

## Impact of Global Financial Crisis on South Asia

**February 17, 2009** - The global financial crisis hit South Asia at a time when it had barely recovered from severe terms of trade shock resulting from the global food and fuel price crisis. The food and fuel price shocks had badly affected South Asia, with cumulative income loss ranging from 34 percent of 2002 GDP for Maldives to 8 percent for Bangladesh. Current account and fiscal balances worsened sharply and inflation surged to unprecedented levels.

**Pakistan, Sri Lanka, and Maldives** were particularly vulnerable because difficult political and social environments prevented adequate policy measures to adjust to the terms of trade shock. Additionally, their reliance on foreign funding has been relatively large. The global financial crisis worsened their macroeconomic difficulties as sources of funding contracted. Although **India** was well advanced in responding to the food and fuel price crisis and has generally maintained prudent macroeconomic management, the magnitude of the financial crisis has hit India very hard because of the strong connectivity to global financial markets.

**Bangladesh, Nepal, and Bhutan** have been mostly insulated from the first round effects of the financial crisis owing partly to sound macroeconomic management, but also because of the underdeveloped nature of the financial markets that are not well connected to international markets. They are however vulnerable to the second round effects of a global economic slowdown working through export earnings, tourism receipts, remittances and external financing for infrastructure. Issues in **Afghanistan** are much more complex and relate more to security and the political environment rather than the impact of global financial crisis.

The recent slide in food and fuel prices has provided South Asia with a welcome relief. But overall, the evidence suggests that growth, investment, exports and employment have been hurt. The outlook for 2009 is bleak as the global downturn deepens further. **Growth in South Asia decelerated in 2008, falling from 8 percent in 2007 to 6 percent. It is projected to decline to 5 percent in 2009, before recovering to 6 percent in 2010.**

## India

India, South Asia's largest economy, has been facing major challenges owing to the global financial crisis. The immediate effects were plummeting stock prices, a net outflow of foreign capital, a large reduction in foreign reserves and a sharp tightening of domestic liquidity. These caused a rapid depreciation of the exchange rate and a surge in short-term interest rates. The second round effects emerged from a slowdown in domestic demand and exports. Demand effects have been particularly severe in housing, construction, consumer durables and the IT sector. As a result, manufacturing production has taken a hit and activities in the organized services sector (housing, construction, IT) are down sharply. Exports declined for two consecutive months in October and November 2008. A recent government study estimates job losses to the tune of five hundred thousand between October and December 2008. **GDP growth rate is now estimated at around 7 percent for 2008, down from 9 percent in 2007, and is projected to decline to around 5 percent in 2009.**

The government of India has been highly proactive in managing this ongoing crisis with a slew of monetary and fiscal measures to stabilize the financial sector, ensure adequate liquidity, and stimulate domestic demand. The monetary policy measures have succeeded in stabilizing interest rates and the availability of domestic liquidity. The exchange rate has also stabilized and capital outflows have been contained, with foreign exchange reserves maintained at around \$250 billion level. The pressure on the financial sector has been eased, although there is some evidence of an increase in non-performing loans. However, the financial sector has become more risk-averse. The decline in global fuel and other commodity prices has helped the balance of payments and lowered inflation, which has fallen sharply from a peak of 12.8 percent in July 2008 to below 6 percent in December 2008. This has created the space for monetary easing as well as providing better scope for the fiscal stimulus. **The monetary and fiscal stimulus package is expected to contain the downward slide in demand in 2009 while providing a good basis for recovery in 2010.**

## Pakistan

**Pakistan's economy has been under strain due to excess demand pressures that have been building since 2004.** The combined effects of global food, fuel and financial crisis took quite a toll on the economy as the current account balance and fiscal deficits increased, inflation surged and

growth slowed. Fortunately, strong corrective actions have been taken over the past few months including an IMF program in November that is helping stabilize the Pakistani economy. Macroeconomic imbalances are showing signs of improvement while inflation is easing. But economic growth has taken a hit, with growth slowing down from 7.3 percent during 2004-07 to 5.8 percent in 2008 and projected to slide to around 3 percent in 2009. The scope for counter cyclical fiscal policy is limited at this time, but Pakistan is taking measures to protect social spending to help reduce the adverse effects of the crisis on the poor.

The story in Sri Lanka and Maldives is worrisome. Like Pakistan, these countries have been struggling with excess demand pressures, which have been further aggravated by the global food, fuel and financial crises.

## **Sri Lanka**

**Sri Lanka has taken actions to reduce monetary growth and contain the fiscal deficit.** This, along with lower commodity prices, has helped reduce inflation, which has come down sharply from a peak of 28 percent in June 2008 to 11 percent in January 2009. But Sri Lanka's balance of payments is under stress, as current account deficit surged to about 7.5 percent of GDP in 2008 and reserves have now fallen to less than 2 months of imports. Access to foreign commercial credit has also been sharply curtailed by the rapid rise in the cost of borrowing. Economic growth has come down from 7 percent during 2006-2007 to 6 percent in 2008 and expected to decline to 4 percent in 2009. Further actions are needed to stabilize the external economy to provide the basis for recovery of growth in 2010.

## **Maldives**

Maldives is still grappling with major fiscal and current account imbalances, which has been further hurt by a slowdown in foreign private capital inflows and deceleration in the tourism sector. The new government is looking at ways to bring the macro economy back on track.

Evidence from other South Asian countries that are not well connected to global financial markets—Bangladesh, Bhutan, and Nepal—show that the direct first round effects of the global financial crisis have been muted.

## Bangladesh

**Bangladesh has held up remarkably well due to deft economic management that helped absorb the pressure of the global food and oil price crisis of the January 2007-May 2008 period without jeopardizing macroeconomic stability.** Although stock prices have fallen, domestic liquidity seems adequate. Domestic interest rates, both long-term and short-term, are stable. Exports for the first 6 months of the fiscal year (July-December) have grown at a healthy pace of 19 percent and remittance inflows show a 31 percent increase. The recent decline in global commodity prices, especially food and fuel, is helping ease inflationary pressure while also providing a welcome increase in the fiscal space and balance of payments.

## Bhutan

Bhutan's economy is closely tied to India. Since there are no indications of reductions in aid or delays in the development of the next mega-hydropower projects, the macroeconomic underpinnings appear sound. The banking system has adequate liquidity, reserves are at a high level (exceeding 14 months of imports), and the authorities continue to make good progress with implementing their reform program. Second round effects are expected, however, with growing non-performing loans and weaker tourism activity later in 2009.

## Nepal

Nepal is benefitting from higher inflows of remittances and healthy availability of foreign aid. Along with the decline in global commodity prices, the balance of payments and fiscal situation are comfortable and there is no evidence of a liquidity constraint on domestic demand. On the contrary, the large foreign exchange inflows are creating some demand pressure that has contributed to a surge in inflation that requires better management.

## Next Steps

Nevertheless, there is no room for complacency for any South Asian countries. While Bangladesh's overall exports for the first six months show strong growth, exports during October-December 2008 actually declined by 1.4 percent over the same period in 2007 as compared with 42 percent growth during July-September, indicating a worrisome outcome. Importantly, the adverse effects of the global economic slowdown are still emerging, especially given the growth outlook for industrial economies for 2009. In addition to lower demand, there is strong evidence of a trade credit crunch. So, the spillover negative effects for developing country exports including South Asia can be very large. There are also populist pressures in industrial countries for trade protection that could further hurt South Asia's export prospects in 2009 and beyond. Similarly, while remittances are holding up well so far, the sharp decline in oil prices will likely reduce the demand for additional migrant labor in the oil-rich Arab countries and could hurt remittance income in the coming months.

**Moving forward, the South Asian countries can do a number of things to reduce the adverse effects of the financial crisis and prepare the way for a resumption of rapid growth in 2010.**

**First**, policy attention needs to focus on creating as much additional fiscal space as possible to prop up the domestic economy while preserving macro economic stability. As noted, the decline in global fuel and food prices has provided a welcome opportunity to regain the loss in fiscal space owing to previous higher prices. This gain should not be wasted in reversing the policy changes made in aligning domestic prices better to the global prices, especially domestic fuel prices. Additionally, efforts must intensify to raise public revenues. All South Asian countries have scope for raising revenues through strengthening tax compliance and aligning better public utility prices to their production costs.

**Second**, a careful look at expenditure priorities is in order. Public spending that creates jobs, especially for the poor, will be essential. Important examples include rural and other infrastructure (rural roads, irrigation facilities, rural power); basic urban services; and well-designed safety net programs.

**Third**, the ongoing efforts to increase the efficiency and effectiveness of the banking sector must continue. These measures should aim to lower intermediation cost, reduce non-performing loans, improve banking services, and strengthen prudential regulations.

**Fourth**, in the face of sliding world demand, efforts to raise domestic productivity and competitiveness become critical factors for protecting export market shares. The scope for increasing the competitiveness of the South Asian economies is large and includes policies to improve the availability of infrastructure, lower the transaction cost of private investment through better governance, and reduce restrictions on trade and investment.

**Finally, in an environment of constrained resources, greater attention to improving implementation capacity and corruption prevention in public spending becomes even more important.**