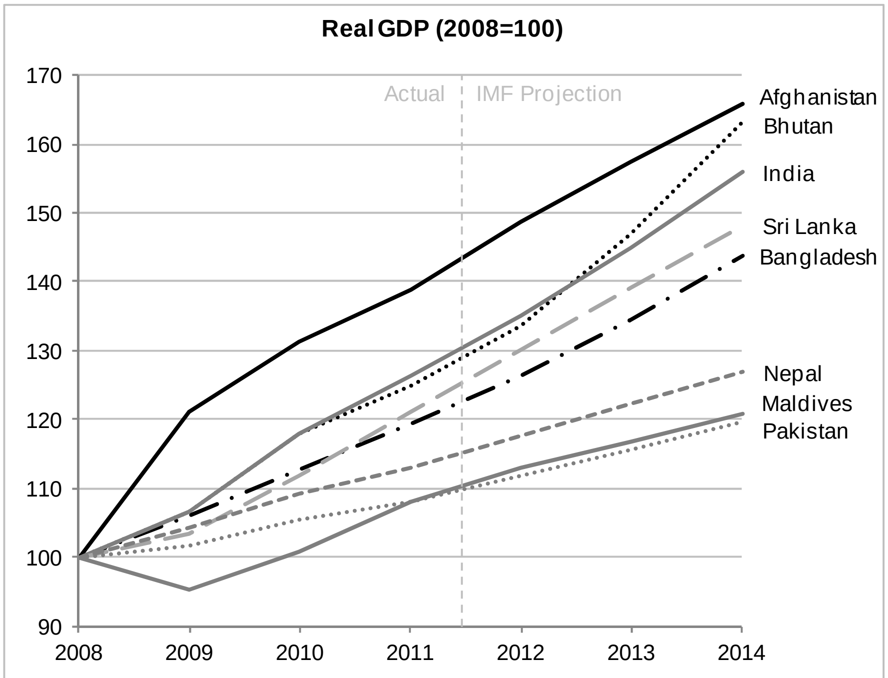
South Asia

May 2012

Economic Overview



SOURCE: IMF, *World Economic Outlook*, April 2012.

Real GDP growth in South Asia decelerated to 5.8 percent in 2011 and is expected to maintain that same rate in 2012, a sharp fall from 7.3 percent in 2010. The regional deceleration in growth reflects internal and external headwinds. On the domestic front, restrictive macro-economic policy stances, aimed at reducing high inflation and fiscal deficits have contributed to weaker domestic demand. Meanwhile, higher borrowing costs, high inflation, and country-specific factors such as policy uncertainty and deteriorating political and security conditions have contributed to a significant slowdown in investment growth.

At the same time, the external environment has become increasingly challenging and uncertain. While exposure to euro area banks is limited, the European debt crisis has hit equity finance with regional stock markets retreating in concert with the rest of the world during the second half of the year. A fall-off in foreign bank lending has also contributed to a sharp depreciation of local currencies against the dollar in the second half of 2011.

India, which accounts for 80 percent of South Asia's GDP, has contributed significantly to the regional slowdown as its GDP growth weakened to an estimated 7.2 percent in 2011, down from 10.6 percent in 2010. The slowdown reflects moderation in domestic demand, given a deceleration in investment growth in the face of rising borrowing costs, high input prices, slowing global growth and heightened uncertainty. Growth is projected to hold steady at 6.9 percent in 2012 before accelerating to 7.9 percent in 2013. Pakistan, the second largest economy in the region, continues to lag considerably behind the outcomes elsewhere in the region, reflecting worsening security conditions, greater uncertainty and a breakdown in policy implementation. GDP growth slowed to 2.4 percent in 2011, down from 3.8 percent in 2010. Pakistan is projected to post a rebound of 3.4 percent in 2012. By contrast, Bhutan has posted high GDP growth, boosted by large hydropower projects and is predicted to rise even further at a rate of 7.0 percent in 2012 and 9.9 percent in 2013 as large infrastructure projects continue.

Countries covered in this report: Afghanistan, Bangladesh, Bhutan, Maldives, Nepal, Pakistan, Sri Lanka, and India. Due to data limits, not all countries are represented in every graph or analytical section.

In Afghanistan, the main source of economic growth remained private consumption, mainly supported by large aid flows. The Asian Development Bank predicts that the foreign troop pullout in 2014 will lower the annual growth by at least 2–3 percentage points after that date, as a result of reduced local spending by these forces and by foreign civilian organizations with international and national staff.

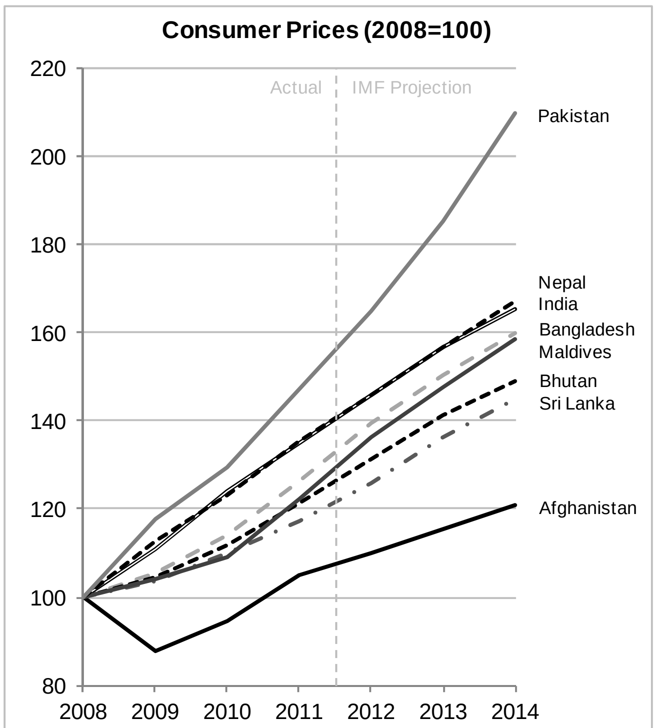
Bangladesh, Bhutan, India, the Maldives, and Sri Lanka all saw their current account deficit widen. Afghanistan (not including grants) and Nepal saw their current account deficits contract while Pakistan's current account posted a marginal surplus of 0.1 percent of GDP, boosted by a strong inflow of remittances, flood-related grants and inflows from the United States Coalition Support Fund. Bhutan's overall current account deficit widened from 9.9 percent of GDP in 2010 to about 20.6 percent in 2011, reflecting the large hydropower project's import requirements. However, associated capital inflows are expected to keep the overall balance of payments in surplus. Meanwhile, in India, the current account deficit widened to an estimated 3.6 percent of GDP in 2011 and is forecast to improve marginally to 3.3 percent of GDP in 2012. However, still high global oil prices and slowing external demand will continue to exert pressure on the current account deficit in 2012. In Afghanistan, with foreign troops' withdrawal slated for 2014, fiscal policy will have to finance security spending and other expenditures within a very tight budget constraint. As a result, Afghanistan's debt burden could rise substantially in the near future.

Real GDP Growth, 2012 (IMF Projections)	East Asia 7.9%	Central Asia 6.2%	South Asia 5.8%

Inflation

Consumer prices in South Asia are forecast to rise by 8.8 percent in 2012 and 8.0 percent in 2013 down from 10.2 percent in 2011. However, the unstable geopolitical situation in the Middle East could trigger further oil price spikes, reviving inflation in Asia.

In India, inflation persisted at around 10 percent through most of 2011 despite earlier rounds of monetary tightening. Bhutan's local price movements mostly follow India's as Bhutan's currency is pegged to India's and there are strong trading ties between the two countries. In Bangladesh, inflation is at a multi-year high and is expected to further rise to 10.4 percent in 2012. Annual inflation rose to 8.8 percent from 7.3 percent in 2010 due to the rise in global food and commodity prices and a strong expansion in domestic credit.



SOURCE: IMF, *World Economic Outlook*, April 2012.

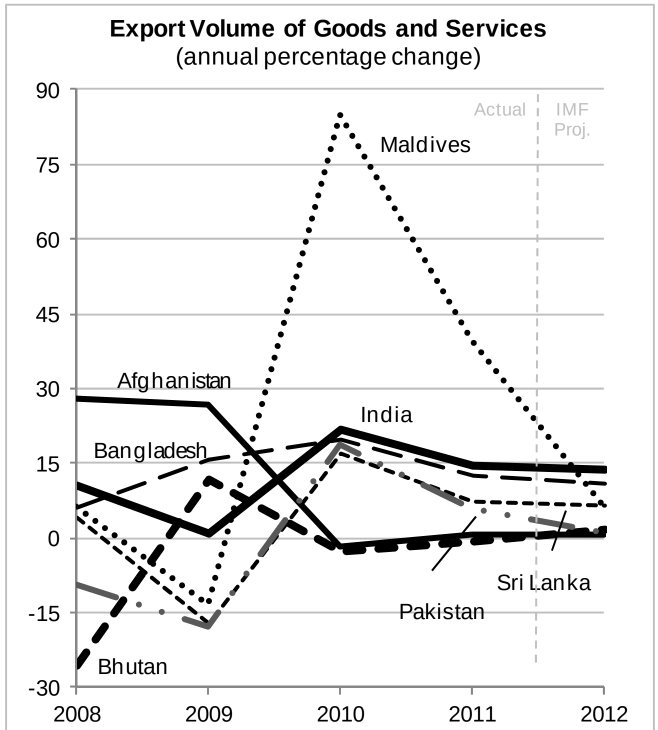
Consumer prices are highly volatile in Afghanistan because of heavy import dependence, including food and fuel. Inflation which peaked in 2011 receded slightly in 2012, mainly due to declining global food prices. The Central Bank adopted a relatively tight monetary policy during 2011 to contain inflationary pressures, although they stemmed largely from global price increases.

In Pakistan, inflation, already under pressure from increasing global commodity prices, remains higher than for any other country in the region. This is mostly due to flood-related shortages, especially for food and higher costs due to damaged transport networks. Responding to price pressures, the Central Bank tightened monetary policy in 2011, raising the discount rate, bringing it to 14 percent. In addition, food inflation has averaged 18 percent a year for the past 3 years (much higher than overall inflation) ensuring that a larger share of income is required to meet this essential need.

CPI Inflation, 2012 (IMF Projections)	South Asia 8.8%	East Asia 7.7%	Central Asia 7.3%

Trade

The effects of spillovers from Europe can be seen in the declines in the demand for the region's exports of goods and services with a near halving of export growth to 5.8 percent in 2011, down from 11.3 percent in 2010. Contributing factors to slowing export demand include stagnant GDP in the European Union and the projected global slowdown, including the influence of tighter monetary policy in China and fiscal consolidation in Europe. In addition, euro-area banks have begun reducing their cross-border lending and while Asian banks are generally in good financial health and many have sufficient capacity to increase lending, euro-area banks handle a substantial share of trade credit in the region and often specialize in complex project financing, for which it would be difficult to find quick substitutes.



SOURCE: IMF, *World Economic Outlook, April* 2012.

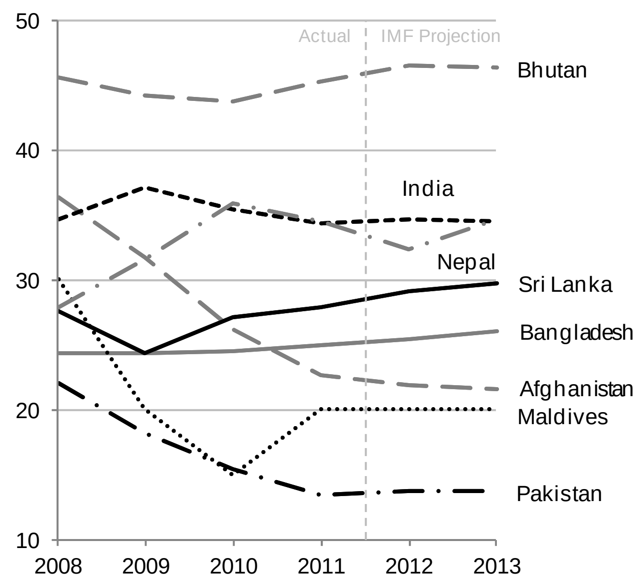
In Bangladesh, exports grew 12.7 percent in 2011, reflecting a sharp recovery in garment demand in the main markets in the European Union and the United States and a pickup in garment exports to new markets, though these remain a small part of total sales. However, export growth is projected to slow to 10.8 percent in 2012, mainly reflecting weak demand for garments from the euro area and the US.

With markets in the United States and Europe expected to experience prolonged weakness, South Asian countries have the opportunity to pursue new sources of growth in both domestic and external markets. This may include focusing exports toward faster growing emerging markets, as well as internal market enhancement through structural and governance reforms. Such actions would help boost export demand, increase investment and increase employment.

Investment

Investment has remained relatively stable in the South Asian economies with the exception of Pakistan, whose investment declined by a total of 8 percentage points of GDP over the last three years (2008–2011). Investment is not expected to pick up due to structural and security issues. In Pakistan the economy continues to be affected by structural problems, including a domestic energy crisis, a precipitous decline in investment, persistently high inflation and security issues. Severe floods at the start of 2011 disrupted economic activity in most sectors in the first half of the year. Industry has stagnated under the weight of energy shortages and low investment. The economy was characterized by low growth for the fourth year in a row (a period average of 3 percent). Investment continued to shrink, reflecting structural and security issues. The economy is expected to grow modestly without a more predictable energy supply and improved investment flows.

Investment as Percentage of GDP



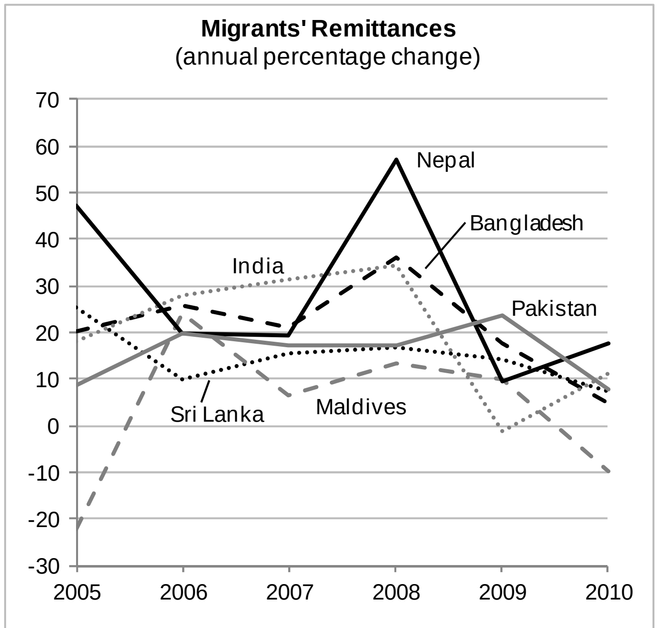
SOURCE: IMF, *World Economic Outlook*, April 2012.

Investment in India peaked in 2009 and has since reversed its trend. The factors of investment's deceleration include the slump in the global economy and trade, tighter monetary policy and higher nominal interest rates targeted at high inflation. Investment is expected to remain in the 34 percent range over the next three years.

Bhutan's level of investment as percent of GDP is the highest in the region at 45.3 percent, driven by the construction of large hydropower projects.

Total Investment, 2012 (as a % of GDP) (IMF Projections)	East Asia 34.6%	South Asia 28.0%	Central Asia 27.1%

Remittances



SOURCE: UNCTAD Foreign Direct Investment Database.

Worker remittances constitute a critical source of foreign exchange in South Asia. They also contribute significantly to local household's incomes and consumption capability. A measure of remittances' magnitude is as a percentage of GDP. In 2010, remittances represented 20.0 percent of GDP in Nepal, 9.6 percent in Bangladesh, 7.0 percent in Sri Lanka, and 5.0 percent in Pakistan. If the global conditions were to deteriorate sharply, remittances growth could stall, resulting in weaker incomes, weaker foreign currency earnings and slower domestic demand growth.

In Nepal, remittances peaked in 2008 at 57 percent annual growth. Remittances growth decelerated in 2010, possibly affected by the instability in the Middle East, the main employment destination.

In Sri Lanka, private consumption remained the main driver of economic growth, in part fueled by remittances. In addition, improved workers' remittances and an increased surplus services account helped contain the current account deficit. According to the Asian Development Bank, workers' remittances, up by 25.0 percent in 2011 remained the single largest foreign exchange earner at $5.1 billion or 8.7 percent of GDP.

Additional Information

For questions or more information, please contact the author, Marie-Ellen Ehounou, at mehounou@devtechsys.com.

For country-specific data and additional information about the countries covered in this report, please visit the EADS Country Portal at http://esdb.eads.usaidallnet.gov/query/do?_program=/eads/esdb/countryPortal.

Sources used in compiling this report include the semi-annual *World Economic Outlook* from the International Monetary Fund (http://www.imf.org/), the *Global Economic Prospects* from the World Bank (http://www.worldbank.org/), and the annual *Asian Development Outlook* from the Asian Development Bank (http://www.adb.org/).