South Asia Region

Overview

Economic activity in South Asia has slowed considerably, following a promising start to 2012. Regional industrial production, exports and capital flows, which showed signs of recovery in the first two months of the year, faltered by the end of the first quarter. The new slowdown comes on the heels of a sharp deceleration in economic growth in the second half of 2011, which saw regional GDP growth decline to an estimated 7.1 percent for the year, from 8.6 percent in 2010. In India, the region's largest economy, growth measured at factor cost slowed sharply to 6.5 percent in the 2011-12 fiscal year ending in March, from 8.4 percent in the previous two fiscal years.

An expansionary fiscal policy stance, energy and infrastructure constraints, and political and security uncertainties, together with headwinds from resurgent Euro Area tensions, are continuing to act as a drag on private investment and growth. Inflationary pressures continue to remain strong across the region, despite easing briefly in India in early 2012. High fiscal deficits compared to other developing regions are likely crowding out productive investment and eroding future growth potential. Trade deficits have widened and current account positions come under pressure, mainly due to high crude oil prices in 2011 and weaker export demand, resulting in depreciation of currencies.

Agriculture, however, has performed well, and remittance inflows have continued to grow robustly. Private capital flows to South Asia saw a brief revival in the first two months of 2012 but appear to have slowed again by the end of May. Net private capital flows fell 18 percent in 2011 and are projected to decline a further 24 percent this year, mainly due to substantially weaker syndicated bank lending and bond inflows stemming from European banking sector deleveraging and India's worsening credit profile. Foreign direct investment (FDI) inflows are also likely to weaken in 2012 after increasing robustly in 2011.

Outlook: GDP growth in South Asia is expected to slow further to 6.4 percent in 2012, partly due to a weak carryover from the sharp deceleration in the second half of 2011, and to increase modestly to 6.5 percent and 6.7 percent respectively in 2013 and 2014. Economic activity in the region is expected to remain subdued in the medium-term mainly due to continuing external weakness and domestic concerns, including fiscal deficits, high inflation, and energy and infrastructure constraints. Private capital inflows are likely to reach the level reached in 2010 only by 2014. India is expected to see a modest increase in growth measured at factor cost to 6.9 percent in the current fiscal year ending in March 2013, and gradually pick up pace to 7.2 percent and 7.4 percent in the 2013-14 and 2014-15 fiscal years, respectively. In Pakistan, growth is expected to firm from its recent sluggishness to 3.8 percent and 4.1 percent in the 2012-13 and 2013-14 fiscal years, respectively. Bangladesh, which has seen a modest decline of growth in 2011-12, will see growth firm to 6.4 and 6.5 percent in 2012-13 and 2013-14, respectively.

Risks and vulnerabilities: South Asia's growth remains vulnerable to several external and domestic risks.

Euro Area uncertainty. A worsening of Euro Area turmoil, heightened risk aversion and European banking sector deleveraging could result in lower and potentially more volatile private capital inflows, which together with the region's weakened current account position could cause balance of payments difficulties.

Limited policy options. The already loose fiscal policy and high inflation in South Asia imply there is limited room for demand stimulus in the event of a negative external (or domestic) shock. There is an urgent need for rebuilding policy buffers, including credible fiscal consolidation, while protecting the most vulnerable.

Policy uncertainty and infrastructure constraints. In the absence of substantive action, policy uncertainty, electricity shortages and infrastructure constraints could continue to dampen private investment and regional growth.

Recent developments

South Asia's growth slowed sharply in the second half of 2011.[1] Headwinds from the intensification of the Euro area sovereign debt crisis caused a steep deceleration in South Asia's exports and a withdrawal of portfolio capital. Several rounds of monetary policy tightening in India, energy and infrastructure constraints across the region, together with political and security uncertainties and fiscal and inflation concerns, resulted in a falloff in regional investment and industrial activity. Trade balances and current account positions of South Asian countries came under pressure mainly due to the weaker export demand and adverse terms of trade shock from elevated international crude oil prices, which rose 32 percent in 2011 from the average level in 2010. Regional GDP growth, thus, declined from 8.6 percent in 2010 to an estimated 7.1 percent in 2011.

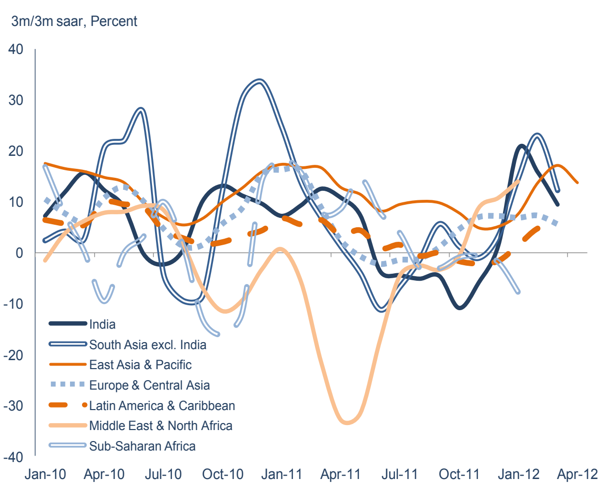
Trade and industrial production activity began to recover in early 2012. Industrial activity, however, faltered by end of the first quarter, with regional industrial production slowing from an annualized pace of 18.8 percent in the three months ending January to 10.3 percent in March (figure SAR.1). While this represents a rebound from the steep quarter-on-quarter declines seen in the second half of 2011, industrial activity remains weak on an annual basis. Regional export (import) volumes surged 22.6 percent (40.3 percent) in the three months ending February, but weakened to 13.1 percent (2.5 percent) by April (figure SAR.2). Regional imports in US dollar terms outpaced exports during the 12 months ending April, partly due to high crude oil prices compared to previous years.

Private capital flows to South Asia revived briefly in the first two months of 2012, but portfolio flows (mainly focused on India) fell off again between March and May amid concerns about fiscal and current account deficits, slow pace of policy reform, proposed taxes on cross-border investments in India, and resurgent Euro area uncertainties after inconclusive Greek elections in early May. The weaker current account positions and decline in private flows put the balance of payments position of South Asian countries under considerable stress, resulting in a drawdown of reserves and depreciation of currencies. Remittance inflows, however, continued to increase robustly providing support to current account positions, particularly in countries other than India.

Inflationary pressures continue to remain strong in South Asia

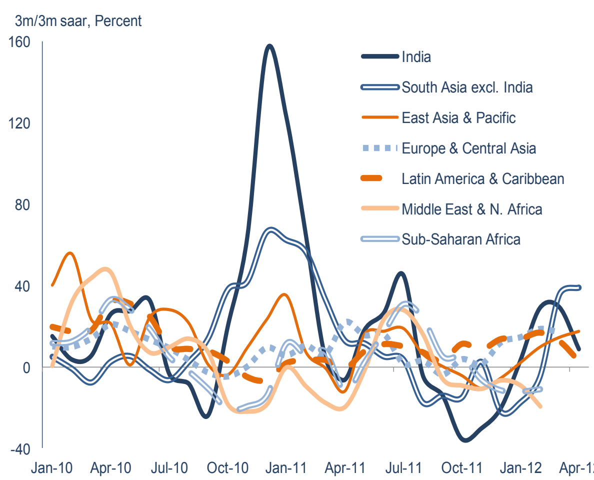
Inflationary pressures continue to remain strong in most South Asian countries. On the domestic side, pressures are arising from capacity

Figure SAR.1 Industrial production is reviving in South Asia



Sources: Datastream and World Bank.

Figure SAR.2 South Asia's exports are showing signs of recovery



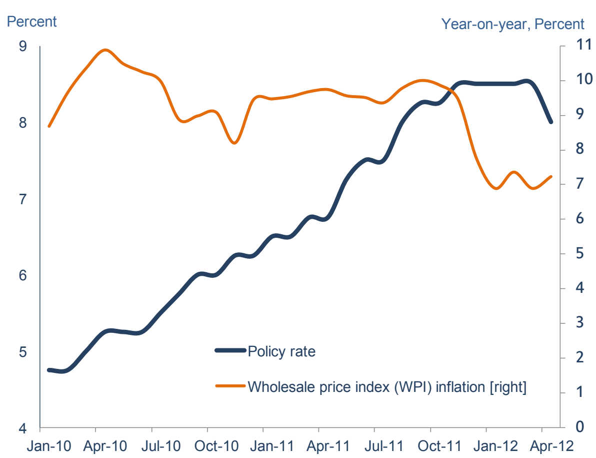
Sources: Datastream and World Bank.

constraints, persistent fiscal deficits, strong wage push pressures, and high food inflation (which is expected to subside after harvests). High crude oil prices compared to the average levels in previous years and currency devaluation in several countries are further adding to inflationary pressures.

India's inflation rate eased in early 2012 with the benchmark wholesale price index (WPI) inflation declining from 10 percent on year-on-year basis in September 2011 to 6.9 percent in January 2012, mainly due to interest rate increases and slowing economic growth (figure SAR.3). But WPI inflation inched back again to 7.2 percent by April. Moreover, India's consumer price inflation, based on an index covering rural and urban areas, surged to 10.4 percent year-on-year in April, with food inflation rising sharply to 10.2 percent from 4.1 percent in January. Food prices in India have risen together with international food prices, which increased 8 percent between December 2011 and March 2012. Although India's food grain production has grown robustly, increases in consumption of proteins and other food items driven by income gains in the past few years and supply not keeping pace with demand have also contributed to higher domestic food prices.

In addition to India, there are signs of an uptick in Pakistan and Sri Lanka, where annualized quarterly inflation is in excess of 14 percent

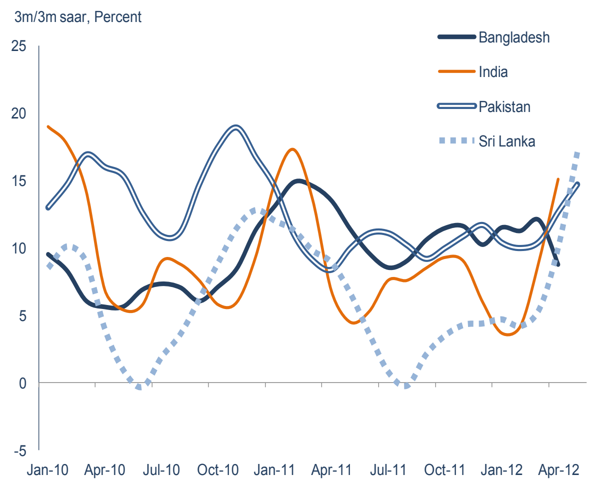
Figure SAR.3 Policy rate increases in India helped to drive down wholesale price inflation



Sources: Haver Analytics and World Bank.

(figure SAR.4). The depreciation of the Sri Lankan rupee and increases in administered prices for fuel have contributed to inflationary pressures. Although inflation in Nepal appears to have moderated in recent months with food inflation easing, its currency has depreciated in step with the Indian rupee, and energy and transport costs have increased. In Bangladesh too, inflation appears to have eased from double-digit rates over most of last year, with lower food inflation contributing to a fall in overall inflation to 9.2 percent on a year-on-year basis in May. Non-food inflation also slowed in May together with easing of international commodity prices, but remains high at 12.7 percent, partly reflecting pressures from higher government spending and strong domestic demand.

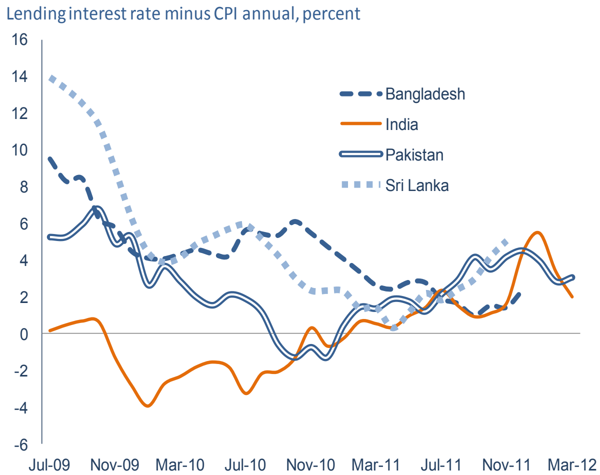
Figure SAR.4 Consumer price inflation remains high across South Asia



Sources: Haver Analytics and World Bank.

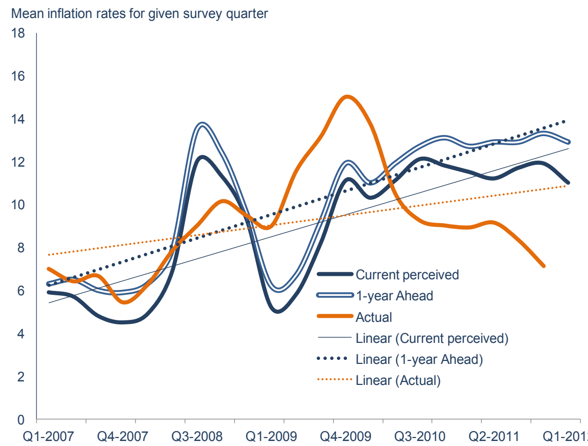
South Asian countries tightened monetary policies over the last year to contain inflationary pressures (figure SAR.5). India's key policy rate was increased by a cumulative 375 basis point between April 2010 and October 2011, but monetary policy eased in the first four months of 2012 as the central bank reduced cash reserve ratio requirements and cut the policy rate from 8.5 percent to 8 percent in a bid to stimulate investment activity amid slowing growth. Bangladesh's benchmark repurchase rate has been raised 150 basis points since mid-2011 to 7.75 percent with a penalty rate for discretionary

Figure SAR.5 Real interest rates increased with tightening of monetary policies



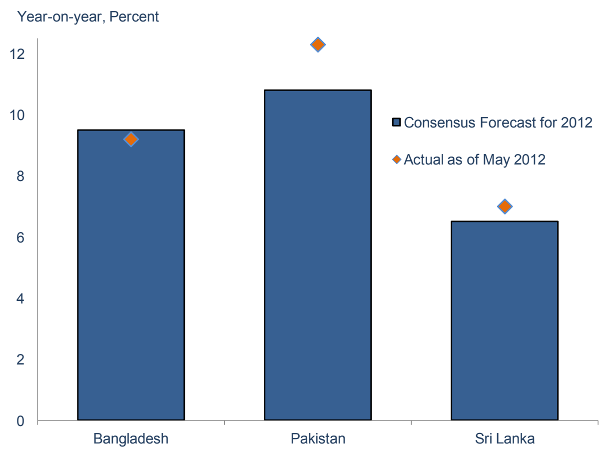
Sources: IMF International Financial Statistics, EIU and World Bank.

Figure SAR.6 India's households' inflation expectation have not declined to the extent of fall in actual inflation



Sources: Reserve Bank of India and World Bank.

Figure SAR.7 Inflation is expected stay close to current rates in Bangladesh and Sri Lanka



Sources: Consensus Economics and World Bank.

liquidity support. Pakistan has kept its key policy rate steady at 12 percent since October 2011. Sri Lanka's rapid credit growth of nearly 35 percent in 2011 decelerated sharply in early 2012 after a 50 basis point increase in the policy rate and other policy measures to slow private sector lending.

Expectations of future inflation remain high in South Asia. Inflation expectations of households in India for the next quarter, and for next year, lagged the fall in inflation in the first quarter of 2012 (figure SAR.6). This suggests that households expected the decline in inflation in the first quarter to be short-lived. Inflation is also expected to persist at close to current rates in Bangladesh and Sri Lanka through the year, and to fall modestly from the current high rate in Pakistan (figure SAR.7). Inflation expectations in South Asia are partly influenced by the likelihood of higher extent of pass-through of international oil prices to domestic prices, as governments across South Asia are attempting to reduce subsidies in a bid to rein in fiscal deficits. Administered prices for fuel and electricity have been raised in Bangladesh and Pakistan in order to reduce losses of state-owned energy companies. In Sri Lanka, prices of petroleum and electricity were increased 32 percent and 20 percent, respectively, by mid-March. Similar increases are likely to follow in India, where the administered price of diesel fuel used mainly in the transport sector was last raised in June 2011.

Fiscal deficits remain at worrisome levels

Across the region, fiscal balances have come under pressure from fuel and fertilizer subsidies, social welfare programs, and weak tax collection. Administered domestic fuel prices, which attempt to shield consumers to varying degrees from increases in international prices, have resulted in fiscal subsidies that are eventually unsustainable. These large deficits and government borrowing programs are likely crowding out private investment, and have stoked inflationary pressures. Fiscal slippages have become increasingly common across the region.

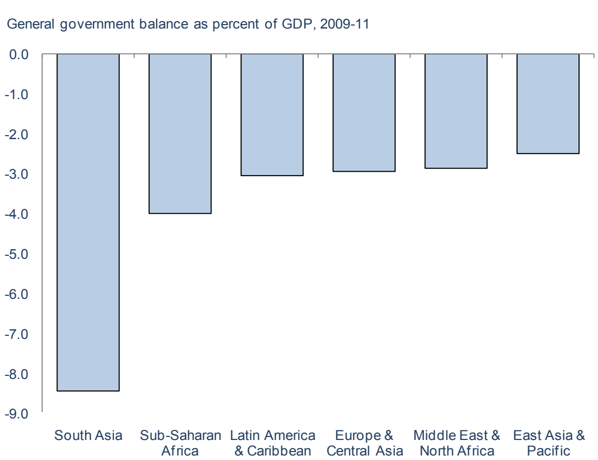
South Asia on average has the highest fiscal deficits among the six developing regions (figure SAR.8). India's central government deficit for the 2011-12 fiscal year ending in March was 5.8 percent of GDP, 1.2 percent higher than targeted, and the general government deficit including state budget deficits exceeds 8 percent of GDP. Sri Lanka's fiscal deficit has fallen from nearly 10 percent of GDP in 2009 due to efforts to control expenditures, but still remains close to 7 percent of GDP, as it does in Pakistan (figure SAR.9).

In Bangladesh, a short-term reliance on oil-powered rental power plants to boost generation capacity and mounting losses of the state-owned Bangladesh Petroleum Corporation due to low administered fuel prices have resulted in a subsidy burden of more than 3 percent of GDP. The off-budget financing of state-owned electricity companies has contributed to fiscal woes and increased non-performing loans of banks. High prices of imported crude oil compared to average levels in previous years have similarly resulted in an increasing subsidy burden in Pakistan.

India's subsidy burden reached an estimated 2.4 of GDP in the 2011-12 fiscal year ending in March mainly due to energy subsidies and social welfare programs. The divergence between international prices and domestic prices for diesel, liquefied petroleum gas (LPG) and kerosene in India has resulted in nearly a doubling of "under-recoveries" (losses of public sector oil marketing companies from sale price below import equivalent plus taxes), which are partially covered by the government and have added to the fiscal burden. Petrol prices in India are market-based, but are set by state-owned retailers and have lagged international prices, implying losses for these firms. Transfer payments and employment-generation programs in India have supported demand, particularly in rural areas, but some of the potential welfare gains have been lost due to leakages in public distribution systems and the inflationary impact of the commensurately higher fiscal deficit.

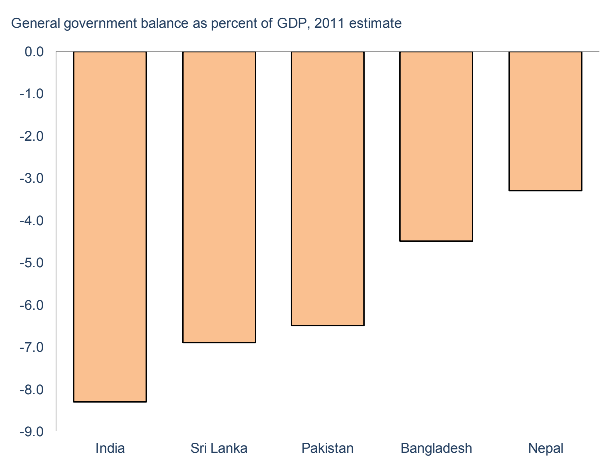
On the revenue side, tax collection as a share of GDP has been weaker in South Asia in recent years compared to other developing regions (figure SAR.10). Reform of indirect taxes in India, which proposes a unified goods and services tax to replace a number of existing central and state indirect taxes (including excise

Figure SAR.8 South Asia has the highest fiscal deficit among developing regions



Source: World Bank.

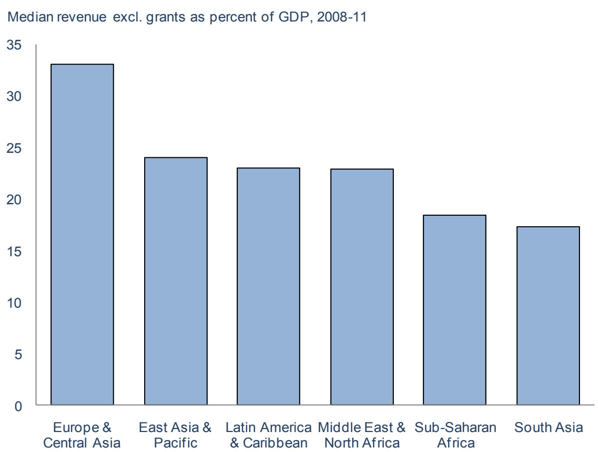
Figure SAR.9 Fiscal deficits are high across South Asian countries



Source: World Bank.

duty, service tax and value-added tax), has been pending for several years. Pakistan's tax base remains very narrow, with a small fraction of the population paying taxes despite recent efforts by the government to improve tax collection and reduce evasion. Bangladesh's tax revenues amount to a tenth of GDP, constraining development spending and public investment in infrastructure and other areas. One-off factors also contributed to fiscal slippages in specific years. For instance, lower than expected revenues from equity sales of state-owned enterprises in India were part of the reason for a larger than targeted deficit in the 2011-12 fiscal year.

Figure SAR.10 Revenue collection is weaker in South Asia compared to other regions



Source: World Bank.

Trade and current account positions deteriorated mainly due to weaker external demand and negative terms of trade shocks

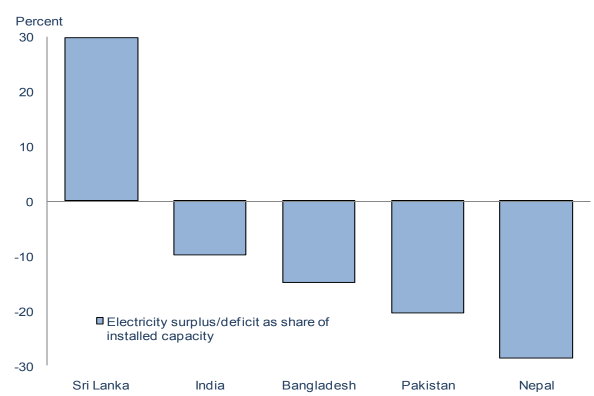
South Asian countries experienced deteriorating current account balances due to the combined effect of weak demand in key export markets and negative terms of trade shocks from the increases in crude oil prices in both 2010 and 2011 (figure SAR.11). Despite an annualized decline of 33 percent in the three months ending November 2011 during the intensification of the Euro area sovereign debt crisis, South Asia's export volumes registered growth of 19 percent for the full calendar year. Exports were cushioned to some extent by increasing diversification towards markets in Asia, Africa and high-income countries that are not part of the OECD, where growth has held up better than the Euro Area and the U.S. South Asian firms are also becoming increasingly integrated into global production and supply chains, and are moving into higher value-added and more sophisticated products.

However, imports in nominal dollar terms surged across the region as elevated crude oil prices—which rose 28 percent in 2010 and a further 32 percent in 2011—and relatively strong domestic demand, in particular in India and Sri Lanka, increased the import bill. In consequence, India's current account deficit widened to nearly 4 percent of GDP in the 2011-12 fiscal year

Box SAR.1 Energy shortages are weighing down South Asia's investment and growth

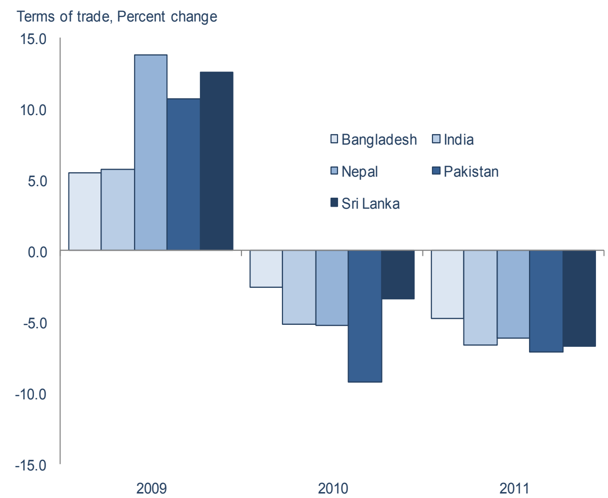
Pervasive electricity shortages and infrastructure constraints across much of the South Asia region have made the operating environment difficult for the private sector and increased the cost of doing business. The gap between the demand for electricity and installed capacity is particularly acute in South Asia, ranging from 10 percent in India to nearly 30 percent in Nepal (SAR box figure 1). Electricity generation companies in Bangladesh, India, and Pakistan often lack reliable access to inputs. In India, the dominance of state-owned enterprises in coal extraction, below-market pricing for certain sectors and underinvestment in capacity expansion, among other factors, has kept production below demand. Supply of imported crude oil used for power generation in Bangladesh has become more expensive and the supply of natural gas in Pakistan remains sporadic. Tight supply of inputs, has, in turn, forced both public and private power generation companies to ration output, which in turn has cut into activity levels and exports. Energy shortages have likely reduced the willingness of South Asian firms to invest, thereby hurting South Asia's longer-term growth potential.

Box figure SAR.1 Electricity demand-supply gaps are acute in South Asia



Source: *More and Better Jobs in South Asia*, World Bank.

Figure SAR.11 Terms of trade moved against South Asian countries in 2010 and 2011 as international crude oil prices rose

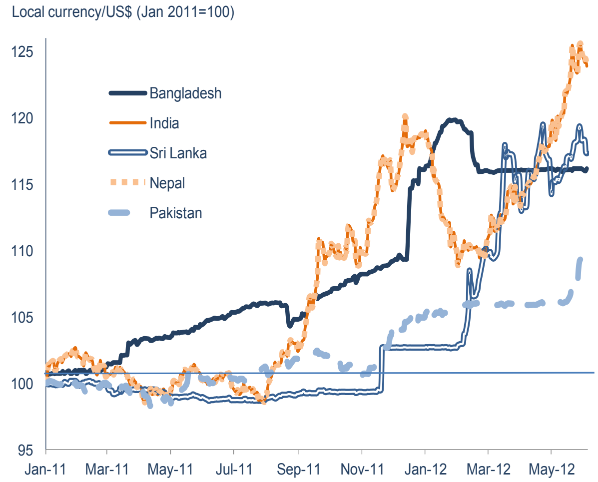


Note: Terms of trade based on Keyfitz import and export price indices
Source: World Bank.

ending in March. Strong demand, in particular for gold partly due to the perceived safety of the asset in a high inflation environment, also contributed to the deterioration of the current account position and increased pressure on reserves, which declined from 9.6 to 6.4 months of import cover between October 2010 and February 2012. Pakistan's current account went from near balance to a deficit of 1.7 percent of GDP in the first nine months of the 2011-12 fiscal year ending in June, despite a 21.5 percent year-on-year increase in remittances to nearly $10 billion during this period.

Reflecting the deterioration in India's external balances, the Indian rupee depreciated by nearly 10 percent against the dollar between February and early June, losing all the gains made in January following a steep depreciation during the Euro Area debt crisis in the second half of 2011 (figure SAR.12). Nepal's currency depreciated in step with the Indian rupee due to the currency peg. Other South Asian currencies have also faced depreciation pressures requiring international reserves to be drawn down. The Sri Lankan rupee depreciated by over 12 percent between February and April after the central bank removed the trading band and allowed

Figure SAR.12 Nominal exchange rates depreciated in South Asia



Source: World Bank.

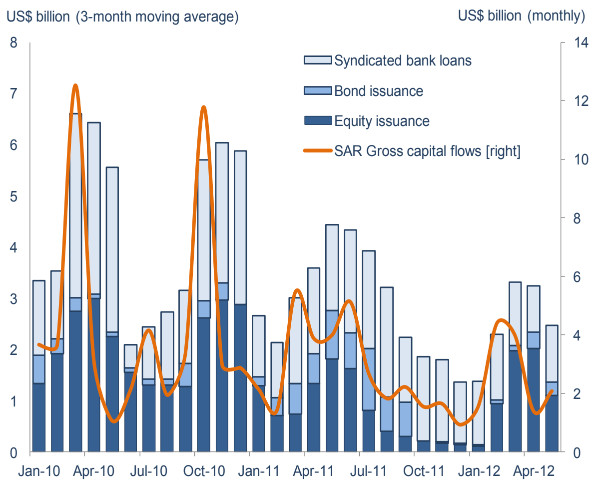
greater exchange rate flexibility. The Pakistani rupee and Bangladeshi taka faced depreciation pressures since mid-2011, with a relatively sharp depreciation of the taka in December. The taka, however, appears to have stabilized since February.

Private capital flows to South Asia slowed sharply, but remittances remained robust

Private capital flows to South Asia fell off sharply during the intensification of the Euro Area debt crisis in second half of 2011, and net private inflows to the region declined by an estimated 18 percent in 2011 (figure SAR.13 and table SAR.1). While portfolio equity and debt inflows declined by more than 60 percent, net foreign direct investment (FDI) inflows to the region—mainly focused on India—rose to $51.6 billion in 2011. Net FDI inflows to Pakistan, however, shrunk by nearly 50 percent in the first nine months of the 2011-12 fiscal year mainly because of deteriorating macroeconomic fundamentals, energy shortages and a difficult political environment.

Portfolio flows to India rebounded in the first two months of 2012 (figure SAR.13). But resurgent Euro area turmoil and concerns about fiscal and current account deficits, delayed reforms, and uncertainty about application of the proposed General Anti-Avoidance Rule (GAAR) to cross-border transactions (later postponed until the start of the 2013-14 fiscal year) again led to a falloff in private flows in the subsequent months. European banking sector deleveraging resulted in a more than two-third decline in syndicated loans organized and led by European banks in the six month period ending March 2012. The lowering of the outlook for India's BBB- investment grade sovereign credit rating from stable to negative by Standard and Poor's in April 2012 has also dampened investor sentiment.

Figure SAR.13 Private capital flows to South revived in early 2012, but fell off since March



Sources: Dealogic and World Bank.

Net private capital flows to South Asia are projected to fall a further 24 percent in 2012 (table SAR.1), with bank lending and bond inflows declining sharply by more than 70 percent. Portfolio equity flows are expected to also weaken by a third in 2012 from a low base in 2011, while net FDI inflows are also likely to weaken by more than 10 percent.

By contrast, remittances sent by international emigrants have remained resilient. South Asia received $97 billion in remittances in 2011, an increase of 18 percent from the previous year (figure SAR.14). India remains the largest recipient of remittances among developing countries, but remittances are more important as a share of domestic product in other South Asian countries, where they range from 5 to 20 percent as a share of GDP. Remittance inflows in nominal dollar terms increased by 27 percent, 25 percent and 17 percent in Pakistan, Sri Lanka and Nepal, respectively, in 2011, while flows to Bangladesh grew at a relatively slower pace of 11 percent.

Slower growth in high income countries and tighter immigration policies in some host countries has dampened remittances from these sources. However, sustained labor demand from oil-exporting Gulf Cooperation Council (GCC) countries that are benefiting from high international crude oil prices (compared to

Table SAR.1 Annual net capital flows to South Asia

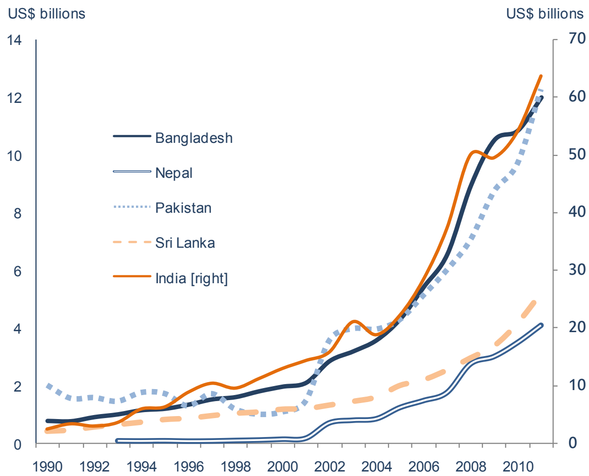
$ billions

	2008	2009	2010	2011e	2012f	2013f	2014f
Capital Inflows	**64.8**	**86.2**	**111.5**	**90.5**	**70.4**	**85.6**	**109.0**
Private inflows, net	55.9	75.2	101.9	83.7	63.3	77.7	100.3
Equity Inflows, net	35.2	59.9	67.4	62.2	52.1	60.5	76.2
FDI inflows	51.1	39.4	28.0	51.6	45.0	48.5	56.2
Portfolio equity inflows	-15.8	20.5	39.4	10.6	7.1	12	20
Private creditors, net	20.7	15.2	34.5	21.5	11.2	17.2	24.1
Bonds	1.7	1.9	10.1	4	0.3	3	3
Banks	11.2	10.8	12.8	6.5	2	3	7
Short-term debt flows	7.9	2.6	11.7	10.9	9.0	11.0	14.0
Other private	0.0	-0.1	-0.1	0.1	-0.1	0.2	0.1
Offical inflows, net	8.8	11.0	9.6	6.8	7.1	7.9	8.7
World Bank	1.4	2.4	3.3	2	..	..	..
IMF	3.2	3.6	2.0	0.5	..	..	..
Other official	4.2	5.0	4.4	4.3	..	..	..

Note :
e = estimate, f = forecast

Source: World Bank.

Figure SAR.14 Exponential increase in remittance flows to South Asia since 2000



Source: World Bank Migration and Development Brief 18

average levels in previous years), and a diversification of migration destinations towards non-OECD high income countries such as South Korea and to other developing countries (e.g., Malaysia) has contributed to relatively robust demand for South Asian migrants, and thereby to the steady growth of remittances.

Medium-term outlook

South Asia's GDP growth is expected to slow further in 2012 due to weak carry-over from 2011

Despite an incipient recovery in industrial activity and exports in early 2012, South Asia's GDP growth is expected to slow further to 6.4 percent in 2012. The weaker than average carry-over (see box 3 in the main text) resulting from the sharp deceleration of growth in India in the second half of 2011, along with domestic policy uncertainties across the South Asia region and a still-fragile external environment are expected to moderate regional growth in 2012. The fiscal balances of South Asian countries are likely to remain under considerable pressure if crude oil prices remain close to the average level in 2011 (see Commodity Annex), and in particular if adjustment of domestic subsidized prices closer to international prices is delayed further. Since inflation expectations have become entrenched in South Asian countries, and because of capacity constraints, particularly in Sri Lanka and Maldives, relatively little progress toward disinflation is expected. Near-stagnant output in the Euro area and spillover of the current turmoil to other high income and developing countries could dampen South Asia's export performance.

Food grain production in South Asia has remained buoyant, with annual production outpacing consumption demand in the 2011-12 crop year (table SAR.2). Although the share of agriculture in South Asia's overall GDP has declined over time, a strong agricultural outturn in the 2012/13 crop year, with production levels similar to that experienced in the previous year, is likely to contribute to rural demand and provide a lift to growth, while reducing inflationary pressures.

However, activity levels in the region are expected to remain subdued in the medium-term due to the fragile external environment amid slower growth in high income countries as well as domestic policy concerns, including fiscal deficits, high inflation, and energy and infrastructure constraints. Private capital inflows are likely to remain below the level reached in 2010 (table SAR.1) and could become more volatile during the course of 2012, particularly if the ongoing Euro area turmoil worsens and if European banking sector deleveraging accelerates. Uncertainty about private capital inflows would make it difficult to finance South Asia's current account deficits. In addition, remittance inflows in dollar terms are likely to increase at a slower pace of 7.4-8.4 percent annually during 2012-14, according to the World Bank's *Migration and Development Brief 18*. South Asia's growth is expected to pick-up modestly during the course of 2013 as global growth resumes (albeit at a relatively weak pace) and to gradually increase to 6.7 percent by 2014 (see table SAR.3 for the regional forecast summary and table SAR.4 for country-specific forecasts).

GDP growth in India (the largest economy in the region accounting for about 80 percent of

Table SAR.2 South Asia's grain balances are expected to continue to improve

(millions metric tons)

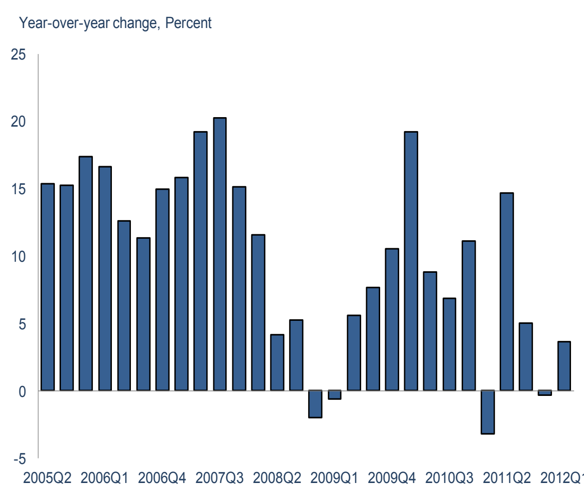
	2000-2001	2001-2002	2002-2003	2003-2004	2004-2005	2005-2006	2006-2007	2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	2012-2013(f)
Production	257	258	233	258	255	268	269	289	292	284	299	315	319
y-o-y growth (%)	*2.2*	*0.3*	*-9.5*	*10.5*	*-1.2*	*5.1*	*0.5*	*7.2*	*1.2*	*-2.7*	*5.1*	*5.4*	*1.5*
Consumption	239	251	247	258	256	261	268	281	279	278	293	300	309
y-o-y growth (%)	*-3.2*	*5.4*	*-1.7*	*4.2*	*-0.6*	*2.2*	*2.5*	*5.0*	*-0.8*	*-0.3*	*5.2*	*2.4*	*3.2*
Net exports	2.1	5.9	8.2	8.3	4.5	6.2	-2.0	4.1	-2.4	1.6	1.4	8.9	7.0
Ending stock	50.1	50.8	28.8	20.9	15.2	15.2	18.4	21.4	36.5	40.7	45.3	51.2	54.1

Sources: U.S. Department of Agriculture and World Bank.

output) slowed to 5.3 percent year-on-year in factor cost terms in the first quarter of 2012—down from the robust 8.4 percent annual growth rates recorded in both the 2009-10 and 2010-11 fiscal years. GDP growth slowed to 6.5 percent in the 2011-12 fiscal year ending in March. A slow pace of policy reform and reversals on a range of issues have dented the confidence of both domestic and international investors. Delays in passing legislation on land acquisition; cancellation of mobile telecom licenses following concerns about allocation; bans on mining activity by the courts in Karnataka state (partially lifted in April) and on cotton exports by the government (lifted in early May); policy reversal on foreign direct investment in the retail sector; and uncertainty about budget plans to expand taxation of cross-border acquisitions involving local assets have contributed towards creating a relatively uncertain policy environment for investors. Together with the effect of loose fiscal policies on credit availability for the private sector, electricity shortages, and the weaker external environment, policy uncertainty appears to have contributed to a slowdown in investment growth in recent quarters, particularly compared to the robust rates of increase experienced in the period prior to the Lehman crisis in 2008 (figure SAR.15).

Agricultural production in India, accounting for nearly a fifth of the economy and close to half of overall employment, has however performed relatively well due to normal rainfall and absence of drought. Good agricultural performance (together with employment generation programs and transfer payments) has provided a boost to the rural economy in recent years. Monsoon rains during the June-September period accounting for more than two-third of India's annual rainfall are expected to be close to the long-term average, according to India's Meteorological Department, although El Nino conditions could cause rainfall scarcity in some parts of India. GDP growth in India measured at factor cost is expected to pick up at a modest pace of 6.9 percent in the 2012-13 fiscal year, and to rise to 7.4 percent by the 2014-15 fiscal year. The relatively modest recovery projected for 2012-13 partly reflects the weak carry over from the previous fiscal year and is predicated on a limited set of reforms, resumption of mining activity after a partial or full lifting of

Figure SAR.15 India's fixed investment growth has slowed



Sources: India Central Statistical Office, Datastream and World Bank.

court-imposed bans, efforts to limit energy and other subsidies, and good agricultural production following normal monsoon rains. A worsening of the current Euro area turmoil, however, could result in a less favorable growth outturn in the 2012-13 fiscal year.

Economic growth in Pakistan, the second largest economy in the region accounting for nearly 10 percent of regional GDP, has remained sluggish. High inflation, power shortages and the political situation have hampered investment activity and industrial output, and led to a sharp decline in foreign direct investment. After experiencing heavy damages during devastating floods in the 2009-10 fiscal year ending in June 2010, agricultural production in Pakistan revived in 2011-12. However, recurrent power shortages and heavy rains that have damaged standing crops in some parts of Pakistan could result in relatively subdued agricultural performance. Pakistan's GDP growth is estimated to have increased to 3.6 percent in the 2011-12 fiscal year after the sharp deceleration experienced in 2010-11. Despite the pickup, growth remains well below the regional average and per capita growth below 1.5 percent. GDP growth is expected to remain in the range of 3.8-4.1 percent in the 2012-13 and 2013-14 fiscal years. Lower foreign investment inflows and IMF debt repayments coming due could exacerbate balance of payments difficulties.

Bangladesh's economy has suffered from political turmoil and periodic strikes, widespread electricity shortages, near-double digit inflation, fiscal deficits, and deteriorating external balances. GDP growth is estimated to have

Table SAR.3 South Asia's forecast summary

(annual percent change unless indicated otherwise)	98-07[a]	2009	2010	2011	Est. 2012	Forecast 2013	2014
GDP at market prices (2005 US$) [b,f]	6.5	5.3	8.6	7.1	6.4	6.5	6.7
GDP per capita (units in US$)	4.8	3.8	7.1	5.7	5.0	5.2	5.4
PPP GDP [d]	6.5	5.3	8.6	7.1	6.4	6.5	6.8
Private consumption	5.2	6.9	7.4	6.8	5.9	6.2	6.5
Public consumption	5.5	9.3	9.6	5.8	5.5	5.2	4.9
Fixed investment	10.0	8.9	9.4	5.9	5.2	7.6	9.6
Exports, GNFS [e]	14.9	-7.2	13.6	15.0	6.6	7.6	9.2
Imports, GNFS [e]	11.1	-7.4	10.6	16.3	7.7	7.4	8.6
Net exports, contribution to growth	-0.1	0.6	0.0	-1.2	-0.7	-0.4	-0.4
Current account bal/GDP (%)	-0.4	-1.7	-2.5	-3.5	-3.2	-2.4	-2.0
GDP deflator (median, LCU)	6.1	8.5	9.7	8.5	8.0	7.7	7.7
Fiscal balance/GDP (%)	-7.0	-9.2	-8.4	-7.9	-7.5	-7.3	-6.9
Memo items: GDP at market prices [f]							
South Asia excluding India	4.8	3.4	4.9	4.8	5.0	5.2	5.3
India	7.1	9.1	9.6	6.9	6.6	6.9	7.1
at factor cost	-	8.4	8.4	6.5	6.9	7.2	7.4
Pakistan	4.7	3.6	4.1	2.4	3.6	3.8	4.1
Bangladesh	5.6	5.7	6.1	6.7	6.3	6.4	6.5

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 non-factor services (GNFS).

f. National income and product account data refer to fiscal years (FY) for the South Asian countries, while aggregates are presented in calendar year (CY) terms. 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. Due to reporting practices, Bangladesh, Nepal, and Pakistan report FY2009/10 data in CY2010, while India reports FY2009/10 in CY2009.

Source: World Bank.

slowed to 6.3 percent in the 2011-12 fiscal year ending in June from 6.7 percent in 2010-11. Exports have been affected by weaker demand from key European trade partners, while infrastructure constraints, especially electricity shortages, have become acute, in part due to high crude oil prices. Agricultural output growth is also estimated to have slowed to less than 2 percent in the 2011-12 fiscal year from the previous fiscal year's 5.1 percent. But good crop harvests are expected for the current agricultural season due to favorable weather. Monetary tightening and easing of food inflation are likely to continue to put downward pressure on overall inflation. Non-food inflation, however, remains persistently high partly due to still high cost of imported inputs and pressures from higher government spending. Migrant remittances have remained resilient increasing 11 percent on a year-on-year basis in the first eleven months of the 2011-12 fiscal year to $11.8 billion; but reserves have been under pressure due to the high crude oil import bill. GDP growth is expected to pick up to 6.5 percent by the 2013-

Table SAR.4 South Asia's country forecasts

(annual percent change unless indicated otherwise)					Est.	Forecast	
	98-07[a]	2009	2010	2011	2012	2013	2014
Calendar year basis [b]							
Bangladesh							
GDP at market prices (2005 US$) [c]	5.6	6.0	6.4	6.5	6.4	6.4	6.5
Current account bal/GDP (%)	0.1	3.5	2.4	0.6	0.8	1.0	1.2
India							
GDP at market prices (2005 US$) [c]	7.0	5.7	9.5	7.6	6.7	6.8	7.0
Current account bal/GDP (%)	-0.3	-2.0	-2.9	-3.8	-3.6	-2.7	-2.2
Nepal							
GDP at market prices (2005 US$) [c]	3.8	5.3	4.0	3.9	4.2	4.2	4.3
Current account bal/GDP (%)	-1.6	0.9	-1.8	-0.2	0.6	0.8	1.1
Pakistan							
GDP at market prices (2005 US$) [c]	4.7	1.6	3.3	3.0	3.7	4.0	4.1
Current account bal/GDP (%)	-0.8	-2.5	-1.9	-2.2	-2.3	-2.2	-2.0
Sri Lanka							
GDP at market prices (2005 US$) [c]	4.9	3.5	8.0	8.3	6.4	6.7	7.0
Current account bal/GDP (%)	-3.2	-0.7	-2.2	-8.0	-4.4	-3.4	-2.9
Fiscal year basis [b]							
Bangladesh							
Real GDP at market prices	5.6	5.7	6.1	6.7	6.3	6.4	6.5
India							
Real GDP at market prices	7.1	9.1	9.6	6.9	6.6	6.9	7.1
Memo: Real GDP at factor cost	-	8.4	8.4	6.5	6.9	7.2	7.4
Nepal							
Real GDP at market prices	3.7	4.4	4.6	3.5	4.2	4.1	4.3
Pakistan							
Real GDP at market prices	4.7	3.6	4.1	2.4	3.6	3.8	4.1

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, Maldives are not forecast owing to data limitations.

a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.

b. 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. Due to reporting practices, Bangladesh, Nepal, and Pakistan report FY2009/10 data in CY2010, while India reports FY2009/10 in CY2009. 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.

Source: World Bank.

14 fiscal year.

Sri Lanka's economy has grown robustly since the end of civil war with GDP growth of 8.3 percent in the 2011 calendar year, slightly higher than 8 percent growth registered in 2010. This buoyant growth was mainly due to reconstruction spending, and increases in tourism arrivals and strong remittance inflows, which grew at 31 percent and 25 percent, respectively, in 2011. However, Sri Lanka's external position came under tremendous pressure because of a nearly 50 percent increase in import demand fueled by rapid domestic credit growth and robust consumption demand, together with high crude oil prices compared to the average levels in previous years. In consequence, Sri Lanka's current account deficit swelled from 2.2 percent of GDP in 2010 to nearly 8 percent of GDP, and the authorities have had to intervene to support the currency, drawing down international reserves which declined from $8 billion in mid-2011 to $5.5 billion or a little over 2 months of import cover by early 2012. Inflation has inched up to 7 percent in May on a year-on-year basis, suggesting that demand pressures continue to remain strong. The central bank has taken a number of measures to limit domestic credit growth and import demand, allowed the exchange rate to depreciate, and taken recourse to IMF assistance to improve the reserve position. Growth outturns in the medium term are expected to be in the range of 6.4-7.0 percent during 2012-14, a lower but more sustainable pace compared to that in recent years.

Nepal's GDP growth is estimated to have picked up to 4.2 percent in the 2011-12 fiscal year ending in mid-July from 3.5 percent in 2010-11, supported by a good agricultural harvest, robust remittance inflows and tourism revenues. Although the political situation is much improved compared to the period of civil conflict prior to 2007, it remains characterized by instability due to as yet unresolved constitutional issues. This uncertainty continues to hold back investment and industrial activity. Remittances have supported consumption in recent years, but strong demand resulted in rising real estate prices, a surge in imports, and a current account deficit in 2010. But the ability of the domestic economy to respond to supply remittance-fueled demand appears to be improving. Robust demand for migrants and depreciation of the Nepali rupee (due to the currency peg with the Indian rupee) has also created additional incentives for sending remittances, contributing to an improvement in the current account position. Growth is likely to be subdued in the near term, but increase gradually over the medium-term.

Afghanistan's economy continues to be characterized by a heavy reliance on external aid, weak governance and an uncertain security situation. GDP growth in Afghanistan surged to 21 percent and 8.4 percent respectively in the 2009-10 and 2010-11 fiscal years mainly because of donor assistance. But growth slowed to an estimated 5.7 percent in 2011-12 due to a poor crop and partly since aid has leveled off and is therefore not contributing as much to growth. The monetary policy transmission mechanism and financial sector also remain weak, particularly in the wake of the Kabul Bank crisis. The withdrawal of the majority of foreign NATO forces by 2014 could reduce largely aid-financed growth to 4-5 percent, according to recent World Bank estimates – necessitating an adjustment to domestic sources of growth. Agriculture and services are the mainstay of the economy, but recently awarded contracts for gold and oil extraction could see an increase in the contribution of mining to growth.

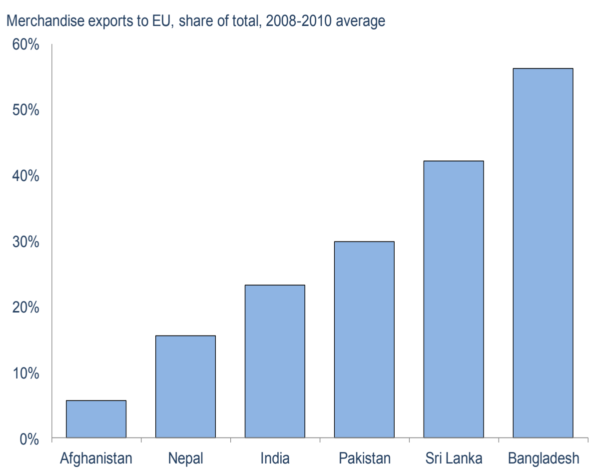
Maldives has been beset by political uncertainties for much of the last year – adversely affecting tourism revenues. Fiscal expansion following the change of government, including increase in public sector wages and the introduction of universal healthcare, has fed into import demand and increased inflationary pressures already running in the double digits.

Fiscal balances in South Asia are likely to continue to remain stressed in absence of substantive action to reduce fuel, electricity and fertilizer subsidies and parallel efforts to improve revenue performance. India has set a target of reducing overall subsidies to 2.0 percent in the 2012-13 fiscal year, which is likely to require significant upward adjustment to administered fuel prices. Even after recent price hikes in Bangladesh and Sri Lanka, energy products are still subsidized to some extent. Moreover, elections scheduled in the coming two years in several South Asian countries and a desire to protect consumers from the inflationary impact of higher fuel prices could make it difficult to reduce subsidies and raise administered prices closer to cost recovery levels.

Risks and vulnerabilities

South Asia's growth remains vulnerable to external and domestic downside risks. On the external front, an escalation of Euro area uncertainties during the course of the year—in particular after Greek elections in mid-June—would likely have a negative impact on South Asia's growth prospects. Weaker demand for exports from Europe (figure SAR.16) and lower and potentially more volatile private capital flows would put additional strains on the balance of payments position of South Asian countries, and delay a recovery in investment and output. An increase in geopolitical tensions in the Strait of Hormuz that causes a major disruption to global oil supply would also adversely impact this net oil-importing region. If global oil prices were to rise by $50, South Asia's current account and fiscal deficits could be expected to rise by 1.5 percent and 0.8 percent of regional GDP, respectively, by 2013, and GDP could decline by 1.3 percent relative to the baseline (see scenario in box 6 in the main text).

Figure SAR.16 South Asian countries have significant trade exposure to European markets



Sources: UN COMTRADE and World Bank.

India's short term debt obligations remain elevated, with short-term claims comprising more than half of overall foreign currency claims of international banks that report data to the Bank for International Settlements (BIS). An increased reliance on short-term funding, which is projected to decline at a much smaller pace than other inflows (table SAR.1), could increase vulnerability to external events.

The already loose stance of fiscal policy and high inflation rates in South Asia imply that there is limited space for demand stimulus in the event of a negative external or domestic shock. Were a crisis to materialize, the burden of adjustment would fall mainly on private consumption and investment, in turn depressing future productivity and growth and potentially eroding the recent gains against poverty. Nonetheless, expansion of demand through further policy easing could prove counterproductive with risk of higher inflation, crowding out of private investment by ever-larger government borrowing, and possibly greater macroeconomic instability.

An upside risk for South Asia's growth is that alleviating the economic policy, energy and infrastructure constraints outlined above could potentially lift South Asia's growth closer to the pre-crisis trend. Recent progress on reducing barriers to intra-regional trade in South Asia, if sustained, could expand markets within the region and bring significant benefits, in particular to South Asian economies other than India. However, tackling South Asia's "behind the border" constraints remains key to improving the region's growth prospects.

Another upside risk for regional growth is that of crude oil and international commodity prices declining over the course of 2012, if global demand weakens further or if additional supply comes on stream, which could reduce the pressure on current account positions of South Asian countries. A 20 percent fall in crude oil prices could reduce South Asia's regional current account deficit by 1.2 percent of GDP and boost regional GDP by 1 percentage point relative the baseline in the presence of government budget financing constraints (see table 5 in main text). Similarly, a faster than expected growth of remittances and larger aid flows would also ease the strain on external positions. But in the absence of substantive policy actions to reduce internal imbalances, both domestic and foreign investment are likely to remain weak, thereby eroding the longer-term growth potential of the region.

Policy measures

There is urgent need for policy action in several areas, including: rebuilding policy buffers, in particular through credible fiscal consolidation over the medium-term while protecting the most vulnerable; creating a stable and predictable policy environment for the private sector; and finding sustainable longer-term solutions to ease electricity shortages and infrastructure gaps.

Allowing domestic energy prices to adjust in line with international prices, reducing leakages in public distribution systems, and better targeting can limit the fiscal burden of fuel and other subsidies. However, given the amplitude of spending in these areas, implementation is likely to be difficult. A policy that explicitly ties reductions in subsidies to an increase in more targeted anti-poverty measures may be easier to implement politically. Moreover, given South Asia's weak revenue performance relative to other developing regions, there needs to be sustained efforts to broaden the tax base, simplify the tax code, and strengthen tax collection.

Recent moves toward greater exchange rate flexibility in some South Asian countries, if sustained, will allow exchange rates to better absorb external shocks, facilitating a faster pace of adjustment of output and prices while reducing pressures on international reserves.

Creating a more predictable policy environment for both domestic and foreign investment and accelerating the pace of reforms will help to increase competitiveness and raise South Asia's growth potential. Longer-term sustainable measures to address South Asia's energy and infrastructure deficit by increasing efficiency of existing players and creating incentives for investment and capacity expansion remains one of the key elements necessary to sustain South Asia's growth performance.

Notes:

1 The years in the text refer to calendar years unless otherwise stated. Several South Asian countries measure output in fiscal years, which extends from July 1 to June 30 in Bangladesh and Pakistan, from April 1 to March 31 in India, and from July 16 through July 15 in Nepal.

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