

SUMMARY

South Asia's rebound since March 2009 has been strong, and is comparable to that in East Asia.

South Asia is poised to grow by about 7 percent in 2010 and nearly 8 percent in 2011, thanks to the strong recovery in India, good performance in Bangladesh, post-conflict bounce in Sri Lanka, recovery in Pakistan, and turnarounds in other countries, including Afghanistan, Bhutan, and Maldives. The region's prospective growth is close to pre-crisis peak levels and faster than the high rates of the early part of the decade (6.5 percent annually from 2000 to 2007). The recovery is being led by rising domestic confidence and is balanced in terms of domestic versus external demand, consumption versus investment, and private demand versus reliance on stimulus.

Government policy, external support, resumption of private spending and global recovery are driving the rebound.

Strong government fiscal and monetary stimulus packages and, in some cases, external assistance are helping stimulate recovery. Improved optimism is helping the recovery in private spending in India, Bangladesh, Bhutan, and Sri Lanka. World trade and demand recovery is also supporting the rebound in exports and tourism, as are capital inflows. Not everyone is doing equally well, with slower recovery in countries with weaker fundamentals, those with unresolved conflict or post-conflict issues, and those that were heavily exposed to the global downturn (Maldives, Nepal, and Pakistan). Some significant risks are ahead in the global environment—slowing worker remittances and exports in a still hesitant and uncertain global recovery (which recent events in Europe have highlighted), volatile commodity prices, and continuing volatility in global capital flows.

Strong, timely policy interventions were and are a key to confidence and recovery.

Monetary policy was eased and interest rates sharply lowered during the crisis, cushioning private demand. Fiscal stimulus amounted to more than 3 percent of GDP in India and helped revive confidence and optimism, assisted by pre-election spending and civil service salary raises. Bangladesh was similarly placed to take fiscal action. Other countries had more limited room, and they tightened policies initially to shore up macrostability, before easing policies to strengthen their recoveries (Pakistan and Sri Lanka).

South Asia's particular strengths and forms of global integration—not the lack of it—was a key reason that allowed greater resilience.

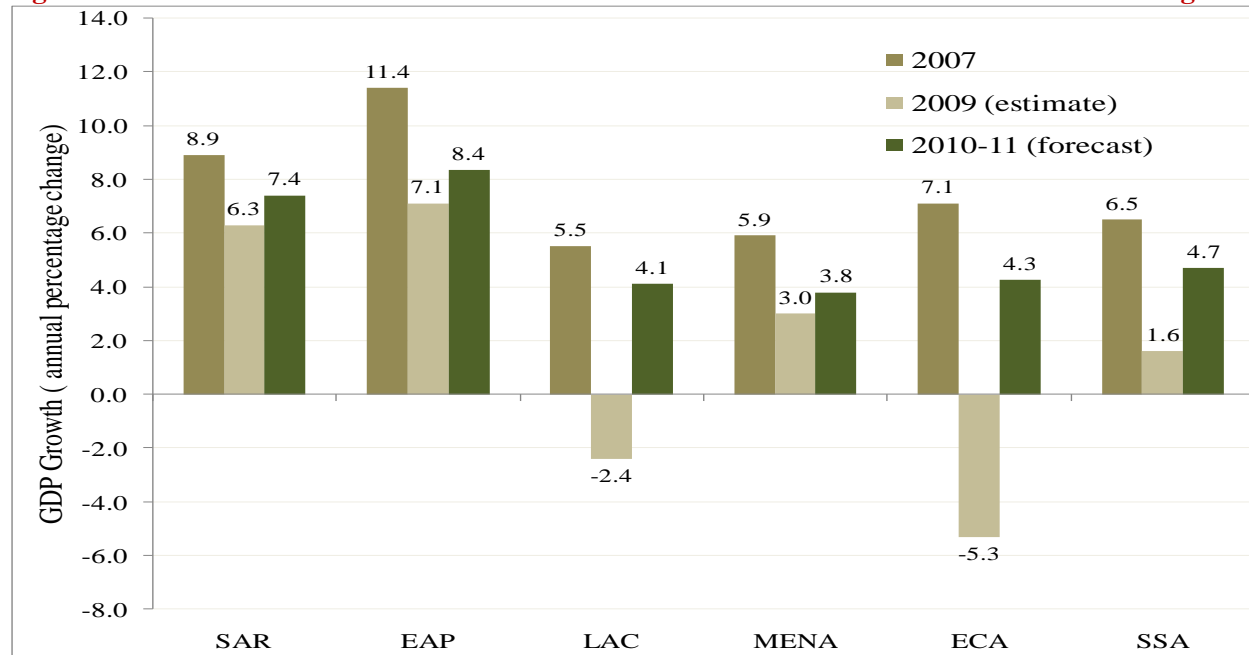
The view that South Asia is relatively less integrated with the outside world, and that this helped protect it from the global recession, is outdated. Over the past 15 years the region has become much more open—and it appears that the form of openness it has chosen has provided resilience in the face of recent shocks:

- Financial systems proved relatively robust, with limited financial integration and exposures to overseas subprime markets, while long-standing capital account restrictions lessened, but not altogether avoided, vulnerability to sudden capital outflows
- Remittance inflows proved surprisingly resilient, as opposed to trends elsewhere, as workers from South Asia kept remitting earnings and savings from abroad even as they faced job losses and downturns in main migration centers
- Exports proved relatively resilient, especially given the types of specialization such as in the IT services sector (India), and in the garment and textile sectors (Bangladesh and Sri Lanka) where the region maintained competitiveness
- Foreign direct investment flows proved more buoyant and resilient than in other parts of the world.

As a result, South Asia weathered the global shocks much better than expected. The slowdown in regional GDP growth of nearly 3 percentage points—from a peak of 8.9 percent in 2007 to 6.3 percent in 2009—was the least pronounced of that for all developing regions. The effects were nevertheless significant—large negative output shocks, job losses, wealth and confidence losses, stock market

declines, indirect contagion effects propagated by domestic financial markets, losses in exports and tourism, and pressures on already weak fiscal, balance-of-payments, reserves and exchange rates—but these effects were eventually contained.

Figure 1: South Asia: Smallest Decline in Growth from Global Financial Crisis and Recovering



Source: Figure 1.4 in main text of the Update.

Note: SAR refers to South Asia; EAP to East Asia and Pacific; LAC to Latin America and Caribbean; MENA to Middle East and North Africa; and SSA to Sub-Saharan Africa region.

Managing the immediate recovery—create fiscal space, contain inflation, and boost agriculture. As South Asia’s recovery gathers momentum, an immediate challenge is to create fiscal space and contain rising inflationary pressures, while ensuring that the exit from fiscal and monetary stimulus is in tune with the recovery of private demand. South Asia stands out compared to all other developing regions in terms of high levels of public debt and deficits (similar to levels in highly indebted developed countries). Greater fiscal space is needed to deal with unexpected future shocks, not crowd out the private sector, and permit governments to finance crucial public investment. Managing inflationary pressures will also benefit from gradually tighter fiscal and monetary demand management to contain core nonfood inflation which has risen to a relatively high level of 7-10 percent, surpassing the pre-crisis average of 4-6 percent. Food prices have been rising especially sharply in recent months, because of poor weather in India compounded by delayed adjustment to higher global prices; they should moderate in the near-term, but a renewed focus on agriculture is also vital, especially given the persistently high rural populations and poverty.

Sustaining inclusive and faster growth—new drivers of growth. The challenge now is to also make this regional recovery more durable, inclusive and sustained, looking not to just cement its past successes, but to future drivers. The world that the region is facing after this crisis is different—with slowing growth in high income countries and faster growth in emerging markets—offering both opportunities and challenges. The model that has served the region well in the past, the growth of increasingly sophisticated service sectors, should continue to serve it well. But it will be useful to add to that in order to create more jobs and help realize the demographic potential of the region.

One of the key new drivers is likely to be the rise of a globally competitive manufacturing sector.

South Asia in recent years has attracted greater investor attention, because of faster growth, its large size of domestic markets, and as an increasingly attractive location for labor-intensive manufactures given low-wage costs. And paradoxically, its growing prowess in exports of sophisticated services as it became more open and integrated with global markets is also enhancing its possibilities in industrial and other sectors. Such services will serve as critical inputs to the growth of manufacturing. This set of endowments and interest of investors can now be turned to decisive advantage by stepping up policy support to manufacturing, with a focus on new entry and growth of the “missing-middle” of more dynamic mid-sized firms and more “sophisticated” manufactures. Policies that might support such goals are: greater export-orientation and trade links, reduced behind-the-border costs, better infrastructure, and a differentiated strategy of industrial support—such as industrial clusters and export-processing zones in late or new industrializing areas, and accelerated skills-training, infrastructure, and a deregulated business environment (land, labor) in already established areas.

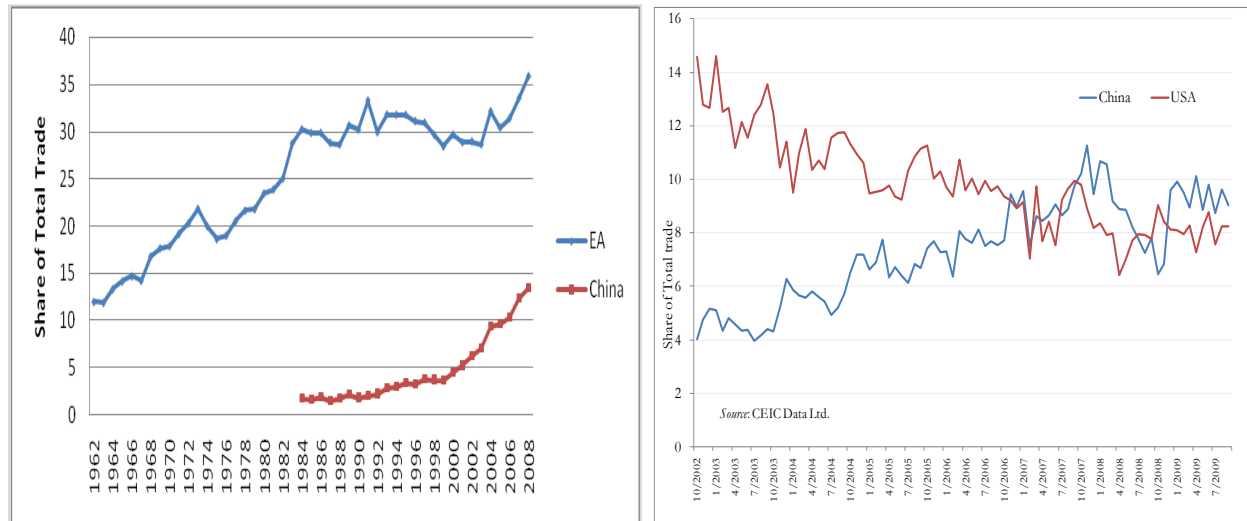
The process has already started. Rapid spread of mobile telephony and financial services are boosting domestic markets and productivity growth. Private sector investment is also addressing critical bottlenecks. In the first three quarters of 2009, South Asia remarkably attracted some 40 percent of total investment commitments in private participation in infrastructure projects in the developing world worth some record US\$26 billion, much of it going into the crucial energy and transport sectors, mainly in India, but spreading to other countries. Foreign direct investment has been surging, much of directed to the new manufacturing and services sectors. In the first six months of 2009, India exported more small cars to the rest of the world than did China, thanks to the relocation of car manufacturing from Korea and Japan. Sri Lanka has started exports of sophisticated optical equipment, electronics and high-end garments, and become a transshipment hub. And Bangladesh is beginning to attract investment into sophisticated ship-building and newer manufacturing, in addition to its traditional specialization in low-cost garments, jute, and ship-breaking.

Taking advantage of three levels of growing integration: with East Asia, within the region and with the rest of the world. There is a significant consensus now that what will come after this crisis in the global economy will not be simply a return to pre-crisis conditions, but a “new normal.” Developed countries are starting to save more and spend less, are burdened with large fiscal and financial adjustment after the crisis, and are likely therefore to grow at a much slower pace, especially in Europe and North America, whereas Asia and emerging markets will become much bigger drivers of global growth. As a special topic for this Outlook, the report examines and recommends three principal directions to reposition South Asia’s trade and investment integration policies and profitably expand their domestic economies in both manufacturing and services.

Intensify their Look East strategy to integrate faster with East Asia, a region with a combined GDP of US\$6 trillion and South Asia’s natural trading partner. Look East integration is already happening, with quite remarkable results, and South Asia is well on its way to integrating rapidly with East Asia (with trade potentially tripling to some US\$450 billion annually in terms of gravity model results). One of the largest copper mines is being established in Afghanistan by investment from China. The biggest FDI project in India is an integrated steel plant investment from Korea. Financial services are being deepened by investments from Singapore, as are electronics with investments from Asian NICs. Energy and food imports from Malaysia and Indonesia are reducing domestic constraints. Imports of sophisticated capital goods are helping the productivity climb of large segments of manufacturing, including consumer electronics and capital goods. The recovery of tourism in Maldives, as well as other countries is being driven by increased flows from East Asia. Given complementary economic structures and specialization possibilities, such trade and investment integration will help boost domestic manufacturing and services output and productivity further, and provide significant gains for growth and welfare—provided policies improve and attract investment in trade logistics and other backbone services and help integrate South

Asia faster into global manufacturing value chains. Reducing tariffs to East Asian levels, liberalizing foreign direct investment into services sectors, and reducing behind-the-border administrative and regulatory trade barriers will be important to achieve these gains.

Figure 2: South Asia's Rising Trade with East Asia, and India's Trade with China and the United States



Source: Figures 3.2 and 3.3 in the main text of the Update.

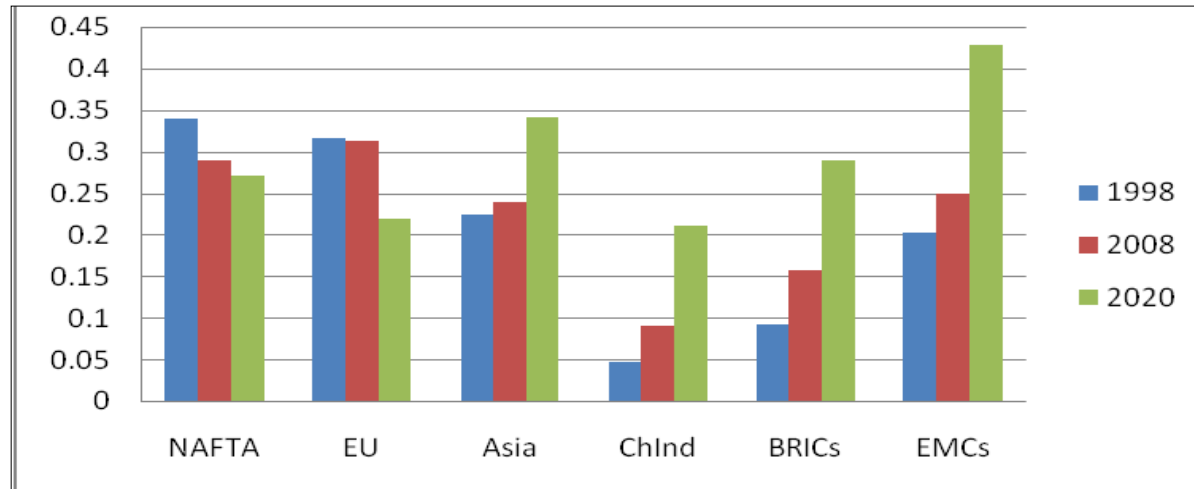
Integrate more closely with each other within the South Asia region as a key complementary driver.

The potential for closer integration within South Asia is large (with annual trade potentially increasing by some US\$50 billion), similar to the experience in the EU, East Asia and other regional trading arrangements. The gains from a Look East strategy will be even stronger with such an expanded regional market. Such a larger regional market will allow bigger scale economies, induce greater competition and technology spillovers, improve trade logistics and attract greater private investment from East Asia and the rest of the world. The role of India will be central to improve integration opportunities for smaller neighbors as they respond. While the gains for India are smaller, the gains for smaller neighbors are much bigger. Growing bilateral hub-and-spoke trade, in both manufacturing and in services, with private investment as the driver, is likely to be the most promising route (complementing regional initiatives). Again, there are increasingly prominent gains happening on the ground. Sri-Lanka-India trade has boomed following the bilateral trade agreements, extending to services, such as open-skies agreement that has brought new carriers and tourism, while Sri Lanka's exports to India have quadrupled. Nepal's access to India's labor markets has increased remittances dramatically. Bhutan's power projects are providing a surge in export earnings and growth, while helping supply critical power. The recent 2010 Bangladesh-India trade agreement promises to open similar avenues to growth, not just to the two countries, but also boost transit trade for land-locked Nepal and Bhutan and India's Northeast. Afghanistan-Pakistan border trade is booming with large benefits to both countries.

Finally, preserve links to high-income markets in Europe and North America, and others, as these will continue to be important for labor-intensive exports, services, and as sources of capital and know-how. High-income markets are already vital for growing information technology and outsourced business process services (United States accounts for over half of India's service exports) and labor-intensive manufactured exports, even if at a slower pace than in the past. Other emerging markets and regions, such as the Middle East, Africa and Latin America, are also fast-growing and are increasingly important partners. In its pursuit of a Look East and accelerated regional integration strategy, South Asian countries will therefore stand to gain by pursuing an unilateral opening of their merchandise and services

trade and direct investment—in an ‘open regionalism’ fashion—to improve their access to all markets, and increase inflows of capital and know-how for manufacturing and backbone infrastructure services at home. These, in turn, will complement and sustain the domestic engines of productivity and growth. The effects of lowering real trade costs could be as powerful as increasing trade impacts by a factor of two or more.

Figure 3: The Growing Share of Emerging Markets (Share of World GDP, in Current US\$)



Source: Figure 3.1 in main text of the Update.

Concerns about security, including day-to-day insecurity, will need to be addressed if the region is to fulfill its full potential. For some countries in the region, and some regions in all countries, economic growth and development has been hobbled in past decade by rising conflict and insecurity. As peace returns, the post-conflict peace dividends can be large but are not automatic; policy settings need to be supportive—potentially raising growth by 2-3 percentage points annually in the countries and more in the sub-regions severely affected. The post-conflict bounce in growth and optimism in Sri Lanka is an example, and could be possible in Nepal, if policies sustain the dividend. On the other side, in protracted conflict affected regions, although it is a very complex issue, one factor that might help is more jobs for a fast-rising young population. Winning the peace and ensuring security there will require the successful creation of jobs, and strengthening the role of the state to deliver better services and good governance. Expanding the private sector, including in agriculture, will require vast improvements in public infrastructure, sustaining and scaling up of successful national programs, and strengthening economic governance.

Increased trade among neighbors might help. One example of this is the possibility of a larger regional energy ring trade that might bring large regional benefits. Bangladesh, India, Pakistan, and Sri Lanka all have a demand for energy that is in excess of their domestic capacity to varying degrees, and the gap will only become larger with future growth. Conversely, Bhutan and Nepal in the region; the Islamic Republic of Iran and Qatar in the Middle East and North Africa region; Kyrgyzstan, Tajikistan, and Turkmenistan in the Central Asia region; and Myanmar in the East Asia region all have resource endowments considerably in excess of domestic demand. The tapping of this potential with regional energy links by some estimates could generate benefits valued at US\$12-15 billion annually. But this potential would only be realized with improved security and regional cooperation, including at the ground level and with discernible benefits to the local populations.