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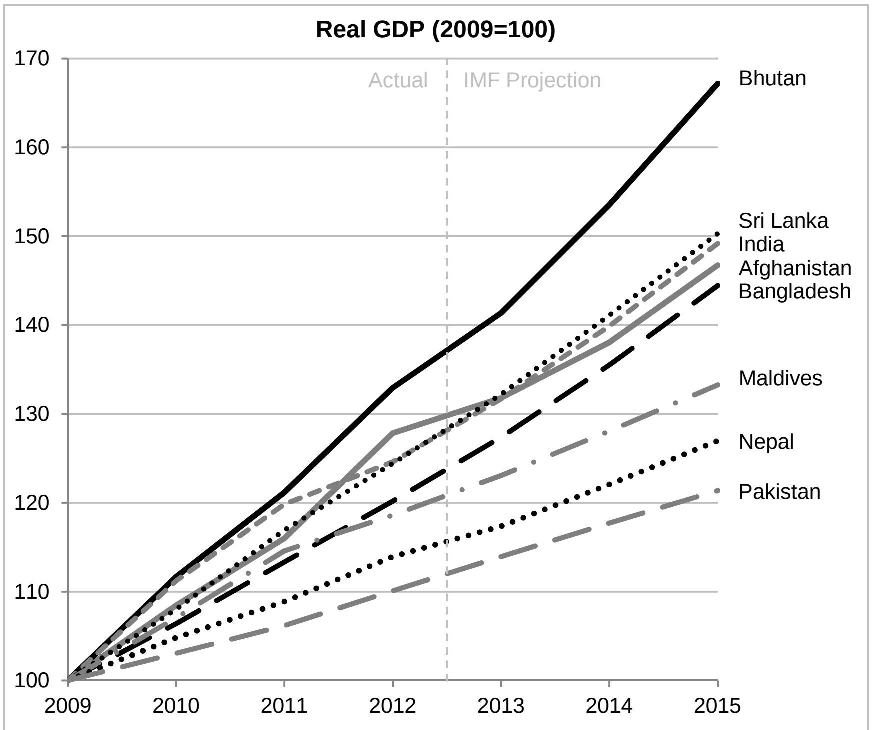
EADS Economic Trends Report

South Asia

May 2013

Economic Overview

South Asia is expected to experience steady GDP growth through 2018, but at a slower rate than before the financial crisis. Low investment, a lack of fiscal and monetary options, and political uncertainty in some countries will limit the growth rate.



SOURCE: IMF, *World Economic Outlook*, April 2013.

The average GDP growth rate of countries in South Asia decreased to 6.0 percent in 2012 and is expected to decrease further to 4.7 percent in 2013, a fall from 6.5 percent in 2011. On the domestic front, late monsoon rains and electricity shortages contributed to 2012's slowdown, while high inflation and fiscal deficits reduced governments' ability to enact fiscal or monetary stimulus measures. Security concerns in some countries further increased uncertainty.

At the same time, the euro area debt crisis has made global conditions more uncertain. The euro area is South Asia's largest export market, and as a result, South Asia's exports and foreign direct investment inflows fell in 2012. International bank lending also fell due to reduced lending from euro area banks. However, equity inflows to India, the region's largest economy, grew.

India, which accounts for 80 percent of South Asia's GDP, contributed significantly to the regional slowdown as its GDP growth weakened from 7.7 percent in 2011 to 4.0 percent in 2012. The slowdown reflects a slump in domestic consumption, exports, industrial production, and investment. India's growth is projected to increase to 5.7 percent in 2013 and to 6.2 percent in 2014. Pakistan, the second largest economy in the region, continues to lag considerably behind its neighbors, due to low investment, electricity shortages, security concerns, high deficits, and political paralysis. However, an increase in consumption fueled by remittances and government salary increases drove slightly higher GDP growth of 3.7 percent in 2012, up from 3.1 percent in 2011. Pakistan's GDP growth is expected to continue to decline through 2018, when it will be back to its 2011 level. The slowest-growing economy in the region in 2012 was in the Maldives at 3.5 percent as tourism declined. By contrast, Afghanistan posted growth of 10.2 percent, driven by aid-fueled consumption and an improvement in weather and

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

agricultural performance since a 2011 drought. However, Afghanistan's growth is expected to slow to 3.1 percent in 2013, as agricultural production returns to normal; security uncertainty increases with the continued withdrawal of foreign military forces; and spending by foreign troops and civilians decreases. Afghanistan's projected growth, unlike that of the other countries, is highly variable. Bhutan continued a strong growth streak driven by hydropower and tourism.

Fiscal and Monetary Policy

India and the Maldives saw their current account deficits widen in 2012. India's grew due to trade imbalances; exports were low because of weak global demand, but imports did not greatly decrease. Bhutan and Sri Lanka saw their current account deficits contract while Bangladesh and Nepal went from deficit to surplus in 2012 due to higher remittances. Despite a slight surplus in 2011, Pakistan ran a current account deficit of 2.0 percent of GDP in 2012 due to increases in imports, especially of fuel and fertilizer, and declining exports; this contributed to its struggles with its balance of payments. Afghanistan's current account surplus including grants increased in 2012 while its deficit excluding grants increased slightly. 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.

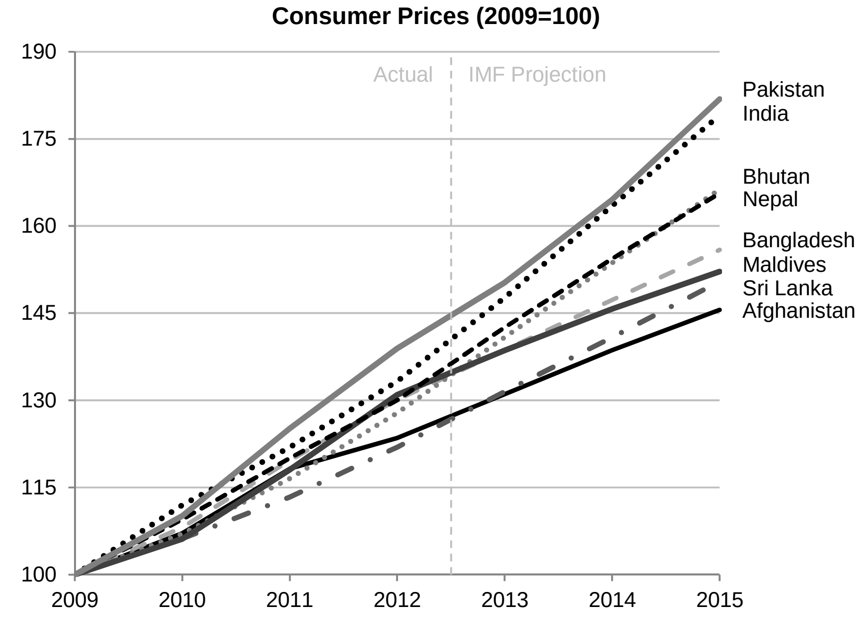
Due to high inflationary pressures, many countries in the region had limited monetary options to encourage growth. They generally pursued conservative monetary policies, either maintaining rates to keep inflation in check despite slow growth, or lowering rates only when inflation was within targets. India maintained its policy rate despite a slowdown in order to combat inflation. It did, however, use other tools to try to improve the economy, such as lower reserve requirements for banks. Pakistan was able to cut its interest rate due to lower inflation. Many South Asian countries have higher fiscal deficits than the average developing country. India's deficit, according to the World Bank, is significantly higher than the average of 1.7 percent of GDP for emerging markets, though it did manage to contain 2012's deficit to 5.2 percent of GDP. Pakistan, Sri Lanka, and Bangladesh also have high deficits. Slow growth, high subsidies, losses in public-sector firms, and low tax receipts all contribute to regional budget deficits.

Real GDP Growth, 2013 (IMF Projections)	East Asia 7.8%	Central Asia 6.9%	South Asia 4.7%

Inflation

The average inflation in South Asia is forecast at 8.1 percent in 2013 and 7.7 percent in 2014, down from 8.7 percent in 2012. In general, countries were able to contain inflation, though India and Pakistan had higher price increases. Several South Asian countries pursued tighter monetary policies in 2012, though as price increases slowed in some countries, a few lowered their interest rates to spur growth. Average inflation rates for countries in South Asia are expected to decrease steadily through 2018 to 6.3 percent.

In India, inflation was 9.3 percent in 2012, higher than in 2011 but down from 12.0 percent in 2010. India has been pursuing a tight monetary policy in an attempt to contain inflation; coupled with the economic downturn, this kept nonfood inflation low in 2012 despite high food prices. Bhutan's local price movements mostly follow India's because its currency is pegged to the Indian rupee and there are strong trading ties between the two countries. In Bangladesh, inflation fell from a multi-year high of 10.7 percent in 2011 to 8.7 percent in 2012 and is expected to fall further.



SOURCE: IMF, *World Economic Outlook*, April 2013.

Consumer prices are highly volatile in Afghanistan because of heavy import dependence, including for food and fuel. Inflation, which peaked at 10.4 percent in 2011, fell to 4.4 percent in 2012 due to a drop in food prices. The central bank adopted a relatively tight monetary policy during 2012 to contain inflationary pressures. Inflation is forecast to be higher at 6.1 percent in 2013, but should drop and be steady around 5.0 percent through 2018.

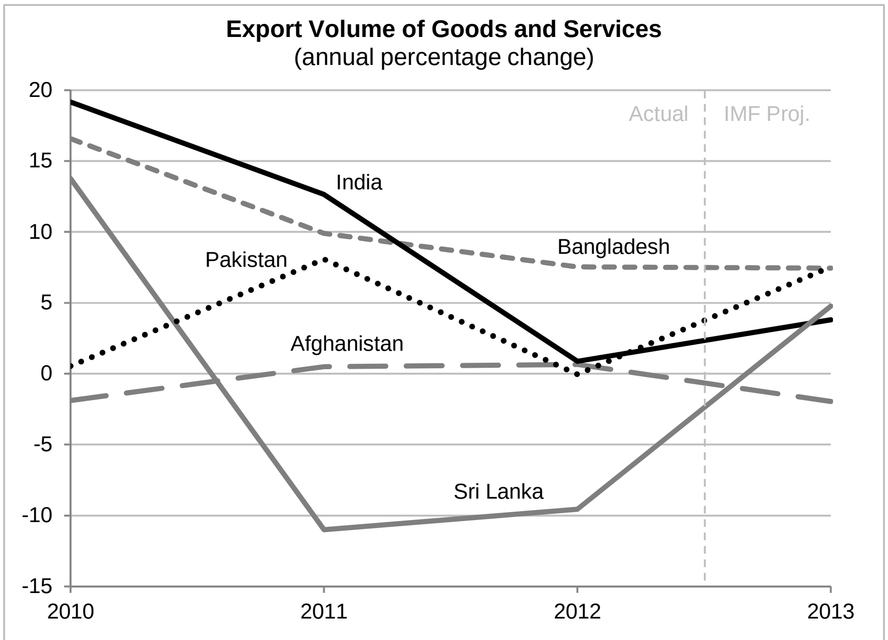
Inflation in Pakistan, under pressure from increasing global commodity prices, is forecast to be higher than for any other country in the region through 2018. It was 11.0 percent in 2012, down from 13.7 percent in 2011. The decrease was mainly attributable to lower food prices. Responding to price pressures, the central bank tightened monetary policy in 2011, but loosened it again in 2012 in response to the lower inflation rate. Pakistan's inflation rate is expected to increase each year from 2013 through 2018; this is in sharp contrast to all other countries in South Asia, which are expected to see declines in inflation.

CPI Inflation, 2013 (IMF Projections)	East Asia	Central Asia	South Asia
	6.1%	8.0%	8.1%

Trade

The effect of spillovers from Europe's economic woes can be seen in the lower demand for South Asia's exports, with export growth for the average country in the region declining by 2.3 percent in 2012. However, some global economic risks are lower than they were in 2011: the U.S. is past the fiscal cliff and the euro area crisis has eased somewhat, though political and economic challenges continue in both places. Domestic markets in many Asian countries are growing and creating new sources of demand for local products or exports. Imports dropped by 1.6 percent for the average South Asian country in 2012, though import growth rates are expected to increase each year from 2013–2018.

Bangladesh had the highest export growth in the region in 2012 at 7.5 percent, down from 9.9 percent in 2011. This moderation in export growth reflects falling garment prices and weaker demand in the U.S. and euro area. The export growth rate in Bangladesh is projected to rise again beginning in 2014. Bangladesh's import growth was also 7.5 percent in 2012 and will be higher from 2013–2018. Sri Lanka had the lowest trade growth in 2012, continuing 2011's slide in export volume. Low exports were mainly due to low global demand for garments and economic weakness in Europe and the United States, its main export markets. Imports to Sri Lanka also dropped by 20.0 percent in 2012 but should see positive growth beginning in 2013. The decline in Sri Lanka's exports is forecast to cease in 2013, when the IMF projects slight positive growth. However, because of continuing weak demand, trade recovery will be slow. India's trade has recovered slightly from 2012 with the recovery of manufacturing exports. The slide was caused by lower demand from Asian and European economies and lower demand for India's service exports. India's imports grew only slightly in 2012 at 2.7 percent, but will grow faster beginning in 2013. Afghanistan is forecast to see exports decline in 2013 due to a small export base dependent on a few products. Imports will continue to grow, though more slowly than they have been, exacerbating its trade deficit.



SOURCE: IMF, *World Economic Outlook*, April 2013.

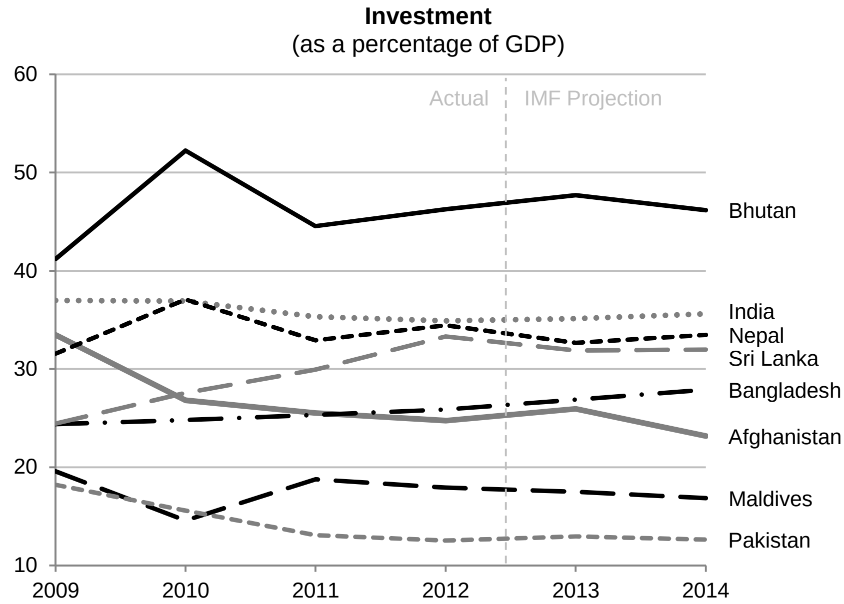
Trading Partners

In South Asia, the past decade has seen a shift away from exports to advanced economies toward exports to developing economies. In 2012, 48 percent of South Asia's exports to non-South-Asian countries went to developing and emerging economies, compared to 25 percent in 2000. Over the same time period, the Middle East and North Africa's share of South Asia's exports has increased by 86 percent. Likewise, East Asia and Pacific's share has increased 30 percent. Although total exports to all regions have increased, the share of South Asia's exports going to North America has declined from 27 to 15 percent, and Europe and Eurasia's share has declined from 32 to 24 percent since 2000.

In 2012, only 5.7 percent of exports from South Asian countries went to other South Asian countries. However, we see variation within the region, with smaller economies often trading heavily with their neighbors. For instance, in 2012, 62 percent of Nepal's exports and 50 percent of Afghanistan's go to other South Asian economies, whereas only 2 percent of Bangladesh's and 5 percent of India's go to their neighbors. Pakistan and India, the two largest economies, have been increasing trade with each other despite political tensions. In an effort to increase intra-regional trade, the South Asian Free Trade Agreement went into effect in 2006. All countries in the region participate, but countries may have lists of exempted goods.

Investment

Investment has remained relatively stable in South Asian economies, with structural challenges and difficult business environments preventing investment from increasing much as a percent of GDP. South Asia's investment rate lags behind that of East Asia, contributing to the somewhat slower growth in the region. Pakistan has the lowest investment in South Asia and investment declined by almost 6 percentage points of GDP from 2009–2012. Investment in Pakistan is not expected to pick up due to low export demand, security uncertainty, and power shortages. Pakistan's low investment, especially in infrastructure, will continue to impede its economic growth in the coming years. Bhutan's level of investment is the highest in the region at 46.3 percent of GDP, driven by the construction of large hydropower projects.



SOURCE: IMF, *World Economic Outlook*, April 2013.

Investment in India peaked in 2009 and has since decreased because of the slump in the global economy, tighter monetary policy, and higher nominal interest rates targeted at high inflation. Investment is expected to increase slightly and remain in the 35 percent range in the next three years. Business Monitor International believes that India will see improved investment in upcoming years thanks to low inflation creating room for more expansionary monetary policy; improving business confidence; and the need for Indian private sector companies to invest in new capital.

Investment, 2013 (as a percentage of GDP) (IMF Projections)	East Asia 31.0%	South Asia 28.8%	Central Asia 27.1%

Business Climate

South Asia's business environment continues to pose a challenge to economic growth and investment in the region. From the 2012 to the 2013 index, only Sri Lanka improved its rank in the World Bank's *Doing Business* survey, going from 96th in the world to 81st out of 185 ranked countries and territories. Currently, it is the strongest performer in the region on this index and the only one that is ranked in the better half of countries. Of its neighbors, Afghanistan, Bangladesh, Bhutan, Maldives, Nepal, and Pakistan all slid in the 2013 rankings; India's ranking of 132nd remained unchanged.

Sri Lanka made several reforms to improve its 2013 ranking: it made it easier to start a business, to register property, to access credit, and to trade internationally. Of the other countries in the region, India improved its process for construction permits but made no other changes; Bangladesh improved access to credit, but made it more difficult to get electricity at the same time. The Maldives levied new taxes, which hurt its ranking. Bhutan introduced a minimum wage, which does not appear to have affected its ranking. The other countries made no changes, but because the rankings are relative, improvements made in other countries caused drops in the rankings of countries with no reforms.

South Asia Ranking for Selected Doing Business Indicators, 2013 Index
(lower ranking = easier to do business)

Ease of Doing Business	Getting Credit	Getting Electricity	Protecting Investors	Registering Property	Trading Across Borders
			Bangladesh: 25		
	India: 23		Pakistan: 32		
	Sri Lanka: 70		India: 49		
	Nepal: 70		Sri Lanka: 49		
	Pakistan: 70		Maldives: 82	Nepal: 21	Sri Lanka: 56
Sri Lanka: 81	Bangladesh: 83		Nepal: 82	Bhutan: 85	Pakistan: 85
Global Median: 93	Global Median: 93	Global Median: 93	Global Median: 93	Global Median: 93	Global Median: 93
Maldives: 95	Bhutan: 129	Nepal: 96	Bhutan: 150	India: 94	Bangladesh: 119
Pakistan: 107	Afghanistan: 154	Sri Lanka: 103	Afghanistan: 185	Pakistan: 126	India: 127
Nepal: 108	Maldives: 167	India: 105		Sri Lanka: 143	Maldives: 138
Bangladesh: 129		Afghanistan: 110		Maldives: 151	Nepal: 171
India: 132		Maldives: 120		Afghanistan: 174	Bhutan: 172
Bhutan: 148		Bhutan: 136		Bangladesh: 175	Afghanistan: 178
Afghanistan: 168		Pakistan: 171			
		Bangladesh: 185			

For the individual components of the *Doing Business* ranking, there is great variation within the region and within countries. The ease of registering property in South Asia, for instance, varies from a high of 21st in the world (Nepal) to a low of 175th (Bangladesh). Despite its low score in registering property, Bangladesh ranks 25th in the world in protecting investors. The region also has some bottom-of-the-world scores: 185th for protecting investors (Afghanistan), resolving insolvency (Bhutan), and getting electricity (Bangladesh). Electricity is a challenge for the entire region; Nepal leads South Asia in this category, with a below-average rank of 96th. Although countries in the region do not always have business-friendly environments, they tend to do a better job of protecting investors. For instance, India ranks 132nd overall in ease of doing business but ranks 49th in protecting investors. Bangladesh, Pakistan, and Sri Lanka also show better investor protections than their overall business climates might suggest. Despite these bright spots, the business climate in South Asian countries is fairly dismal overall. Unfortunately, there is little evidence of a systematic attempt to improve the business environment, except in Sri Lanka. 108 countries had at least one positive reform in the 2013 index, so countries that maintain the same policy regimes may still find themselves slipping in the rankings.

Additional Information

For questions or more information, please contact the author, Katherine Shanahan, at kshanahan@devtechsys.com.

For country-specific data and additional information about the countries covered in this report, please visit the ESDB 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/).