remains subject to substantial downside risks, which would pose additional challenges to policy makers already grappling with the current crisis. A deeper and more protracted global recession (the deeper growth recession discussed in chapter 1) cannot be ruled out. Within the region, political tensions remain a constant, tending to restrain international capital flows that might otherwise contribute to a deepening of capital markets and private investment. Further, needed reform efforts, some initiated during the crisis period, could receive less attention and commitment once economic conditions start to normalize.

The recent difficulties of Dubai World holding company—an entity of the Government of Dubai, United Arab Emirates—in asking its creditors for a six-month standstill on all scheduled debt payments, indicates that financial institutions in the region were not entirely unaffected by the global financial crisis. Given the very high investment levels of the past several years, as well as asset inflation (property prices increased particularly sharply in Egypt and Morocco), there may be additional large-scale financial losses that have yet to be realized. Though a systemic crisis in Dubai will likely be averted thanks to the diversified holdings of the Dubai government and emergency support from the emirate of Abu Dhabi (both bilaterally and through the federal authorities), it may have an adverse impact on the balance sheets of local and regional banks holding Dubai World debt. The financial problems facing Dubai, along with previous defaults by two large Saudi private companies, will continue to raise concern amidst the need for comprehensive corporate governance and debt restructuring reforms in the region.

South Asia

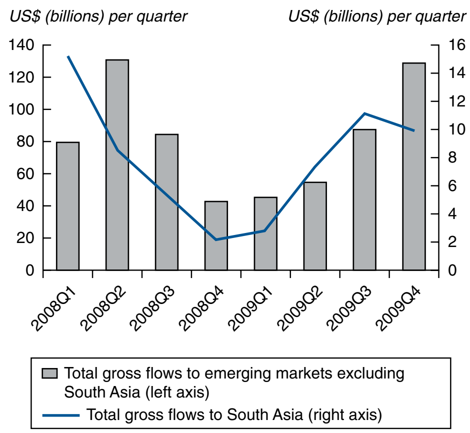
Recent developments

The global financial crisis contributed to a marked deceleration in real GDP growth in South Asia, from 8.7 percent in 2007 to 6.0 percent in 2009, which was largely driven by a pronounced decline in investment growth and, to a lesser extent, private consumption. While exports contracted sharply with external demand, the decline in imports was steeper, and net trade actually supported growth on the regional level. As the crisis took hold, equity markets and exchange rates plunged in most countries in the region. Sovereign bond spreads spiked with the contraction in capital flows, as both domestic and international investors sought safe-haven assets outside the region.

Although the global financial crisis had a sharp negative impact on South Asia, the slowdown in regional GDP growth was the least pronounced among all developing regions. This partly reflects the relatively closed nature of the region's economies. Private capital inflows—a key transmission channel of the crisis—are less significant as a share of South Asia's GDP (particularly foreign direct investment), compared with most other regions. Economic activity in South Asia is also less specialized in manufacturing and natural resources—sectors that have been particularly negatively affected by the crisis. Correspondingly, the region's greater reliance on services trade—roughly double the 7.7 percent average share of GDP for developing countries in 2008—also provided a buffer to the crisis, as services tend to be more resilient during downturns (although smaller countries with important tourism sectors, such as the Maldives, were hit hard). Domestic demand in the region was relatively resilient, having been cushioned by countercyclical macroeconomic policies. Interest rates were rapidly cut across most economies. Although fiscal space in most economies was limited, substantial fiscal stimulus measures were introduced in India (including pre-election spending), Bangladesh and Sri Lanka (in the form of incentives and safety net expenditures). Relatively robust, albeit moderating, regional remittance inflows have been supportive, particularly in Bangladesh, Nepal, and Sri Lanka, where they continue to represent over 5 percent of GDP. Real incomes were also boosted by the collapse in global commodity prices—particularly for food and fuel, which represent a large share of regional household outlays.

The extent of the downturn in the individual economies has been mixed and reflects initial conditions. Growth has been weakest in countries that entered the crisis with large internal and external imbalances and that were forced to severely constrain domestic demand, such as the Maldives, Pakistan, and Sri Lanka. Countries that entered the crisis with stronger fundamentals, such as Bangladesh Bhutan, and India, weathered the crisis better. A number of regional economies also faced ongoing internal conflicts that continued to disrupt economic activity, notably Afghanistan, Pakistan, Sri Lanka (which ended a decades-old civil war in mid-2009), and to a lesser extent Nepal (where warring factions reached a peace accord in late 2006, but are still vying for political control).

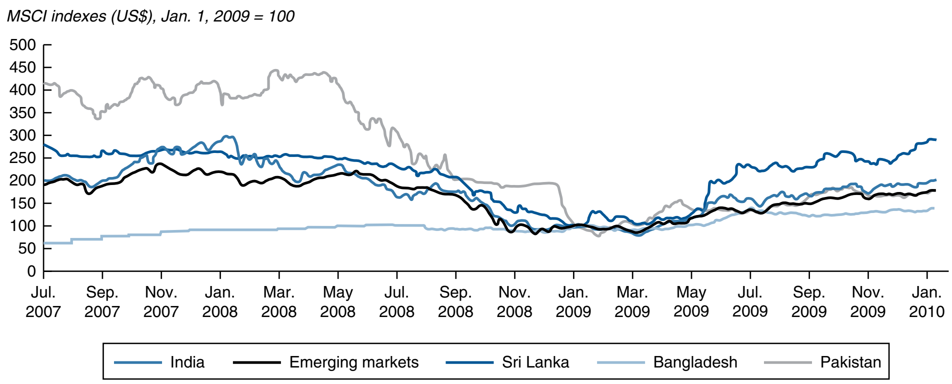
Figure A25 Gross capital inflows to South Asia are recovering but remain below pre-crisis levels



Sources: Dealogic and World Bank.

The stabilization and progressive thawing of global financial markets in early 2009 and the rebound of world trade and output growth beginning in the second half of 2009 have contributed to improving conditions in South Asia. Since the second quarter of 2009, local equity markets and capital inflows to the region began to recover—largely in line with trends across developing countries (figures A25 and A26). This process has been supported by improved investor sentiment on comparatively strong growth outturns (India and Bangladesh), ongoing or new International Monetary Fund (IMF) stabilization programs (Pakistan, Sri Lanka, and most recently the Maldives), steep reductions in interest rates,

Figure A26 Local equity markets have generally returned to pre-crisis levels



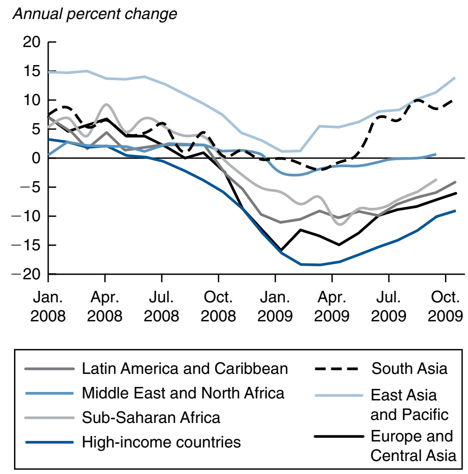
Sources: Bloomberg and World Bank.

Note: MSCI = Morgan Stanley Capital International.

and improved political stability. While the region experienced a sharp decline in gross capital inflows during the first half of 2009, portfolio inflows surged in the fourth quarter and bond issuance and syndicated bank lending jumped in the fourth quarter, such that total gross inflows firmed in 2009 to an estimated $31 billion. As inflows to other regions shrank (particularly in Europe and Central Asia), South Asia's share of total capital inflows to developing countries rose to 8.9 percent in 2009 from 6.7 percent in 2008. While most local stock exchanges have recovered to pre-crisis levels, the majority remain well below peak levels posted in late 2007 and early 2008 (in both local currency and U.S. dollar terms). In Bangladesh, where capitalization of listed companies (relative to GDP) is lower than in its neighbors and where foreign participation is limited, the equity market remained stable during the crisis and posted strong growth in recent months. Sri Lanka's equity market is also an exception, with a recovery to pre-crisis highs of 2007 supported by the improvement in sentiment following the end of the civil war and the formal standby arrangement reached with the IMF in mid-2009.

Regional industrial activity, which did not contract as much as in most other developing regions, has shifted into positive growth, led by India, Bangladesh, and more recently Pakistan. Fiscal stimulus measures have supported the rebound in output by helping to revive consumer demand. Further, continued robust remittance inflows boosted construction activity, especially in Bangladesh and Nepal. The recovery in regional output is ahead of most other developing regions—with the exception of East Asia and the Pacific—and of high-income countries (figure A27). Regional agricultural output was buoyed by a good monsoon in 2008 that contributed to a good harvest in 2009 across much of the region. One exception is Afghanistan, where agricultural output contracted sharply (16.5 percent in FY2008/09). In Sri Lanka the agricultural sector benefited from the end of fighting and from acreage brought back into production.

Figure A27 Recovery in industrial production has taken hold in South Asia ahead of most other regions



Sources: Thomson Datastream, IMF and World Bank.

However, a poor monsoon season in India in 2009 suggests that agricultural growth will be modest in the current 2009–10 crop year (which began in late 2009). Regional services activity decelerated with the decline in global tourism, hitting the Maldives, Nepal, and Sri Lanka, in particular, where tourism is a key sector. In contrast, in India, services activity was supported by resilient outsourcing.

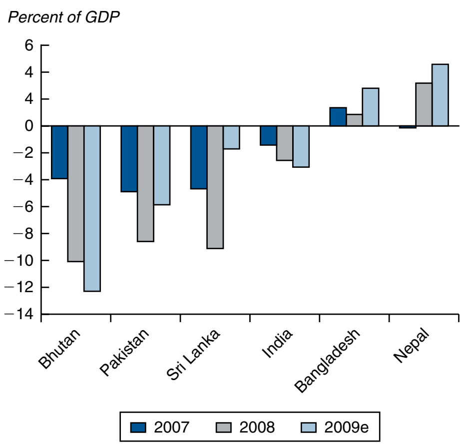
Merchandise trade growth remains below previous-year levels for the region, with imports down much more sharply than exports, given the sharp compression of demand in Maldives, Pakistan, and Sri Lanka in particular. Indeed, the 32 percent decline in South Asia's import volumes through July 2009 compared with the previous year is the second steepest among developing regions after that of Europe and Central Asia (39 percent). In contrast, the decline in the region's merchandise export volumes was less severe than in most other developing regions, with the exceptions of East Asia and the Pacific and Latin America and the Caribbean. This partly reflects the low manufacturing and commodity content (sectors particularly hard hit by the recession) of the region's exports. Some sectors also demonstrated marked resilience during the crisis, such as ready-made garments in Bangladesh, where competitive pricing has enabled producers to build market shares (i.e., the "Wal-Mart effect") and in Sri Lanka, where long-term strategic partnerships with mid- to high-end retailers in the United States and the European Union, (such as Victoria's Secret, Diesel, and Nike) created a buffer, and in India, where information technology software also proved relatively resilient.

Overall, the combination of a sharp fall in the value of imports, a somewhat less steep decline in exports (both reflecting favorable terms-of-trade developments), and resilient remittance inflows meant that current account balances generally improved in 2009 (figure A28). Regional external positions had come increasingly under strain from the multiyear boom in food and fuel prices before mid-2008. During 2009, the Maldives, Pakistan, and Sri Lanka posted the largest adjustments in their current account deficits. Domestic demand was sharply compressed in the three economies, where large fiscal deficits had contributed to the buildup of considerable external imbalances before the crisis. The Maldives is an extreme case, where a massive upswing in government outlays and a surge in imports for resort-related construction materials contributed to the sharp deterioration in the current account balance.

While the adjustment was less stark, India also posted a shrinking current account deficit in 2009, as imports fell faster than exports. Bangladesh and Nepal recorded rising current account surpluses, as the moderation of export growth was less pronounced than the decline in imports, supported by continued firm remittances inflows. In contrast, Bhutan's current account deficit is estimated to have grown from 10 percent of GDP in 2008 to 12.3 percent in 2009, partly reflecting the start of interest payments for the Tala hydropower scheme (figure A28). Afghanistan's current account deficit, including official transfers (equivalent to some 50 percent of official GDP) is estimated to have shifted from a surplus of 0.9 percent of GDP in 2008 to a deficit of 1.6 percent in 2009.

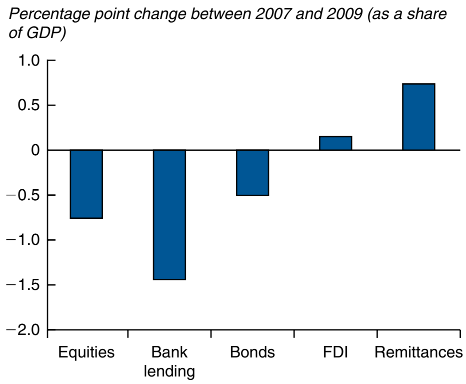
Remittance inflows—a key source of foreign exchange for the region—declined in 2009, pushed down by the decline in economic activity and the rise in unemployment in migrant-host countries. However, remittance inflows remained relatively strong compared with other sources of foreign exchange, and indeed are above their 2007 levels (figure A29). Remittance inflows to South Asia contracted by a modest

Figure A28 Current account balances improve across much of South Asia in 2009



Source: World Bank.

Figure A29 International flows to South Asia



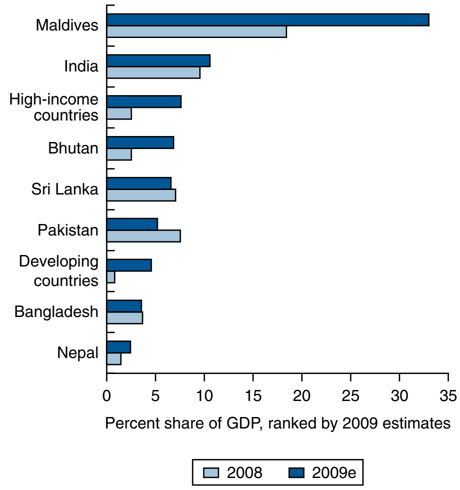
Source: World Bank.

1.8 percent in 2009, compared with a 7.5 percent decline for developing countries excluding South Asia (World Bank 2009). Growth in the Arabian Gulf and East Asian economies, which host a significant share of South Asia's migrant workers, has not been as adversely affected as growth in other key host economies, such as the United States, the European Union, and Russia. Among South Asia's economies, India—the largest recipient of remittances in the world in dollar terms—posted a contraction in remittance inflows in 2009, while Bangladesh, Nepal, Pakistan, and Sri Lanka, experienced a slower pace of growth of remittances inflows.

With the moderation in demand and collapse in energy prices, inflationary pressures across the region subsided following the onset of the crisis, particularly in the first half of 2009. This helped reverse the buildup of inflationary pressures that became increasingly evident in 2007 and 2008, as fuel and food prices spiked—despite efforts by authorities to contain the price increases. Lower oil prices have eased pressures on fiscal deficits stemming from fuel price subsidies. The moderation in inflationary pressures and falling international commodity prices also provided scope for regional central banks to introduce expansionary measures to support domestic demand in response to the crisis. Bangladesh, India, Pakistan, and Sri Lanka cut policy interest rates. Activity in Bhutan and Nepal, where the currencies are tied to the Indian rupee, was supported by India's expansionary monetary policy stance.

Regional fiscal positions deteriorated in 2009 in response to a combination of reduced tax receipts resulting from the decline in economic activity and higher outlays. Corresponding to the introduction of more accommodative monetary policies, expansionary fiscal policy measures were introduced in Bangladesh, India, and Sri Lanka to support domestic demand through various expenditure and incentive programs. Pakistan also sought to stimulate its economy through an increase in its public sector development program. While these stimulus measures helped offset the negative effects of the global crisis, they also led to higher fiscal deficits in nearly all of the regional economies. Even before the crisis, sizable fiscal deficits were already a problem for many South Asian economies, where weak tax administration and structure resulted in low domestic resource mobilization (figure A30).

Figure A30 Budget deficits in most South Asian countries outstrip developing-country average



Source: World Bank.

Medium-term outlook

South Asia's GDP growth is projected to firm from an estimated 6 percent in 2009 to 7.0 percent in 2010 and 7.4 percent in 2011. External demand for goods and services is anticipated to recover, while improving consumer and business confidence, combined with the lagged effects of expansionary monetary and fiscal policy measures and a positive turn in the inventory cycle, should contribute to strengthening domestic demand. A projected firming of capital inflows will also support regional economic activity. The regional current account deficit is projected to rise modestly, from 1.2 percent in 2009 to 2.2 percent in 2010 and 2.4 percent in 2011, a result of firming domestic demand that is expected to drive import growth ahead of export growth.

Table A9 South Asia forecast summary
(annual percent change unless indicated otherwise)

	1995–2005[a]	2006	2007	2008	2009[g]	2010[h]	2011[h]
GDP at market prices (2005 US$)[b,f]	6.0	9.0	8.5	5.7	5.7	6.9	7.4
GDP in calendar year basis[c]	6.1	9.3	8.7	6.9	6.0	7.0	7.4
GDP per capita (units in US$)	4.1	7.3	6.8	4.2	4.3	5.5	6.1
PPP GDP[d]	6.0	9.0	8.5	5.7	5.7	6.9	7.4
Private consumption	4.7	6.0	7.0	2.7	4.2	6.0	6.7
Public consumption	5.0	9.9	5.6	21.1	7.1	7.3	7.2
Fixed investment	8.0	14.6	13.6	7.6	4.1	9.7	10.2
Exports, GNFS[e]	11.3	17.7	3.5	10.5	−4.6	10.3	12.1
Imports, GNFS[e]	10.6	22.7	6.8	14.9	−6.9	10.6	12.3
Net exports, contribution to growth	−0.2	−1.7	−1.0	−1.7	0.9	−0.6	−0.7
Current account balance/GDP (%)	−0.6	−1.5	−1.3	−3.3	−2.3	−3.2	−3.4
GDP deflator (median, LCU)	5.9	5.2	7.4	7.2	13.8	6.9	6.5
Fiscal balance/GDP (%)	−8.1	−5.1	−5.7	−8.9	−9.5	−8.6	−7.8
Memo items: GDP[f]							
South Asia excluding India	4.5	6.4	6.0	3.9	4.4	4.1	4.8
India	6.4	9.7	9.1	6.1	6.0	7.5	8.0
Pakistan	4.1	6.2	5.7	2.0	3.7	3.0	4.0
Bangladesh	5.3	6.6	6.4	6.2	5.9	5.5	5.8

Source: World Bank.

a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 2005 U.S. dollars.
c. GDP figures are presented in calendar years (CY) based on quarterly history for India. For Bangladesh, Nepal, and Pakistan, CY data is calculated taking the average growth over the two fiscal year periods to provide an approximation of CY activity.
d. GDP measured at PPP exchange rates.
e. Exports and imports of goods and nonfactor services.
f. National income and product account data refer to fiscal years (FY) for the South Asian countries with the exception of Sri Lanka, which reports in calendar year (CY). The fiscal year runs from July 1 through June 30 in Bangladesh and Pakistan, from July 16 through July 15 in Nepal, and from April 1 through March 31 in India. Because of reporting practices, Bangladesh, Nepal, and Pakistan report FY2007/08 data in CY2008, while India reports FY2007/08 in CY2007.
g. Estimate.
h. Forecast.

Although regional GDP growth is projected to accelerate, a return to boom-period growth rates is not anticipated over the forecast horizon, as investment growth is expected to continue to be constrained by supply bottlenecks and higher capital costs in the wake of the crisis. (table A9). External demand is expected to firm, but it too will expand less quickly than during the boom years. The regional fiscal deficit is projected to narrow on planned structural fiscal consolidation and cyclical factors, as well as a reversal of stimulus measures introduced to support demand during the crisis. Nevertheless, the aggregate regional fiscal deficit is projected to continue to exceed its pre-crisis 2007 deficit of 5.7 percent.

Expected progressive tightening of monetary conditions over the forecast horizon will contribute to an easing of inflationary pressures by 2011 across the region. Further, given strong aversion to food price inflation within the region, monetary authorities are particularly responsive to signs of inflationary pressures building.

The recovery path for the individual economies will vary substantially (table A10). India, Bangladesh, and Bhutan are expected to emerge from the global crisis with stronger growth performances, backed by generally sound economic policies and greater resilience of trade, investment, and remittances. Sri Lanka is also forecast to post a relatively firm recovery, supported by the recent surge in capital inflows and improvement in investor confidence following the cessation of fighting after nearly three decades of civil war. Elsewhere in the region, conflict-affected

Table A10 South Asia country forecasts
(annual percent change unless indicated otherwise)

	1995–2005[a]	2006	2007	2008	2009[c]	2010[d]	2011[d]
Calendar year basis							
Bangladesh							
GDP at market prices (2005 USD)[b]	5.0	6.3	6.5	6.3	6.1	5.7	5.7
Current account balance/GDP (%)	−0.6	2.0	1.3	1.4	3.1	1.8	1.5
India							
GDP at market prices (2005 USD)[b]	6.7	9.9	9.3	7.3	6.4	7.6	8.0
Current account balance/GDP (%)	−0.4	−1.1	−0.7	−2.6	−2.4	−3.5	−3.6
Nepal							
GDP at market prices (2005 USD)[b]	3.9	3.4	3.5	4.3	5.0	4.3	4.3
Current account balance/GDP (%)	−3.1	−0.1	−1.5	3.7	4.4	1.0	1.4
Pakistan							
GDP at market prices (2005 USD)[b]	3.7	6.9	5.9	3.8	2.9	3.3	3.5
Current account balance/GDP (%)	−1.0	−5.7	−6.3	−10.2	−5.2	−4.1	−4.6
Sri Lanka							
GDP at market prices (2005 USD)[b]	4.5	7.7	6.8	6.0	3.6	5.0	6.0
Current account balance/GDP (%)	−3.2	−5.8	−4.7	−9.1	−1.7	−2.7	−2.9
Fiscal year basis							
Bangladesh							
Real GDP at market prices	5.3	6.6	6.4	6.2	5.9	5.5	5.8
Current account balance/GDP (%)	−0.8	1.3	1.4	0.9	2.8	2.2	1.5
India							
Real GDP at market prices	6.4	9.7	9.1	6.1	6.0	7.5	8.0
Current account balance/GDP (%)	−0.2	−1.2	−1.0	−1.4	−2.6	−3.1	−3.3
Nepal							
Real GDP at market prices	4.1	3.7	3.3	5.3	4.7	4.0	4.5
Current account balance/GDP (%)	0.2	2.3	−0.1	3.2	4.6	2.4	1.1
Pakistan							
Real GDP at market prices	4.1	6.2	5.7	2.0	3.7	3.0	4.0
Current account balance/GDP (%)	−0.8	−4.0	−4.9	−8.6	−5.9	−4.5	−4.1

Source: World Bank.

Note: World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.

Afghanistan, Bhutan, and the Maldives are not forecast owing to data limitations. National income and product account data refer to fiscal years (FY) for the South Asian countries with the exception of Sri Lanka, which reports in calendar year (CY). The fiscal year runs from July 1 through June 30 in Bangladesh and Pakistan, from July 16 through July 15 in Nepal, and April 1 through March 31 in India. Because of reporting practices, Bangladesh, Nepal, and Pakistan report FY2007/08 data in CY2008, while India reports FY2007/08 in CY2007. GDP figures are presented in calendar years (CY) based on quarterly history for India. For Bangladesh, Nepal, and Pakistan, CY data is calculated taking the average growth over the two fiscal year periods to provide an approximation of CY activity.

a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflators are averages.
b. GDP measured in constant 2000 U.S. dollars.
c. Estimate.
d. Forecast.

countries—Afghanistan, Pakistan, and to a lesser extent, Nepal—are expected to face more moderate growth outturns, as political uncertainty and fighting continue to disrupt economic activity.

Regional economies are projected to benefit from stronger remittance inflows over the forecast horizon, which in turn should boost private consumption and support growth—particularly in Bangladesh, Nepal, Pakistan, and Sri Lanka. However, the recovery in remittance growth is anticipated not to take hold immediately as job growth typically lags output growth in high-income markets—a lag that could be more extended than usual given the synchronicity of the global downturn. However, the slowdown in growth in the Arabian Gulf and East Asia—South Asia's key migrant destination countries—was generally less pronounced than in other labor-importing countries, which is expected to allow a relatively rapid recovery in remittances inflows to South Asia.

Risks

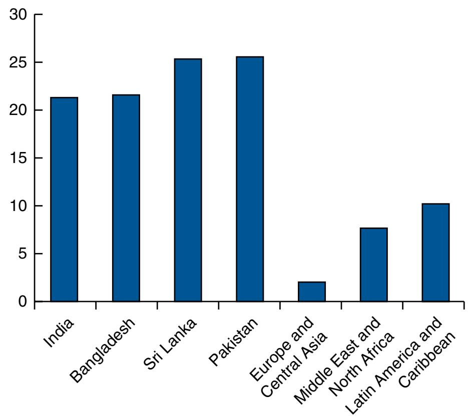
As the global economic recovery begins to take hold in the second half of 2009, risks to the GDP growth forecast for South Asia have lessened. Nevertheless, downside risks remain and center on the extent of the upswing and durability of the global recovery.

Downside risks to the forecast are represented by the region's large fiscal imbalances and its relatively high reliance on trade taxes. An extended period of weak external demand would likely erode these revenues and increase pressures on government coffers. The region's large fiscal imbalances also represent a potential drag on long-term growth by crowding out private investment through the public sector's large financing requirement and higher interest rates. Interest payments in South Asia represented 21.7 percent of central government expenditures in 2007, more than double the share represented in other developing regions (figure A31). By reducing the large fiscal deficits and payment obligations, regional governments could free up resources to devote to development spending. The region has a very low tax base compared with other developing regions, so improving tax collection would help alleviate fiscal pressures. Similarly, revamping the tax structure (including introduction of value-added taxes in some countries) could help boost revenue mobilization.

Remittances inflows—which provided a cushion for the region—could fail to recover in the event of a prolonged global recession or a jobless economic recovery (potentially coupled with tighter immigration controls). The debt payment problems of Dubai World in the United Arab Emirates that erupted in late-November 2009 suggest that economic activity in the Arabian Gulf economies could surprise to the downside, pointing to downside risks for South Asian migrants working in the Gulf and reduced remittances flows to their home countries. Correspondingly, should a significant portion of the stock of expatriate workers return home with accumulated savings due to the downturn in the Gulf, near-term remittances inflows might rise.

Figure A31 Interest payments represent a significant burden in South Asian economies

Percent share of fiscal expenses in 2007[a]



Source: World Bank.

a. Pakistan data are from 2008.

Overheating is also a risk. Should the recent surge in capital inflows to developing countries (see chapter 1) be sustained, they could lead to ballooning asset markets and appreciation of currencies (with the latter hindering export prospects), creating challenges for monetary authorities. Failure to mop up excess liquidity in banking systems or to bring down the region's large fiscal deficits could lead to higher inflationary pressures. Separately, while global rice markets appear well-supplied, and stock-to-use ratios have returned to more normal levels (along with maize and wheat stocks), a serious weather event or policy action could also cause prices to rise significantly, as only seven percent of global rice production is traded.