

SOUTH ASIA

Prior to the 11 September terror attacks on the US, South Asia had been less affected by the global economic slowdown and the downturn in the electronics cycle due to its relatively closed economies. The attacks, however, worsened the external outlook for the subregion. Domestic constraints, including adverse weather, widening fiscal deficits, political uncertainty, and lagging structural reforms, also continue to hinder subregional prospects.

Economic Indicator (percent)	1998	1999	2000	2001		2002	
				Current	ADO 2001	Current	ADO 2001
GDP growth	5.8	5.9	5.1	5.2	5.8	5.7	6.5
Inflation rate	6.3	4.2	6.4	4.8	5.4	4.8	4.8
Export growth	-0.1	4.4	17.2	5.2	10.6	5.9	12.4
Import growth	-5.7	10.5	7.3	5.3	6.8	6.7	8.3
Current account/GDP	-1.4	-1.7	-1.1	-1.6	-1.7	-1.9	-1.5

Economic Assessment. Weaker growth in the US and EU, South Asia's main export markets, has led to a deceleration in India's exports of software and cut diamonds, Pakistan's exports of cotton, and subregional exports of textiles and ready-made garments. The events of 11 September, coming on top of this global slowdown, have further weakened the outlook for the subregion in the short term. An immediate consequence has been to increase freight charges to and from Pakistan due to its perception as a war zone. At the same time, Pakistan textile and garment manufacturers have seen cancellations of export orders and a sharp drop in new orders because importers feel that they will be unable to maintain their existing production schedules due to uncertainty about current US actions in neighboring Afghanistan and the resultant impact on Pakistan. The prevailing uncertainty is also having an adverse budgetary impact, with the Government of Pakistan having to incur additional expenses associated with an increased number of refugees, and maintaining law, order, and defense preparedness. More generally, subregional exports and investment inflows are likely to be negatively affected by more subdued global demand and a loss of investor confidence. Heightened security concerns have already affected tourism arrivals in India, Maldives, Nepal, and Sri Lanka. Recent events are also likely to hurt remittances from South Asians working in the Middle East and the US. Although both India and Pakistan are likely to benefit from increased access to concessional aid and foreign investment inflows following the recent removal of the remaining sanctions imposed on them after their 1998 nuclear tests, the near-term economic impact is unlikely to be significant.

On the domestic front, bad weather in India, Nepal, Pakistan, and Sri Lanka led to depressed agricultural activity and private consumption growth earlier in the year. Manufacturing output in India, Pakistan, and Sri Lanka has been affected by the slowdown in exports and a shortage of power caused, in part, by a drought-induced fall in hydropower generation.

In Bangladesh and Nepal, manufacturing activity has also been affected by work stoppages and strikes. Slower export growth is likely to hold back domestic consumption, and domestic and foreign investment, in the subregion. Investment has also been affected by political uncertainty and lagging structural reforms. Weaker economic growth and reduced international trade flows are leading to shortfalls in revenue collections and to pressure on fiscal balances. This is likely to constrain the extent to which fiscal policy can be used to stimulate domestic demand and offset export deceleration. As a result of these developments, GDP growth in the subregion is likely to slow to 5.2 percent in 2001, from the *ADO 2001* forecast of 5.8 percent.

In 2001, subregional export growth (in US dollar terms) is expected to decline to 5.2 percent from 17.2 percent in 2000. The slowdown in exports has, to some extent, been offset by a relatively modest slowdown in imports arising from weaker domestic demand and the import-dependent nature of exports. As a result of slower export growth, reduced inflows of worker remittances, and lower earnings from tourism, the current account deficits of subregional economies are likely to widen somewhat in 2001.

Higher subregional inflation during the first half of 2001—stemming from poor agricultural harvests (India and Pakistan) and higher administered prices (Pakistan and Sri Lanka)—is likely to ease during the rest of the year due to an expected recovery in the agriculture sector and restrained domestic demand. In Pakistan and Sri Lanka, downward pressure on inflation will, to some extent, be balanced by currency depreciation and the removal of subsidies.

Economic Management Issues. Fiscal imbalances continue to be a drag on economic growth throughout the subregion. Despite recent efforts at restructuring state and central government finances, fiscal deficits remain large and are continuing to rise. Near-term prospects are for a further deterioration in these deficits as slower economic activity leads to revenue shortfalls and increased pressure for fiscal stimulus. In addition, greater political opposition to the proposed widening of tax bases and the selling of public assets in some South Asian countries will reduce prospects for significant revenue enhancement. Fiscal discipline, however, remains critical for both domestic and foreign investor confidence and for sustaining private sector activity. While depressed domestic economic activity would suggest that the costs of borrowing and crowding-out effects associated with large fiscal deficits are not the main reasons for current weak levels of private investment, such considerations will nevertheless be more important as subregional economic activity picks up. High fiscal deficits, however, affect private investment through the quality of public expenditure and its impact on the overall environment in which businesses operate. With public debt rising significantly, a large and increasing portion of government revenue goes toward interest payments—a situation in recent years that has led to smaller fiscal space for development and infrastructure expenditures.

Partly as a consequence of this, persisting infrastructure bottlenecks are preventing subregional economies from reaping the benefits that are offered by market reforms and trade liberalization. For example, transport sector

bottlenecks and power shortfalls are proving to be a constraint on sustained economic growth. Faced with severe budgetary constraints, subregional governments need to encourage foreign investment in infrastructure, and to implement appropriate regulatory policies governing the relationship between private and public provision of infrastructure services. Although governments in the subregion are now more aware of what needs to be done to overcome infrastructure constraints, the political economy of these reforms is very complex and, consequently, progress to date has been slow.

Another challenge facing the subregion, and one that has failed to generate sufficient attention in the current global electronics-led slowdown, is the need for export diversification, both of products and export markets. Although South Asian countries are not as dependent on electronics exports as their Southeast Asian and East Asian counterparts, they depend heavily on textile and garment products, as well as on the US market. As a share of total exports, individual country exposure to textile and garment exports varies from over 25 percent for India to around 75 percent for Bangladesh, whereas exposure to the US varies from over 20 percent for India and Pakistan to over 30 percent for Bangladesh and Sri Lanka. The subregion as a whole needs to continue making progress in trade liberalization, labor market reforms, and human resources development to provide the greater flexibility for it to take full advantage of opportunities that the globalized economy provides.

Forecast. In 2002, the dampening effect on external demand of a deeper and more protracted global slowdown is likely to be offset to some extent by a pickup in domestic demand if expectations of stronger agricultural performance materialize. Revival of agricultural growth will be accompanied by a moderate improvement in the industry and services sectors. The latter sector is also likely to benefit from further subregional efforts to liberalize the services sector. As a result, subregional GDP growth is projected to increase moderately to 5.7 percent in 2002.

The overall current account deficit for the subregion is likely to deteriorate further in 2002, as subdued export growth is accompanied by faster import expansion due to a pickup in domestic economic activity. Imports of investment goods are, however, likely to be contained due to significant excess capacity in India. Under the assumption of normal weather conditions, subregional inflation is likely to remain broadly stable in 2002. Low food-price inflation, due to the availability of ample food supplies, will be offset by demand-related inflationary pressures resulting from increased economic activity and utility price increases imposed by governments in the subregion, in an attempt to rein in higher fiscal deficits.