

South Asia



GNP per capita, 1997: \$380

Recent developments

SO FAR, EAST ASIA'S FINANCIAL CRISIS has had only a limited impact on South Asia, which last year grew at 5.2 percent. As a result, South Asia emerged as the fastest growing region of the world in 1998. However, it was also the poorest, with GDP per capita averaging just less than \$450 in 1997.

India, the dominant economy in the region, was protected by its large domestic market and capital account restrictions that dampened the effects of turbulence in international capital markets. Recent estimates suggest that growth of 5.8 percent may be achieved during the fiscal year 1998–99. Throughout 1998 the currency was allowed to drift lower to safeguard the competitiveness of exports, and the real effective exchange fell 10 percent between August 1997 and December 1998. This put it at about the same level as in late 1993. One result will be higher consumer price inflation for 1998–99. By contrast, wholesale price inflation has been much lower (the yearly rate is expected not to exceed 5 percent during 1998–99), owing to low and declining prices of agricultural commodities, fuel, and power prices. In spite of the economic sanctions that followed the nuclear tests in May 1998 and the deterioration of market sentiment, India successfully launched a five-year Resurgent India bond in August 1998, attracting more than \$4 billion from nonresident Indians. But trade and fiscal balances deteriorated. The trade deficit widened and, despite low oil prices, the current account may reach 2.5 percent of GDP in 1998–99 compared to 1.6 percent in 1997–98. The central government deficit may rise to about 6 percent of GDP in 1998–99, above the target of 5.6 percent because of a shortfall in government revenues.

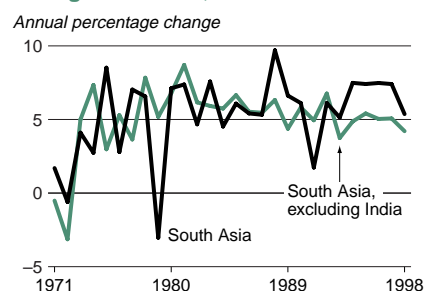
GDP in Pakistan rose by 5.4 percent and inflation decelerated to less than 8 percent in 1997–98. Increased political uncertainty, falling prices of cotton, and lower textile sales resulted in sluggish export growth. An exchange and debt crisis emerged in May 1998 after the nuclear tests and the freezing of foreign currency accounts, leading to a sharp decline in international reserves and the accumulation of large external payments arrears. Measures to remedy the external crisis included devaluation of the rupee, the introduction of some exchange rate restrictions, a moratorium on servicing public and publicly guaranteed debt, an increase in the price of gasoline, and reductions in development expenditures. An agreement was reached in January 1999 between Pakistan and the IMF on a \$5.5 billion rescue package.

Sri Lanka is the most open economy in the region—exports equal 37 percent of GDP—but has nonetheless escaped serious harm from the world slowdown as exports to its neighbors have held up well. Real GDP grew by 6.4 percent in 1997 and may reach growth of 6 percent in 1998, because of broad-based strength in most sectors of the economy. Economic growth in Bangladesh was 5.5 percent in 1997–98 and was projected at about 6 percent for 1998–99, before the economy was hit by devastating floods during July–October 1998. The floods caused more than 1,500 deaths and widespread damage to industry, agriculture, and infrastructure. GDP estimates for 1998–99 have been revised down to 3.8 percent.

Debt indicators

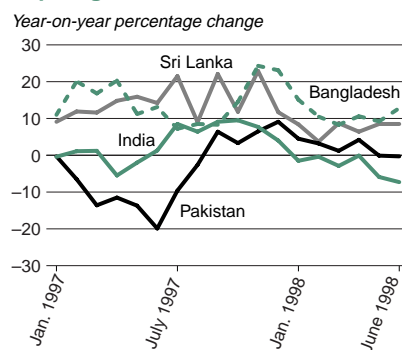
The long-term external debt stock increased from \$144 billion in 1997 to \$152 billion in 1998. Debt from pri-

GDP growth rates, 1971–98



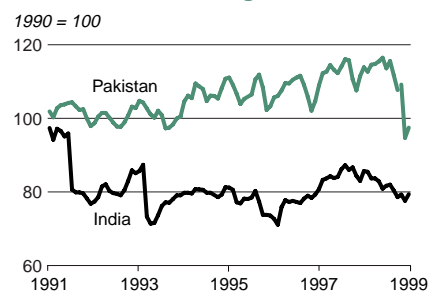
Source: World Bank.

Export growth, 1997–98



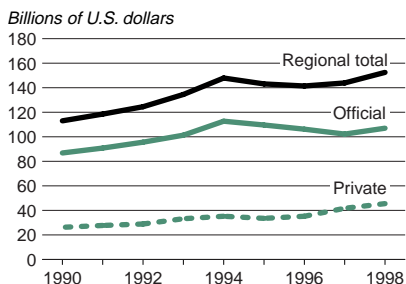
Note: Calculated as a three-month moving average. Source: Datastream.

Real effective exchange rates, 1991–99



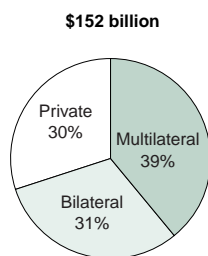
Source: J. P. Morgan.

Long-term debt outstanding, 1990–98



vate creditors rose slightly, despite the drop in gross disbursements. However, official debt, which accounts for more than 75 percent of total long-term debt, increased for the first time in four years. No official debt restructuring took place in the South Asia region. The debt-to-export ratio increased from 193 percent in 1997 to 201 percent in 1998, due to the increase in total external debt, despite the rise in exports. The debt-to-GNP ratio increased slightly.

Sources of long-term debt, 1998



Aggregate resource flows

Aggregate resource flows declined from \$15 billion in 1997 to \$12 billion in 1998. Net private flows fell to \$8 billion. While foreign direct investment declined only slightly, flows from the international capital markets (bonds, bank lending, and portfolio equity) fell to \$3 billion, compared to \$6 billion in 1997. As in past years, India received most of the region's net private flows.

Net private-source debt flows to South Asia totaled \$3 billion in 1998, down only slightly from \$4 billion in 1997, despite investors' concerns over the implications of foreign reaction to the nuclear tests in India and Pakistan. Another factor contributing to the lower figure was the general retreat from emerging markets following the Russian debt moratorium in August. Portfolio equity flows fell by almost \$2 billion in 1998, to \$0.4 billion. Flows to India accounted for most of the total flows to the region. Pakistan received \$221 million in 1998, compared with \$268 in 1997.

Foreign direct investments to the region equaled \$4.4 billion in 1998, down from \$4.7 billion in 1997. India, which received 80 percent of the region's foreign direct investment flows in 1998, experienced an increase in flows. Although FDI increased slightly to some of the smaller countries (for example, Maldives and Nepal), in Pakis-

tan it fell by \$100 million. FDI flows to Bangladesh were \$0.4 billion in 1997/98 and may increase to \$0.7 billion in 1998/99.

Official finance increased from \$3.6 billion in 1997 to \$4.5 billion in 1998. The largest increase was in net bilateral concessional loans, which jumped from a negative \$1.2 billion in 1997 to a positive \$300 million in 1998, in part related to emergency assistance to rebuild after the Bangladesh floods.

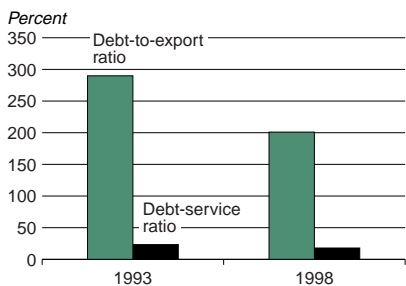
Prospects and risks

GDP growth in India is likely to reach 4.8 percent in 1999–2000, based on a rebound in fixed capital formation and an acceleration in industrial production. But a significant acceleration in growth over the forecast period will be difficult to achieve, as restrictive trade policies, a high public sector deficit, and supply bottlenecks will continue to constrain growth over the medium term to below the 6.5–7 percent rate needed for poverty reduction. The economy includes some extremely dynamic and competitive sectors, including software (growing at more than 75 percent per year), and gems and jewelry (10 percent), but economic reforms needed to revitalize the economy as a whole are proceeding slowly.

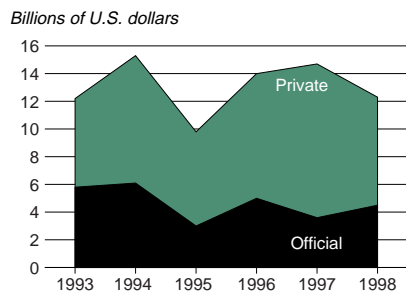
Pakistan is getting back on track after narrowly averting default on its nearly \$30 billion in external debt. Still, GDP growth is expected to reach barely 3 percent in 1998–99 instead of the targeted 6 percent; exports may drop by 12 percent. The target fiscal deficit for 1998/99 is 4.3 percent, but the fiscal situation remains fragile.

The outlook for Bangladesh is dominated by recovery from the floods. While an extensive relief effort has helped avert a severe food shortage, the challenge of rehabilitating the economy remains massive. GDP growth may barely reach 3.8 percent during 1998–

Debt indicators, 1993 and 1998



Aggregate net resource flows, 1993–98



99, as agricultural output is likely to contract by 2 percent and manufacturing growth may fall to 3 percent. Exports may expand by 5–6 percent, despite disruption in production and shipping from the floods. Growth should recover to 5.5 percent in 1999–2000.

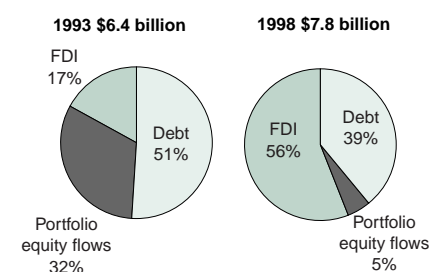
The Sri Lankan economy is expected to grow by 5 percent in 1999, as the record rice harvest more than compensates for slower industrial growth, partly because of weaker demand for exports. The December 1998 trade agreement with India should improve the outlook for exports. The agreement cut tariffs on Sri Lankan goods by 50 percent (except from a 400-item exempt list, mostly agricultural goods). A further 70 percent cut is scheduled. The agreement is intended to be a precursor to the South Asian Free Trade Area, with agreement on the rules for establishing the free trade area scheduled for 2001.

Capital flows in South Asia are expected to remain stable. Private flows

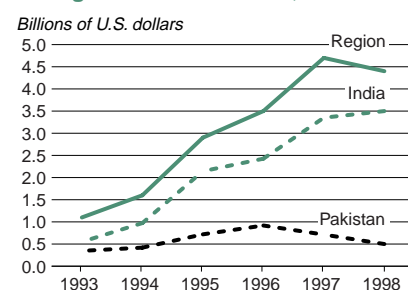
to South Asia should recover from the lows reached in 1998, as investors' concerns over reaction to the nuclear tests wanes. Net official finance may fall from the highs reached in 1998, however.

On the international front, prospects have improved since both India and Pakistan have announced their intention to sign the Comprehensive Test Ban Treaty. However, vested interests and loss of momentum may further slow economic reforms in India, particularly in the financial sector. Moreover, fiscal imbalances remain important at both the central and the state levels. Failure to undertake reforms in the public sector, including the civil service, tax administration, and expenditure allocation, may become the most important constraint on growth and poverty reduction. State finances are becoming increasingly fragile and may impair the ability of the states to deliver basic services to the population.

Composition of private flows



Foreign direct investment, 1993–98



South Asia forecast summary

(percent per annum)

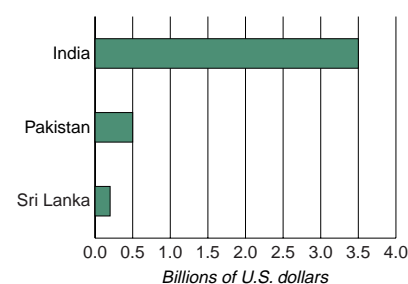
Growth rates/ratios	1988–97	1996	1997	1998	Baseline forecast		
					1999	2000	2001
Real GDP growth	5.8	6.9	6.9	5.2	4.4	4.8	5.2
Consumption per capita	2.8	4.8	4.5	4.1	3.4	3.7	3.0
GDP per capita	3.7	5.0	4.9	3.4	2.6	3.0	3.4
Population 16–65 years	2.4	2.3	2.4	2.3	2.3	2.3	2.4
Median inflation ^a	9.6	7.0	9.2	7.3	6.7	6.2	6.4
Gross domestic investment/GDP	23.2	25.8	25.7	25.1	24.6	24.1	24.0
Budget balance	-6.9	-5.4	-8.4	-8.8	-9.7	-9.6	-8.9
Export volume ^b	10.6	6.6	8.9	6.5	6.1	7.4	11.6
Current account/GDP	-2.1	-2.1	-1.7	-1.0	-1.2	-1.9	-1.6

a. GDP deflator.

b. Goods and nonfactor services.

Source: World Bank baseline forecast, March 1999.

FDI by country, 1998



Net private flows, 1998

