

How Should South Asia Deal with the Global Financial Crisis?

December 7, 2008

Table of Contents

How Should South Asia Deal with the Global Financial Crisis?¹

Executive Summary	i
1. Introduction.....	1
2. Growth Outlook - will the downturn be gradual and temporary or deep and prolonged?.....	2
3. External vulnerability--is the outlook for remittances resilient?	4
4. Macroeconomic Impact - is there room for counter-cyclical policies?	9
5. Impact on Corporate Sector and Financial Institutions.....	17
6. Impact on the Poor	19
7. How Can the World Bank Help?	24

¹ This note was prepared by Ejaz Ghani, Priya Basu, Vivek Suri, and Rabin Hattari. A section on infrastructure will be added soon. The views expressed here are those of the authors and Bank staff and do not reflect the official views of the World Bank. We are grateful for inputs and comments to Dilip Ratha, Caglar Ozden, Annette de Klein, Brian Pinto, Mansoor Rashid, and Pierella Paci; and to Ernesto May, Sadiq Ahmed, and Ahmad Ahsan for suggestions. Any errors are the responsibility of the authors.

How should South Asia deal with the Global Financial Crisis?

Executive Summary

- Just as South Asia was recovering from the impact of high global fuel and food prices, the region has been hit by the global financial crisis and the ensuing global economic downturn. The growth outlook of South Asia has come down significantly, and has been trended down.
- The slowdown in growth has started to reveal structural deficiencies in South Asia which were earlier hidden by rapid growth. This crisis is an opportunity to renew the emphasis on improved economic management, stronger institutions, better governance, and increased market integration and competitiveness.
- Lower global commodity prices and reduced inflationary pressures have created some room for counter-cyclical and accommodative monetary policies to thaw the tight credit markets and revive bank lending to firms and households. But the room for stimulus is limited. Pakistan and Sri Lanka need to sustain tight macro policies. The challenge ahead is to finely balance the needs for increased social and infrastructure spending without compromising medium term sustainability of macroeconomic policies.
- To strengthen preparedness for dealing with a more serious crisis, contingency plans need to be developed, particularly for dealing with individual bank failures. A framework for corporate debt restructuring should be carefully and quickly considered and adopted. Given that foreign financing is unlikely to be easily available for some time, structural reforms will be needed to enhance domestic financing, especially long term domestic financing.
- The economic downturn has started to adversely impact the poor. Like in past financial crises, the immediate impact is likely to be felt by the urban poor and migrant workers. It is too early to quantify the social impact of the crisis. High frequency data on labor markets and poverty are not available for South Asia. Nevertheless, South Asian countries need to invest in well targeted safety net systems (cash or conditional cash transfers or workfare, depending on country context). The absence of well functioning safety net systems in the region, makes it difficult to protect the poor against adverse impact of shocks, such as the recent crisis. Countries that have well targeted safety nets, such as in Latin America and Europe and Central Asia are best able to scale up their programs to protect those households affected by diverse aggregate shocks.
- The Bank could help Governments, in partnership with the IMF, to strengthen surveillance of macro-financial developments and appropriate fiscal, monetary and structural policy responses. The Bank could assist clients to deal with the impact of the financial crisis by working with central banks to strengthen preparedness for dealing with a more serious crisis, help develop and deepen domestic capital markets, and step up financing to implement already planned infrastructure investments. The Bank can also increase investments in pro-poor urban and rural infrastructure investments.

How Should South Asia Deal with the Global Financial Crisis?

1. Introduction

Just as South Asia was recovering from the impact of high global fuel and food prices, which led to a sharp deterioration in fiscal balances, increased inflationary pressures, and widening trade deficits, the region was hit by the global financial crisis and the ensuing global economic downturn. Contrary to the common perception that South Asia is relatively insular, the region's economies have been negatively impacted by the global crisis. The growth outlook of South Asia has been nearly halved from a peak GDP growth rate of 9 percent in 2006 to nearly 5 percent in 2009, and the growth forecasts are trended down.

The slowdown in growth has started to reveal structural deficiencies in South Asia which were earlier hidden by rapid growth. This crisis is an opportunity to renew the emphasis on improved economic management, stronger institutions, better governance, and increased market integration and competitiveness. Inflation has started to come down but it remains at high levels. The room for counter-cyclical macroeconomic policies is limited by the high levels of inflation, large public deficits, high public debt, and the continuing outflows of capital and widening trade deficits. However, lower global commodity prices should allow some room for counter-cyclical macroeconomic policies, though not in all countries.

Policy responses will need to be tailored to the specific country conditions. Lower global commodity prices and reduced inflationary pressures have also created room for accommodative monetary policies to thaw the tight credit markets and revive bank lending to firms and households. However, in Sri Lanka and Pakistan, given large initial imbalances, the room for stimulus is limited. Indeed, there is a need for further macroeconomic tightening.

The economic downturn has started to adversely impact the poor, as jobs are lost, and wage rates decline. Like in past financial crises, for example, the East Asian crisis of 1997-98, the immediate impact is likely to be felt by the urban poor and migrant workers. If the downturn is prolonged, it will reduce the pace of new job creation, preventing the region to benefit from demographic dividend, and millions of new workers who will join the labor force will be unemployed. This has the potential to create friction and instability in the region.

The challenge ahead is to finely balance the needs for increased social and infrastructure spending without compromising the medium term sustainability of macroeconomic policies. Improving economic efficiency and stability will set the basis for sustainable growth while protecting vulnerable population groups. The weeks and months ahead will be trying times for economic policymakers everywhere, as they try to contain the fallout

of the crisis on growth and employment. Raising trade barriers will be a temptation (as was the case in South Asia during the food crisis), especially when currencies fluctuate so much. But the experience with the Great Depression teaches us that beggar-thy-neighbor policies do not work. Trade protection will add fuel to fire and magnify the costs of the crisis and risks of contagion. The most serious challenge is to ensure that the financial and economic crisis does not lead to a vicious cycle of protectionism, globally or regionally, exacerbating the economic downturn. Experience with past financial crises has also shown that countries with more flexible exchange rates have done better. The current crisis also strengthens the case for greater market integration.

The rest of the note addresses the following questions:

- How has the growth outlook of South Asia changed?
- How will the external vulnerability of the region be impacted by the global financial crisis?
- Is there room for counter-cyclical macroeconomic policies to deal with increased downside risks to growth?
- How will the financial and corporate sectors be impacted?
- What will be the impact on the poor?
- How can World Bank support South Asia to deal with the global crisis?

2. Growth Outlook - will the downturn be gradual and temporary or deep and prolonged?

This global financial crisis is different from past financial crises. The causes of this crisis can be traced to incomplete and fragmented finance sector regulation, poor risk management, global imbalances, high levels of liquidity, low interest rates, and poor incentives combined with incomplete and asymmetric information and lack of transparency in the financial sector. The crisis has clogged global credit markets and payments systems, and has resulted in substantial re-pricing of risks and de-leveraging of financial institutions. Both developed and developing countries have been hit hard by tight credit conditions--high LIBOR rates, high credit default swap rates, and poor access to credit by firms and households.

The severe tightening of credit markets in South Asia and the high costs of capital faced by firms have dramatically slowed down private investments. Fixed investments in South Asia which grew by more than 16 percent in 2006 are expected to fall to less than 5 percent in 2009. High frequency data show that monthly industrial production growth has turned negative for Pakistan and is close to zero for India (see Figure 1). The surplus on the capital account has shrunk dramatically with South Asia suffering a “sudden stop”. The tightening of credit markets can be seen in portfolio outflows, decline in external commercial borrowing, and an increase in spreads².

² In India, spreads for dollar loans for Indian banks had widened from 30 bps above LIBOR last year to 150 bps for one year money, and to at least 250 bps from 50 bps last year for three-year Certificates of

The growth outlook for South Asia is highly uncertain, because of the sustained degree of volatility and synchronized nature of the slowdown across countries—and because the full extent of financial disruption on both regional and global economies remains unclear (see Table 1). Nevertheless, our revised projections indicate a significant slowdown of growth rates in India, Nepal, Pakistan and Sri Lanka (see Table 2).

Continued financial sector volatility and balance sheet weaknesses are translating into risk aversion on the part of banks and investors. Weakening foreign demand is expected to lead to a significant slowing in regional export growth, including services. Recession in developed countries (USA, Europe and Japan) is projected to lower the growth in South Asia's exports of goods and non-factor services from 17 percent in 2006 to less than 4 percent in 2009. In Sri Lanka, the tea, rubber and garment industries may suffer heavily from the current slowdown. In India, the information technology and communications sector is considered vulnerable to shifts in financial sector activity, and clothing and tourism revenues are vulnerable to shifts in discretionary spending. Recession in high-income countries and a slowdown in growth among the Gulf oil exporters are expected to depress remittances inflows.

Table 1: South Asia forecast summary

(annual percent change unless indicated otherwise)

	91-00 ¹	2005	2006	Est.	Forecast		
				2007	2008	2009	2010
GDP at market prices (2000 USD) ²	5.2	8.7	9.0	8.4	6.3	5.4	7.2
GDP per capita (units in USD)	3.1	6.9	7.2	6.9	4.8	4.0	5.8
PPP GDP ³	6.3	8.7	9.0	8.4	6.3	5.4	7.2
Private consumption	3.9	7.0	6.0	7.5	5.7	4.7	5.7
Public consumption	4.7	8.8	10.0	4.9	8.8	9.2	6.7
Fixed investment	5.5	14.6	16.5	13.5	7.1	4.8	10.7
Exports, GNFS ⁴	10.6	7.0	17.3	7.3	4.3	3.7	8.3
Imports, GNFS ⁴	9.8	12.9	21.9	7.0	6.5	2.7	7.8
Net exports, contribution to growth	-0.1	-1.0	-0.8	0.0	-0.5	0.2	0.0
Current account bal/GDP (%)	-1.6	-1.2	-1.5	-1.6	-3.5	-2.0	-1.9
GDP deflator (median, LCU)	8.2	6.5	9.2	8.4	9.7	8.0	6.0
Fiscal balance/GDP (%)	-7.7	-5.9	-6.1	-6.4	-8.1	-8.6	-8.0
Memo items: GDP							
South Asia excluding India	4.4	6.7	6.4	6.1	6.1	4.0	5.2
India	5.5	9.2	9.7	9.0	6.3	5.8	7.7
Pakistan	3.9	7.7	6.2	6.0	6.0	3.0	4.5
Bangladesh	4.8	6.0	6.6	6.4	6.2	5.7	6.2

Notes: 1. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.

2. GDP measured in constant 2000 U.S. dollars. 3. GDP measured at PPP exchange rates.

4. Exports and imports of goods and non-factor services.

5. To simplify presentation across countries and with other regions, annual national income and product account data for South Asia are reported in calendar years, although official country data are originally reported by fiscal year for Bangladesh, India, Pakistan and Nepal.

Source: World Bank

Deposits, despite RBI's monetary relaxation. The JP Morgan EMBIG spreads for both Sri Lanka and Pakistani sovereign bonds have widened to around 2000 basis points.

Table 2--South Asia Country forecasts

(annual percent change unless indicated otherwise)

	91-00 ¹	2005	2006	Est. 2007	Forecast		
					2008	2009	2010
Bangladesh							
GDP at market prices (2000 USD) ²	4.8	6.0	6.6	6.4	6.2	5.7	6.2
Current account bal/GDP (%)	-0.4	-0.3	2.0	1.2	0.8	0.7	0.7
India							
GDP at market prices (2000 USD) ²	5.5	9.2	9.7	9.0	6.3	5.8	7.7
Current account bal/GDP (%)	-1.2	-1.0	-1.0	-1.2	-3.1	-1.7	-1.9
Nepal							
GDP at market prices (2000 USD) ²	5.0	3.1	3.7	2.6	5.5	3.8	4.9
Current account bal/GDP (%)	-6.3	0.0	-0.1	-1.2	1.2	1.0	0.8
Pakistan							
GDP at market prices (2000 USD) ²	3.9	7.7	6.2	6.0	6.0	3.0	4.5
Current account bal/GDP (%)	-3.7	-3.3	-5.4	-5.8	-8.1	-4.6	-3.2
Sri Lanka							
GDP at market prices (2000 USD) ²	5.2	6.0	7.7	6.8	6.3	4.0	5.5
Current account bal/GDP (%)	-4.6	-3.2	-5.3	-4.4	-7.5	-5.7	-5.5

Notes: 1. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.

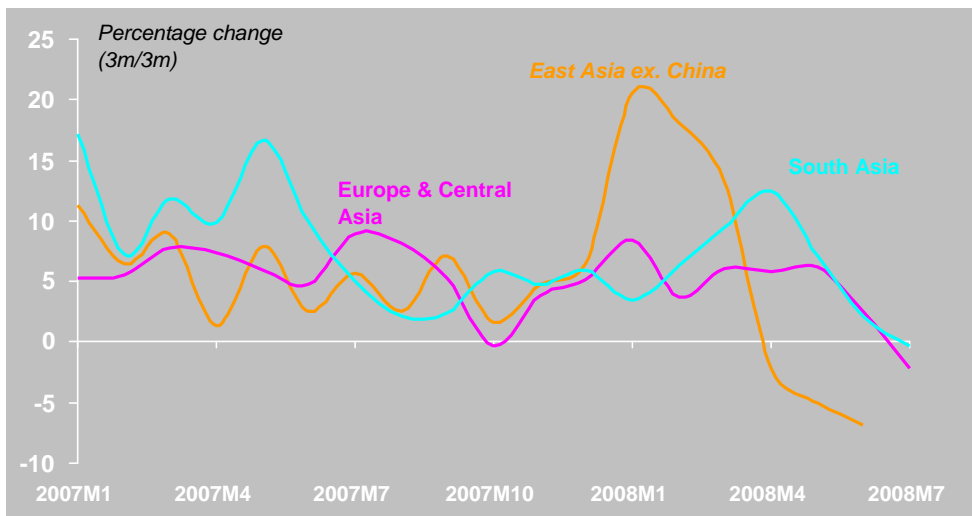
2. GDP measured in constant 2000 U.S. dollars.

3. Growth and Current Account figures presented here are World Bank projections and may differ from targets contained in other Bank documents.

4. Afghanistan, Bhutan, Maldives are not forecast owing to data limitations.

Source: World Bank

Figure 1: Annual Growth of Industrial Production



Source: DEC Prospects Group.

3. External vulnerability--is the outlook for remittances resilient?

Large remittance inflows have been a key factor offsetting large trade gaps and sustaining the stability of current account balance in countries like Bangladesh and Nepal (in 2007 remittance inflows in Nepal were equivalent to 18 percent of GDP and 9 percent for Bangladesh). The total remittance flows into India increased to US\$36 billion in 2007

from US \$13 billion in 1997. In the case of South Asia, external remittance inflows dwarf the other private capital inflows, except in 2008 when private portfolios surged (see Figure 2). The global downturn has, however, raised the question—how resilient is external remittance?

Figure 2: Remittance Inflows Dwarf Private Capital Inflows

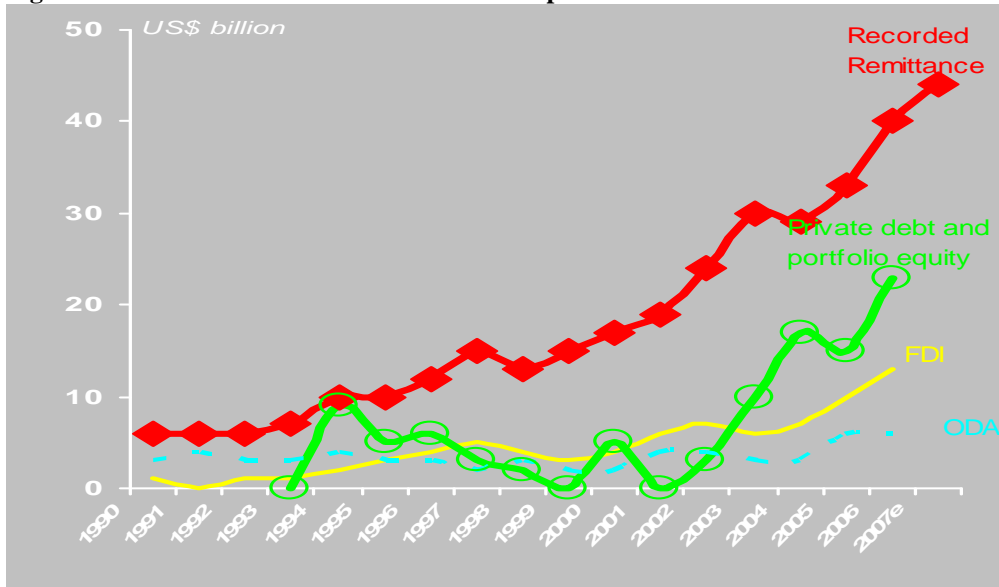
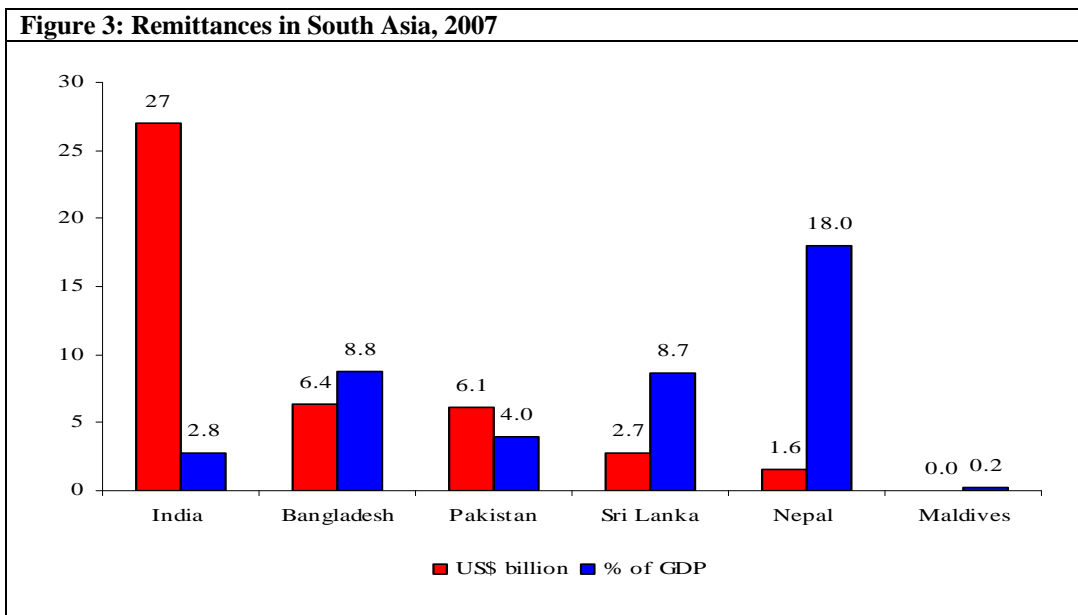


Figure 3: Remittances in South Asia, 2007



After several years of strong growth, remittance flows have begun to slow down, starting with the third quarter of 2008. This slowdown is expected to deepen further in 2009 in response to the global financial crisis, although the exact magnitude of the growth moderation (or outright decline in some cases) is hard to predict given the uncertainties

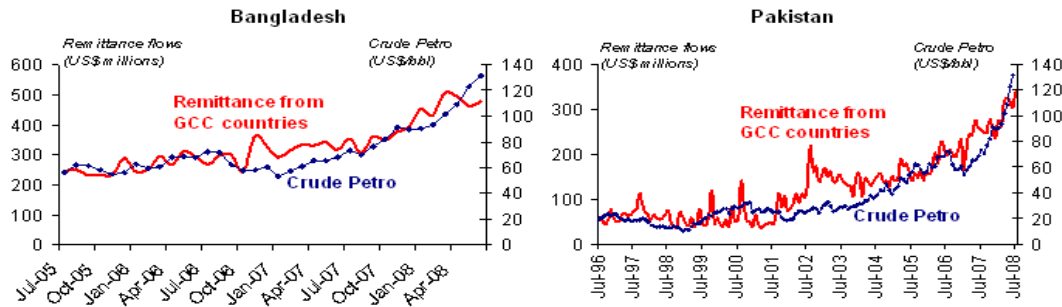
about global growth, commodity prices, and exchange rates. In nominal dollar terms, officially recorded remittance flows to South Asia are estimated to reach \$50.9 billion in 2008, up 16.2 percent from \$43.9 billion in 2007 (see Table 3). Bangladesh and Nepal have reported a surge – over 40 percent year-on-year growth year-to-date – in remittance inflows especially from the GCC countries. Pakistan and India have also reported robust growth in remittance flows from the GCC countries in 2008. But going forward, remittances into the region, in nominal dollar terms, are expected to remain flat or even decline somewhat in 2009. Migration flows from the region may slow as a result of the global growth slowdown, but the stock of international migrants is unlikely to decrease. In the unlikely event that new migration flows stop altogether, and recent migrants have to return as they lose employment in the destination countries, remittance flows to the region are expected to fall by 6.8 percent to \$48 billion in 2009.

	Volume (US\$ billion)				Growth rate (%)			Share in GDP(%)			
	2007	2008e	2009f	2010f	2007-08	2008-09	2009-10	2007	2008e	2009f	2010f
South Asia Region	43.8	50.9	50.9	55.1	16.2%	-0.1%	8.2%	3.1%	3.7%	3.4%	3.1%
Afghanistan	..	..	..	..	..	..	..	..	..	..	..
Bangladesh	6.6	8.9	9.1	10.1	35.5%	2.2%	11.0%	9.5%	11.4%	10.1%	9.9%
Bhutan	..	..	..	..	..	..	..	..	..	..	..
India	27	30	29.8	32	11.1%	-0.5%	7.3%	2.4%	2.7%	2.5%	2.3%
Maldives	0	0	0	0	3.1%	-1.1%	6.9%	..	..	..	..
Nepal	1.7	2.3	2.4	2.7	30.0%	6.0%	12.2%	15.5%	17.5%	18.4%	16.6%
Pakistan	6	7.1	7	7.6	17.9%	-1.4%	8.3%	4.2%	4.9%	4.6%	4.1%
Sri Lanka	2.5	2.7	2.6	2.7	7.7%	-4.6%	5.0%	8.1%	6.5%	5.1%	4.7%
Developing countries	265	283	280	297	6.7%	-0.9%	6.1%	2.0%	1.8%	1.6%	1.5%

Remittance flows from the Gulf Cooperation Council (GCC) countries are likely to fall more than those from the US and Europe. Remittance flows from oil-rich (GCC) countries accounted for 63 percent and 52 percent, respectively, of the remittance flows to Bangladesh and Pakistan. A continuation of the recent decline in oil prices, which have fallen nearly 60 percent from the peak, would make the GCC economies more vulnerable. Combined with the impact of the financial crisis on the banking sector of these countries, this could potentially lead to a significant deceleration in construction activities in which a large number of migrants have been employed in recent years.

This decline in the growth of remittance flows, however, will be smaller than the fall in overall private capital flows. Remittances are expected to remain resilient relative to many other categories of resource flows to developing countries. A key risk is that a serious worsening of the economic environment could result in protectionist pressures in developed countries and restrictions on foreign workers and visas. While the risks are still small, they should not be dismissed. Some countries in the region will show more vulnerability to oil price declines. For example, recent data indicate that remittance from GCC countries to Bangladesh and Pakistan are more correlated with oil prices (see Figure 4).

Figure 4: Remittance Flows from the GCC countries vs. Global Oil Price

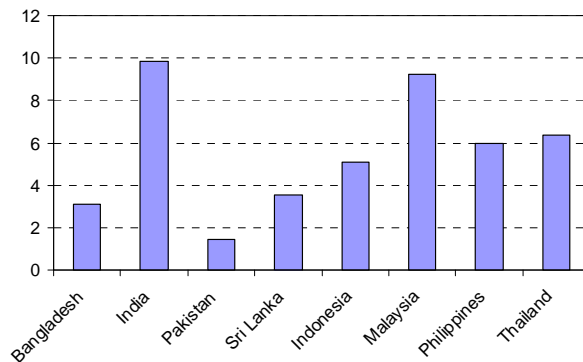


Source: Bangladesh Bank, State Bank of Pakistan, and World Bank DECPG.

Foreign reserves, capital flows and exchange rates

Whereas India holds sizable foreign exchange reserves (despite significant recent draw-downs) to help weather more negative-than expected growth dynamics, other countries in the region have seen widening trade deficits and capital outflows which have reduced their reserve holdings, increasing their vulnerability to sustained pressure on currencies (see Figure 5). Countries holding substantial short-term debt obligations would be more vulnerable. In the Maldives, the rapid buildup of debt obligations with the construction boom following the tsunami is of concern.

Figure 5: Forex Reserves (in months of imports)



Sri Lanka has a large public debt burden (equivalent to 83 percent of GDP in 2007), with 44 percent of the debt external, albeit primarily concessional; the country’s fiscal position is thus vulnerable to higher interest rates and exchange rate depreciation. Bhutan also holds significant external debt obligations, but these are held primarily by India for the development of hydroelectric power, which Bhutan is in turn exporting to India. Should a deeper crisis lead to a falloff in foreign assistance, countries significantly reliant on aid (such as Afghanistan) would be more adversely affected

The initial effects of the global financial crisis in South Asia were sharp declines in equity markets. By mid-November, stock prices in India, Pakistan, and Sri Lanka dropped 57 percent, 31 percent, and 33 percent, respectively, since the beginning of the calendar year (see Figure 6).

Equity sell-offs and ‘flight-to-quality’ especially by foreign investors looking to transfer funds home led to heavy capital outflows which contributed to significant pressure on exchange rates. Local currencies in India, Pakistan and Nepal fell by 27 percent, 28

percent, and 15 percent respectively against the dollar, over the year through mid-November. Over the same period, the Sri Lankan rupee largely held steady, as it has been effectively pegged to the U.S. dollar (see Figure 7).

Figure 6: Equity Market Indices Year-to-Date

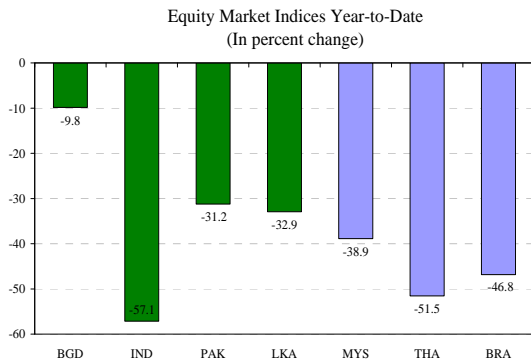
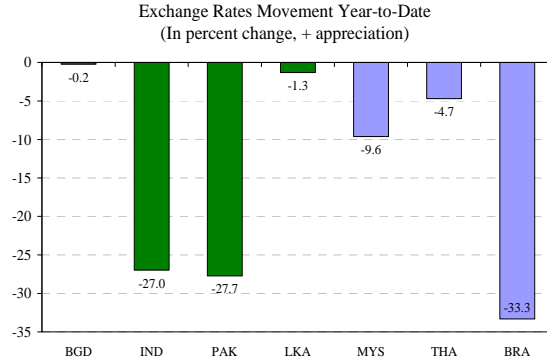


Figure 7: Exchange Rates Movement Year-to-Date



Net portfolio flows which were robust in 2007 turned sharply negative during 2008. *In India*, where portfolio inflows surged to 3 percent of GDP in 2007, *outflows* are likely to exceed 1 percent of GDP in 2008. On the monthly basis, the average of *net outflows* reached Rs. 6 billion in October 2008 (see Figure 8). Foreign holding of stocks of the top 500 listed companies has declined from about 17 percent a year ago to around 13.8 percent. Foreign exchange reserves have fallen to \$251 billion as of November 7 compared with \$314 billion in May 2008. The sharp decline (of more than \$30 billion) in October alone also reflects intervention in the foreign exchange market by the Reserve Bank of India to defend the rupee (see Figure 9) as well as the impact of currency revaluations (because of dollar appreciation).

Figure 8: Net Foreign Institutional Investment Flows

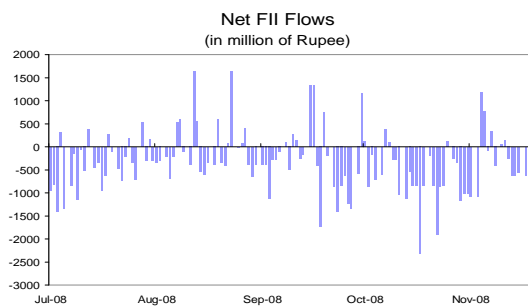
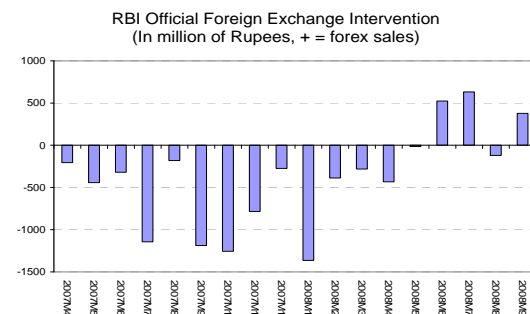


Figure 9: Official Foreign Exchange Intervention



Faltering investor confidence led to higher international bond spreads, with those for Pakistan and Sri Lanka spiking to prohibitive levels of around 2000 basis points in September and October. Sri Lanka had debuted in the international market with a 5-year bond issuance of \$500 million in October 2007 with a yield of 8.25 percent.

Net portfolio inflows to *Pakistan* collapsed from \$3.3 billion in FY2007 to an estimated \$36 million in FY2008. During Jul-Oct, FY2009, net total capital inflows to Pakistan slowed to \$1.1 billion compared with \$3.1 billion in the corresponding period of FY08. State Bank of Pakistan's foreign exchange reserves have depleted by \$5.0 billion in this period, with a cumulative depletion of \$10.7 billion as of November 10, 2008 since end October 2007 when reserves were at their peak of \$14.3 billion.

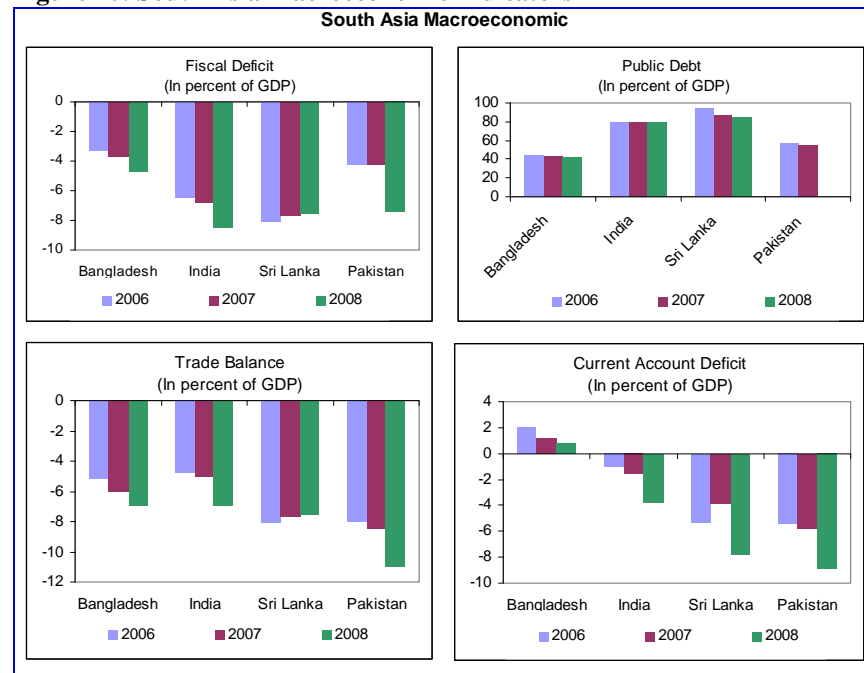
In *Sri Lanka*, capital inflows in the first six to eight months of 2008 had been robust, as FDI, net portfolio inflows as well as government borrowing increased. Financial flows to the government increased substantially during the first eight months of 2008 mainly due to the disbursement of foreign loans by bilateral and multilateral development partners and foreign investment in treasury bills and bonds. The treasury bill market was opened for foreign investors in May 2008, with holding limited to 10 per cent of the value of outstanding bills.

4. Macroeconomic Impact - is there room for counter-cyclical policies?

The food and oil price increase has left most countries in South Asia with widening twin

deficits-- large budget deficits and increasing trade deficits (see Figure 10). The impact of the global financial crisis is now increasingly being felt in squeezed domestic economic activity, through shrinking external demand and tightening of domestic credit markets

Figure 10: South Asia Macroeconomic Indicators



and a growing risk aversion of financiers. Downside risks to growth is taking a front seat and concerns about inflation is taking a back seat. With oil prices declining countries are experiencing 'savings' relative to expenditures anticipated in mid-2008. Against this backdrop, questions about the role of counter cyclical macroeconomic policies to boost aggregate demand and prevent a sharp decline in economic growth have been raised.

Box: Fiscal Stimulus: Timely, Targeted, and Temporary

According to one view¹, to be effective, a fiscal stimulus program for countering an economic downturn needs to fulfill the 3-Ts criteria, i.e., it needs to be timely, targeted, and temporary. In case of many developing countries, where governance problems hound public spending, a fourth 'T' for transparent, could be added.

A recent IMF study shows that on average, for all economies, a discretionary stimulus package equivalent to 1 percent of country's GDP is associated with GDP increases of about 0.1 to 0.2 percent. The challenge for policy makers is to ensure that the fiscal policy measures constituting the stimulus — an increase in discretionary spending or reduction in taxes — are delivered quickly and that they do not cause concerns about future debt sustainability. Tax cuts or spending increases that make debt unsustainable are likely to cause output to fall, not rise.

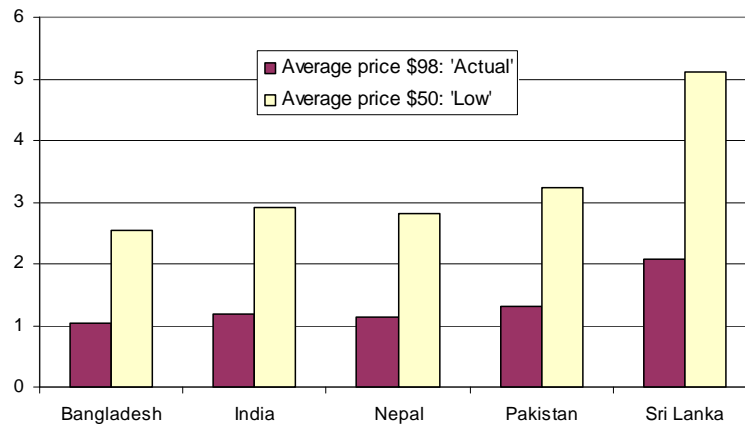
An additional issue is that while in advanced economies, discretionary fiscal policy has typically been countercyclical—that is, taxes have been cut and spending increased during downturns, in emerging economies, it has been procyclical. In other words, a stimulus has been added during good times and removed during downturns. Governments may thus have missed the opportunity to strengthen their fiscal position during good times, which would have enhanced their capacity to counter downturns. Not only do government's need to ensure that they improve fiscal positions during good times but they need to credibly commit that stimulus packages introduced during downturns are temporary. Fiscal sops introduced to encourage economic activity during a slump should be phased out as the upturn begins. If fiscal measures often become permanent, public debt creeps upward.

Additional spending or tax reduction measures need to be targeted to programs, populations or sectors where they are likely to have their maximum impact on output, and employment. These sectors or programs are likely to vary among countries. Typical areas include expansion of safety net programs, tax incentives for businesses or households, or infrastructure projects. Often due to poor governance, public spending does not reach the desired beneficiaries. Such leakage or waste needs to be especially guarded against during a downturn.

In practice, discretionary fiscal measures are typically slower to arrive than monetary policy responses, which entail changes in interest rates or exchange rate targets. Implementation of fiscal measures may take time because of political negotiation and the administrative process of providing extra government funds or tax relief to households and firms. Monetary policy is thus sometimes considered a more effective counter-cyclical instrument than fiscal policy because interest rate changes can be swiftly introduced and reversed. However, fiscal policy can have a quicker impact on actual spending whereas the impact of interest rate changes on aggregate demand is subject to long and sometimes uncertain lags. Fiscal policy also has the ability to impact on income-sensitive (in addition to interest-sensitive) components of aggregate demand. But timeliness is key: waiting too long may imply that the stimulus arrives when the upturn may already be underway.

1. Attributed to Larry Summers. Others such as John Taylor recommend that a fiscal stimulus be pervasive, permanent, and predictable. This box draws upon the IMF's *World Economic Outlook*, October 2008.

Figure : BoP ‘savings’ from falling oil prices (in % of 2008 GDP)¹



1. Represents the reduction in trade balance relative to an average oil price of \$125 bbl in 2008. The ‘actual’ average price in 2008 is estimated to be around \$98.

Is there room for countercyclical fiscal policy?

In general, the high twin deficits and elevated levels of public debt limit the extent of countercyclical fiscal and monetary policies.

In *India*, the decline international commodity prices, slowing domestic inflation, and weaker growth prospects provide a modest case for expansionary fiscal policy, in concert with a loosening of monetary policy. With international oil prices declining sharply, and with downward adjustments to domestic prices being partial, the oil subsidy bill will be significantly lower than anticipated. In May, when oil prices were \$130 per barrel, subsidies on oil and fertilizers were expected to be of the order of 4 percent of GDP. Under current price trends this estimate may well be halved. These ‘savings’ would provide room for a well targeted stimulus program. On the revenue side, in the last three years, direct taxes on corporates and individuals have been the main drivers, buoyed by rapid economic growth. While recent government reports show revenues from this source on target, with growth slowing, these are likely to come under pressure. Fiscal and monetary loosening will be constrained by the ongoing foreign capital outflows and a high trade deficit. In addition substantial fiscal loosening is already present, for instance, in the form of higher civil service wages and the loan write-offs for farmers.

In December the government of India announced a fiscal stimulus package of Rs. 300 billion or around 0.6 percent of GDP. Recent economic events that provided the backdrop of this package include:

- While one month does not make a trend, for the first time in five years, India’s export growth turned negative in October 2008 contracting by 12 percent y-o-y
- Industrial production slowed to a seasonally adjusted 1.4 percent in August 2008 compared with 11 percent in the same month a year ago. GDP growth slowed to 7.6 percent in the first half of FY09 from over 9 percent in the previous year.

- Growth in the six core infrastructure industries dropped to 3.9 percent in the first half of FY09 compared with the previous year's level of 6.9 percent.
- Meanwhile, inflation pressures abated, as the WPI eased to a single-digit 5-month low of 8.4 percent in mid-November.

The slowdown in infrastructure reflects supply side factors which could be alleviated through government funds to expedite projects which were languishing as inflows from private and foreign sources started to dry up. Under the stimulus package, to ensure that infrastructure projects are not starved of funds, the government has allowed the India Infrastructure Finance Company to raise Rs 100 billion through tax-free bonds, giving it a larger pool of funds to refinance long-term bank loans to the sector, particularly highways and ports. The power sector has been allowed duty-free import of naphtha.

Central excise duty has been cut across-the-board by 4 percent, barring petroleum products. The three major rate slabs of central excise duty, of 14 percent, 12 percent and 8 percent, will now stand at 10 percent, 8 percent and 4 percent. To the extent that the reduction is passed on to the consumers, this move could provide a boost to sectors such as automobiles, consumer durables and cement that are most affected by the economic slowdown.

Exporters will be provided a 2 percent interest rate subvention up to March 31, 2009 in pre-and post-shipment credit for labor-intensive exports subject to minimum rate of interest of 7 per cent a year. Additional funds will also be allocated for export incentive and guarantee schemes.

Partial sales of state owned enterprises could be contemplated to create one-off fiscal space, but the government will get fair value for its holdings only if it can also enact a credible set of reforms that minimize future interference. Measures to shrink wasteful subsidies could also be contemplated, but the political calendar does not look promising.

In Pakistan, there is no room for a counter cyclical response. To the contrary, the need is for fiscal stabilization, which is a key element in the \$7.6 billion IMF program. Low pass through of global commodity price hikes combined with a persistent rise in aggregate demand pressures resulted in rising fiscal and external account deficits during FY08 beyond sustainable levels. The large fiscal deficit was financed in growing measure through inflationary borrowing from the central bank. The government's aim is to bring down the fiscal deficit from 7.4 percent of GDP in FY08 to 4.2 percent in FY09, and to put a halt to its borrowing from the central bank. While by now the government has virtually eliminated oil subsidies, the savings on this count will mainly aid fiscal consolidation rather than allow room for a fiscal stimulus.

Unlike Indian and Pakistan, ***Sri Lanka*** had passed on the international oil price increase to domestic consumers, though a subsidy was retained on fertilizers. The overall budget deficit in 2008 is expected to be around 7.0 per cent of GDP. Though lower than the 7.7 per cent recorded in 2007, it is still high especially against the backdrop of a high public debt level. Moreover, the reduction is mainly due to lower capital expenditure which in

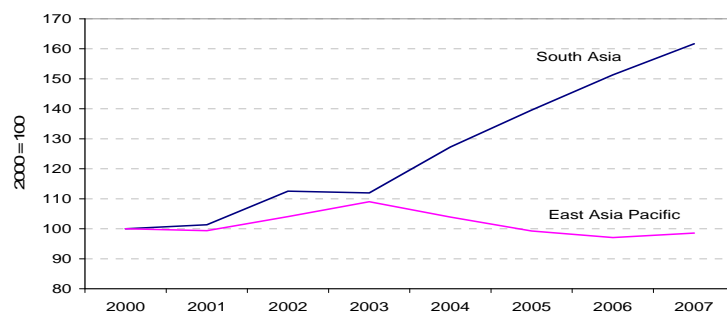
turn stems from procurement delays, complex and time consuming administrative procedures, and delays in acquisition of land.

Credit crunch and measures to ease liquidity

Since 2000, South Asia has experienced one of the fastest rates of credit growth in the world (see Figure 11). South Asia, and India in particular was a beneficiary of a "virtuous cycle" of large capital inflows, low interest rates, and high investments and it experienced a credit growth of more than 40 percent in the last two years, one of the highest in emerging markets. This virtuous cycle is now broken by the global financial crisis, the loss in global appetite for risk, and large macro imbalances.

With the unfolding global financial crisis, domestic credit markets have tightened considerably. Cost of funds for banks has risen and they are becoming increasingly risk averse in their credit decisions. As a result, throughout the region, even established corporate sector

Figure 11: Domestic Credit: South Asia and east Asia



players are finding it hard to access financing on either domestic or international markets.

One reason for the liquidity squeeze in India is that the private sector's funding from foreign sources, external commercial borrowing, has dried-up. A combination of capital outflows and falling share prices has also made it very difficult to raise funds through domestic bonds and equity issuance. By one estimate, in 2007-08 nearly 40 percent of funds available to Indian industry were raised through external commercial borrowings and new equity issues. To make up for this shortfall there has been a sharp increase in the demand for credit from domestic banks. This phenomenon also helps explain the apparent paradox of higher credit growth in the month of October, coupled with complaints of a liquidity squeeze. Banks also appear apprehensive that liquidity can tighten again in the next six to 12 months due to potential ECB repayments which are unlikely to be rolled over in the international markets and hence will be a demand on domestic liquidity.

In the coming months, a credit crunch induced by asset price deflation is likely to be a key factor constraining private sector investment. Typically, during the boom phase firms finance their investments by increasing leverage. In India, for instance, debt-equity ratio for non-financial listed companies increased from 50 percent in 2003 to nearly 80 percent in 2007. Three large real estate companies have net gearing ratios ranging from 1.25 to 1.8. Prices of assets used as collateral for obtaining credit rise rapidly during the upswing which provides banks a sense of security and encouragement to lend. Banks are also comforted by strengthening cash flows in firms, and expectations of higher firm profits,

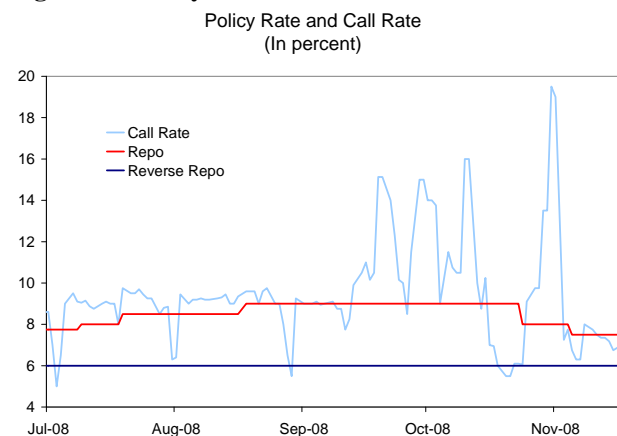
typically reflected in rapidly rising equity market valuations. Healthier balance sheets and lower perceived risk lower borrowing costs which feeds back into more corporate borrowing and investment. As credit booms lending standards in banks are often compromised.

But asset prices have now begun to deflate in the downturn. Also, earnings expectations formed during the upswing now turn out to be unrealistic and firms are unable to meet loan payments. Bank balance sheets begin to deteriorate as non performing loans build up. Dwindling asset prices not only make banks reluctant to lend, they may in fact be forced to sell collateral at distressed prices, thereby further depressing asset prices. This is especially the case for banks that built up a large exposure to the real estate sector. In India, several of the new private sector banks rapidly increased their exposure to the real estate sector in recent years. In FY07, 32 percent of their loans were to the real estate market, including direct and indirect exposures. With the threat of credit losses and capital erosion now looming, banks become excessively risk averse and even stronger firms in all sectors find it hard to obtain credit, and forced to cut investment. While financial systems across the world are turning to governments for additional risk capital, the Pakistani, Sri Lankan and Indian governments have little room to accommodate these needs because of large fiscal deficits. Given that investment had been a major contributor to GDP growth in the last few years, 50 percent in the last 5 years in India, economic activity is likely to face a large negative shock through this route.

Measures to ease domestic liquidity

In India, monetary tightening, earlier in the year, in response to commodity price shocks and rising domestic inflation, has given way to loosening. The Reserve Bank of India (RBI) has injected huge additional liquidity to ease the tightness in the domestic money and credit markets. Sharp peaks in the call money market, well above RBI's policy repo rate (see Figure 12) provide an indication of the liquidity crunch.

Figure 12: Policy Rate and Call Rate



To ease liquidity, during October-November, the RBI lowered the repo rate by 150 bp to 7.5 percent, reduced cash reserve ratio by 350 bp to 5.5 percent, and also cut the amount banks are required to invest in government bonds (Statutory Liquidity Ratio) to 24 percent from 25 percent. As Figure 12 shows there was some success. The overnight money market rate remained within the informal corridor set by the repo/reverse repo rates (6.0 per cent to 7.5 per cent) since early November. The weighted average call money rate declined from a recent high of 19.7 per cent to 6.1 per cent on December 5. The top five public sector banks have reduced their benchmark prime lending rates

(BPLR) from 13.75 – 14 per cent as on October 1 to 13 – 13.5 per cent. But given that bank lending remained sluggish, a further cut in the repo rate to 6.5 percent and in the reverse repo rate to 5 percent was announced on December 5.

RBI has also employed counter-cyclical prudential measures. The general provisioning requirement on all types of standard assets has been reduced to a uniform level of 0.40 percent (for agricultural and SME sectors provisioning will remain at 0.25 percent). Earlier, during the economic upswing, provisioning against standard assets had been raised to 1-2 percent depending on the type of asset. In addition risk-weights on banks' exposures to certain sectors, which had been increased during the economic upswing, have been brought down. The risk-weighting on loans to commercial real estate has been reduced to 100 percent versus 150 percent earlier.

Given its vulnerability during a downturn, the real estate sector has been given special attention in RBI's most recent policy announcements on December 5. Banks have been allowed to treat restructured loans extended to companies in this sector as a "standard account", instead of making higher provisions by classifying them as non-performing assets. A Rs. 40 billion refinance window for National Housing Bank has been proposed. In addition, advances from banks that are used by Housing Finance Companies to offer home loans of up to Rs. 2 million to individuals will be allowed dispensation as a priority sector, which will help reduce borrowing costs and clear unsold properties. To enhance credit delivery to the employment-intensive micro and small enterprises (MSE) sector, refinance of an amount of Rs. 70 billion was granted to the Small Industries Development Bank of India (SIDBI).

In *Pakistan*, on the other hand, the central bank has been in tightening mode in a bid to reduce aggregate demand pressures, control inflation, curtail the trade deficit, stem the outflow of reserves, and build foreign investor confidence. In its most recent move, it raised its key interest rate from 13 percent to 15 percent on November 11. SBP has also increased the CRR and statutory liquidity requirement, imposed a minimum interest rate on savings deposits, increased letter of credit margins on most imports, tightened controls on exchange companies, and re-imposed limits on some advance payments. Higher interest rates are beginning to have a devastating impact on corporate sector performance. State Bank of Pakistan (SBP) has recently warned banks against any further increases in lending rates (SBP wants banks to freeze the KIBOR at 15.75 percent and not raise it any further).

But at the same time SBP has taken measures aimed at accommodating exceptional liquidity requirements of the banking system, which do not constitute a change in the SBP's otherwise tight monetary policy stance. Under the Export Finance Scheme (EFS), SBP has provided liquidity through lowering of reserve ratios as well as 100 percent refinancing to banks to meet the working capital financing requirements of exporters. Furthermore, 100 percent finance will also be provided under Part II of EFS and Long-Term Financing Facility (LTFF) to promote real investment in the country.

In *Sri Lanka*, a combination of monetary restraint to curb inflation and inflationary expectations earlier in the year, and more recently the growing risk aversion of banks, has resulted in a decline in the growth of bank loans and advances from 15.8 percent y-o-y (Sept 2007) to 3.9 percent (Sept 2008), with bulk of the slow down coming in the consumer lending and housing sectors. In October 2008 the central bank implemented measures to avoid liquidity constraints in the market. The Statutory Reserve Requirement (SRR) on all Rupee deposit liabilities of commercial banks was reduced by 75 basis points to 9.25 per cent from 10 percent. Also, the limit on the access of commercial banks and primary dealers to the Reverse repurchase facility of the Central Bank at the Reverse repurchase rate when the market liquidity is short was enhanced from 3 times per calendar month to 6 times and further to 10 times in October 2008.

It is important that apart from undertaking the actions that are needed to resolve immediate liquidity pressures, governments in South Asia undertake bold and ambitious reform programs to keep growth going. Indeed, the shadow of a crisis in India may offer the necessary impetus, much as it did in 1990-91; in Pakistan, the IMF-standby facility should help. However, the room for using credit policies to support growth will differ from country to country. While the scope is high in some countries, it is limited for Pakistan and Sri Lanka, given high levels of initial macroeconomic imbalances.

Recent measures to ease foreign exchange pressure in India

Reduced access to international capital is weighing in on fixed investments, and further lowering growth prospects. Policy makers are trying to reverse this trend through the following measures:

Limit on External Commercial Borrowings (ECBs) for infrastructure companies were raised from US\$100m to US\$500m. Given widening credit spreads, the Reserve Bank of India raised the interest ceiling by 100bps from Libor + 350 to Libor + 450 bps to enable companies access overseas markets. These policy changes are aimed at sustaining high investment rates but they may not work if financial crisis deepens.

With worsening global financial conditions, banks abruptly reduced even the most basic banking services, including trade credits and guarantees, thereby threatening international trade transaction. India has an outstanding trade finance of an estimated \$43.7bn. To ease exporters' concerns, RBI doubled the funds it makes available for banks to refinance export credit at favorable interest rates to \$4.5bn; and also extended the export credit repayment window for exporters to 9 months from 6 months.

To encourage inflows from non-resident Indians, the interest rate ceiling on certain types of foreign currency non-resident deposits of all maturities has been increased to 100bp over Libor/swap rates from 25bp earlier.

Indian companies have been allowed to prematurely buy back their Foreign Currency Convertible Bonds (FCCBs). FCCBs issued by Indian corporate are currently trading at a deep discount in the global markets. In some cases it is thus possible that buying them

back is actually a lower cost option than paying the principal and interest when the bonds fall due. Given that current share prices are significantly lower than the conversion price noted in the FCCB, there is no incentive to convert the debt into equity. Firms which could potentially gain include heavyweights like Reliance Infrastructure, L&T, Tata Tele, Wockhardt, Ashok Leyland, Tata Motors and Zee as they have maturities falling due in 2009.

5. Impact on Corporate Sector and Financial Institutions

Impact of the Crisis on Corporations

There are now fears of widespread corporate defaults in Pakistan. In India, although nonfinancial corporations' leverage has increased rapidly in recent years, it is broadly in line with regional peers. In the aggregate, nonfinancial listed companies have debt to equity ratios of about 80 percent, up from about 50 percent in 2003. However, this overall comforting picture masks sharp differences, with some sectors such as fertilizer, power, and metals having significantly higher leverage ratios. Moreover, with the cost of debt increasing by about 300 bp, corporate profitability is likely to come under severe stress. A recent McKinsey study estimates that 40 percent of Indian corporations are in sectors earning a return on invested capital below their cost of debt. These sectors including critical ones like power, transportation, retail trade, construction, telecom, and petroleum. While a low return on invested capital does not imply default, it does imply a need for continued financing, which will be more difficult in the coming years. A sharp slowdown in credit and higher rates would likely hit hardest those sectors where credit growth has been most rapid in recent years, i.e. services, real estate, and SMEs.

There are several sectors where problems are likely to appear. These include:

a) Construction and Real Estate: Housing prices are falling rapidly in many cities. In India, real estate firms are highly indebted, and the flow of direct investment from foreign financial firms (Lehman invested more than \$ 700 million in Indian realty) has dried up. Domestic banks have also withdrawn overdraft facilities and loans to real estate companies. The supply elasticity of real estate construction has been very high in the current boom (compared to the past) and this supply overhang has the potential to deepen the correction that is required. There has been a significant easing of credit standards in retail lending in the last few years. We have anecdotal evidence that the retail unsecured lending portfolio of some large finance companies (including some foreign owned ones) received exit valuations of as little as 30 percent of face value early this year, and are probably worth even less currently. The cumulative loan to value ratio (CLTV) has been around 100 percent in a number of cases because of furniture loans and other similar loans that were added on to the basic housing loan. Unfortunately, systematic data are hard to come by here – some surveys suggest Indian households typically have substantial equity. The concern may be about certain pockets, where prices have risen more and banks have been more aggressive. Recovery processes in case of large-scale mortgage defaults are untested, and the effect of distress sales on local housing prices

could be significant. New frameworks for debt renegotiation, as well as recovery procedures may be needed to ensure distressed loans do not clog bank balance sheets, and harm households. The data on both residential and commercial real estate are sparse. Both could be problematic, areas, especially given the global re-pricing of real estate assets. This is certainly a potential area for concern.

b) Small and medium enterprises (SMEs): Heavily indebted SMEs, especially those reliant on export markets, are likely to face increased pressure, especially as banks turn more cautious.

c) Infrastructure: The broader infrastructure sector is also vulnerable, given its reliance on foreign portfolio flows. Lately, after having raised money through IPOs, many Indian infrastructure companies have gone in for Qualified Institutional Placements (QIPs) with financial majors across the world. Both sources of funding are likely to dry up, and Indian commercial banks do not have the long term funding base to replace them. Similar problems in infrastructure financing are likely to play out in other countries in the region.

d) Corporations that have taken major projects with foreign financing: A number of corporations (e.g., India's Tata Motors) have borrowed to finance foreign debt. Others have taken on Convertible Foreign Debt, which is unlikely to convert given low equity prices. These corporations are likely to be at heightened risk of financial difficulty.

Impact on Commercial Banks

Banks in India, Pakistan and Sri Lanka have minimal reported exposure to US structured credit products and to troubled international institutions. The important risks to banks in these countries instead come from any need to roll over foreign funding and domestic market funding, as well as exposure to domestic sectors that are likely to be stressed. Rapid credit growth in recent years, combined with the impact of the global crisis on corporations, will lead to increased delinquencies, especially in corporate and SME loans, as well as housing mortgages. Capital is likely to be a constraint, particularly for medium-sized banks in Pakistan and India's private banks (credit to deposit ratios in India are high at 74 percent on average, with some new private sector banks like Kotak Mahindra Bank and ICICI Bank having high credit to deposit ratios even while not enjoying the access to stable deposits that state owned banks have; private banks have also been more aggressive in lending to SMEs, real estate, and retail loans to households to finance durables -- fast growth areas that are likely to come under greater pressure in a slow down). Non Performing Assets (NPAs) of commercial banks throughout the region are likely to increase considerably as growth slows.

While no failures of any sizeable banks in the region seem likely in the near term, there is a growing concern that banks will not have access to the capital needed to absorb losses and to continue the loan growth that will be needed to underpin growth. A recent study for India by McKinseys estimates that banks will need \$76 billion (\$16 billion to recapitalize plus \$60 billion additional capital) to sustain loan growth at 20 percent under

a scenario where net NPAs reach 5 percent of advances. With stock prices depressed, and with government finances stretched, the absence of this capital is likely to be a very important constraint on growth.

Policy challenges

Policy makers will need to take action on several fronts. First, to strengthen preparedness for dealing with a more serious crisis, contingency plans need to be developed, particularly for dealing with individual bank failures. The time available to respond in case a run starts is minimal, so having a pre-cooked plan without revealing its existence is essential. Issues such as whether all deposits will be guaranteed, whether there will be a temporary guarantee of all short term borrowing by banks, whether the guarantee will be extended to finance companies, money market funds, and brokers, will have to be discussed. The concerned authorities also need to engage in a more coordinated monitoring effort. Second, the framework for corporate debt restructuring should be carefully and quickly considered. In India, there is an urgent need to strengthen the framework for renegotiating mortgages, and for recovering mortgage debt. Pending Asset Reconstruction Company (ARC) applications should be approved, and foreign entry encouraged. In Pakistan, fears of widespread corporate default have led the Economic Advisory Council to review the draft Insolvency law lying since 2004, and convert it to a Corporate Rehabilitation Law along the lines of Chapter 11 in US and the Mexican Insolvency Law of 2000. The law calls for the setting up of a Resolution Trust Corporation to take over the bad assets of the banking system and sell them after a haircut. The law will also try to provide a soft landing to companies in trouble due to the economic crisis. Third, there will be pressure to inject capital/offer guarantees for troubled sectors such as real estate. Given the limited fiscal room, all such pressures, which will only multiply if the corporate sector senses any government willingness to succumb, should be resisted. Governments will need to conserve all available resources to bolster the banking sector, which has far more of a multiplier effect on the economy. Instead, troubled entities should be encouraged to renegotiate their claims with lenders (some of whom will be banks), and the framework to facilitate that renegotiation should be strengthened (see above). Finally, given that foreign financing is unlikely to be easily available for some time, structural reforms will be needed to enhance domestic financing, especially long term domestic financing. The importance of domestic sources of risk capital to plug the holes left by foreign capital cannot be overstated. While the political difficulties in cobbling together legislative majorities should not be underestimated, hopefully the prospect of a potential serious slowdown or even crisis should concentrate minds.

6. Impact on the Poor

It is too early to quantify the social impact of the global financial crisis and how the slowdown in economic growth will impact the poor, although a lower GDP growth will slow down the pace of poverty reduction. High frequency data on labor markets and poverty are not readily available for South Asia.

The impact of the global financial crisis will be felt through two channels. First, how does the labor market adjust to the global financial crisis and economic downturn? Will it adjust through changes in the real wage rate and/or adjustments in the employment rates? The financial crises in East Asia and Mexico showed that urban households felt the impacts disproportionately and that the main transmission channel was the labor market. Because of restrictive labor laws and the low level of industrial development, the overwhelming majority of workers in South Asia work in the informal sector and about half are self employed. In both sectors, underemployment is relatively high and unemployment rates are less likely to be sensitive to output cycles. In these parts the effect is likely to show up as slower growth and even decline in productivity and wages. The second channel is the pace of new job creation and whether the new entrants to the labor force can find jobs. South Asia has one of the youngest labor forces in the world. More than 100 million workers will join the labor force over the next decade. If the economic downturn is prolonged, it will reduce the pace of new job creation, resulting in high unemployment rates among the urban youth, increased conflict, and friction in the region. South Asia has the largest number of people in the world living below \$2 a day (see Table 4) and a prolonged downturn will have severe social impact.

Given that South Asia has the second worst business environment in the world, and data from the Doing Business indicators and the enterprises surveys for the South Asian countries suggest the labor market (except Bangladesh) are relatively rigid, it is likely that the main adjustment mechanism will be via wages. This will call for income support policies in preference to employment support interventions.

The impact of the global financial crisis on the poor is already being felt in South Asia. South Asia's regional average GDP growth is projected to be nearly halved from 9 percent in 2006 to 5 percent in 2009. In Pakistan, real wages appear to have been declining on average in the past year mostly due to high inflation rates. In India, nearly 10000 workers were fired from Jet airways. In textiles industry in India, 700,000 workers are reported to have lost their jobs earlier this year before the financial crisis. Another 500000 workers are also expected to loose their jobs as production growth in the textile industry slows down. There are nearly 100 million migrant workers in India, mostly employed in the urban areas in economically sensitive sectors such as construction, which have become vulnerable to the financial crisis. In India, analysts are projecting major job losses in construction, real estate, financial services, and the auto sector. In Bangladesh, thousands of textile workers have intensified their protest as they feel the impact of high food and fuel prices and now the loss of jobs and stagnant wages as garment exports fall in response to the global slow down. While the global financial crisis will affect both urban and rural populations, the urban poor will first feel its impact. Given their heavy reliance on a cash economy, and employment losses at urban based industries, the city's poor will initially feel the impact of the crisis.

Table 4: South Asia Compared to the Rest of the World

Table 1 South Asia compared to the rest of the world

variable:	GDP total	GDP per capita	GDP density	Population	Population density	Urbanization	Poverty rate	Poverty rate
unit:	2000 I\$ billion	2000 I\$	2000 I\$ / km2 (x1000)	million	# people / km2	%	% < 1\$ / day	% < 2\$ / day
World region / year	2005	2005	2005	2006	2006	2006	2004	2004
East Asia & Pacific	10151	5384	639	1899	120	42.4	9.1	36.6
Europe & Central Asia	3899	8265	168	461	20	63.8	0.9	9.8
Latin America & Caribbean	4121	7482	204	556	28	77.7	8.6	22.2
Middle East & North Africa	1668	5450	186	311	35	57.5	1.5	19.7
South Asia	4102	2791	858	1499	314	28.8	30.8	77.1
Sub-Saharan Africa	1318	1774	56	782	33	35.8	41.1	72.0
	%	%		%		ppt	ppt	ppt
World region / period	1989 – 2005	1989 – 2005		1975 – 2006		1975 – 2006	1990 – 2004	1990 – 2004
East Asia & Pacific	260.3	200.2		51.2		23.1	-20.8	-33.2
Europe & Central Asia	4.2	2.3		19.6		7.9	0.5	5.5
Latin America & Caribbean	56.1	21.8		75.1		16.4	-1.6	-4.1
Middle East & North Africa	91.7	36.6		113.0		13.3	-0.9	-2.0
South Asia	143.2	80.4		86.4		8.6	-12.2	-8.5
Sub-Saharan Africa	54.0	3.6		135.2		14.6	-5.6	-5.1

Sources: World Development Indicators. The years of observation may differ slightly, whenever no data was available for the indicated year, we use the closest year available. Growth of GDP density and population density is the same as GDP and Population growth respectively (given that a region's area does not change).

Over time, we could expect to see a hard impact of the financial crisis and economic slowdown on labor markets in several areas in the next two to three quarters: (a) the white collar high wage growth in the corporate sector in India. Over the past years, financial sector, IT and corporate sector have expanded significantly leading to double digit real wage growth rates in this segment. (b) the slowdown in manufacturing and investment growth in South Asian countries will translate into lower job growth. Recent manufacturing job growth and construction drove the employment growth in recent years. In the event of a marked deceleration of manufacturing and construction, this should lead to a lowering of wages and a reduction of job growth. (c) In the context of a large increase in the labor force due to demographic reasons this could translate into higher unemployment rates in urban areas, where unemployment rates are already high in a country such as India.

Responses to the Crises

In response to the economic downturn, and adverse social impact, policy makers in South Asia have emphasized increased productive investments in infrastructure, health and education, and in social safety nets for the most vulnerable. Public investment in infrastructure has shown to have long term economic benefits and generates employment. Investments in health and education build human capital, and will mitigate the potential

long term negative consequences of malnutrition and school drop out. Well-designed, targeted safety nets can cushion the impacts on the poor, enable households to maintain a basic standard of living, and curtail social unrest. These programs also ease budget constraint reducing probability of drop outs or reduction in quality or quantity of consumption. Finally, there is evidence that urban agriculture can also help to mitigate the impacts of crises through the production of additional income and food for households. Implementing such strategies will require a concerted effort and good collaboration between national and local governments.

Social Safety Nets Safety net programs in South Asia suffer from many weaknesses that make them ineffective in reaching the poor or scaling up to protect additional households affected by disasters. Coverage is mixed. Some countries have no public safety nets (Bhutan and Afghanistan), while others (Pakistan, Sri Lanka and Nepal) have one or two cash transfer based safety net programs. At the other extreme are India and Bangladesh with several safety net programs, including categorical social assistance, workfare, and food based transfers. While some programs are national (e.g. Pakistan Bait-ul- Maal or the Samurdhi program in Sri Lanka, safety net programs in India and Bangladesh are largely rural in their coverage. South Asian countries spend 1-3 percent of GDP, with India being the highest spender, matching spending of OECD countries. Countries do have large food based programs, but the trend is a shift towards cash based programs (India's NREG and BD, FFE to stipend program). Program coverage varies, from 2 percent of the population in Pakistan to 30 percent of the population (India, PDS) to almost 40 percent of the population (Samurdhi, Sri Lanka). There is considerable leakage in programs (particularly those that are food based). For example, even though coverage rates decline with income in Bangladesh, 41 percent of beneficiaries of targeted programs are in the top 3 quintiles. Benefit incidence is also not pro-poor. About 60 percent of PDS (India) accrue to the non-poor.

Poor performance of programs is the result of weak programs design and administration; For example most countries do not have national targeting systems and those that do, for example India, have systems are not very effective. Similarly modern MIS system, beneficiary registries, grievance mechanisms, and strong governance and accountability systems are largely absent. However, not all programs perform poorly. Programs with small and regular cash benefits (e.g. social pensions in India and Nepal) have better performance relative to large food based programs. Similarly, programs that have fewer intermediaries in the delivery process also perform better than those that pass through many administrative layers...

Global experience shows that countries with effective safety nets that target the poor are the most successful in responding to crisis. Thus, it is very important for South Asian countries to develop/strengthen their safety net systems. It is naturally easier to scale up an existing safety net program than to design a new one; particularly to respond to a current crisis. . However, some countries have been able to use a crisis as an opportunity to eliminate ineffective programs and replace them with better designed programs. For example, Mexico was able to use the Tequila crisis to reform its safety net and transform

it into a conditional cash transfer program. For South Asian countries, too, crisis can be a good opportunity to invest in sound and well targeted safety net systems.

The Bank is already helping Bangladesh, Pakistan, Afghanistan, Nepal and India in strengthening their safety net systems through either advisory support or lending. Several of these efforts involve piloting conditional cash transfer programs for possible scale up (Bangladesh, Pakistan); providing advisory services to National Workfare programs (Bangladesh; India, and Nepal); In Bangladesh and India, the Bank supporting the Government in developing urban safety nets, a major gap in program coverage in both countries. That said, greater investment needs to be made through lending and other products to strengthen safety net systems in the region.

- **Afghanistan:** The country has relied mainly on the WFP to protect the poorest regions using food based public works. To build on existing programs, the Bank is preparing its first project to support the development of safety nets in Afghanistan. Initial work will focus on developing a policy framework and piloting and evaluating interventions that are suitable to the complex environment of Afghanistan and can, based on good performance, be scaled up in the future
- **Bangladesh:** The Bank is providing social protection advisory services, including on improving the targeting of safety net programs and strengthening their disaster response. A National Social Protection Project, under preparation, will help strengthen safety net systems. The program will develop modern safety net system (payment, MIS, national targeting system) for cash transfer programs and also pilot a (CCT) system in select urban areas—given a dearth of safety nets in this region, and, based on performance, will then be scaled up nationwide.
- **Nepal:** The Bank has provided financial support to scale up of the WFP program to protect the poor against the adverse impact of the food crisis through the recent Safety Net operation. To respond to Government request to provide technical advice on its proposal for expanding social protection system, a recently approved social protection TA will provide just in time advice on improved targeting and administration of programs.
- **Pakistan:** The Bank has been providing technical assistance to the GoP on improving the targeting system, payment and MIS system, and other governance and accountability of Pakistan Bait-ul Maal, the main cash transfer program. Most recently, the Government has announced a new cash transfer program, the Benazir Income Support Program, which is intended to take the Bait-ul Maals place as the main safety net program for the country, and will cover both rural and urban areas.. The Government has requested the Bank’s assistance to follow on its earlier technical work and provide support to the new program in the same areas. A social protection DPC and a safety net TA project is planned. The country has also fielded a CCT pilot that if successful could be scaled up as part of the overall cash transfer system.
- **India:** Following Bank report on safety net performance in India, the Bank is providing programmatic technical assistance to both GoI and states on improving the administration of their safety net programs. The main emphasis is on lagging states, e.g.: Bihar, where line Ministries have requested technical assistance is strengthening the administration of safety net programs. UP has also established a safety net authority that will provide convergence for safety net programs and has requested Bank technical assistance to support its implementation. A safety net project (state) to strengthen safety net administration is in the pipeline. Urban safety nets are being piloted as part of the urban poverty alleviation project.; Most recently the Government of Delhi has requested support for assistance for promoting convergence/rationalization of safety net programs. A proposal for south-south learning with the Government of Brazil has recently been submitted to the Bank.

- **Sri Lanka:** The Bank is providing programmatic SP technical assistance to improve targeting of the main cash transfer program; as well as the second, smaller social pension program. The technical assistance will also provide guidance on how best safety net programs can respond to shocks, such as natural disasters.

7. How Can the World Bank Help?

The Bank can assist clients in South Asia to deal with the impact of the financial crisis by:

- Helping Governments in partnership with the IMF to strengthen surveillance of macro-financial developments and appropriate fiscal, monetary and structural policy responses. A key challenge will be to help countries balance possible need for short-term demand stimulus with medium-term needs to contain inflation, maintain fiscal sustainability and investments in vital infrastructure and human capital.
- Working with central banks to strengthen preparedness for dealing with a more serious crisis, through helping to develop contingency plans, particularly for dealing with individual bank failures. The time available to respond in case a run starts is minimal, so having a pre-cooked plan without revealing its existence is essential. Issues such as whether all deposits will be guaranteed, whether there will be a temporary guarantee of all short term borrowing by banks, whether the guarantee will be extended to finance companies, money market funds, and brokers, will have to be discussed. The concerned authorities also need to engage in a more coordinated monitoring effort.
- Helping to strengthen frameworks for corporate debt restructuring and asset recovery.
- Supporting governments in their efforts to develop and deepen domestic capital markets, particularly long-term corporate bond markets, through technical assistance, as we are currently discussing with the Government of India.
- Developing real-time monitoring systems based on qualitative and rapid participatory assessments and surveys which will allow for a fine-grained picture of who is being affected, how they are responding, what assistance is reaching them effectively and potential long-term impacts of coping strategies. This will inform expanded advisory and lending support for safety net programs. The ultimate safety net choice: cash or conditional cash transfers, workfare programs will depend on the country context. The Bank could expand policy and lending support for the use of safety net programs, including e.g. conditional cash transfer instruments. Having sound safety net instruments in place will allow governments to scale these up and respond most effectively to both chronic poverty, but also to shocks.

- Stepping up financing to implement already planned infrastructure investments, as we are currently discussing with the Government of India, particularly by supporting PPP projects through the expanded use of partial risk guarantees, the deferred drawdown option and other instruments to encourage private investments. In addition, the Bank could provide rapid response assessments of the contingent liabilities governments face with existing PPP projects that are likely to come under stress, technical assistance to help governments assess options for projects that are already under stress, and assistance in maintaining a PPP project pipeline under current market conditions. The Bank can also increase investments in pro-poor urban and rural infrastructure investments that utilize labor intensive approaches. Indonesia and Argentina both set up workfare programs based on infrastructure development in poor areas in the aftermath of their financial crises in the late 1990s/early 2000's. The Bank could support the rollout of such schemes under existing and future operations. The recently endorsed Sustainable Infrastructure Action Plan provides a platform to ramp up and diversify infrastructure operations in response to the crisis.
- The Bank could also provide support for access to finance programs for SMEs (as we are currently discussing with the Government of India) and micro finance institutions, which are among the major casualties of the recent financial crisis.