.3
Memo: nominal GDP (billions US\$)	9	10.3	12.6	12.6	14.9	16.0	...	...	...	...

Sources: World Bank country sources; Economic Survey; IMF staff papers; World Development Indicators; CEIC Data Ltd.; Central Bank, Finance Ministry, and Statistical Bureau.  
Note: \*Average REER for FY 06/07/08/09; e=estimate; f=forecast.

Prolonged drought and unseasonal rains adversely affected Nepal's largely rain-fed agriculture, which contributes 33 percent of GDP. Industrial growth declined from 4 percent in FY 2007 to 1.8 percent in FY 2008, and then stagnated in FY 2009 mainly due to power shortages, frequent strikes (bandhs), transport disruptions, business extortion, and labor disputes. Projected FY 2010 growth is 3.8 percent, buoyed mainly by construction—which is expected to grow by 6.6 percent—in part supported by large remittance flows that

are channeled into real estate development. Manufacturing's share of GDP has consistently declined, and the absolute output level contracted by 0.5 percent in FY 2009. The services sector has recently been the engine of growth. Its contribution to GDP has risen to 52 percent, up from 46 percent a decade ago. The sector grew by an average of 5.8 percent between FY 2007 and FY 2009.

Growth is expected to slow down to 5.3 percent in FY 2010, partly because the financial intermediation–related services, which grew by double digits in the recent past, may have reached a plateau and are projected to grow only by 4.8 percent in FY 2010. Growth in tourism, telecommunications, and social services has also been contributing to the overall high service growth.

Nepal's financial sector has grown rapidly in recent years, stretching the Nepal Rastra Bank's (NRB) capacity to supervise and regulate it effectively. Rapid increase in financial institutions and credit growth has fed asset price booms especially in real estate.

Reflecting high monetary growth, inflation has remained at double-digit rates since mid-2008. CPI rose by 11.8 percent year-on-year in January 2010, compared to 14.4 percent in January 2009. The index for food and beverages rose by 18.1 percent in 12 months until January 2010, almost equaling the rise in the same period a year earlier. Prices in Nepal are closely linked to those in India due to the open border and the close economic interlinkages between the two countries. However, the increase in consumer prices in 2008 and 2009 was often much higher compared to that in India, and the difference persisted longer than usual. The authorities attribute high inflation to supply disruptions such as general strikes, prolonged road closures, and cartelizing of essential goods and supplies, mainly food items in Nepal. The Nepali rupee is pegged to the Indian rupee.

Fiscal management has remained prudent: there has been progress in revenue administration, and a three-year budgeting framework is being established. The ongoing efforts to increase block grants to local bodies, if managed well, can take resources closer to where they are used. Furthermore, service provision, especially in education and health, is improving as community and user groups are increasingly involved in making decisions that affect their lives.

Nepal has to address a number of structural problems to unleash its growth potential in medium and long run. Investment climate surveys point to key actions as improving business climate, addressing power shortages, improving

infrastructure, and resolving difficult labor relations, as well as bringing political stability and improved security.

In a base case, GDP is projected to grow by 3 percent in FY 2010. In FY 2011, as agriculture recovers with the return of normal rainfall, growth is expected to rise to 4 percent. Thereafter, growth rates of 4.2 percent and 4.4 percent are projected for FY 2012 and FY 2013, respectively. In a high-case scenario, growth could reach 5 percent by FY 2013. Over the long run, growth of around 5.5 to 6 percent is possible if structural impediments are reduced.

## PAKISTAN

Population	166 million
GNI per capita	US\$950
Capital	Islamabad

Pakistan is recovering from the sharp slowdown in GDP growth in 2008–09. Concurrent with the global slowdown, reduction in domestic demand pushed GDP growth down to 2 percent in 2008–09, compared to an average of 6.6 percent in the preceding five years. The slow growth persisted throughout much of the first half of the current year. Although production of major crops is likely to fall, growth could edge up to 3 percent during 2009–10, helped by a revival in manufacturing and services.

Agriculture, which contributes a fifth of GDP, is likely to undershoot its targeted growth of 3.8 percent in 2009–10. Estimates of the *kharif* season indicate declines in the production of rice, sugarcane, maize, and wheat, which are likely to offset the rebound in cotton production. The large-scale manufacturing sector resumed growth in the past seven months to 2.4 percent, ending the 5.4 percent contraction of the previous year. Strong growth in automobiles, electronics, leather, and pharmaceuticals is leading growth in the sector supported by bank credit growth. Sustainability of growth momentum is conditional on domestic security, availability of energy inputs, credit market developments, and the pace of recovery in the advanced countries.

The service sector, the main contributor to overall growth in the last three years, is likely to pick up during 2009–10, benefiting from the revival in the manufacturing sector. Proximate indicators of service-sector growth show good performance in the finance and insurance, transport, storage,

and communication subsectors. The defense sector is expected to grow, in response to higher defense spending in conflict areas.

Commercial bank lending to the private sector has revived modestly, but the outlook is uncertain, as the market rate is starting to rise. The accumulation of nonperforming loans has been slowing since March 2009, and bank deposits have grown strongly since September. These improvements in the balance sheet of the commercial banks have facilitated 4 percent growth in bank lending to the private sector in the first eight months of the year. The spread between the Karachi Interbank Offer Rate and the policy rate has narrowed substantially, as the market is anticipating inflationary pressure from an uncertain fiscal position.

After falling earlier, inflation has been on the rise since October 2009, with a high likelihood that it might exceed the 11 percent target for 2009–10. A drop in cereal production, the rise in international commodity prices, the increase in the prices of electricity and gas, and local supply disruptions are likely to push the headline inflation higher. Core inflation has also been on the rise.



The external account has shown improvement in the first eight months of 2009–10. The current account deficit narrowed sharply to US\$2.6 billion, down from US\$8 billion in the same period last year, as a result of a pull-back in imports and 18 percent growth in worker remittance inflows. Net capital inflows remained larger than the current account deficit, helping to build reserves. Foreign reserves of the State Bank of Pakistan at the end of March 2010 reached US\$11.1 (three months of import equivalent).

Fiscal performance remains weak and continues to impose significant risks to economic stability. The 2009–10 fiscal deficit target has already been revised upward from 4.6 to

## Pakistan

Key Indicators	2005–06	2006–07	2007–08	2008–09	2009–10e	2010–11f	2009			
							Q1	Q2	Q3	Q4
<b>Output, Employment and Prices</b>										
Real GDP (% change y-y)	5.8	6.8	4.1	1.9	3.7	3.0	...	...	...	...
Industrial production index	187.1	205.4	213.1	196.2	...	...	...	...	...	...
(% change y-y)	...	9.7	3.7	-7.9	...	...	...	...	...	...
Unemployment (%)	6.2	5.32	5.2	...	...	...	...	...	...	...
Real wages (% change y-y)	...	...	...	...	...	...	...	...	...	...
Consumer price index (% change y-y)	7.92	7.77	12	20.77	11.5	7.5	...	...	...	...
<b>Public Sector</b>										
Government balance (% of GDP)	-4.3	-4.4	-7.6	-5.2	-5.1	-4.2	...	...	...	...
Domestic public sector debt (% of GDP)	30.1	29.9	31.7	29	31.3	29.9	...	...	...	...
<b>Foreign Trade, BOP and External Debt</b>										
Trade balance (billions of US\$)	-8.4	-9.7	-15.0	-12.6	-12.3	-13.2	-4.5	-3.7	-2.0	-2.4
Exports of goods (billions of US\$)	16.6	17.3	20.4	19.1	19.0	19.6	5.7	4.4	4.2	4.8
(% change y-y)	14.3	4.4	18.2	-6.4	-0.8	3.4	24.0	-6.8	-18.1	-19.5
Key exports (% change y-y)	...	...	...	...	...	...	...	...	...	...
Imports of goods (billions of US\$)	25.0	27.0	35.4	31.7	31.2	32.8	10.2	8.1	6.3	7.2
Current account balance (billions of US\$)	-5.0	-6.9	-13.9	-9.3	-6.7	-7.7	-4.2	-3.6	-0.5	-0.9
(% of GDP)	-3.9	-4.8	-8.4	-5.6	-3.8	-4.0	...	...	...	...
Foreign direct investment (billions US\$)	3.5	5.0	5.3	3.7	2.9	3.5	1.1	1.2	0.7	0.7
External debt (billions US\$)	...	...	...	...	...	...	...	...	...	...
(% of GDP)	28.2	27	26.7	27.9	25.6	26	...	...	...	...
Short-term debt (billions US\$)	464.0	252	878.0	1013.0	256.0	200.0	...	...	...	...
Debt service (% exports of g&s)	...	...	...	...	...	...	...	...	...	...
Foreign exchange reserves (billions US\$)	13.2	16.6	11.6	12.8	...	...	8.8	10.4	11.0	12.8
(months of imports of g&S)	4.8	5.7	3.1	3.9	...	...	...	...	...	...
<b>Financial Markets</b>										
Domestic credit (% change y-y)	17.1	12.9	30.6	14.9	...	...	...	...	...	...
Short-term interest rate (% p.a)	8.46	8.8	9.63	12.93	...	...	...	...	...	...
Exchange rate (/US\$, ave)	59.88	60.64	62.63	78.62	...	...	...	...	...	...
Real effective exchange rate (=100)	...	...	...	...	...	...	...	...	...	...
(% change y-y)	...	...	...	...	...	...	...	...	...	...
Stock market index	9,989.4	13,772.5	12,289.0	7,162.2	...	...	...	...	...	...
Memo: nominal GDP (billions US\$)	127.5	144.0	164.6	166.5	166.5	177.9	...	...	...	...

Sources: World Bank country sources; economic survey; IMF Staff Papers; World Development Indicators; CEIC Data Ltd.; Central Bank; Finance Ministry; Statistical Bureau.  
Note: e=estimate; f=forecast.

5.1 percent of GDP, but even the revised target is subject to risks. The fiscal deficit during the first half of 2009–10 was already 2.7 percent of GDP, and seasonality in revenues and expenditures implies a higher fiscal deficit in the second half of the fiscal year. Federal tax collection has continued to underperform. To stay within the target, the authorities have decided to cut federal development spending by 30 percent. However, in parallel, electricity subsidies are projected to

substantially overrun budgeted targets, and spending on security is expected to increase.

Stepping up domestic revenue mobilization is urgent, and the government is planning to introduce on July 1, 2010, a national VAT, which will cover both goods and services, to increase revenues and broaden the tax base. Weak revenue mobilization has been a challenge. Revenue mobilization

has suffered from an inefficient tax administration, a narrow tax base, a skewed tax structure, and a complex and nontransparent tax system.

Prospects for growth recovery are 3 percent in 2010–11 and rising to around 5 percent in the medium run. However, risks to the economic outlook are global recovery, an uncertain inflation outlook, weak fiscal revenue generation, continuing power shortages, and an uncertain political and security situation.

## SRI LANKA

Population	20.1 million
GNI per capita	US\$1,780
Capital	Colombo

Sri Lankan GDP growth began recovering in the middle of 2009. After dropping to 1.5 percent in the first quarter of 2009, GDP growth reached 6.2 percent in the fourth quarter of 2009.



The recovery was aided by fiscal expansion, monetary stimuli, and large inflows of foreign capital into government securities. Fiscal expansion took the form of hiring of more than 60,000 public employees, providing emergency expenditures to support internally displaced persons, and continuing to make high public investments. Monetary policy easing began in late 2008 and continued into November 2009, bringing benchmark interest rates down between 225–300 basis points and lowering the statutory reserve ratio by a further 75 basis points, to 7 percent.

The recovery in growth is broad based, supported largely by domestic demand. Agriculture expanded by 5.7 percent, despite a poor fall paddy harvest buoyed up by rubber, tea, and fishing. Although rising world market prices helped rubber

## Sri Lanka

Key Indicators	2006–07	2007–08	2008–09	2009–10	2010–11e	2011–12f	2009			
							Q1	Q2	Q3	Q4
<b>Output, Employment and Prices</b>										
Real GDP (% change y-y)	7.7	6.8	6.0	3.5	5.5	6	1.5	2.1	4.2	6.2
Industrial production index (% change y-y)	7.1	7.2	4.9	6.1	....	....	3.6	1.1	3.3	6.1
Unemployment (%)	6.5	6.0	5.4	5.8	....	....	5.5	6.2	5.9	5.7
Real wages (% change y-y)	-14.0	15.7	4.4	-4.6	....	....	0.9	5.1	-0.7	-4.6
Consumer price index (% change y-y)	13.5	18.8	14.4	4.8	9.1	7.3	7.8	2.4	0.9	2.9
<b>Public Sector</b>										
Government balance (% of GDP)	-7.0	-6.9	-7.0	-9.8	-7.5	-7.0	-14.0	-11.9	-9.4	-9.8
Domestic public sector debt (% of GDP)	50.3	47.9	48.5	49.8	....	....	51.8	53.36	50.76	49.8
<b>Foreign Trade, BOP and External Debt</b>										
Trade balance (billions of US\$)	-3.4	-3.7	-6.0	-3.1	-4.0	-4.0	-0.6	-0.6	-0.6	-1.3
Exports of goods (billions of US\$) (% change y-y)	6.9	7.6	8.1	7.1	7.8	8.6	1.6	1.5	1.9	2.0
Key exports (% change y-y)	8.5	11.6	5.9	-12.9	8.6	10.2	-12.3	-23.3	-14.6	-1.1
Imports of goods (billions of US\$)	6.6	10.5	8.6	-5.9	....	....	-1.6	-14.6	-6.5	-1.0
Current account balance (billions of US\$) (% of GDP)	10.3	11.3	14.1	10.2	11.8	12.6	2.3	2.2	2.5	3.3
Foreign direct investment—net (billions US\$)	-1.5	-1.4	-3.9	-0.2	-0.9	-0.7	-0.03	0.17	0.24	-0.43
Total external debt (billions US\$) (% of GDP)	-5.3	-4.3	-9.5	-0.5	-1.8	-1.25	-0.3	-1.8	2.3	-5.2
Short-term debt (billions US\$)	0.5	0.5	0.7	0.4	....	....	....	....	....	....
Debt service (% exports of g&s)	14.0	16.5	17.8	20.9	20.6	21.4	....	....	....	....
Foreign exchange reserves (billions US\$) (months of imports of g&S)	49.5	51.0	43.7	50.4	41.7	38.3	31.3	32.8	36.9	36.5
Debt service (% exports of g&s)	0.6	1.1	1.5	3.1	....	....	....	....	....	....
Foreign exchange reserves (billions US\$)	12.7	13.1	15.1	19.0	....	....	....	....	....	....
Foreign exchange reserves (billions US\$) (months of imports of g&S)	2.5	3.1	1.8	5.1	6.7	7.7	1.3	1.6	4.2	5.1
Financial Markets	3.3	3.7	2.0	6.3	5.6	6.1	1.2	1.8	4.2	6.3
Domestic credit (% change y-y)	26.3	26.1	12.1	16.7	....	....	22.7	24.7	14.9	4.6
Short-term interest rate (% p.a)	11.4	15.4	15.3	10.5	....	....	13.9	9.8	9.2	8.9
Exchange rate (LKR/US\$, ave)	107.6	108.7	113.3	114.4	....	....	115.5	115.0	114.8	114.4
Real effective exchange rate (2006 =100) (% change y-y)	2.6	0.3	18.1	2.2	....	....	13.1	4.4	-0.1	-7.4
Stock market index (ASPI,1985=100)	2,722.4	2,541.0	1,503.0	3,385.6	....	....	1,638.1	2,432.2	2,938.6	3,385.6
Memo: nominal GDP (billions US\$)	28.25	32.35	40.72	41.52	49.36	55.82	....	....	....	....

Sources: World Bank country sources; Economic Survey; IMF staff papers; World Development Indicators; CEIC Data Ltd.; Central Bank, Finance Ministry, and Statistical Bureau.  
Note: e=estimate; f=forecast.

and tea, end-of-conflict-related restrictions lifted fishing. Industrial growth reached 7.9 percent in the fourth quarter of 2009, responding to domestic demand from food processing and construction and mining activities. The service sector, which contributes 60 percent of GDP, grew by 7.4 percent in the fourth quarter of 2009, helped by the domestic trade, telecommunications, and transport subsectors. Although most international trade-oriented sectors languished, the hotel

sector surged by 32 percent, fueled by large tourist arrivals after the end of the conflict.

Banking sector assets shrank in the aftermath of the global crisis, and prudential ratios worsened. Bank assets fell by 5 percent in 2009, in a reversal of the near 20 percent annual growth achieved during 2005–07. The gross nonperforming asset ratio rose to 9 percent by the end of 2009, up from a low

of 6 percent at the start of the crisis. Overall provision cover against delinquent assets declined below 50 percent, down from 70 percent over the same period. Banks will need to grow their assets to earn income in an environment of rising policy rates and will need to build capital to adhere to capital adequacy norms in a riskier investment environment.

External balances improved dramatically. The current account deficit narrowed significantly to an estimated 0.5 percent of GDP in 2009, down from 9.3 percent of GDP in the previous year. Much of the improvement was driven by falling international commodity prices of oil, which was a key factor behind the 30 percent drop in the total import bill in 2009. The decline in exports due to the global economic slowdown was somewhat smaller, with textile exports falling by 5 percent and tea by 9 percent. Significant capital inflows combined with a smaller current account deficit placed the Sri Lankan rupee under pressure for appreciation, prompting the central bank to build reserves to approximately six months of imports.

Inflationary pressures are mounting, with rising food prices and a build-up of demand pressure. Headline inflation (CPI) reached an 11-month peak of 6.9 percent in February 2010. Two-thirds of the increase is attributable to food prices, which make up 47 percent of the CPI basket. Core inflation (excluding food and fuel prices) reached even higher, to 8 percent in February 2010, after having climbed persistently for the previous three months, indicative of the underlying aggregate demand pressure.

The fiscal deficit (after grants) for 2009 reached 9.8 percent of GDP. This deviation from target was almost entirely the result of higher public expenditures, primarily driven by higher interest expenditures, higher rehabilitation and reconstruction expenses with the end of conflict, and the acceleration of infrastructure development projects. The revenue outturn fell short by only 0.2 percent of GDP against the revised budget, but at only 15.1 percent of GDP, continued its long-term declining trend.

The budget for the first four months of 2010 has a generous spending envelope. In view of the general elections, the

government in November 2009 proposed an interim budget (or a vote on accounts [VOA]) to provide for expenditures in the first four months of 2010. The VOA projected a fiscal deficit before grants of 4.6 percent of (full-year) GDP for the four months—equivalent to an increase of 12 percent, compared to the actual outcome in the corresponding period of 2009. A formal budget for 2010 is expected to be approved around mid-year 2010.

Real GDP growth is forecast to improve to above 5 percent in 2010. Domestic demand would mainly underpin this growth. Private and public investments in infrastructure are likely to expand as peace takes hold and reconstruction momentum picks up further. Private consumption, poised to grow as tourists' return to Sri Lanka, will bolster employment. Private remittance inflows continue to be buoyant. Net exports are likely to play a neutral role.

## APPENDIX

**Table A1. Real GDP growth and sectoral growth**

(percent change from a year earlier)

	1991–2000	2004–05	2005–06	2006–07	2007–08	2008–09
<b>SOUTH ASIA (GDP growth)</b>	<b>5.3</b>	<b>7.6</b>	<b>7.8</b>	<b>8.9</b>	<b>8.9</b>	<b>7.8</b>
<b>Bangladesh (GDP growth)<sup>1</sup></b>	<b>4.8</b>	<b>6.0</b>	<b>6.6</b>	<b>6.4</b>	<b>6.2</b>	<b>5.7</b>
Agriculture	3.2	2.2	4.9	4.6	3.2	4.6
Industry	7.0	8.3	9.7	8.4	6.8	5.9
Services	4.5	6.4	6.4	6.9	6.5	6.3
<b>Bhutan (GDP growth)</b>	<b>5.1</b>	<b>7.5</b>	<b>6.7</b>	<b>13.2</b>	<b>11.7</b>	<b>6.2</b>
Agriculture	1.7	1.4	2.5	1.9	0.4	1.4
Industry	6.1	5.5	5.4	28.1	21.0	5.2
Services	7.8	12.7	11.0	6.8	7.8	9.7
<b>India (GDP growth)</b>	<b>5.6</b>	<b>7.5</b>	<b>9.5</b>	<b>9.7</b>	<b>9.2</b>	<b>6.7</b>
Agriculture	2.9	0.0	5.9	3.7	4.7	1.6
Industry	5.7	10.3	10.2	12.7	9.5	3.9
Services	7.1	9.1	10.6	10.2	10.5	9.8
<b>Nepal (GDP growth)</b>	<b>5.0</b>	<b>3.5</b>	<b>3.4</b>	<b>3.3</b>	<b>5.3</b>	<b>4.7</b>
Agriculture	2.5	1.8	1.8	1.0	4.7	2.2
Industry	7.8	3.0	4.5	3.9	1.9	1.8
Services	6.4	3.3	5.6	4.5	7.1	5.8
<b>Pakistan (GDP growth)</b>	<b>4.0</b>	<b>9.0</b>	<b>5.8</b>	<b>6.8</b>	<b>4.1</b>	<b>2.0</b>
Agriculture	4.4	6.5	6.3	4.1	1.1	4.7
Manufacturing	4.4	15.5	8.7	8.3	4.8	-3.3
Services	4.5	8.5	6.5	7.0	6.6	3.6
<b>Maldives (GDP growth)</b>	<b>8.3</b>	<b>9.5</b>	<b>-4.6</b>	<b>18.0</b>	<b>7.2</b>	<b>6.3</b>
Agriculture	2.7	2.9	12.2	-0.7	-14.9	-4.5
Industry	10.0	12.9	3.0	10.6	10.1	8.4
Services	9.0	9.7	-8.3	24.0	9.1	6.7
<b>Sri Lanka (GDP growth)</b>	<b>5.2</b>	<b>5.4</b>	<b>6.2</b>	<b>7.7</b>	<b>6.8</b>	<b>6.0</b>
Agriculture	1.9	0.0	1.8	6.3	3.4	7.5
Industry	6.8	5.4	8.0	8.1	7.6	5.9
Services	5.8	6.7	6.4	7.7	7.1	5.6

Sources: World Bank staff estimates for GDP growth; sectoral growth data are from a combination of country sources and World Development Indicators.

**Table A2. Real GDP and components of aggregate demand**

(percent change from a year earlier)

		Bangladesh	India	Nepal	Pakistan
GDP	2005/06	6.6	9.5	3.4	5.8
	2006/07	6.4	9.7	3.3	6.8
	2007/08	6.2	9.2	5.3	4.1
	2008/09	5.7	6.7	4.7	2
	2009/10	5.5	7.4	3	3.7
Private consumption	2005/06	4.3	8.6	5.4	1.0
	2006/07	5.9	8.3	3.0	4.7
	2007/08	5.5	9.7	3.3	-1.3
	2008/09	5.9	6.8	5.7	-1.3
	2009/10	6.0	4.1	...	5.2
Fixed investment	2005/06	8.3	15.3	11.1	18.4
	2006/07	8.5	14.3	1.9	12.9
	2007/08	1.8	15.2	6.0	3.9
	2008/09	5.6	4.0	5.9	3.8
	2009/10	3.8	6.5	...	-6.2
Exports of goods & services	2005/06	25.8	25.9	-1.1	9.9
	2006/07	13.0	21.8	-4.7	2.3
	2007/08	7.0	5.2	-8.9	-5.3
	2008/09	12.2	19.3	22.5	-5.3
	2009/10	4.0	-15.8	...	9.0

Sources: World Bank country sources; Economic Survey; World Development Indicators; CEIC Data Ltd.; Central Bank, Finance Ministry, and Statistical Bureau.

**Table A3. South Asia: export growth**

(percent change from a year earlier)

	Merchandise Export Growth					Service Export Growth				
	2006-07	2007-08	Q3 2009	Q4 2009	2009-10	2006-07	2007-08	Q3 2009	Q4 2009	2009-10
Bangladesh	15.7	15.9	-11.7	0.9	8.6	10.7	27.4	21.0	-4.0	0.0
India	24.5	26.4	-23.0	2.9	-12.5	28.0	22.1	-25.4	-12.3	-20.9
Nepal	...	7.1	7.2	5.4	...	32.6	41.5	...	...	...
Pakistan	4.4	18.2	-18.1	-19.5	-0.8	9.8	-13.3	-22.5	4.4	...
Sri Lanka	11.4	6.1	-14.6	-1.1	-12.6	17.7	33.3	25.9	9.5	-2.5
South Asia Median	14.0	14.7	-12.0	-2.3	-4.3	19.8	22.2	-0.3	...	...

Sources: World Bank country sources; World Development Indicators; CEIC Data Ltd.; Central Bank, Finance Ministry, and Statistical Bureau; trade bureaus.

**Table A4.** Net remittance inflows (US\$ billions)

	Bangladesh	India	Nepal	Pakistan	Sri Lanka
2000	2.0	12.6	0.1	1.1	1.1
2001	2.1	13.9	0.1	1.5	1.0
2002	2.8	15.0	0.6	3.6	1.1
2003	3.2	20.4	0.7	4.0	1.2
2004	3.6	17.9	0.7	3.9	1.4
2005	4.3	21.5	1.1	4.3	1.7
2006	5.4	27.3	1.3	5.1	1.9
2007	6.6	35.8	1.6	6.0	2.2
2008	9.0	46.7	2.6	7.0	2.6

Sources: World Development Indicators, World Bank 2010.

**Table A5.** Country aggregates for poverty measures in South Asia

	Mean Consumption (2005 PPP\$/ month)	\$1.25-a-day		\$2-a-day		Population (million)
		Headcount Index (%)	Number of Poor (million)	Headcount Index (%)	Number of Poor (million)	
<b>Bangladesh</b>						
1991	35.8	66.8	77.2	92.5	107.0	115.7
1996	41.5	59.4	76.5	87.4	112.7	128.9
2000	42.4	57.8	80.6	85.4	119.1	139.4
2005	47.5	49.6	76.1	81.3	124.6	153.3
<b>India</b>						
1977.5	37.7	59.2	379.8	89.1	572.4	642.1
1983	41.4	48.0	352.4	85.3	626.0	734.1
1987.5	43.5	46.2	368.6	84.3	673.1	798.7
1993.5	45.6	41.8	376.1	82.2	739.3	899.3
2004.5	52.6	34.3	370.7	76.6	827.5	1,079.7
<b>Nepal</b>						
1990	32.5	77.0	14.7	91.8	17.5	19.1
1993	34.7	73.8	14.1	90.5	18.6	20.6
1996	38.3	68.4	13.1	88.1	19.6	22.2
1999	46.2	61.8	11.8	83.4	19.9	23.9
2002	53.6	56.4	10.8	79.0	20.1	25.5
2005	56.6	54.7	10.4	77.3	21.6	27.9
<b>Pakistan</b>						
1987	41.1	49.6	49.6	86.36	86.3	100.0
1990.5	41.7	47.8	51.6	85.14	92.0	108.0
1992.5	68.9	8.5	9.7	56.51	64.2	113.6
1996.5	58.8	15.4	19.3	68.17	85.5	125.4
1998.5	67.4	13.5	17.7	59.85	78.8	131.6
2001.5	59.4	17.5	24.8	67.68	95.7	141.5
2004.5	71.5	9.0	13.7	53.04	80.7	152.1

Sources: Povcalnet and country sources, World Bank 2010.

Note: Mid-year surveys are denoted as 0.5.

**Table A6. South Asia: exchange rates**

(local currency per U.S. dollar, average)

	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
2005–06	67.2	44.7	44.3	12.8	72.3	59.88	107.6
2006–07	69.1	44.2	45.1	12.8	70.5	60.64	108.7
2007–08	68.6	40.4	40.1	12.8	65	62.63	113.3
2008–09	68.8	47.9	45.9	12.8	76.9	78.62	114.4
2009 Q1	68.9	49.8	48.5	12.8	75.0	79.7	115.5
2009 Q2	69.0	48.8	48.3	12.8	77.3	80.7	115.0
2009 Q3	69.1	48.4	46.7	12.8	81.1	82.7	114.8
2009 Q4	69.1	46.6	46.0	12.8	77.3	83.7	114.4
2009 Nov	69.1	46.6	46.5	12.8	74.7	83.7	114.5
2009 Dec	69.2	46.6	46.7	12.8	74.4	84.1	114.4
2010 Jan	69.2	46.0	46.4	12.8	74.2	84.6	114.4
2010 Feb	69.3	46.3	46.2	12.8	73.9	85.0	114.4

Sources: World Bank country sources; Economic Survey; World Development Indicators; CEIC Data Ltd.; Central Bank, Finance Ministry, and Statistical Bureau.

**Table A7. South Asia: foreign reserves minus gold**

(in billions of U.S. dollars)

	Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
2005–06	2.04	3.5	0.5	145.1	0.23	1.8	13.2	2.5
2006–07	2.78	5.1	0.6	191.9	0.31	1.9	16.6	3.1
2007–08	3.48	6.2	0.6	299.2	0.24	2.4	11.6	1.8
2008–09	4.45	6.7	0.8	241.4	0.26	2.8	12.8	5.1
2009 Q1	....	6.0	....	255.3	0.27	....	8.8	1.3
2009 Q2	....	7.5	....	271.0	0.23	....	10.4	1.6
2009 Q3	....	9.4	....	265.2	0.21	....	11.0	4.2
2009 Q4	....	10.3	....	...	0.26	....	12.8	5.1
2009 Nov	....	10.4	....	270.0	0.23	....	14.5	5.2
2009 Dec	....	10.3	....	265.2	0.26	....	15.8	5.1
2010 Jan	....	10.1	....	262.9	0.26	....	15.0	5.2
2010 Feb	....	10.6	....	260.4	0.31	....	15.1	5.0

Sources: World Bank country sources; Economic Survey; World Development Indicators; CEIC Data Ltd.; Central Bank, Finance Ministry, and Statistical Bureau.

**Table A8. South Asia: balance of payments**

(in percent of GDP)

	Overall Balance				Current Account				Capital Account			
	2006–07	2007–08	2008–09	2009–10	2006–07	2007–08	2008–09	2009–10	2006–07	2007–08	2008–09	2009–10
Bangladesh	2.2	0.4	2.3	...	1.4	0.9	2.8	2.1	1.8	0.1	-0.4	..
Bhutan	11.3	3.8	8.7	1.0	14.3	-2.1	-4.5	-11.5	11.4	8.0	6.6	12.5
India	3.8	7.5	-1.7	1.9	-1.0	-1.4	-2.5	-2.4	4.8	8.6	0.5	4.3
Maldives	7.3	-5.4	1.4	-2.0	-41.5	-51.4	-28.5	-28.9	48.8	46.0	32.1	22.6
Nepal	-0.8	3.5	3.5	-2.8	-0.1	2.7	4.3	-2.0	0.6	0.9	0.6	0.6
Pakistan	2.6	-3.3	-1.8	0.8	-4.8	-8.4	-5.6	-3.8	7.3	5.0	3.6	4.5
Sri Lanka	1.6	-3.0	6.6	6.5	-5.3	-4.3	-9.3	0.7	0.8	0.7	0.6	0.6
South Asia median	4.0	0.5	2.7	0.9	-5.3	-9.2	-6.2	-6.6	10.8	9.9	6.2	7.5

Sources: World Bank country sources; Economic Survey; World Development Indicators; CEIC Data Ltd.; Central Bank, Finance Ministry, and Statistical Bureau.

Note: For Bhutan, high net errors and omissions for 2007–09 result in discrepancies.

**Table A9. South Asia: capital account components**

(in percent of GDP)

	Net FDI				Net Portfolio				Net Other Capital			
	2006–07	2007–08	2008–09	2009–10	2006–07	2007–08	2008–09	2009–10	2006–07	2007–08	2008–09	2009–10
Bangladesh	1.2	0.9	1.1	...	0.2	0.1	-0.2	...	-0.2	-1.6	-1.8	...
India	0.8	1.2	1.4	2.0	0.7	2.4	-1.2	1.9	3.3	5.2	0.5	0.4
Maldives	1.4	1.0	0.7	0.7	...	...	...	...	40.5	38.4	25.4	18.4
Nepal	0.0	0.0	0.2	0.2	0.0	0.0	0.0	0.0	-1.5	0.5	0.4	-1.6
Pakistan	3.5	3.2	2.2	1.6	2.3	0.0	-0.6	0.0	1.5	1.8	2.1	2.9
Sri Lanka	1.6	1.7	1.7	0.9	0.2	0.3	0.1	-0.02	3.7	3.6	1.8	4.8
South Asia median	1.4	1.4	1.2	1.1	0.7	0.6	-0.4	0.5	7.9	8.0	4.7	5.0

Sources: World Bank country sources; Economic Survey; World Development Indicators; CEIC Data Ltd.; Central Bank, Finance Ministry, and Statistical Bureau.

**Table A10. South Asia: financial market indicators****Domestic credit (% change y-y)**

	2006	2007	2008	2009	2009			
					Q1	Q2	Q3	Q4
Bangladesh	20.3	14.8	21.0	16.0	18.7	16.0	12.4	13.7
Bhutan	1.6	16.3	32.8	17.7	6.1	-23.6	26.4	15.0
India	20.7	20.5	17.4	23.0	23.0	25.4	23.2	19.6
Maldives	38.6	44.7	35.2	14	23.6	19.6	10.5	14
Nepal	12.5	15.7	19.9	26.8	...	...	...	...
Pakistan	17.1	12.9	30.6	14.9	19.6	19.3	18.2	19.9
Sri Lanka	33.6	28.7	29.5	3.4	23.4	22.1	10.4	3.4

**Short-term interest rate (% p.a)**

	2006	2007	2008	2009	2009			
					Q1	Q2	Q3	Q4
Bangladesh	6.5	7.9	7.9	7.5	8.2	5.7	3.6	3.5
Bhutan	3.5	3.5	6.0	6.0	...	...	...	...
India	5.5	6.0	6.0	3.5	3.3	3.3	3.3	3.5
Maldives	5.3	6.3	6.3	6.1	6.3	6.3	6.3	6.1
Nepal	2.8	2.4	4.2	5.8	...	...	...	...
Pakistan	8.5	8.8	9.6	12.9	13.2	13.2	12.3	12.5
Sri Lanka	11.4	15.4	15.3	10.5	13.9	9.8	9.2	8.9

**Stock Market index**

	2006	2007	2008	2009	2009			
					Q1	Q2	Q3	Q4
Bangladesh	1,340	2,149	3,001	3,010	2,967	2,795	2,447	3,010
India	11,280	13,072	15,644	9,709	14,494	17,127	17,465	17,528
Maldives	138	343	288	229	281	302	229	229
Nepal	387	684	963	749	998	734	664	696
Pakistan	9,989	13,773	12,289	7,162	5,988	7,214	8,249	9,251
Sri Lanka	2,722.4	2,541.0	1,503.0	3,385.6	1,638.1	2,432.2	2,938.6	3,385.6

Sources: World Bank country sources; Economic Survey; World Development Indicators; CEIC Data Ltd.; Central Bank, Finance Ministry, and Statistical Bureau.

Note: T-bills rate (182-Days); data for Bhutan covers FY (July to June); short-term interest rate covers 91-day Royal Monetary Authority bills; Nepal: weighted-average treasury bill rate (91 days).

**Table A11.** South Asia: public finances

	<b>Budget Balance (% of GDP)</b>				
	<b>2005–06</b>	<b>2006–07</b>	<b>2007–08</b>	<b>2008–09</b>	<b>2009–10</b>
Afghanistan	...	-2.9	-1.8	-3.7	-0.7
Bangladesh	-3.4	-3.1	-3.6	-3.6	-3.9
Bhutan	0.2	7.1	3.9	2.3	-4.7
India	-6.8	-5.4	-5.0	-8.8	-9.5
Maldives	-7.2	-4.9	-17.1	-26.3	-17.4
Nepal	-3.6	-4.1	-4.6	-5.4	-6.3
Pakistan	-4.3	-4.4	-7.6	-5.2	-5.1
Sri Lanka	-7.0	-7.0	-6.9	-7.0	-9.8

	<b>Total Government Debt (% of GDP)</b>				
	<b>2005–06</b>	<b>2006–07</b>	<b>2007–08</b>	<b>2008–09</b>	<b>2009–10</b>
Afghanistan	...	155	20.7	19.2	10
Bangladesh	46.9	46.8	46.8	45.3	43.8
Bhutan	89.6	76.3	62.3	54.2	59.5
India	80.6	77.3	74.5	75.1	77.1
Maldives	64.9	62.9	66.4	68.6	94.0
Nepal	35.6	30.2	40.3	40.3	37.5
Pakistan	59.5	57.9	58.4	56.9	56.9
Sri Lanka	90.6	87.9	85.0	81.4	86.2

Sources: World Bank country sources; Economic Surveys; IMF staff reports; World Development Indicators; CEIC Data Ltd.; Central Bank, Finance Ministry, and Statistical Bureau.

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# Moving Up, Looking East

WORLD BANK SOUTH ASIA ECONOMIC UPDATE 2010

*The World Bank South Asia Economic Update 2010: Moving Up, Looking East* is the World Bank's comprehensive annual report on the region's economies. In this first edition, the Bank finds that South Asia's strong rebound since March 2009 is comparable to that in East Asia. Government policy, external support, resumption of private spending, and the global recovery are driving the rebound. Robust and timely policy interventions were, and continue to be, key to confidence and recovery. South Asia's particular strengths and forms of global integration—not the lack of it—were the main factors that allowed greater resilience. As a special topic, the report examines and recommends three principal directions to reposition South Asia's trade and investment integration policies and profitably in the context of a "new normal" after this crisis. The recommendations are to (i) intensify integration with East Asia, South Asia's fastest growing and natural trade partner; (ii) accelerate trade and investment and reduce the border barriers between countries in the region; and (iii) preserve links with traditional developed countries and other emerging markets in an open regionalism framework.



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