

Global Financial Crisis: Implications for South Asia

I. Overview

The global financial crisis is hitting South Asia at a time when it is already reeling from the adverse effects of a severe terms-of-trade shock. Countries have responded by partially adjusting domestic fuel prices, cutting development spending and tightening monetary policy. **The adverse effects of these terms of trade losses have been substantial, reflected in a slowdown of growth, worsening of macroeconomic balances and huge inflationary pressures.**

The global financial crisis will likely worsen these trends, particularly on the growth and balance of payments front. Slowdown in global economy will adversely affect South Asian exports and could hurt income from remittances. Lower foreign capital flows and harder terms will reduce domestic investment. Both will lower growth prospects.

II. Terms of Trade Shocks: 2003-2008

Huge Terms of Trade Shock: Between January 2003 and May 2008 South Asia suffered a huge loss of income from a severe terms-of-trade shock owing to the surge in global commodity prices ([Figure 1](#)). While MENA, LAC and ECA gained from higher prices on a net basis, South Asia lost substantially from both higher food and petroleum prices. Within South Asia, losses range from 36 percent of GDP for the tiny Island country of Maldives to 8 percent for Bangladesh ([Figure 2](#)). **Much of the loss came from higher petroleum prices, where all countries lost.** On the food account, Bangladesh lost most, followed by Nepal and Sri Lanka. Pakistan and India actually gained, being significant rice exporters. Although reliable data is not available for Afghanistan, losses from the oil and food price crisis are believed to be substantial.

Figure 1

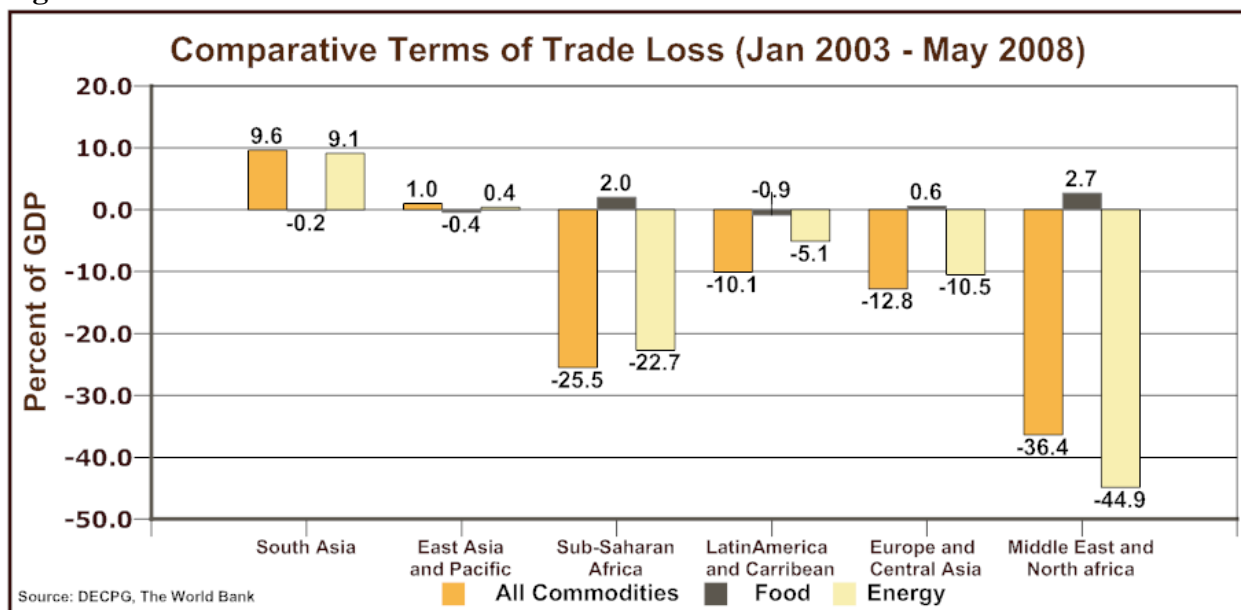
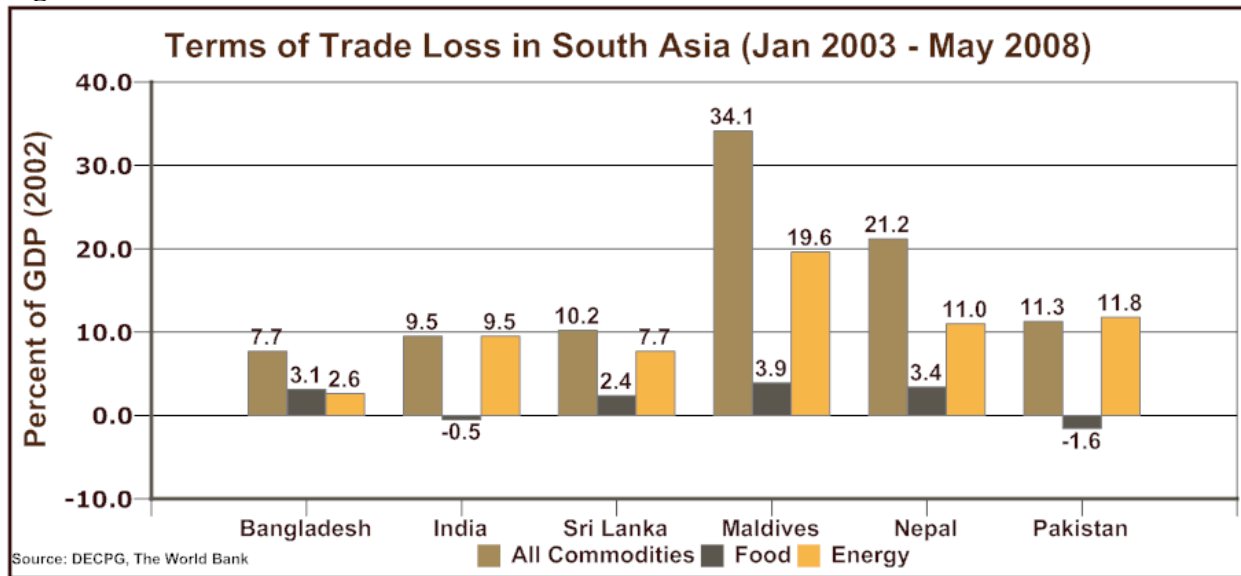
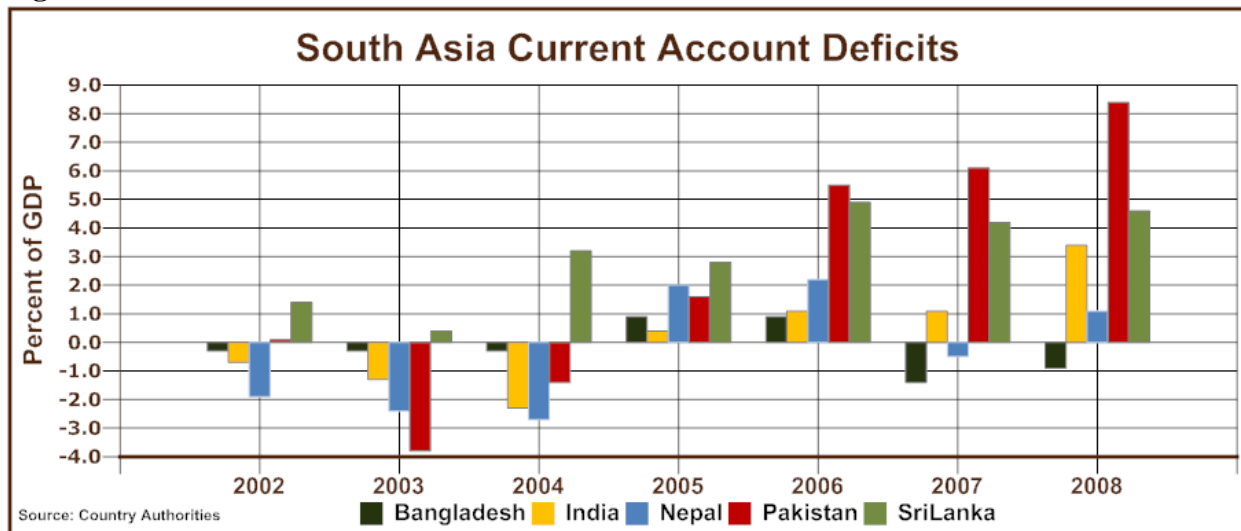


Figure 2



Deterioration in external and fiscal balances: The large loss of income from the terms of trade shock was partially compensated by rising remittances. Nevertheless there has been a negative impact on the external balances of most South Asian countries (Figure 3). Pakistan suffered the most rapid deterioration in the current account balance, which turned from a surplus of around 4 percent of GDP in 2003 to a deficit of over 8 percent in 2008. Sri Lanka similarly registered a sharp increase in current account deficit. Even in India, the current account widened sharply from a surplus of more than 2 percent of GDP in 2004 to a deficit of over 3 percent in 2008. The current balance in Nepal that was in surplus for a fairly long period finally turned into a deficit in 2008. **Only Bangladesh continued to enjoy a surplus in its current balance.**

Figure 3



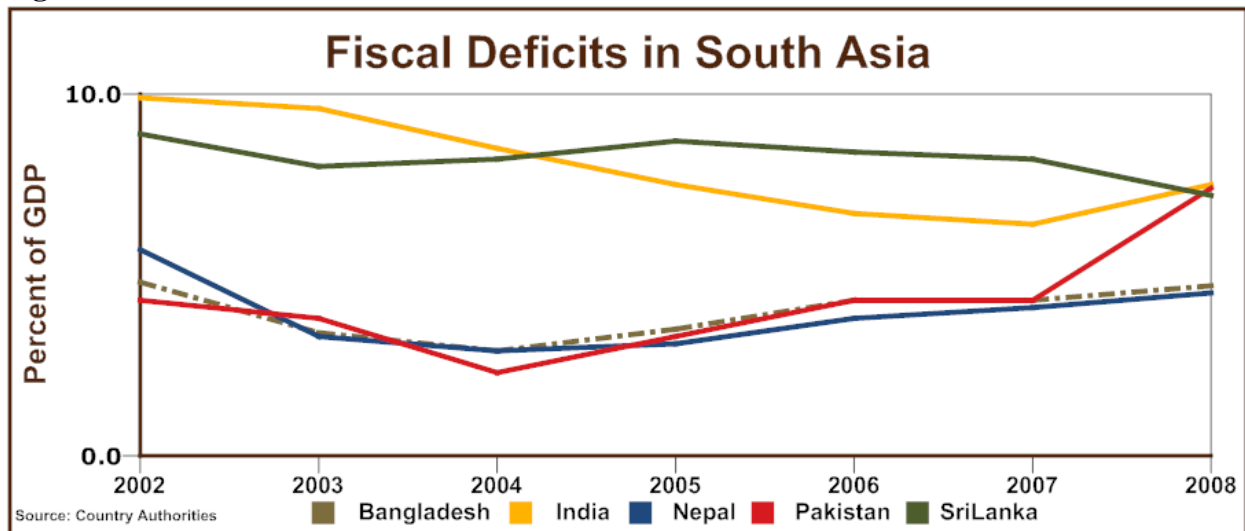
These differential effects reflect a number of factors including: the relative magnitude of terms of trade shocks, the differences in compensating growth of remittances, and policy responses.

Bangladesh in particular benefitted tremendously from the growth in remittances. Pakistan and Sri Lanka have been facing balance of payments pressures from expansionary fiscal and monetary policies; the terms of trade shocks accelerated the deterioration.

Concerning fiscal balance, all countries except Sri Lanka registered sharp deterioration (Figure 4). The fiscal deficit widened most for Pakistan, rising from 2.4 percent of GDP in 2004 to 7.4 percent in 2008. India had made good progress in reducing fiscal deficit between 2003 and 2007. This progress was reversed in 2008 as sharp increase in fuel subsidies (growing from 1 % of GDP in FY2007 to an estimated 4% of GDP in FY2009) threatens to wipe off the gains made so painfully over the past few years. Bangladesh also struggled quite a bit.

Budget deficit widened to almost 4 percent in 2008 and is projected to grow further to over 5 percent, mostly due to increases in food and petroleum subsidies. Nepal's fiscal deficit has grown from its low level in 2004 owing mainly due to fuel subsidy. Sri Lanka has long suffered from high fiscal deficits; as a result, it seceded to pass on the global price increases in petroleum to consumers.

Figure 4

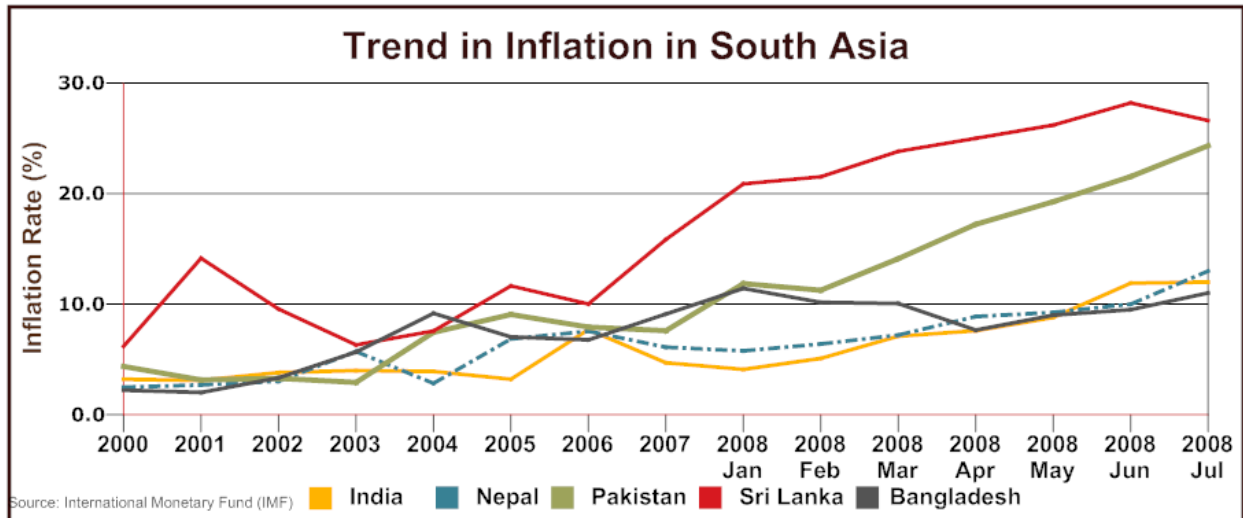


Impact on inflation: Rising food and fuel prices have been a major source of inflationary pressure in South Asian countries (Figure 5). In Afghanistan, Sri Lanka, Pakistan, Bangladesh and Nepal, food prices made a bigger impact on inflation than fuel. In India, however, the main surge to inflation came from fuel price increases. Afghanistan saw the steepest increase in staple food prices between 2007 and August 2008, with wheat prices more than doubling, due to poor domestic production and export restrictions by Pakistan.

Other South Asian countries saw staple food price increases ranging from a low of only 12 percent for India to 83 percent for Sri Lanka. Prices of staple food have started to come down in all South Asian countries owing to good harvests in 2008 and falling global prices. The global oil prices have also come down sharply to around \$70/barrel level as compared with the spike at \$150/barrel. **The combined effects of lower food and fuel prices along with demand**

management are reducing inflationary pressure in most South Asian countries except Pakistan.

Figure 5



III. Effects of the Emerging Global Financial Crisis

As noted, the South Asia economies are already limping from the adverse effects of the huge terms of trade shocks of the past 6 years. **The reduction in global petroleum and food prices observed over the past few months provides a silver lining for South Asia in an otherwise difficult external environment.** Yet this silver lining is now heavily clouded by the emerging global financial crisis that poses tremendous downside risks to South Asia.

These risks can transmit from both the financial sector in terms of volume and price of foreign capital flows as well as from the real sector based on adverse effects of a global slowdown on South Asian exports, possible downward pressure on remittances, and slowdown in private and public investment owing to higher interest rates as well as lower export demand.

(a) Financial sector effects: South Asia is fortunate to have a broadly resilient financial sector due to a combination of past financial sector reforms and capital controls that insulate these economies to a great extent from the risk of a financial crisis transmitted from abroad. However, individual country risks vary substantially as the macroeconomic performances, financial sector health and exposure to foreign capital markets differ considerably by countries.

The largest economy, India, is relatively more exposed to the contagion effects of global financial markets through adverse effects on capital flows from portfolio and direct foreign investments, and also through exposure of domestic financial institutions to troubled international financial institutions and to contracts—including derivatives—that have undergone large value changes. The evidence so far shows significant losses in the stock market and a reduction in the flow of foreign capital. Yet these risks are countered by a fundamentally strong macro economy including prudent foreign debt management, high savings rate, solid financial sector health, and a pro-active monetary policy management that will likely allow India to ride the crisis without destabilizing the financial sector.

The Central Bank has already responded by letting the exchange rate depreciate to stem the outflow on the current account, by providing extra liquidity to the financial sector, and by raising the limit on private foreign borrowing. The nature and depth of the global financial crisis is still evolving and there is a significant downside risk of further slowing down of net capital flows and a hardening of terms. But these are countered by an overall healthy banking sector with low non-performing loans and a comfortable capital base and a pro-active monetary and exchange rate management. Foreign debt and debt service is low, and reserve cover (\$274 billion) is still substantial. The high domestic saving rate (34 percent of GDP) provides added cushion. **The main effects of the global financial crisis will be to reduce the availability of funds leading to higher interest rates and lower public and private investment that will hurt growth.**

The second largest economy, Pakistan, is much more fragile and faces the most vulnerability in the region. High fiscal and current account deficits, rapid inflation, low reserves, a weak currency, and a declining economy put Pakistan in a very difficult situation to face the global financial crisis. Efforts are now underway to arrest the decline of the macro economy through appropriate demand management including tightening of monetary and fiscal policies. Pakistan's ability to borrow externally is already heavily constrained and bond spreads are very high. The global financial crisis means that non-official foreign capital flows would be even more expensive than now. The contagion effects on domestic financial sector could be substantial, but stress tests suggest that the banking sector as a whole is likely to withstand the shocks. This is mainly due to the improved health of the financial sector based on past reforms.

Sri Lanka suffers from high inflation and large current and fiscal account deficits. To stem the deteriorating macro-balances Sri Lanka has started tightening monetary policy and is also trying to contain the fiscal deficit by passing on the energy price increases to consumers. The performance of the financial sector has improved over time, although there is a slight upward trend in Non-performing loans (NPL) in recent years. The role of foreign capital in Sri Lanka's domestic financial sector is limited. The main downside risk on the financial sector is a reduction in capital flows from outside, including for the government. There is already evidence of a rise in spreads for Sri Lanka bonds. Switching of demand to domestic financing in an environment of high inflation and further tightening of monetary policy would raise interest rates and slowdown economic activity. Financial difficulties in domestic firms could also adversely affect NPLs. Overall, though, there is little risk of a financial collapse.

Bangladesh has maintained generally prudent macroeconomic policies. Balance of payments is in surplus owing to rapidly rising remittances and prudent demand management. Inflation, which reached double digit, is now coming down due to falling food prices. Fiscal deficit has increased to 5-6 percent, but remains manageable in view of falling global oil and food prices from their global peaks last fiscal year. The financial sector is showing signs of improved health from past reforms and is mostly insulated from foreign markets because of very low private capital inflows. External debt is low and reserves are comfortable. In this environment, the effect of the global financial crisis on the financial sector is likely to be negligible. Bangladesh is relatively more exposed from the real economy effects of a possible slowdown in exports, especially garments, and from remittances.

Nepal is emerging from a conflict situation with low growth and the adverse effects of a global food and fuel crisis. Inflation is showing signs of deceleration due to reduction in international food and fuel prices. Its domestic financial sector is very weak in terms of financial indicators with large non-performing loans and low capital adequacy. However, the financial sector is pretty much insulated from global finances due to the negligible amount of foreign private capital flows. The risks to the macro economy come from a potential expansionary budget in an environment of a deteriorating global economy.

(b) The real sector effects: The possible downside effects of the financial sector crisis are much more direct and substantial from the real economy implications. These will work through trade, remittances and investments.

Exports: Based on progress on trade reforms, South Asian economies have become much better integrated with the global economy than in the early 1990s. Exports are now over 20 percent of GDP and are a major source of growth stimulus. The recession in OECD countries will almost certainly lower the export prospects for all South Asian countries, but especially India that has done remarkably well in the services sector and now faces a sharp slowdown in demand. South Asia is also a major exporter of textiles and garments that are vulnerable to the recession in the OECD economies. Depending on the magnitude and the period of this recession, the adverse effects on exports can be large.

Imports: One redeeming feature emerging from the import side is the observed downward trend in commodity prices, especially food and fuel. The import bills on these accounts, especially fuel, are already coming. The recession in OECD countries will likely cause a further reduction in commodity prices with positive effects for South Asia.

Remittances: Foreign remittances have grown rapidly in South Asia over the past few years. These have not only provided an offsetting cushion on the balance of payments, but more importantly they have been a huge source of income and safety net for a large number of poor households in South Asia, especially in the poor countries of Afghanistan, Bangladesh and Nepal. Much of these remittances come from low-skilled workers engaged in the oil-rich countries of the Middle East. These earnings do not face an immediate risk as these economies have huge earnings and reserves from the oil price boom and oil prices are still substantially higher than in 2002 in real terms. However, remittances from OECD countries can be adversely affected. India and Pakistan are particularly exposed to this slowdown. On balance the downside risk of substantial lower earnings from remittances appear low.

Investment: The main risk to growth comes from the likely adverse effects on investment of the combined effects of a slowdown of foreign funding and a possible increase in non-performing assets of domestic banks owing to lower profitability of firms producing for export markets. At the same time, higher inflation has required tightening of monetary policy. All of these factors will reduce the availability of domestic financing of private investment. Public investment is already constrained by rising fiscal deficits. Overall, there is likely to be a slowdown in the rate of domestic investment. Improvements in saving rates in South Asian economies have been an important cushion. But inadequate adjustment to the losses from terms of trade, combined with a

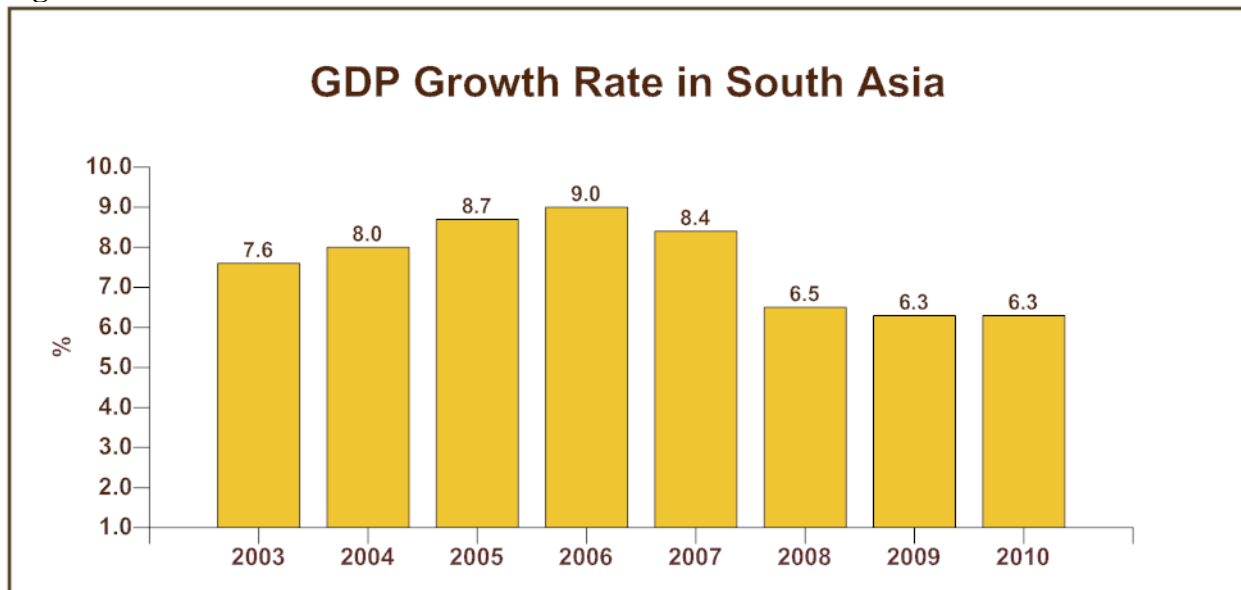
possible slowdown of exports earnings and foreign capital flows will almost certainly reduce investment and growth.

(c) Impact on macroeconomic balances: As noted South Asia's macroeconomic balances had already worsened considerably owing to the term of trade shocks. The falling commodity prices of the past few months from their peak levels were providing some relief in FY09. Inflation also has been coming down in most South Asian countries. The global financial crisis could offset some of these improvements. A slowdown in earnings from exports and remittances would tend to hurt the current account, while lower growth of important demand and falling commodity prices would tend to improve. The fiscal picture will improve from lower subsidies due to falling prices, but revenue earnings can decline from lower growth. **On balance, though, we expect inflation to fall and much of the impact will be absorbed by lower growth**

IV. Growth Prospects

Since 1980, South Asia has been on a rising growth path, reaching a peak of 9 percent in 2006. Growth has been on a declining trend since then. In particular, the adjustment to the terms of trade shock brought about a slowdown in growth in 2008 for all South countries, notwithstanding the benefits of a strong agriculture recovery. The onset of the global financial crisis suggests a significant slowdown in South Asia's growth prospects for 2009-10 (Figure 6). The slowdown will be particularly notable for India and Pakistan. India's prospects will be hurt by the reduction in capital flows and possible slowdown in the growth of exports. Pakistan's economy is already facing difficulties; the financial crisis will aggravate it.

Figure 6



IV. Policy Issues and Challenges Moving Forward

Growing fiscal deficits due to food and fuel subsidies and rising inflation suggest that South Asian countries have basically run out of fiscal space and do not have the option of riding out further shocks with expansionary fiscal and monetary policies. **So, in the near term growth will need to fall to absorb the shock from the financial crisis.** Indeed, as noted, all South Asian countries have responded with some degree of monetary tightening and cutbacks in development spending, and have also adjusted domestic fuel and fertilizer prices in varying degrees to stem the widening of the fiscal deficit.

The policy option of full pass through of fuel and fertilizer prices to consumers **is not a politically viable option**, although further reduction of the gap between domestic and international prices and better targeting of open-ended subsidies are possible options especially in Pakistan which faces the largest macroeconomic imbalances.

Falling global prices also provide some relief. On the balance of payments side, the flexibility of the exchange rate has been a positive factor, although this has happened only recently in Pakistan. Nevertheless, further tightening of demand, especially in Pakistan and Sri Lanka, will be necessary. Demand management will obviously need to focus on the right mix between fiscal and monetary policies with a view to ensuring that there is enough liquidity in the short-term to avoid a financial crunch while also ensuring that aggregate demand falls to reduce inflation and improve the macroeconomic balances.

Over the medium term, there is substantial scope for domestic resource mobilization through the tax system that will play a key role to regain the growth momentum. All South Asian countries can benefit from it. In the short term, countries have tended to cut development spending to contain the rise in fiscal deficits, which is contributing to the growth slowdown. **So, better expenditure management is also a medium-term option for reconciling stabilization with growth objectives.**

Since 1980, South Asia's growth benefitted from prudent macroeconomic management and both structural and institutional reforms. **Refocusing policy attention to the next phase of structural and institutional reforms will also help growth to recover.**