

South Asia

Recent developments

After growing a robust 9.3 percent during calendar year 2010, activity in South Asia moderated in the first quarter of 2011—pointing to a projected slowdown in aggregate regional growth to a still buoyant 7.5 percent in 2011. This slowdown partly reflects macroeconomic policy tightening aimed at curbing stubbornly high price pressures and reducing large fiscal deficits. Tighter financing conditions have contributed to a moderation in private investment growth, while private consumption growth has been hit by high and rising food and fuel inflation. The moderate compression of domestic demand has been partly offset by strong exports, as countries in South Asia have benefited from robust import demand in

developing countries, recovering demand in high-income countries and resilient worker remittances inflows (table SAR.1).

The regional economic slowdown in 2011 mainly reflects a fall-off in activity in India, which represents about 80 percent of South Asia's GDP, where growth is projected to ease to 8 percent in FY2011/2012 from 8.8 percent in FY 2010/11 (box SAR.1). The slowdown stems from a moderation in domestic demand, as elevated inflationary pressures have cut into disposable incomes and household spending, and as more restrictive monetary conditions have contributed to a dampening of investment activity. In particular, investment growth decelerated sharply in Q1-2011 to 0.4 percent from 7.8 percent in Q4-2010 and 14.1 percent

Table SAR.1 South Asia summary forecasts

	(annual percent change unless indicated otherwise)			Est. 2010	Forecast		
	98-07 ^a	2008	2009		2011	2012	2013
GDP at market prices (2005 US\$) ^{b,f}	6.0	5.9	6.2	9.3	7.5	7.7	7.9
GDP per capita (units in US\$)	4.4	4.4	4.8	7.9	6.1	6.4	6.6
PPP GDP ^d	6.0	5.8	6.3	9.0	9.5	7.7	7.7
Private consumption	4.9	6.8	6.4	7.0	5.9	5.6	5.9
Public consumption	3.9	16.9	13.6	2.8	6.7	5.4	4.8
Fixed investment	9.5	5.6	3.9	14.3	9.4	12.6	13.1
Exports, GNFS ^e	14.1	13.7	-6.3	12.7	11.3	11.7	12.4
Imports, GNFS ^e	9.3	24.8	-6.5	3.2	8.8	10.5	11.6
Net exports, contribution to growth	-0.2	-3.7	0.6	1.7	0.1	-0.2	-0.4
Current account bal/GDP (%)	-0.4	-3.3	-1.7	-2.4	-2.8	-2.6	-2.4
GDP deflator (median, LCU)	5.7	8.4	7.5	9.8	8.8	8.6	7.0
Fiscal balance/GDP (%)	-7.1	-7.3	-8.9	-8.4	-8.6	-8.2	-7.7
Memo items: GDP at market prices ^f							
South Asia excluding India	4.5	4.8	3.9	5.0	4.7	4.7	5.2
India	6.4	4.9	9.1	8.8	8.0	8.4	8.5
at factor cost	-	6.8	8.0	8.5	8.2	8.5	8.6
Pakistan	5.0	1.6	3.6	4.1	2.5	3.9	4.3
Bangladesh	5.1	6.2	5.7	5.8	6.2	6.4	6.6

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.

for 2010 overall (year-on-year). At the sectoral level, a recent good harvest buoyed agricultural production, following poor crops on low rainfall with the 2009 monsoon. In contrast, industrial output growth was weak in early-2011.

Economic growth in Pakistan—the region’s second largest economy (representing about 15 percent of regional GDP)—significantly lags much of South Asia, and is projected to slow to 2.5 percent in FY2010/11 (ending June-2011) from 4.1 percent in FY2009/10, reflecting the devastating flooding across much of the country in July and August 2010. The easing of GDP

growth is also tied to worsening security conditions, heightened political uncertainty, stalled policy implementation, and extensive infrastructure bottlenecks. While whole year growth numbers are expected to be weak, activity has begun to firm recently, as the effects of the 2010-flooding (which affected an estimated one-fourth of agricultural productive capacity) wear off, supported by a surge in exports in early-2011, and an upswing in worker remittances inflows.

Real GDP growth in Sri Lanka remains buoyant, but has decelerated in early-2011, due to floods

Box SAR.1 GDP reporting practices—market price versus factor cost and calendar year versus fiscal year

There are a number of measures of economic output—including gross domestic happiness as reported in Bhutan. Most governments report headline GDP at market prices in calendar-year terms. In South Asia, many governments report data on a fiscal-year basis using factor costs to weight output rather than market prices. The Indian government reports data in two different ways: factor cost and market prices, both in fiscal-year terms—although it places greater emphasis on the factor-cost measure. Importantly, although these measures are consistent, they can yield large differences.

The differences arise because the weights attached to sectoral growth rates differ, depending on which measure you use. The factor-price measure weights output using prices that are net of indirect taxes less subsidies in a base year, while the market-price measure uses weights that are based on the actual market prices observed in a base year. If the underlying growth rates of sectors with relatively high net tax-rates are different from those of sectors with relatively low net tax-rates in the base year, then there will be a systematic and persistent difference between real GDP growth measured at factor cost and GDP measured at market prices. Indeed such persistent differences between real GDP growth at market prices and at factor cost are observable across most countries that publish both data, including Brazil, Australia and Germany, for example. In India, this difference is historically about 0.3 percentage points over the past twenty years, and by even more in recent years.

There are a number of reasons why countries choose to report different headline measures. Only a small subset of countries (Egypt, Indonesia, Iran, and much of South Asia), report headline GDP at factor cost, in part reflecting that agricultural sectors remain important drivers—albeit typically declining—to their growth outturns. Similarly, countries often report data in fiscal years (instead of calendar years), as this often reflects the given country’s crop year.

For the purposes of this report, GDP growth is provided at the country level at market prices in both calendar-year terms and fiscal-year terms for South Asia, while all regional aggregates are provided at market prices in calendar-year terms. The use of GDP at market prices in calendar-year terms enables ready comparison and aggregation across countries. This is because the vast majority of governments outside of South Asia report headline GDP at market prices—as it tends to be easier to monitor (and more reliable) given tax receipts, for example. Additionally, fiscal years can vary significantly across countries. For example, India’s fiscal year runs from April 1 through March 31 and Nepal’s fiscal year runs from July 16 through July 15.

India's real GDP growth at market prices and factor cost, in calendar year- and fiscal year-terms

	2003	2004	2005	2006	2007	2008	2009	2010
Market Price	6.9	7.9	9.2	9.4	10.1	6.2	6.8	10.3
Factor Cost	7.4	7.2	9.2	9.6	9.7	6.1	8.5	9.0
	2003-04FY	2004-05FY	2005-06FY	2006-07FY	2007-08FY	2008-09FY	2009-10FY	2010-11FY
Market Price	8.4	8.3	9.3	9.3	9.8	4.9	9.1	8.8
Factor Cost	8.5	7.5	9.5	9.6	9.3	6.8	8.0	8.5

Sources: Central Statistics Office, India and The World Bank.

Note: For years 2006 and 2005-06FY onward, the base year is 2004-05FY. For prior years, the base year is 1999-2000FY.

that damaged a significant share of this year's early crop. GDP growth in 2010 (calendar year) registered 8 percent and has been strongly underpinned by the peace dividend following the end of the decades-old civil war. The recovery was led by private consumption and investment. Agricultural output growth was boosted by the return to production of previously fallowed land with the cessation of fighting, while services activity benefitted from an upsurge in tourism. Activity in the first few months of 2011 has slowed due to waning of these rebound effects from the end-of-conflict and more normal growth rates in agriculture (aside from the negative impact of floods).

Afghanistan's GDP (on a fiscal year basis) is expected to have grown 8.2 percent in FY2010/11 (ending June-2011), down from an unsustainable 20.1 percent increase in FY2009/10 that was driven by a record harvest (following a long period of drought) and an upswing in donor grants. Output this year continues to be bolstered by reconstruction and strong aid inflows, which are reflected in a robust expansion of services (including transport) and vibrant construction activity.

Nepal also experienced a moderation in activity in early-2011. Ongoing political uncertainty attached to the post-conflict transition to a new government has extended into its fourth year, with law and order problems, continued extensive infrastructure bottlenecks (particularly widespread load-shedding and unreliable power delivery) projected to limit real GDP growth to 3.5 percent in FY2010/2011 (ending mid-July-2011), down from 4.6 percent in FY2009/10.

GDP growth has been picking up in Bangladesh, where private consumption spending has been supported by higher private sector credit growth and public- and private-sector wage increases. However, the strong boost to consumer incomes from worker remittances in 2009 (up 17.1 percent in dollar terms that year) has given way to a much more modest 2.7 percent gain in 2010, reflecting falling net outmigration since 2009 and fewer remitters following last year's return of workers from several gulf states. At the

sectoral level, rising agricultural output reflects good harvests, and strengthened industrial production has been buoyed by a revival in garment exports. However, Bangladesh's output continues to be constrained by widespread power supply outages, which are expected to limit GDP gains to 6.2 percent FY2010/11 (ending June-2011) from 5.8 percent in FY2009/10.

Among the remaining economies in South Asia, Bhutan's real GDP is firming, underpinned by construction of additional hydropower projects, and to a lesser extent by a revival in tourism. In FY2010/2011 GDP growth is projected to rise to 8.3 percent, up from 6.9 percent in 2009/10, (ending June-2010). The recovery in the Maldives appears to have firmed slightly in early-2011 with strong tourism arrivals. In 2011, GDP growth is projected to accelerate to 5 percent (calendar year) following 4.8 percent in 2010. Tourism is expected to remain the key driver for growth, supported by a 17.4 percent expansion of capacity (number of beds) at end-2010 and robust growth in arrivals stemming from diversification to faster-growing new markets. In particular, China surpassed the United Kingdom in 2010 as the largest source of tourists to the Maldives.

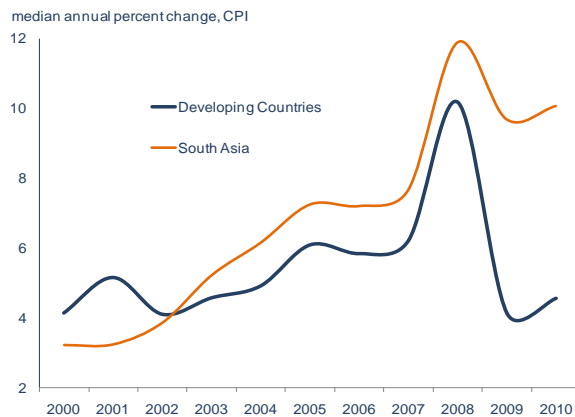
Inflationary pressures are elevated across South Asia reflecting various factors, including higher international food and fuel prices, tight capacity utilization, and past macroeconomic loosening, which have led to elevated inflation expectations and higher core prices (figure SAR.1). High international fuel and food prices are key factors in South Asia because of its heavy reliance on imports of oil and some staples, such as edible oils. Additionally, food represents a large share (about 40 percent) of the regional household consumption basket, a key concern from a poverty perspective.

In particular, international wheat and edible oils prices have surged, while rice prices have remained more stable. Afghanistan, the Maldives and Sri Lanka—where at least one-third of domestic consumption of grains (including rice, wheat, pulses) and edible oils is imported—are most exposed to an imported pass-through of

higher international commodity prices (figure SAR.2). Indeed, reliance on imported edible oils is high across the region, where at least two-thirds of consumption is imported (in Afghanistan, Bangladesh, India, Pakistan, and Sri Lanka, for which data is available). Some countries are self-reliant in key staples, such as Bangladesh, India and Nepal, where rice-imports represent a very small share of consumption (2 percent or less). Notably, the short-run pass-through (monthly) of international grain prices is generally low in South Asia, partly reflecting administered prices. For example, in India, wheat prices have remained well-below international prices, compared to near complete pass-through in Bangladesh.

The strength of the recovery in South Asia partly explains the persistence of inflation in the region, as little spare capacity remains. Although estimates of potential output can vary depending on methodology and assumptions—especially for countries with ongoing conflict, such as Pakistan, or coming out of conflict, such as Sri Lanka—measures across sources for many of the region’s economies (Afghanistan, Bangladesh, India, Sri Lanka) suggest output gaps narrowed (or closed) in 2010, which has likely contributed to price pressures. In addition, a series of local one-off factors have contributed to price pressures including: the economic disruptions from flooding in Pakistan (during the second half of 2010) and Sri Lanka (early-2011); the

Figure SAR.1 South Asia’s inflationary pressures sharply exceed other developing countries in post-crisis years



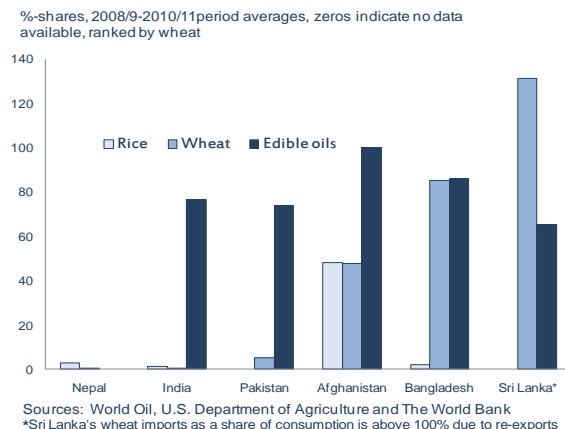
Sources: Thomson Reuters and World Bank.

partial liberalization of petroleum prices in India (mid-2010); and the raising of administered petrol prices elsewhere in the region (including Bhutan, the Maldives, and Pakistan). A recent devaluation of the Maldives’ currency, following the introduction of an exchange rate band around the Rufiyaa/US-dollar peg (R12.85/\$1) of plus or minus 20 percent, has also contributed to a resurgence of inflation in that country.

To rein-in domestic demand and inflationary pressures, monetary authorities have initiated policy rate hikes in Bangladesh, India, and Pakistan, with the Reserve Bank of India having started raising rates in March 2010. Despite these measures, real policy interest rates are negative—or remain looser than they were prior to the crisis (figure SAR.3). Unfortunately, bringing inflation back down will be complicated by the trend rise in inflation over the past decade, which has contributed to an increase in inflationary expectations in recent years. Household surveys in India, for example, indicate that consumers’ inflation expectations have increased over the last four years (from 5.8 percent in Q4-2006 to 13.1 percent in Q4-2010 for year-ahead inflation), and have recently jumped by 1.2 percentage points in the second half of 2010 (figure SAR.4).¹

Despite the steps taken earlier to reduce fuel subsidies, the pass-through of higher international energy prices is incomplete,

Figure SAR.2 Imports of rice, wheat and edible oils as a share of domestic consumption



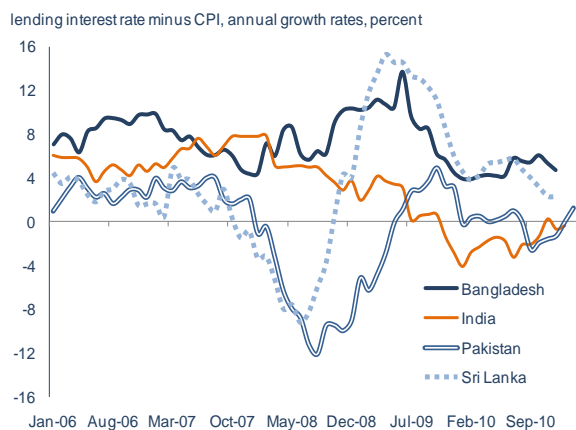
Sources: World Oil, U.S. Department of Agriculture and The World Bank
*Sri Lanka’s wheat imports as a share of consumption is above 100% due to re-exports

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

increasing subsidization costs and contributing to fiscal deficits (figure SAR.5). The region's large general government budget deficits are also complicating efforts to restrict domestic demand and reduce inflation. South Asia's aggregate fiscal deficit continues to outstrip those of other developing regions. And, despite progress toward fiscal consolidation in some countries (India, Maldives and Sri Lanka) in 2010, general government deficits remain very high, at 8.8 percent of GDP in India for FY2010/11, 20.7 percent in the Maldives for CY2010, and 7.9 percent in Sri Lanka for CY2010. Large outlays for interest payments are slowing progress toward fiscal consolidation, and—while improving in some countries (Afghanistan, Maldives, and Sri Lanka, for example)—the region's low tax base makes consolidation particularly challenging.

Elsewhere in the region, fiscal balances have deteriorated. In Pakistan—after rising to 6.3 percent of GDP in FY2009/10—the deficit continued to expand in the first half of FY2010/11 tied to flood-related outlays, high power-sector subsidies and increased defense spending. In Bhutan, the fiscal deficit rose to an estimated 4.4 percent of GDP in FY2010/11, as the government continues to plow money into development and infrastructure projects (including roads, financial services and information technology) that are only partly

Figure SAR.3 Real lending rates remain expansionary in India and Pakistan, despite monetary policy tightening

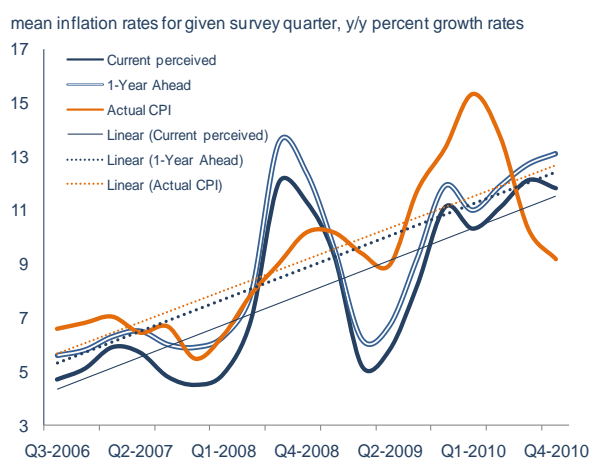


Sources: Economist Intelligence Unit and World Bank.

funded by the Tala hydroelectric project revenue stream. In Bangladesh, the deficit rose to 4.9 percent in 2010/11, due to large outlays for investment in power generation and higher subsidies. Sizeable foreign aid inflows and improved revenue performance helped contain Nepal's deficit to a relatively modest 2.8 percent of GDP and helped Afghanistan retain a surplus of 0.6 percent of GDP.

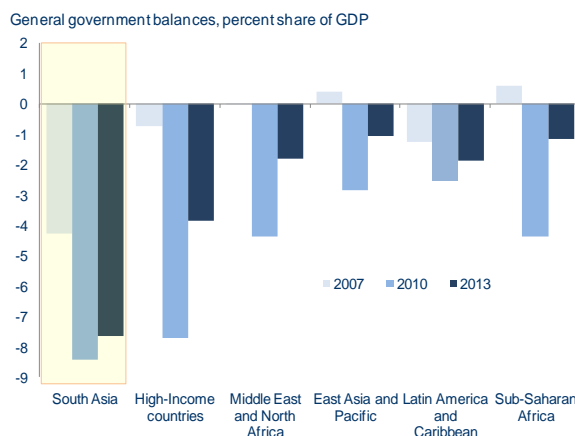
Given high inflation rates—currencies in South Asia appreciated in real effective (trade-weighted and inflation adjusted) terms, with the

Figure SAR.4 India's household inflation expectations have increased



Sources: Reserve Bank of India and World Bank.

Figure SAR.5 Elevated food and fuel prices are likely to weigh on fiscal balances and might delay consolidation



Source: World Bank.

largest increases in Pakistan and Nepal, where currencies stood about 15 percent above mid-2008 levels at end-2010. Bangladesh's real effective exchange rate had appreciated strongly as well, but depreciated during much of 2010 and ended the year 12 percent above pre-crisis levels. In India and Sri Lanka, real effective exchange rate appreciation has been less pronounced, about half the rates of appreciation across the rest of the region (8 percent and 6 percent, respectively, over the same period).

Despite headwinds implied by appreciating currencies, regional merchandise export volume growth accelerated sharply in the second half of 2010 (figure SAR.6). As the global growth recovery has deepened, external demand for South Asia has firmed, with volume growth given an extra impetus following a shift in export market composition toward higher-growth developing countries (China) and away from traditional export markets in slower-growing Europe and the United States (figure SAR.7). In India, the value of exports rose by 37.5 percent year-on-year to reach \$245 billion in FY2010/11, exceeding the \$200 billion government target. Among other factors, this strong performance reflects the success of the government's strategy to expand export markets in emerging economies, particularly in Latin America and Asia. Regional merchandise import volume growth remained robust as well, which

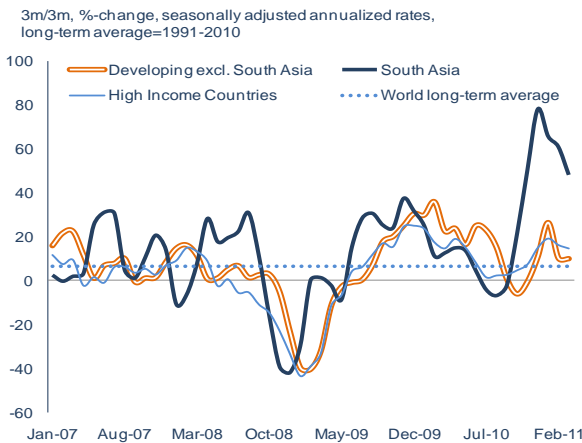
in combination with higher import prices led to a modest deterioration in the region's trade deficit from 6.2 percent of GDP in 2009 to 6.4 percent of GDP in 2010.

Tourism receipts rebounded in 2010 following the 2009 downturn with nearly all countries in the region registering a recovery (Bhutan, India, Maldives, Nepal, and Sri Lanka). Sri Lanka in particular posted a 46 percent upsurge in tourist arrivals following the end of civil war in 2009. In general, higher regional tourist arrivals reflected recovery in high-income Europe and vibrant growth in developing East Asia, especially China.

Worker remittance inflows to South Asia rose in U.S.-dollar terms by 8.2 percent in 2010 to \$81 billion, helping to offset sizeable trade deficits, remaining a critical source of foreign exchange.² However, when measured in local currency terms, remittances inflows to the region grew by only 4.1 percent in 2010, while high inflation rates meant that the real value of these inflows declined by 3.9 percent.

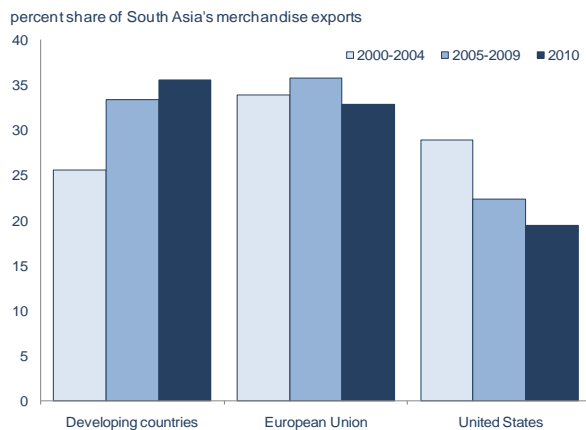
The pick-up in the dollar value of remittances was strongest in Sri Lanka, where they increased 24 percent in 2010—reflecting increased inflows through official channels and the boost in confidence following the end of the civil war. In Nepal, the dollar value of remittances expanded

Figure SAR.6 South Asia's merchandise goods exports recover following sharp deceleration in mid-2010



Sources: Thomson Datastream and World Bank.

Figure SAR.7 Shift toward developing country export markets buoys South Asia's export growth as demand slackens in high-income countries



Sources: CEIC and World Bank.

17 percent, supported in part by vibrant growth in India, a key source-country for Nepalese remittances. In India, the uptick in the dollar value of remittances inflows was more modest (7.4 percent), reflecting larger shares of Indian migrants in high-income countries that have yet to fully recover from the financial crisis. Elsewhere in the region, remittances inflows moderated sharply in 2010 (in dollar terms) by 2.7 percent in Bangladesh, following 19.4 percent growth in 2009. The deceleration appears to partly reflect a delayed impact of the decline in the net outflow of migrants, which nearly halved during the first half of 2009 and continued to decline in 2010 and into early-2011.

South Asia's current account deficit deteriorated in early 2011, reflecting higher oil import bills and strong, albeit moderating, import volume growth. Helping to contain the deterioration in external balances, the region recorded strong export volume growth in early-2011 (led by India, Pakistan and Sri Lanka)—supported by strong external demand from China. During calendar year 2011, the regional current account deficit is projected to expand to 2.8 percent as a share of GDP from 2.4 percent in 2010. In part this reflects a projected shrinking of Bangladesh's current account surplus, due to a stronger pace of growth in imports over exports, falling terms of trade (driven by rising international food and fuel prices) and a major slowdown in worker remittances receipts. Indeed, deterioration in the current account prompted the government of Bangladesh to seek IMF funding to help maintain business and investor confidence. While FDI to the region has fallen (India and Pakistan), the regional current account deficit is expected to continue to be covered by significant foreign exchange reserve holdings, particularly in India, and sustained capital inflows.

Capital Flows

Net private capital inflows to South Asia expanded by an estimated 12.3 percent in 2010 to \$76.6 billion, driven by a doubling (110 percent growth) in portfolio equity inflows (table SAR.2). As a share of GDP, however, inflows

fell to 3.8 percent from 4.2 percent—roughly half the peak share (7.8 percent) recorded in 2007 when inflows reached \$113.3 billion. South Asia accounts for a small share (10 percent in 2010) of total private capital inflows to developing countries, in part reflecting more shallow financial markets—with the exception of equities (India). Capital inflows to South Asia rose in the third quarter of 2010, after which they fell-off in the fourth quarter and into early-2011, very much in line with the overall trend in flows to developing countries in aggregate.

The composition of South Asia's inflows has shifted markedly since the onset of the global crisis, led by a sharp contraction in FDI inflows—which are down 50 percent in 2010 from the 2008-peak. This compositional shift also reflects a recovery in portfolio equity inflows, which have expanded 19 percent above the 2007-peak as of 2010. In comparison, for the rest of the developing countries FDI inflows are down by only 18 percent as of 2010 from the 2008-peak (including a 52 percent decline posted by Europe and Central Asia). Portfolio inflows to South Asia are more in line with developments in the rest of the developing world, standing 12 percent above 2007 peaks as of 2010. As a share of FDI inflows to developing countries in aggregate, South Asia captured 5 percent, roughly in line with those captured by Sub-Saharan Africa and the Middle East and Africa.

In contrast, South Asia attracts a disproportionately large share of total portfolio inflows to all developing countries, equivalent to 28 percent in 2010, for example (or 1.5 percent of South Asia's GDP versus about 0.8 percent for other developing countries). While these flows are more volatile than FDI flows, South Asia has generally accounted for a relatively large share of the total, and for 2010 exceeded the shares of portfolio inflows accounted by other regions, with the exception of Latin America and the Caribbean (with 35 percent in 2010) and just above East Asia and Pacific (24 percent in 2010). Investors have been drawn to South Asia's relatively liquid equity markets—notably in India, where its companies have

continued to issue ADRs (American Depository Receipts) and GDRs (Global Depository Receipts) in recent years (in contrast to China for example, where companies have stopped ADR and GDR issuances). In comparison to equities, South Asia's bond markets—including in India—are much less developed, thus effectively channeling foreign investors into equities. Elsewhere, flows to Latin America and the Caribbean tend to be more concentrated in bonds and flows to Europe and Central Asia—prior to the global crisis—were more concentrated in banking instruments.

India continues to account for the bulk of portfolio inflows to the region, which are channeled largely through institutional investors (which tend to squeeze out individuals). Foreign equity inflows into India reached a record \$44.8 billion in 2010, exceeding the previous peak of 2007 before the market crash of 2008. The increased participation of many foreign mutual funds in the country has contributed to the success of many new issues by Indian companies, such as the mega, public sector offering of Coal India. In 2010 IPOs were nearly

double the level in 2009, with 47 percent of the funds flowing to the energy sector. After India, Sri Lanka and Pakistan also attract significant equity inflows. Following the end of the civil war in Sri Lanka of 2009 capital inflows have surged, contributing to the Colombo Stock Exchange's boom returns of 96 percent in dollar terms in 2010, registering the largest gains in the world in the year.

FDI to India, the region's main recipient, fell by nearly one-third in 2010. In January 2011, FDI continued to decline sharply, down nearly by half from January 2010. This weak FDI performance has occurred despite India's strong growth. A confluence of factors may have contributed to the sharp decline, which has prompted the government of India to form a panel to investigate possible causes. Nevertheless, it appears that increased regulatory scrutiny of the sources of FDI has contributed to a fall-off in flows tied to 'round-tripping' (to avoid taxes, for example) via offshore accounts. Flows from Mauritius and Cyprus—which together account for two-fifths of flows to India—contracted markedly in 2010, by 60

Table SAR.2 Net capital flows to South Asia

\$ billions											
	2003	2004	2005	2006	2007	2008	2009	2010e	2011f	2012f	2013f
Current account balance	12.5	-1.2	-15.1	-16.8	-17.6	-49.9	-28.0	-49.6	-60.3	-60.9	-63.2
as % of GDP	1.6	-0.1	-1.5	-1.5	-1.2	-3.3	-1.7	-2.4	-2.8	-2.6	-2.4
Financial flows:											
Net private and official inflows	14.5	21.2	28.5	76.6	117.7	61.4	77.7	88.3			
Net private inflows (equity+private debt)	18.6	21.5	25.6	73.1	113.3	52.8	68.2	76.6	103.1	107.3	118.3
..Net private inflows (% GDP)	2.4	2.4	2.5	6.3	7.8	3.5	4.2	3.8	4.8	4.5	4.5
Net equity inflows	13.5	16.8	23.6	36.4	68.4	32.9	58.8	67.2	73.1	82.8	92.3
..Net FDI inflows	5.4	7.8	11.2	26.0	32.3	48.7	38.3	24.2	36.1	43.8	51.3
..Net portfolio equity inflows	8.0	9.0	12.4	10.4	36.1	-15.8	20.5	43.0	37.0	39.0	41.0
Net debt flows	1.0	4.4	4.9	40.2	49.3	28.5	18.8	21.1			
..Official creditors	-4.1	-0.3	2.9	3.5	4.4	8.6	9.5	11.7			
....World Bank	-2.3	2.3	2.3	2.0	2.0	1.4	2.1	3.9			
....IMF	-0.1	-0.3	0.0	-0.1	-0.1	3.2	3.6	3.8			
....Other official	-1.8	-2.4	0.6	1.6	2.4	4.0	3.8	4.0			
..Private creditors	5.1	4.7	2.0	36.7	44.9	19.9	9.3	9.4	30.0	24.5	26.0
....Net M-L term debt flows	3.1	4.0	-0.2	19.9	32.0	12.0	10.3	3.2			
.....Bonds	-3.7	3.9	-2.8	6.4	10.7	1.7	1.7	-2.6			
.....Banks	6.8	0.5	2.8	13.5	21.3	10.3	8.6	5.8			
.....Other private	0.0	-0.3	-0.2	-0.1	0.0	0.0	0.0	0.0			
....Net short-term debt flows	2.0	0.7	2.3	16.8	12.9	7.9	-1.0	11.1			
Balancing item /a	10.0	7.6	-6.6	-18.2	3.7	-37.8	-11.0	-30.4			
Change in reserves (- = increase)	-36.9	-27.6	-6.8	-41.7	-103.8	26.3	-38.6	-8.3			
Memorandum items											
Workers' remittances	30.4	28.7	33.9	42.5	54.0	71.6	75.1	81.2	88.7	93.8	

Note: Only for Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.

e = estimate, f = forecast

/a Combination of errors and omissions and transfers to and capital outflows from developing countries.

Source: World Bank.

percent and 78 percent, respectively. In contrast, total inflows to India excluding these countries contracted by only 8 percent. Similarly, some projects were delayed for environmental compliance issues. For example, South Korean steel giant POSCO suffered a setback when the Environment Ministry delayed the operation of its \$12 billion steel project in Orissa in mid-2010. U.K.-based Vedanta's investment of around \$9 billion was also halted in 2010, as it had breached environmental regulations in the mining sector. Other countries in the region generally rank below India in international investor surveys, with Afghanistan often ranked near the bottom, helping to explain relatively weak FDI inflows to South Asia. Remarkably, Pakistan—where security concerns remain a key hindrance—captures a similar share of FDI relative to GDP as India and has exhibited the same pattern of declining FDI inflows as India over recent years (figure SAR.8).

Government debt is elevated across the region—reflecting the impact of long-term structural fiscal deficits—and exceeds the average for developing countries in aggregate (except for Afghanistan) (figure SAR.9). As of FY2009-10, debt as a share of GDP in the Maldives (96 percent), Sri Lanka (82 percent) and India (73 percent), sharply exceeded the average for developing countries (37 percent). Indeed, South Asia's government debt is more closely in line

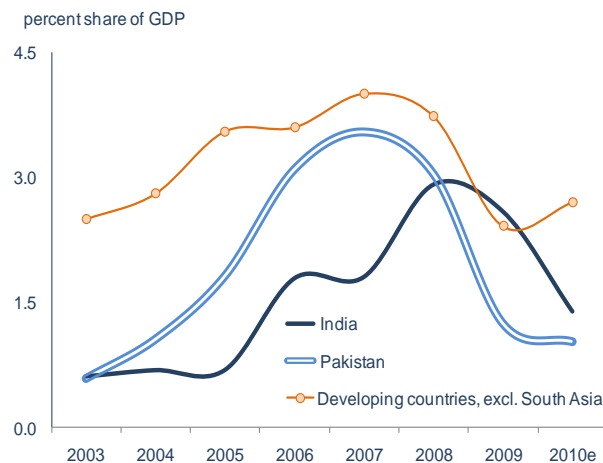
with that of high-income countries (91 percent), although the upward trajectory since the onset of the financial crisis is not as pronounced in South Asia as in high-income countries—with the marked exception of the Maldives.

Medium-term outlook

Regional GDP growth is projected to continue to record strong growth outturns averaging 7.7 percent in calendar terms and at market prices from 2011 through 2013, off 1.6 percentage points from the 9.3 percent outturn of 2010—but 1.7 percentage points above the pre-crisis decadal average from 1998 through 2007. The deceleration from 2010 reflects progressive tightening of monetary policy and fiscal consolidation aimed at a quelling excess demand and inflationary pressures, reducing unsustainably large fiscal deficits and containing deterioration in external balances. Aside from dampening private sector demand, fiscal consolidation is expected to lead to a slowing of public sector consumption.

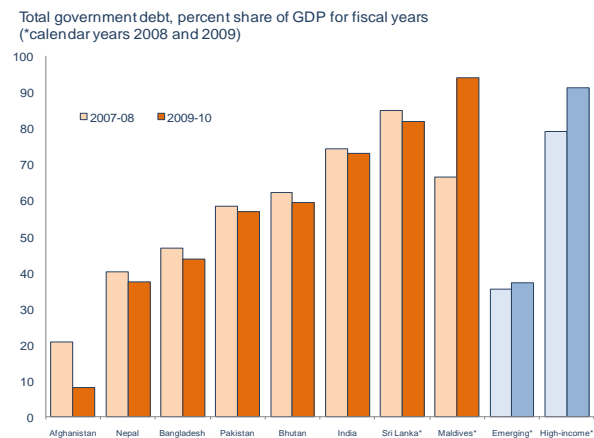
In combination with macro-policy tightening, improving crop production (Pakistan and Sri Lanka) and an expected moderation in international fuel prices over the balance of 2011 should foster some easing of inflationary pressures ahead. But, deceleration in prices is projected to be slow given incomplete pass-

Figure SAR.8 India and Pakistan FDI inflows as a share of GDP lag other developing countries



Sources: UNCTAD and World Bank

Figure SAR.9 Government debt in South Asia exceeds average for emerging markets -- except in Afghanistan



Sources: CEIC, IMF Fiscal Monitor Jan-2011, and World Bank.

through of higher international prices thus far, particularly for fuel prices. An expected normal crop year (2011/2012) in much of the region and relatively high regional stocks are providing a buffer for grain prices and import demand in 2011 (table SAR.3).³ However, South Asia is facing the current upturn with some weaker initial conditions compared with the 2007-2008 upswing—given less fiscal space and higher inflation—which is posing additional challenges in addressing risks of increased poverty and malnutrition rates.

External demand for goods and services is projected to moderate in 2011, given policy normalization and fiscal consolidation across most of South Asia's export markets, along with a natural deceleration in demand growth as global demand converges back to trend production levels. Accordingly, the pace of growth of tourism activity is projected to moderate in 2011, as arrivals from high-income countries, particularly from Europe, are expected to slow. However, the slowdown in arrivals from Europe is being partially offset by still strong growth from developing East Asia and high-income Middle Eastern economies. Deceleration in domestic demand growth will be reflected in a moderation in South Asia's imports in 2011. However, given the deterioration in the terms of trade (as higher oil prices weigh on the region's import bill) the current account deficit is projected to expand in 2011.

The recent rise in oil prices is projected to

translate into significant terms of trade deterioration for South Asia, compared with oil importers in most other developing regions, with the exception of the Middle East and North Africa (figure SAR.10). Price changes are expected to reduce real incomes in South Asian countries by about 1.1 percent of GDP, largely due to higher oil prices, and partly offset by increases in other commodities. For example, South Asia's cotton producers (such as India) are likely to see marked gains in their terms of trade, as cotton prices are projected to rise by one-third, whereas textile exporters (such as Bangladesh, which imports cotton) are likely to see greater deterioration in their terms of trade.

Remittances are projected to rise 9.1 percent in 2011 in dollar terms, up slightly from 8.2 percent growth in 2010 (growing substantially below pre-crisis boom rates, when they averaged 30 percent over 2007 and 2008), and help provide a cushion to the deterioration in the regional current account balance (figure SAR.11). In particular, worker transfers to South Asia from the high-income Gulf Cooperation Council (GCC) countries (most of the region's 9 million migrants work in these countries) are projected to firm with strengthened activity tied to higher oil-rents, which is boosting labor demand in the oil producers (figure SAR.12).⁴ The countries most affected by political upheaval in the Middle East (Egypt, Libya, Syria, Tunisia, and Yemen) are not large migrant host-countries for South Asia, so the net impact on migrant labor demand and remittances appears positive.

Table SAR.3 South Asia's grain supply and demand balances

1,000 metric tons, unless otherwise noted

	2004/2005	2005/2006	2006/2007	2007/2008	2008/2009	2009/2010	2010/2011	2011/2012
Production	251,472	263,234	264,995	284,200	289,168	278,943	290,733	298,683
<i>y-o-y % growth</i>	-0.6	4.7	0.7	7.2	1.7	-3.5	4.2	2.7
Ending stocks	18,710	20,729	23,117	26,134	40,767	45,389	45,581	43,406
<i>y-o-y % growth</i>	-20.6	10.8	11.5	13.1	56.0	11.3	0.4	-4.8
<i>% share of use*</i>	7.8	8.4	9.2	9.9	15.7	17.5	16.6	15.4
Domestic consumption *	240,445	245,368	251,370	262,857	260,328	259,012	275,288	282,363
<i>y-o-y % growth</i>	-0.6	2.0	2.4	4.6	-1.0	-0.5	6.3	2.6

* Excludes feed consumption.

Countries = Bangladesh, India, Nepal, Pakistan, Sri Lanka.

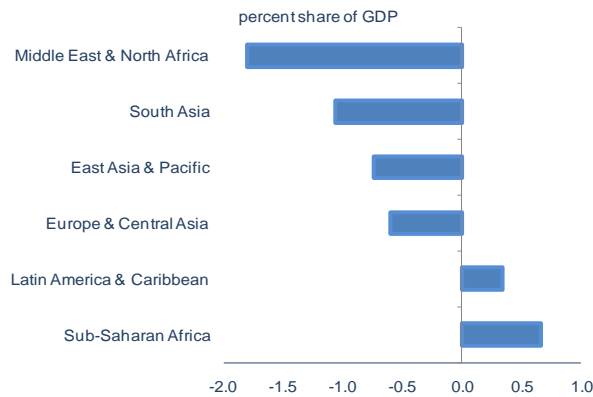
Sources: U.S. Department of Agriculture (11 May 2011) and World Bank.

GDP growth (in calendar year terms) in South Asia is projected to gain momentum incrementally in 2012 and 2013 to 7.7 percent and 7.9 percent, respectively, from an expected 7.5 percent in 2011, led by firming private sector activity, as inflationary pressures diminish and enable monetary authorities to pursue less restrictive stances in the outer years. In particular, investment is expected to firm as tighter monetary conditions are projected to contribute to an easing of inflation expectations and as fiscal consolidation fosters greater access to credit. Additionally, large programmed investment and reconstruction projects in

Afghanistan, Bangladesh, Bhutan, India and Sri Lanka should support acceleration of GDP growth in the outer years, boosting productivity and potential output. External demand is projected to strengthen incrementally in 2012 and 2013—assuming continued increased market penetration to faster growing developing countries—and be supportive of growth as well, as large high-income export markets begin to stabilize macroeconomic conditions.

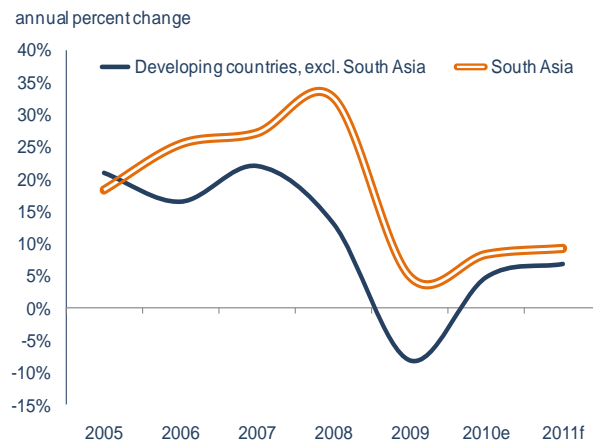
The region’s relatively strong projected growth path—reaching 7.9 percent in 2013 compared with the 6.0 percent average from 1998 through 2007 (compound growth rate)—is projected to be led by India, Sri Lanka and Bangladesh, where acceleration of investment activity is expected to support higher growth outcomes. In contrast, Pakistan and Nepal are expected to lag, given continued political challenges and associated macro-policy slippage. Indeed, GDP growth in Pakistan is not projected to recover to above the pre-crisis decadal average of 5.0 percent during the forecast period (table SAR.4).

Figure SAR.10 Projected terms of trade impacts in 2011 for oil-importing countries (by region)



Sources: UN Comtrade and World Bank.

Figure SAR.11 Growth of worker remittances inflows to South Asia projected to level off in 2011

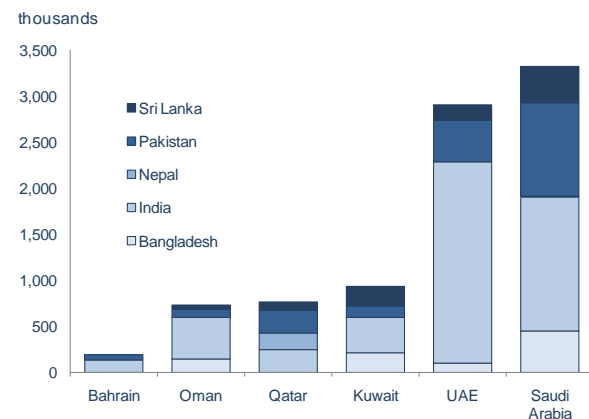


Source: World Bank, Migration and Development Brief No. 16, April 2011.

Risks

The region has witnessed a build-up in price pressures and is bumping up against potential output, which suggests that it needs to address supply constraints through higher investment. However, large fiscal deficits and public sector

Figure SAR.12 Most migrant workers from South Asia are based in the high-income Gulf Cooperation Council countries of the Middle East



Source: World Bank, Migration and Development Brief No. 16, April 2011.

debt may be crowding out private sector investment, which is likely being pressured by a relatively poor business climate and relatively shallow domestic financial markets (such as small corporate bond markets). As a consequence, demand is being channeled into higher prices and deteriorating current account balances. In this context, pursuing policy normalization is critical and failure to bring public finances and monetary policy into line could undermine growth projections and progress toward South Asia's urgent development objectives, including an expansion of infrastructure spending and potential output.

Inflation remains a key downside risk to growth, as policymakers face numerous challenges in reducing price pressures. If inflation remains elevated, unless offset by exchange rate depreciation (itself an inflationary impulse) it is likely to begin eating into the region's international competitiveness and discourage foreign investment—creating headwinds to gains in productivity. Elevated international commodity prices are also a negative risk factor, particularly given political resistance to reducing subsidies. In countries such as India that maintain price controls on food, farmers are not fully participating in the global upswing in prices. Higher monetary policy interest rates

Table SAR.4 South Asia country forecasts

(annual percent change unless indicated otherwise)

	98-07 ^a	2008	2009	Est. 2010	Forecast 2011	2012	2013
Calendar year basis ^b							
Bangladesh							
GDP at market prices (2005 US\$) ^c	5.0	6.3	6.0	5.8	6.0	6.3	6.5
Current account bal/GDP (%)	0.2	1.4	3.5	2.5	-0.5	-1.3	-1.7
India							
GDP at market prices (2005 US\$) ^c	6.4	6.2	6.8	10.3	8.1	8.4	8.5
Current account bal/GDP (%)	-0.3	-2.6	-2.0	-2.7	-2.8	-2.5	-2.3
Nepal							
GDP at market prices (2005 US\$) ^c	3.4	6.2	5.3	4.5	4.1	3.7	4.1
Current account bal/GDP (%)	-1.7	3.0	-2.0	-2.8	-2.9	-2.7	-2.6
Pakistan							
GDP at market prices (2005 US\$) ^c	4.9	3.6	2.6	3.9	3.3	3.2	4.1
Current account bal/GDP (%)	-0.8	-9.6	-2.5	-1.3	-2.4	-2.5	-2.7
Sri Lanka							
GDP at market prices (2005 US\$) ^c	4.4	6.0	3.5	8.0	7.5	6.8	6.4
Current account bal/GDP (%)	-3.2	-9.8	-0.7	-3.5	-4.9	-4.7	-4.2
Fiscal year basis ^b							
Bangladesh							
Real GDP at market prices	5.1	6.2	5.7	5.8	6.2	6.4	6.6
India							
Real GDP at market prices	6.4	4.9	9.1	8.8	8.0	8.4	8.5
Memo: Real GDP at factor cost	-	6.8	8.0	8.5	8.2	8.5	8.6
Nepal							
Real GDP at market prices	3.4	6.1	4.4	4.6	3.5	4.0	4.2
Pakistan							
Real GDP at market prices	5.0	1.6	3.6	4.1	2.5	3.9	4.3

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.

c. GDP measured in constant 2005 U.S. dollars.

d. Estimate.

e. Forecast.

Source: World Bank.

aimed at crimping price pressures, however, could also prompt a rise in capital inflows and complicate monetary policy—emphasizing the need for fiscal consolidation.

Persistently large budget deficits also pose important downside risks to growth, by crowding out private investment and contributing to excess demand. Fiscal slippage is contributing to inflationary pressures and limits policy options in the event of future crises through limited fiscal space. Regional deficit (and debt) problems will need to be resolved by simultaneous reforms on both revenues and expenditures along with reforms to support expansion of the private sector, including deepening financial markets. Efforts to reduce deficits are being hampered by South Asia's weak revenue collection and a small tax base, while large food-, fuel- and fertilizer subsidies are hindering progress toward cutting expenditures.

Key external downside risks are tied to uncertainty in the Middle East and North Africa. If political turmoil leads to sustained high oil prices, South Asia's oil import bill and price pressures could rise further, while a spreading of turmoil to GCC countries could undermine confidence and economic growth in the Middle East and North Africa, and result in sluggish or even falling remittances inflows. Already, recent political tensions have intensified efforts within the GCC to replace migrant workers with nationals, which if it were to spread, could curb remittances flows to South Asia.

Expansion of the sovereign-debt crisis in the Euro Area represents another important external downside risk, particularly if the crisis were to spread to larger Euro Area economies that would lead to weaker goods and services exports, worker transfer receipts and capital inflows for South Asia. The Euro Area represents about one-fourth of South Asia's merchandise export market, of which Germany and France account for 40 percent and 20 percent, respectively.⁵ A spreading of the Euro Area crisis could negatively impact the tourism sectors among the smaller South Asian economies, particularly in

the Maldives and Sri Lanka.

Notes:

1. The Reserve Bank of India's Inflation Expectations Survey of Households conducted in Q4-2010 (Round 22) shows households expect inflation to increase 130 basis points to 13.1 percent from the perceived current rate of 11.8 percent—compared with the expected 11.9 percent inflation rate from the Q2-2010 survey (Round 20), (1-year-ahead expected rates).
2. Nepal, Bangladesh, and Sri Lanka, were among the top 15 recipients of remittances in 2009—with inflows representing the equivalent of 23.8% of GDP in Nepal, 11.8% in Bangladesh, 8% in Sri Lanka, 5.4% in Pakistan and 3.6% in India.
3. Sources: India's Meteorological Department (April 2011 first monsoon forecast for 2011/12), and U.S. Department of Agriculture (May 2011).
4. Over two-thirds of South Asia's migrant workers are based in Saudi Arabia (3.3 million) and the U.A.E. (2.9 million).
5. "European Sovereign Debt Crisis: Links to the South Asia Region". December 2010. Francis Rowe, et al.