

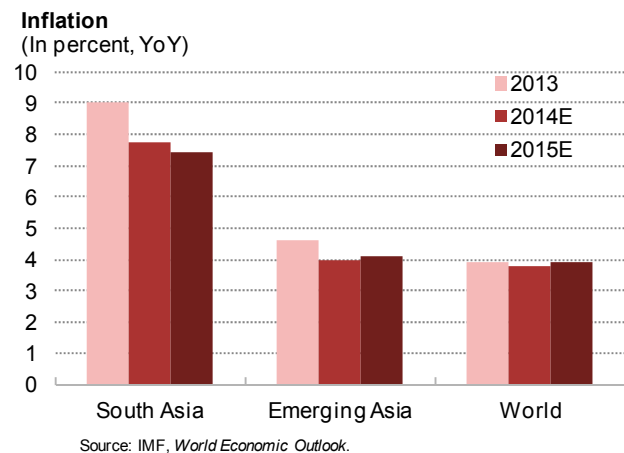
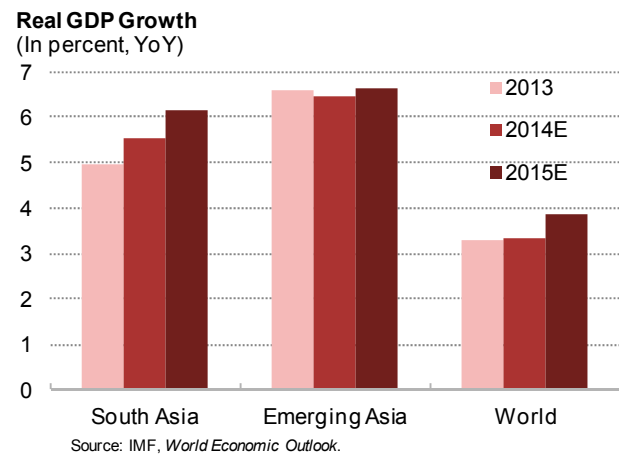
South Asia: Consolidating Gains in the Post-Crisis Era

South Asia's recent economic performance has been strong and prospects appear positive. Most countries in the region have managed to move past the downturn associated with the 2008–09 global financial crisis, and bring growth and economic prospects back to pre-crisis norms. Inflation has dropped, fiscal deficits have generally fallen, and external positions have strengthened. For those with weaker performance, political unrest and security issues have generally been the key constraints. However, as a group these countries continue to face a number of external and domestic risks. They also have a considerable amount of ground to cover to converge with the comparatively stronger performance of emerging and developing Asia as a whole.

Global and Regional Economy

An uneven global recovery continues, but downside risks appear to be once again on the rise. Largely due to weaker-than-expected global activity in the first half of 2014, the growth forecast for the world economy has been revised downward to 3.3 percent for this year, 0.4 percentage points lower than in the April 2014 *World Economic Outlook* (WEO). The global growth projection for 2015 was also lowered to 3.8 percent. Short-term risks include a worsening of geopolitical tensions and a reversal of recent risk spread and volatility compression in financial markets. Medium-term risks include stagnation and low potential growth in advanced economies—South Asia's principal export markets—and a decline in potential growth in emerging markets. Softening of property markets in China and the potential negative impact on real and financial activity has introduced a new risk variable in recent months. However, a silver lining to recent doubts about global growth lies in lower international oil prices, which should help contain inflation and current account deficits in a number of Asian economies.

South Asia has generally enjoyed strong growth in the past year, despite short-term market turbulence. Most countries in the region have managed to move past the downturn associated with the 2008–09 global financial crisis, and bring growth and economic prospects back to pre-crisis norms. Inflation has dropped significantly, fiscal deficits have generally fallen, and external positions have strengthened. For those with weaker performance, political unrest and security issues have generally been the key constraints.



The outlook appears broadly stable with most of the positive trends expected to continue. However, the global risks noted above could negatively affect those countries with greater exposure to international markets (India, Sri Lanka, and Bangladesh). Many South Asian economies also continue to face a number of domestic risks. High inflation is a key concern, as it undermines investor confidence and contributes to exchange rate

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volatility. For most of South Asia, export performance is also weaker than desirable, placing pressure on current account imbalances and reserves. Fiscal deficits are also relatively high in several cases, and structural reforms to enhance the business climate are needed everywhere. As a group, South Asian economies have considerable ground to cover to converge with the comparatively stronger performance of emerging and developing Asia as a whole.

India

India's growth outlook has improved and the balance of risks is more favorable than foreseen in early 2014, helped by lower political uncertainty, improved business confidence, and reduced external vulnerabilities. Real GDP growth is forecast to rise to 5½ percent in fiscal year 2014/15 (up from 4¾ percent achieved in 2013/14), accelerating to 6⅓ percent in 2015/16, despite headwinds from ongoing fiscal consolidation and a tight monetary stance. India's high and persistent inflation remains a concern, and is projected to decline only gradually to around 7½ percent in 2015/16.

India's external vulnerabilities have diminished significantly in the past year. Effective policy actions have helped to shrink the current account deficit and strengthen external buffers. The current account deficit shrank from a record 4.7 percent of GDP in 2012/13 to 1.7 percent of GDP in 2013/14, and is projected to stay at around 2 percent in 2014/15. The 2013/14 fiscal outturn and the 2014/15 budget clearly show the authorities' commitment to fiscal consolidation, however, limited progress on tax and subsidy reforms compromise the quality of fiscal adjustment.

Pakistan

GDP expanded by 4.1 percent in 2013/14, reflecting an easing in structural bottlenecks, particularly in electricity supply, that helped facilitate increased industrial production. Inflation has moderated recently, but remains in the high single digits. Reforms undertaken by the government, supported by the IMF Extended Fund Facility, have helped improve economic conditions. Renewed support from development partners, foreign inflows, and

considerable foreign exchange spot purchases by the central bank helped stabilize the currency and rebuild foreign exchange reserves from very low levels. The current account continued in deficit, driven primarily by the trade deficit, while the financial account has benefitted from net official flows. Remittances continue to grow at a robust pace of about 14 percent in 2013/2014, while foreign direct investment remains weak.

The outlook appears modestly positive, although risks remain relatively high. Growth is likely to rise further to 4.3 percent in 2014/15, and inflation is forecast to moderate slightly and hover around 7½ percent. However, security concerns, limited capacity to implement reforms simultaneously, and basic structural issues pose significant risks. Power shortages, infrastructure bottlenecks and a widening trade deficit are key challenges.

Sri Lanka

Economic growth in Sri Lanka has been strong, and is likely to remain above the South Asian average in the next 1–2 years. After falling to 6.3 percent in 2012, real GDP growth rebounded to 7.3 percent in 2013—boosted by net exports on the back of economic recovery in the advanced economies (Sri Lanka's key export markets) and robust growth in services. Growth has remained strong in the first half of 2014, and will likely be 7 percent or more for the year as a whole. Inflation has remained in the low single digits, despite sizeable increases in electricity tariffs in 2013. The external accounts improved in 2013 as exports climbed and imports (including intermediate goods) declined—a trend that has continued into 2014. Steady fiscal consolidation since 2009 has underpinned a gradual reduction in the debt-to-GDP ratio.

Sri Lanka's vulnerabilities have lessened somewhat in the past year, and may diminish further if sound macroeconomic policies are accompanied by critical structural reforms. The improvement in the external accounts has facilitated an accumulation of international reserves by the central bank, moving reserve coverage into the "adequate" range by most standard metrics. Public debt has also declined as a share of GDP, although the cost of new borrowing

has risen significantly as Sri Lanka shifts from bilateral concessional borrowing to new loans on commercial terms. Fiscal consolidation has also relied heavily on expenditure compression, as tax revenues have steadily declined as a share of GDP—raising concern over the negative impact on growth from lower investment spending, and the medium-term outlook for public finances.

Nepal

The macroeconomic outlook is broadly stable, and both the fiscal and external positions are solid. Growth accelerated to 5.5 percent in 2013/14 owing largely to a favorable monsoon. The peg to the Indian rupee serves as a key source of stability. Inflation has gradually moderated, but remains high at 7.5 percent (y/y) in August. The current account surplus reached 4.6 percent of GDP in 2013/14, as remittances continued to grow rapidly, and international reserves rose to cover more than eight months of imports. The fiscal position in 2013/14 is again in surplus, on account of under-execution of spending amid solid revenue growth.

Looking ahead, growth is expected to reach around 5 percent in 2014/15, fueled by buoyant services on the back of remittance-induced consumption. Inflation is expected to moderate further, in line with inflation developments in India. Although remittance growth is projected to moderate, the current account should remain in surplus, further boosting international reserves. The budget for 2014/15 envisages a small deficit—well within the authorities' fiscal space.

Bhutan

The outlook for Bhutan is broadly stable, with growth poised to regain previous high levels, efforts underway to contain fiscal imbalances, and comfortable foreign exchange reserves. With the recent removal of import and credit bans for purchases related to housing and automobiles, and on-going construction of hydropower projects, growth is set to recover from 2014 onwards. Inflation is elevated, though declining gradually following that of India, to which the Bhutanese currency is pegged. CPI inflation fell from 11¼ percent in December 2013 to 8½ percent in

June 2014, with moderating food and non-food inflation. Fiscal deficits widened in the last two years, due to shortfalls in grants and recourse to domestic borrowing. The FY2015 Budget envisages a significant reduction in the deficit mainly through capital expenditure cuts. Current account deficits are projected to remain elevated as several large hydropower projects remain in construction phase till 2017/18, financed by loans and grants from India. Foreign exchange reserves are comfortable at 9½ months of goods import cover.

Islamic Republic of Afghanistan

Afghanistan's growth slowed in 2014 due to political and security uncertainties in connection with the presidential elections and the drawdown of international troops. Real GDP growth is projected to further decelerate from 3.6 percent in 2013. Slowing economic activity and lower tax compliance led to lower budget revenue which, combined with delays in restraining spending, resulted in a very tight cash position for the Treasury. Notwithstanding the pressure on the cash position, the fiscal deficit (overall budget deficit including grants) is projected to remain broadly stable in 2014 as the authorities prioritize expenditures and donors continue their budget support. Weak demand and favorable global food prices helped keep inflation at around 6 percent, despite looser than planned monetary policy. International reserves remain comfortable at around 7 months of imports and the current account is projected to be in surplus, supported by large donor grants.

The recent conclusion of the Presidential election and signature of the post-2014 security agreement with the U.S. should help reduce uncertainties and restore confidence. Growth is expected to recover in 2015 on the back of reduced uncertainties and increased confidence and inflation is expected to remain in single digits.

Bangladesh

Economic activity was disrupted in the latter half of 2013 by political unrest in the run-up to the January 2014 general elections. Calm has since returned, and data for the first seven months of 2014 (on such

indicators as remittances, imports, and credit growth) suggest a recovery in private domestic demand. Leading indicators (particularly for capital imports) suggest a continued recovery in domestic demand for the rest of 2014, which should be further supported by higher wages in the garment industry and a ramp up in public investment. Real GDP growth in fiscal year 2014/15 is thus projected to rise to 6.3 percent, up from a preliminary (though likely overstated) official estimate of 6.1 percent for 2013/14. With import growth expected to continue to rebound (despite the recent decline in oil prices), and export growth moderating as the garment industry adjusts to higher labor and factory safety standards, the current account is projected to move to a small deficit of 0.5 percent of GDP in 2014/15, from a surplus of 0.9 percent of GDP in 2013/14. Reserves have continued to build, and are now equivalent to over 5 months of prospective imports.

Macroeconomic policies have remained prudent, and broadly in line with targets under the ongoing IMF-supported program. The slowdown in activity in 2013/14 led to a much weaker-than-expected fiscal revenue outturn. However, restraint on current expenditure, lower energy-related subsidies, and some delays in implementation of capital spending helped bring down the fiscal deficit (excluding grants) to 3.7 percent of GDP in 2013/14, from 3.9 percent the previous year. Public debt remains on a steady downward trend. Restrained monetary policy has helped bring down non-food inflation steadily to 5.4 percent (annual average) in 2013/14,

from 7.7 percent the previous year. Food inflation was kept elevated by election-related supply disruptions in the year to January 2014, but has since abated, brought down more recently by a strong rice harvest. Thus, headline inflation has eased, and is expected to continue to moderate to 6.7 percent in 2014/15, from 7 percent in 2013/14.

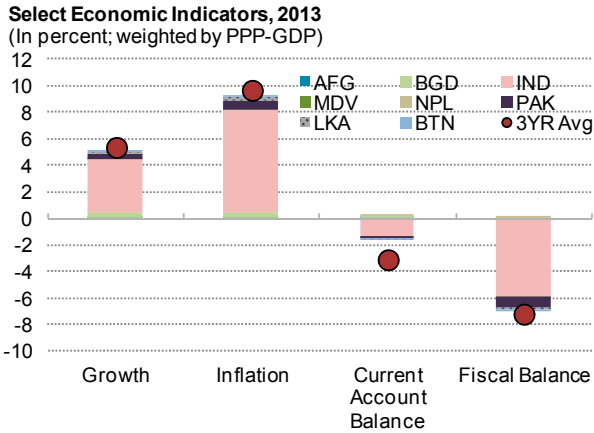
Maldives

Growth is picking up and is expected to reach 4.5 percent in 2014 on the back of stronger tourist arrivals, with a tepid recovery in tourism from Europe and rapid expansion from new markets in Asia. Inflation is contained at 2.4 percent in July reflecting lower global food price inflation. Higher tourism exports and subdued import prices have steadied the current account deficit and the parallel market premium has narrowed to around 5 percent. However the fiscal deficit (11.6 percent of GDP in 2013) is widening once more as recurrent spending is rising. An overall fiscal deficit at around 20 percent of GDP is expected in 2014, and overall public debt is projected to rise to over 96 percent of GDP.

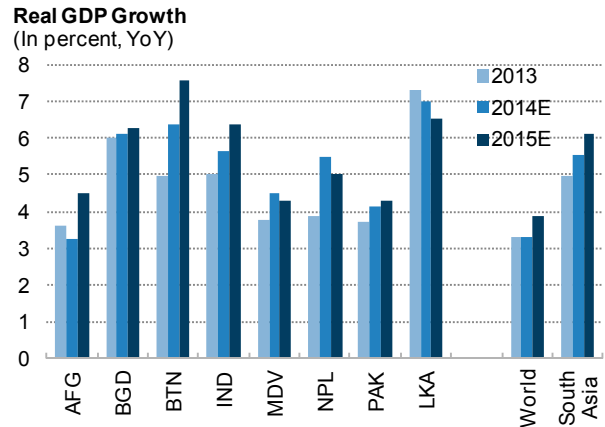
A sizeable fiscal adjustment is needed to restore medium term sustainability. A gradual but concerted adjustment that stabilizes debt in 2017, and brings it down thereafter, could be achieved through strengthening public financial management, expenditure restraint and some further revenue raising measures. Such an adjustment would also help strengthen the external position.

South Asia: Recent Economic Developments and Outlook

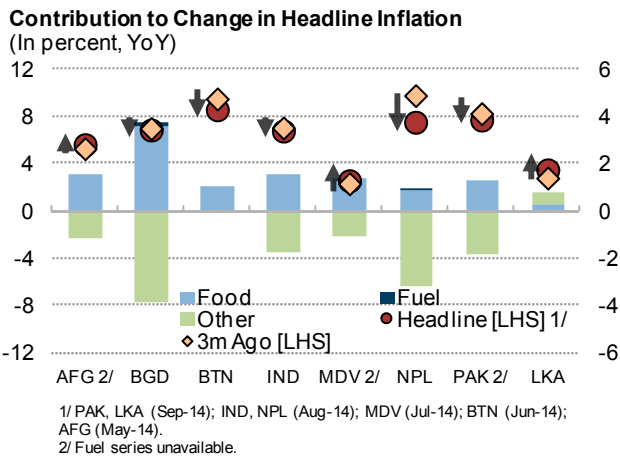
Regional macroeconomic aggregates are near recent medians



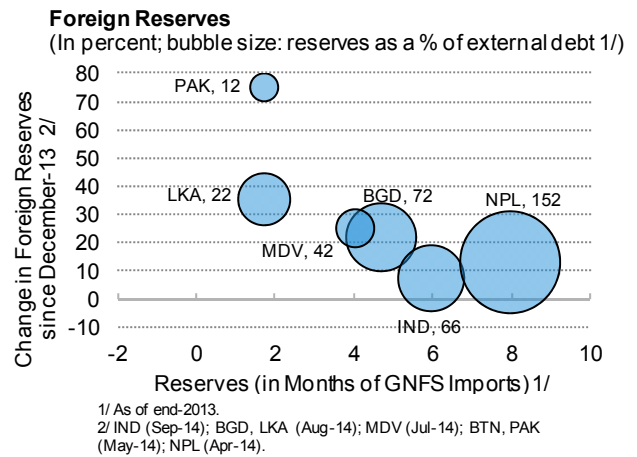
National and regional economic growth is expected to accelerate



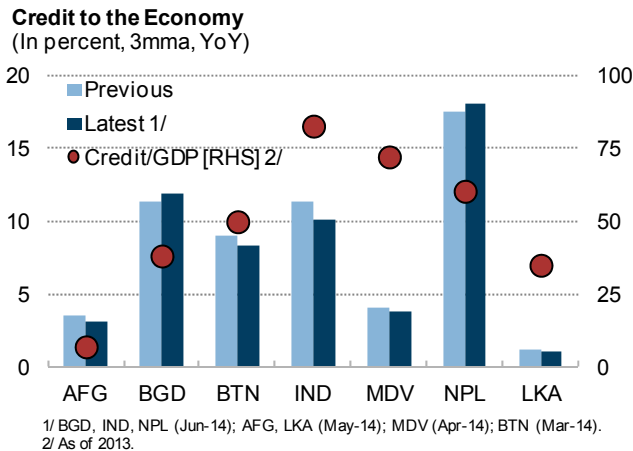
Inflation is decelerating, but is still led by rapid food-price inflation



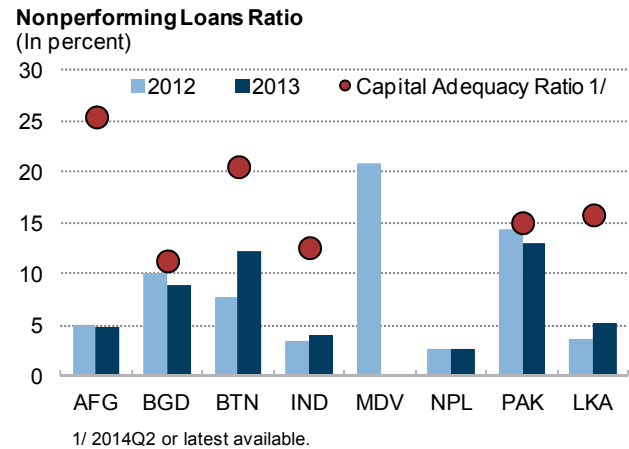
Reserve buffers have grown rapidly



Credit growth has slowed in many countries



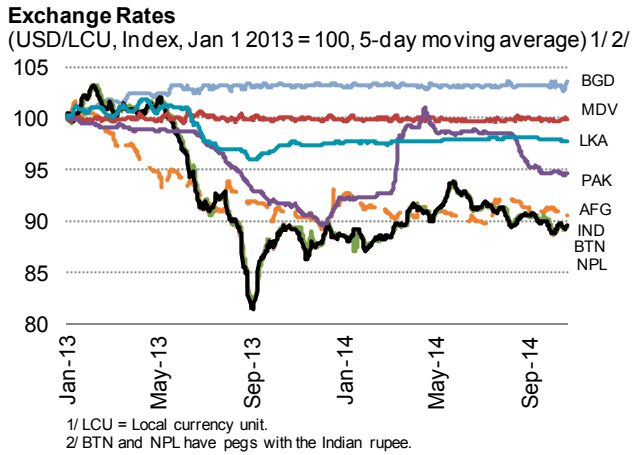
Impaired loans are large in many banking systems



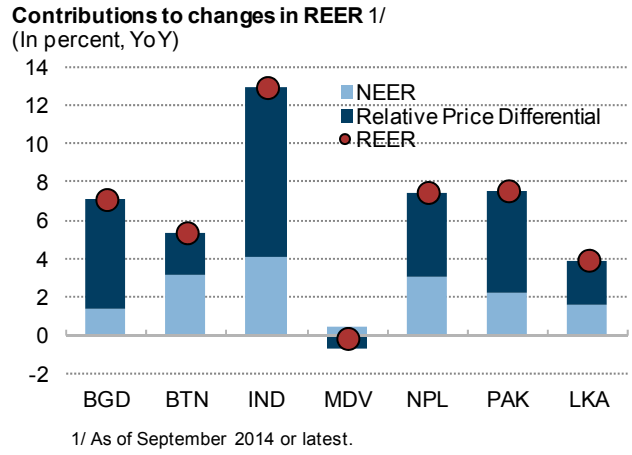
Sources: IMF, *International Financial Statistics*; IMF, *Financial Soundness Indicators*; IMF, *World Economic Outlook*; national monetary authorities; Haver Analytics; Bloomberg; and CEIC. Country acronyms denote: Islamic Republic of Afghanistan (AFG); Bangladesh (BGD); Bhutan (BTN); India (IND); Maldives (MDV); Nepal (NPL); Pakistan (PAK); and Sri Lanka (LKA).

South Asia: Recent Economic Developments and Outlook, cont'd

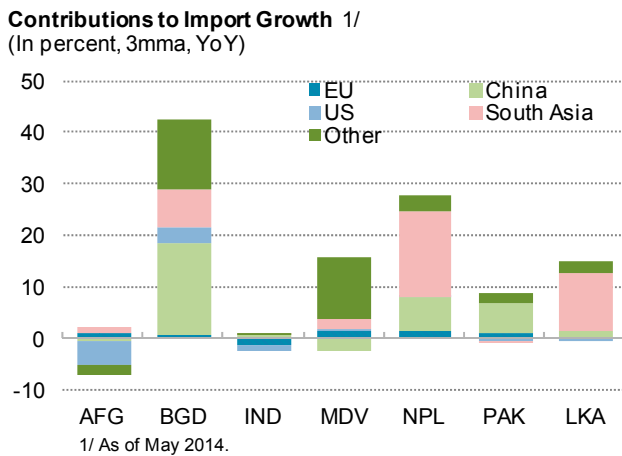
Exchange rate flexibility has been a feature of the policy response to external shocks in some



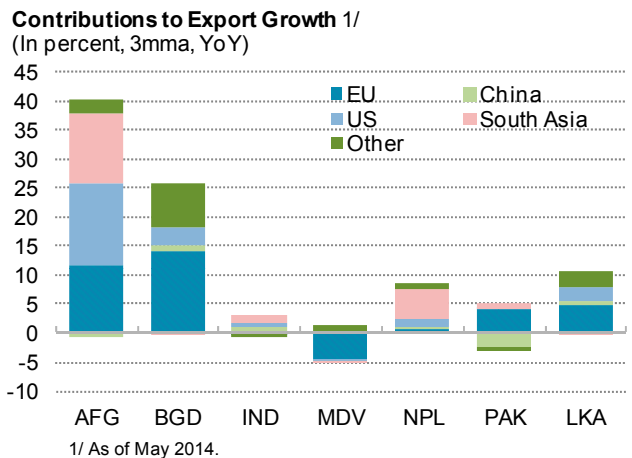
High relative inflation drives much of the movement in real exchange rates



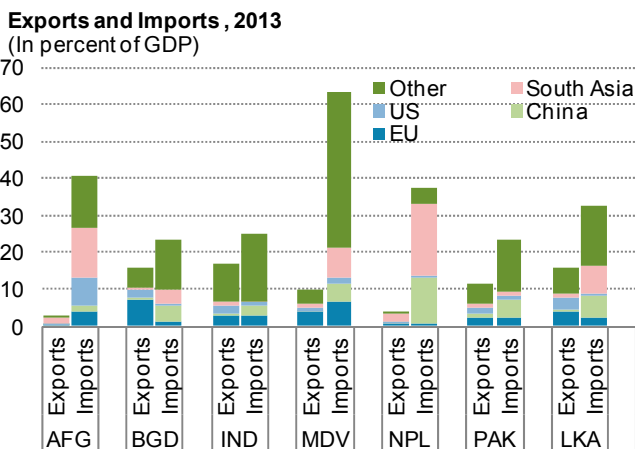
Intra-South Asian trade remains small



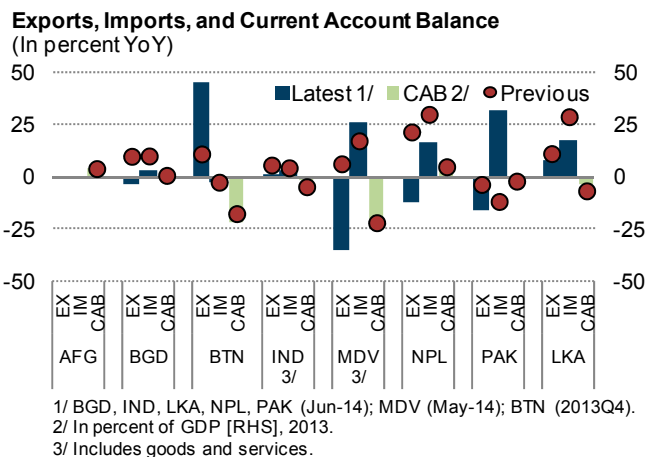
Exports are predominantly outside South Asia



Trade deficits are a common feature in South Asia



Current account imbalances have narrowed recently, driven by robust export performance



Sources: IMF, *Direction of Trade Statistics*; IMF, *World Economic Outlook*; CEIC; Haver Analytics; and Bloomberg. Country acronyms denote: Islamic Republic of Afghanistan (AFG); Bangladesh (BGD); Bhutan (BTN); India (IND); Maldives (MDV); Nepal (NPL); Pakistan (PAK); and Sri Lanka (LKA).

South Asia: Selected Economic Indicators

	Average						Projections	
	2000-08	2009	2010	2011	2012	2013	2014	2015
Real GDP Growth	6.4	7.3	9.1	6.3	4.8	5.0	5.5	6.1
<i>(Annual change; percent)</i>								
Afghanistan	...	20.6	8.4	6.5	14.0	3.6	3.2	4.5
Bangladesh	5.9	5.0	5.6	6.5	6.5	6.0	6.1	6.3
Bhutan	8.4	5.7	9.3	10.1	6.5	5.0	6.4	7.6
India	6.7	8.5	10.3	6.6	4.7	5.0	5.6	6.4
Maldives	7.4	4.5	7.1	6.5	0.9	3.7	4.5	4.3
Nepal	4.1	4.5	4.8	3.4	4.8	3.9	5.5	5.0
Pakistan	5.2	0.4	2.6	3.6	3.8	3.7	4.1	4.3
Sri Lanka	4.8	3.5	8.0	8.2	6.3	7.3	7.0	6.5
Consumer Price Inflation	5.5	11.0	9.3	9.9	10.1	9.0	7.8	7.4
<i>(Year average; percent)</i>								
Afghanistan	...	-6.8	2.2	11.8	6.4	7.4	6.1	5.5
Bangladesh	6.0	7.6	6.8	10.9	8.7	6.8	7.3	7.0
Bhutan	4.3	7.1	4.8	8.6	10.1	8.7	10.2	8.8
India	5.1	10.6	9.5	9.5	10.2	9.5	7.8	7.5
Maldives	3.2	4.5	6.1	11.3	10.9	4.0	3.0	3.1
Nepal	4.8	12.6	9.5	9.6	8.3	9.9	9.0	7.8
Pakistan	6.0	17.6	10.1	13.7	11.0	7.4	8.6	8.0
Sri Lanka	11.9	3.5	6.2	6.7	7.5	6.9	3.8	5.4
General Gov. Overall Fiscal Balance	-7.1	-8.7	-7.7	-7.5	-7.1	-6.9	-6.6	-6.2
<i>(Percent of GDP)</i>								
Afghanistan ¹	...	-1.8	0.9	-0.6	0.2	-0.6	-0.5	-0.8
Bangladesh ¹	-2.9	-3.2	-2.7	-3.6	-3.0	-3.4	-3.2	-3.4
Bhutan	-4.0	-0.5	1.6	-2.1	-1.3	-4.0	-3.8	-2.4
India	-8.1	-9.8	-8.4	-8.0	-7.4	-7.2	-7.2	-6.7
Maldives	-5.4	-21.1	-16.3	-8.7	-9.4	-11.9	-19.2	-15.7
Nepal	-1.7	-2.6	-1.4	-1.3	-1.4	1.5	1.7	0.2
Pakistan	-3.4	-5.0	-5.9	-6.9	-8.4	-8.1	-4.7	-4.4
Sri Lanka	-7.8	-9.9	-8.0	-6.9	-6.5	-5.9	-5.2	-4.7
Current Account Balance	-0.4	-2.7	-2.3	-3.6	-4.2	-1.5	-1.8	-2.0
<i>(Percent of GDP)</i>								
Afghanistan	...	1.9	3.1	3.1	3.9	4.3	4.8	0.1
Bangladesh	0.0	2.0	2.8	-1.7	-0.3	1.6	0.9	-0.5
Bhutan	-11.0	-2.0	-10.3	-23.7	-17.6	-22.1	-21.9	-26.2
India	-0.3	-2.8	-2.7	-4.2	-4.7	-1.7	-2.1	-2.2
Maldives	-14.8	-11.4	-8.9	-20.2	-22.0	-20.8	-19.6	-20.6
Nepal	3.3	4.2	-2.4	-1.0	4.8	3.3	4.6	3.2
Pakistan	-0.8	-5.5	-2.2	0.1	-2.1	-1.1	-1.2	-1.3
Sri Lanka	-3.8	-0.5	-2.2	-7.8	-6.7	-3.9	-3.3	-3.3

Sources: IMF, *World Economic Outlook*; national monetary authorities; and IMF staff estimates and projections.

¹Central government.

Notes: Regional aggregates weighted by PPP GDP. Variables reported on a fiscal year basis for India (April/March); Bhutan, Bangladesh, Pakistan (July/June); Afghanistan (March 21/March 20 until 2011, and December 21/December 20 thereafter); and Nepal (August/July).

