SOUTH ASIA

South Asia has endured significant adverse spillovers from the Russian Federation's invasion of Ukraine. Growth is expected to slow from 7.6 percent in 2021 to 6.8 percent in 2022—0.8 percentage points below previous projections. The external environment has worsened markedly, with soaring energy and agricultural prices, slowing global growth, and rising financing costs. While domestic conditions remain solid in many economies, Afghanistan is facing a humanitarian crisis, and Sri Lanka is facing dual balance of payments and sovereign debt crises. Surging food costs in a region populated by more than one-third of the global poor and where one-fifth of calories come from wheat products pose significant challenges to poverty alleviation and food security. Downside risks to the outlook relate to adverse geopolitical developments, the possibility of even-higher inflation, tighter financing conditions, the re-emergence of stress in the financial sector, and the resurgence of the COVID-19 pandemic, all in an environment of high debt levels and worsening current account positions.

Recent developments

The Russian Federation's invasion of Ukraine has dampened the recovery in the South Asia region (SAR) and amplified pre-existing vulnerabilities. The region entered 2022 with robust economic growth, despite some softening because of an Omicron-driven pandemic resurgence and its attendant restrictions (figure 2.5.1.A). The Omicron wave has since abated across the region, leading to the loosening of restrictions.

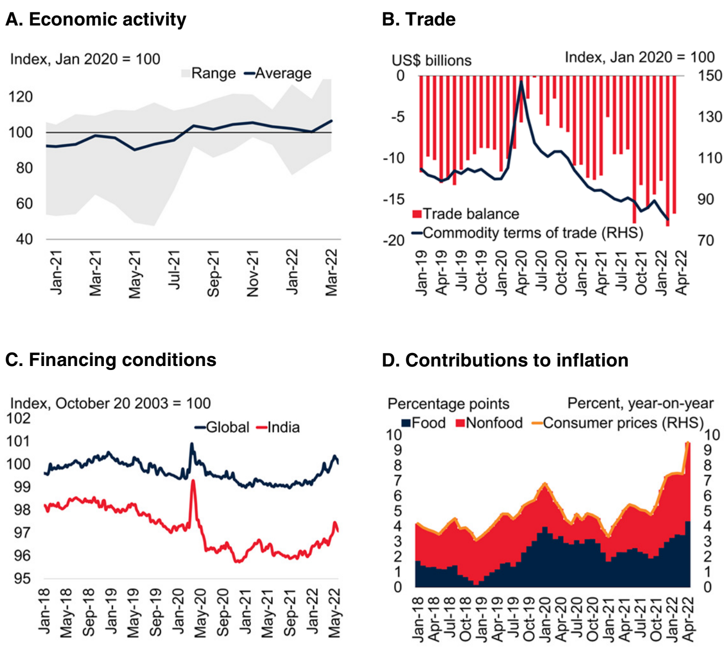
The war in Ukraine has had a small direct impact on the region as trade and financial exposure to Russia and Ukraine is limited. Nonetheless, the indirect impact has been significant, mainly through much higher commodity prices, tighter financial conditions, and weaker external demand. Rising commodity prices are worsening the terms of trade and increasing trade deficits (figure 2.5.1.B). Wheat products account for about one-fifth of calorie intake in the region, however much of the supply comes from within the region. Financial conditions have tightened globally and in SAR (figure 2.5.1.C). The war has also increased global risk aversion, leading to capital outflows, depreciating currencies, falling equity prices, and rising bond yields. Foreign exchange reserves have been under pressure and are dwindling in some economies, eliciting import restrictions (Nepal, Pakistan, Sri Lanka). External demand growth is also slowing as advanced economies face substantial spillovers from the war. In Sri Lanka, with international reserves down to one-fourth of their pre-pandemic level, the government abandoned its exchange rate peg in early March, leading to a close to 80 percent depreciation against the U.S. dollar. Policy rates have been raised by 7 percentage points in response. In India, rising inflationary pressures led to an unscheduled policy rate hike in May. In Pakistan, the central bank has raised rates by 4 percentage points since April.

Some authorities have implemented policies to cushion the impact of high inflation. In Pakistan, for example, the government announced an energy price reduction package in February (World Bank 2022f). However, gasoline and diesel pump prices were recently increased. In India, the government has extended a food scheme to support poor households, reduced taxes on fuels, and reduced import duties on several products. In Bangladesh, the government reduced the value added tax on

Note: This section was prepared by Franz Ulrich Ruch.

FIGURE 2.5.1 SAR: Recent developments

Growth momentum this year has slowed because of the Omicron wave following a robust recovery in the second half of 2021. Increased energy and food prices are raising import bills and worsening terms of trade. Financing conditions have tightened as central banks in advanced economies and the region have reduced policy support, and geopolitical developments have heightened risk aversion. South Asia is seeing broad-based increases in consumer inflation, to rates above central bank targets, on rising food and energy prices.



Sources: Bloomberg; Haver Analytics; International Monetary Fund.
Note: EMDEs = emerging market and developing economies.
A. Unweighted average of industrial production in Bangladesh, India, Pakistan, and Sri Lanka, and tourist arrivals in Maldives. "Range" reflects country minimum and maximum outcomes. Last observation is March 2022.
B. GDP weighted. "Terms of trade" excludes data for Afghanistan. "Trade balance" based on data for Bangladesh, India, Nepal, Pakistan, and Sri Lanka.
C. Based on Goldman Sachs Financial Conditions Index for the Brazil, Euro Area, India, Indonesia, Japan, Mexico, Turkey, United Kingdom, and United States. Weighted using constant 2010-19 U.S. dollar GDP for 2021. Last observation is May 27, 2022.
D. Unweighted average. Based on data for six economies. Urban consumer prices in Pakistan, Colombo prices in Sri Lanka. Last observation is April 2022.

the import of edible oils (soybean and palm) to dampen price increases.

In India, growth slowed in the first half of 2022 as activity was disrupted both by a surge in COVID-19 cases, accompanied by more-targeted mobility restrictions, and by the war in Ukraine. The recovery is facing headwinds from rising inflation. The unemployment rate has declined to levels seen prior to the pandemic, but the labor force participation rate remains below pre-pandemic levels and workers have shifted to lower-paying and less-secure jobs. India's growth in fiscal year 2021/22, which ended in March 2022, was 8.7 percent, with the release of pent-up demand late last year following the mid-2021 wave of the pandemic offset by weakness in early 2022.

For the region excluding India, stronger-than-expected rebounds from the pandemic in Bangladesh and Pakistan helped to boost activity through early 2022, helping to maintain robust growth during their fiscal year 2021/22, ending June 2022. In Bangladesh and Pakistan, goods exports have grown by over 25 percent so far this fiscal year (to April), and manufacturing production in both countries has expanded at its fastest pace in at least four years. But the war in Ukraine has dampened activity, as rising food and energy prices have stunted purchasing power, and increased uncertainty. Conditions are particularly dire in Sri Lanka, where the government announced a cessation of external debt repayments and the country faces dual balance of payments and sovereign debt crises (World Bank 2022g). In Bhutan, after two years of contraction, growth is expected to have returned to positive territory because of an easing of mobility restrictions and ongoing fiscal support, with the fiscal deficit reaching 10.1 percent of GDP in FY2021/22.

Economic and social conditions in Afghanistan remain dire, despite increasing international humanitarian support following the abrupt cessation of aid inflows in August 2021. The economy has collapsed, employment and imports—including food and energy—are estimated to have halved, and government spending has likely fallen by three-fourths since August 2021 (World Bank 2022h). Recent surveys show that three-fourths of households report insufficient incomes to meet basic needs.

Consumer price inflation in South Asia has been rising rapidly and now exceeds central banks' targets (figure 2.5.1.D). In Pakistan and Sri Lanka, annual headline consumer inflation reached double digits by late last year and have accelerated further during 2022; in the latter to close to over 30 percent. In India, both headline and core consumer inflation have breached the upper end of the central bank's headline inflation target range of 2-6 percent. In Maldives, unlike the rest of the region, consumer inflation has remained low at about 1 percent, reflecting a fixed exchange rate and substantial food and energy-related subsidies. Inflation expectations have risen in the region. Higher inflation, especially for food prices, are a significant concern given the region's large share of the global poor, who spend a substantial proportion of their income on food.

Outlook

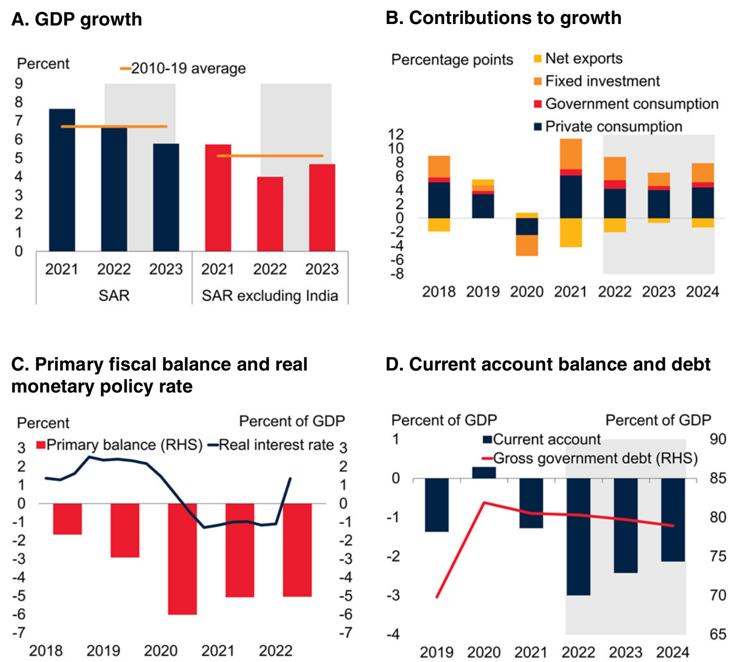
Growth in South Asia is projected to moderate to 6.8 and 5.8 percent in 2022 and 2023, respectively, as the momentum of the recovery wanes, and the war in Ukraine undermines external demand and erodes real incomes through higher food and energy prices (figure 2.5.2.A). Weakening net exports and eroded consumer demand amid higher prices are expected to remain a significant drag on activity, the former reducing growth in 2022 by 2 percentage points (figure 2.5.2.B). As the recovery from the pandemic recession matures, growth will be supported by private consumption, which is projected to contribute about 4 percentage points a year to GDP growth over 2022-24. The contribution to growth from government consumption will peak in 2022 and wane thereafter as fiscal support is withdrawn (figure 2.5.2.C).

In *India*, growth is forecast to edge down to 7.5 percent in fiscal year 2022/23, with headwinds from rising inflation, supply chain disruptions, and geopolitical tensions offsetting buoyancy in the recovery of services consumption from the pandemic. Growth will also be supported by fixed investment undertaken by the private sector and by the government, which has introduced incentives and reforms to improve the business climate. This forecast reflects a 1.2 percentage point downward revision of growth from the January projection. Growth is expected to slow further to 7.1 percent in 2023/24 back towards its longer-run potential.

In the region excluding India, GDP growth, after peaking at 5.7 percent in fiscal year 2021/22 (ending June 2022), is projected to slow to 4.0 percent in 2022/23 on account of policy consolidation, rising inflation, and weakening

FIGURE 2.5.2 SAR: Outlook

Economic prospects for the region have deteriorated since January, and growth in 2022 is now expected to slow to a rate equal to the average of the decade before the pandemic. Private consumption is forecast to remain the largest driver of growth, but its contribution is projected to wane while net exports remain a significant drag. Average real interest rates reflect rapid tightening of policy rates in Pakistan and Sri Lanka and a surprise policy hike in India. Fiscal policy remains accommodative but is gradually tightening. The external current account deficit is projected to widen on geopolitical tensions, and gross government debt remains high but is expected to stabilize over the forecast horizon.



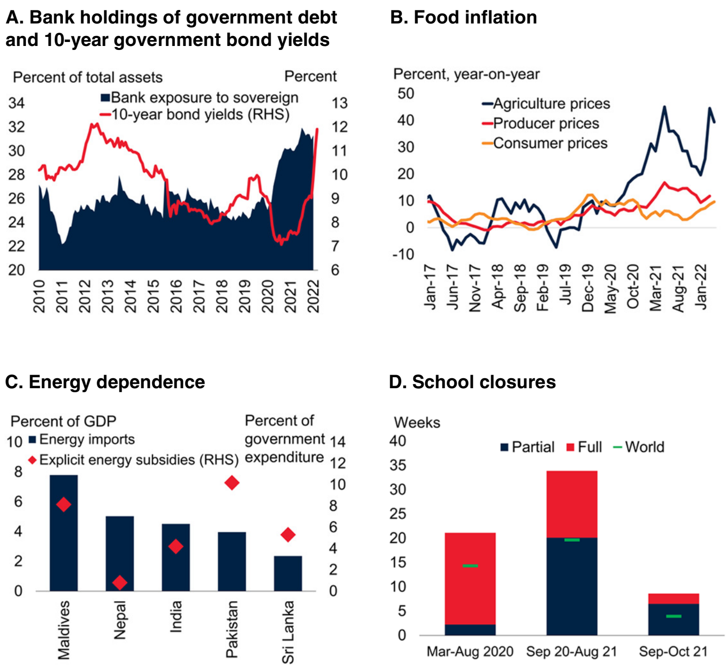
Sources: Consensus Economics; Haver Analytics; World Bank.
Note: EMDEs = emerging market and developing economies; SAR = South Asia.
A.B. GDP at average 2010-19 prices and market exchange rates.
C. Unweighted average. "Real interest rate" is the nominal policy rate less inflation forecasts at a one-year fixed horizon for Bangladesh, India, Pakistan, and Sri Lanka. "Primary balance" excludes Afghanistan.
D. GDP-weighted average. Data exclude Afghanistan.

external growth. In *Pakistan*, growth is expected to slow from 5.7 percent in FY2020/21 to 4.0 percent in 2022/23 as foreign demand slows significantly and policy support is withdrawn to contain external and fiscal imbalances.[1] The current account deficit for the region as a whole is forecast to widen to levels last seen a decade ago (figure 2.5.2.D). In *Bangladesh*, growth is forecast

[1] The Government's preliminary estimate for real GDP (factor cost) growth for 2021/22 is 6.0 percent.

FIGURE 2.5.3 SAR: Risks

Risks of financial stress have been exacerbated by tightening financing conditions in an environment of high debt, the possibility of hidden public debt, and increased exposure of commercial banks to sovereign debt. Agricultural commodity prices have risen on account of geopolitical tensions, with producer and wholesale prices showing double-digit annual increases for almost a year. Further increases in energy prices could undermine income growth and widen fiscal deficits through rising energy subsidies. School closures in South Asia owing to the pandemic were significantly higher than in other regions and could undermine future growth prospects.



Sources: Bloomberg; Haver Analytics; International Monetary Fund; United Nations Comtrade; UNESCO Global Dataset; World Bank.

A. Unweighted averages. "Bank exposure to sovereign" is credit to government as a ratio to total domestic credit of the banking system or commercial banks in net or gross terms (based on availability) in Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka. "10-year bond yields" data for Bangladesh, India, Pakistan, and Sri Lanka.

B. GDP-weighted average of consumer and producer/wholesale food inflation. "Agriculture prices" based on the World Bank's food index adjusted to local currencies.

C. Import value of petroleum and gas as a share of GDP and of explicit energy subsidies as a share of government expenditure. Based on data for 2017-19.

D. Unweighted averages of 8 economies for South Asia and 210 economies for global. "World" reflects both partial and full school closures.

to slow to 6.4 percent in FY2021/22, as pent-up demand subsides, and to pick up to 6.7 percent in 2022/23 as investment recovers and remittance inflows rise as a result of higher growth in the Gulf Cooperation Council countries (particularly Saudi Arabia and the United Arab Emirates). In *Maldives*, projected growth in 2022 has been revised down by 3.4 percentage points to 7.6 percent, reflecting the expected effects of the war in Ukraine on tourist inflows, in a stagnating investment environment. In *Nepal*, growth is forecast to accelerate to 4.1 percent and 5.8 percent, respectively, in the next two fiscal years as pent-up demand boosts the services sector, and hydropower production increases at the recently completed Upper Tamakoshi plant. Growth in *Bhutan* is also expected to benefit from the recovery of services and should see hydropower generation double in the medium term driven by the completion of several projects (World Bank 2022i).

A balance of payments crisis and the cessation of external debt repayments in *Sri Lanka* have significantly deteriorated growth prospects, which are highly uncertain and subject to significant downside risks. The economy is expected to contract by 7.8 percent in 2022 and 3.7 percent in 2023. The contraction can be greater in case of protracted delays in actions by the authorities to restore macroeconomic stability and in debt restructuring. The country faces severe economic difficulties and rising policy uncertainty—with ongoing electricity blackouts and an inability to import sufficient essentials including food and energy. Debt restructuring will be necessary to start the process of fiscal rehabilitation.

Some economies in the region have prioritized structural reforms to strengthen economic growth. In *Pakistan*, the government has enhanced its monetary policy framework by strengthening the functional and administrative autonomy of the central bank, prohibiting government borrowing from the central bank, and entrenching price stability as monetary policy's primary objective (World Bank 2022f). In *Nepal*, reforms will focus on improving governance and transparency; upgrading the tax system and improving spending efficiency; upgrading public debt management; strengthening financial regulation and supervision; ensuring the transition to a green, resilient, and inclusive development path; and integrating digital services (IMF 2022b; World Bank 2022j). In *India*, the focus of government spending has shifted toward infrastructure investment, labor regulations are being simplified, underperforming state-owned assets are being privatized, and the logistics sector is expected to be modernized and integrated.

Risks

Geopolitical developments have magnified downside risks to the regional outlook. Risks include private sector retrenchment resulting from tightening domestic financing conditions, widening current account deficits, eroding real incomes because of further increases in food and energy prices, and new flare-ups of COVID-19.

South Asia is facing an environment of tightening global financing conditions with significantly elevated debt levels, a combination that increases the likelihood of financial stress. Yields on local-currency debt have increased by 290 basis points, on average, since the beginning of 2022 (figure 2.5.3.A). Conditions in Sri Lanka are deteriorating rapidly, with 10-year government bond yields recently at over 20 percent, among the highest in EMDEs. South Asian banks are particularly exposed to sovereigns, with government debt having risen to one-third of bank's assets, on average, from one-fourth before the pandemic. This raises spillover risks from the government sector to the financial sector. Compounding these financial sector risks, the region is also vulnerable because of hidden public debt, including contingent liabilities, given the outsized roles of state-owned enterprises and off-balance-sheet operations (Melecky 2021). State-owned banks, for example, account for the largest share of total bank assets among EMDE regions.

With geopolitical developments affecting the supply of wheat, edible oils, and input costs of fertilizer and energy, agricultural prices (in domestic currency terms) have risen by more than one-fourth since the beginning of 2022 (figure 2.5.3.B). Additional increases in commodity prices may put further upward pressure on food inflation, which is already high, eroding real incomes and reducing consumption. The region is particularly vulnerable to the impact of higher food prices, with food accounting for 43 percent of the consumption basket on average, compared to 33 percent across EMDEs.

Rising energy prices, given the region's high dependence on energy imports and elevated energy subsidies in some economies, could further undermine growth and threaten a widening of fiscal imbalances (figure 2.5.3.C). Energy subsidies as a share of income and government expenditure are lower in SAR than the average EMDE but still account for 5 percent of government expenditure on average in 2021 (Parry, Black, and Vernon 2021). Energy subsidies as a share of government expenditure are highest in Bangladesh, Maldives, and Pakistan. With already high energy costs and the uncertain outlook, the region could face additional pressure on inflation—despite the dampening effect of subsidies—and larger current account deficits. This pressure could undermine growth, increase poverty, and divert budgetary resources away from productivity-enhancing investment and social protection.

While the direct economic impact of new waves of COVID-19 has moderated, pandemic developments remain an ongoing downside risk. The emergence of new variants in the presence of waning vaccine effectiveness could overwhelm health systems unless mobility restrictions are imposed. The longer-term consequences of the pandemic will also be significant. Pandemic-related school closures have averaged 64 weeks in South Asia—much higher than the global average of 38 weeks—and kept nearly 400 million children out of school (figure 2.5.3.D; UNESCO and UNICEF 2021). This outsized damage to human capital accumulation could undermine the pace of poverty reduction and significantly impair lifetime earnings (Azevedo et al. 2021; World Bank 2021d).

TABLE 2.5.1 South Asia forecast summary

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2019	2020	2021e	2022f	2023f	2024f	Percentage point differences from January 2022 projections: 2022f	2023f
EMDE South Asia, GDP [1,2]	**4.1**	**-4.5**	**7.6**	**6.8**	**5.8**	**6.5**	**-0.8**	**-0.2**
GDP per capita (U.S. dollars)	3.0	-5.6	6.5	5.6	4.7	5.4	-0.9	-0.2
(Average including countries that report expenditure components in national accounts)[3]								
EMDE South Asia, GDP [3]	4.1	-4.5	7.6	6.8	5.8	6.5	-0.8	-0.2
PPP GDP	4.1	-4.6	7.6	6.8	5.8	6.5	-0.8	-0.2
Private consumption	4.9	-3.4	8.5	5.8	5.6	6.1	-1.7	0.0
Public consumption	3.9	0.2	7.4	10.5	4.7	6.2	1.0	-0.5
Fixed investment	2.6	-9.6	14.8	10.5	5.9	8.3	0.5	-1.2
Exports, GNFS [4]	1.5	-9.2	18.4	8.9	8.3	7.9	1.3	-0.3
Imports, GNFS [4]	-1.5	-8.6	26.1	11.3	6.9	8.5	2.9	-2.3
Net exports, contribution to growth	0.8	0.8	-4.2	-2.0	-0.7	-1.3	-1.2	0.2
Memo items: GDP [2]	**2018/19**	**2019/20**	**2020/21e**	**2021/22f**	**2022/23f**	**2023/24f**	**2021/22f**	**2022/23f**
South Asia excluding India	5.7	3.0	2.6	5.7	4.0	4.7	1.3	-0.8
India	6.5	3.7	-6.6	8.7	7.5	7.1	0.4	-1.2
Pakistan (factor cost)	3.1	-0.9	5.7	4.3	4.0	4.2	0.9	0.0
Bangladesh	7.9	3.4	6.9	6.4	6.7	6.9	0.0	-0.2

Source: World Bank.
Note: e = estimate; f = forecast; PPP = purchasing power parity; EMDE = emerging market and developing economy. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time.
1. GDP and expenditure components are measured in average 2010-19 prices and market exchange rates. Excludes Afghanistan because of the high degree of uncertainty.
2. National income and product account data refer to fiscal years (FY) while aggregates are presented in calendar year (CY) terms. (For example, aggregate under 2020/21 refers to CY 2020). The fiscal year runs from July 1 through June 30 in Bangladesh, Bhutan, and Pakistan; from July 16 through July 15 in Nepal; and April 1 through March 31 in India.
3. Subregion aggregate excludes Afghanistan, Bhutan, and Maldives, for which data limitations prevent the forecasting of GDP components.
4. Exports and imports of goods and nonfactor services (GNFS).

TABLE 2.5.2 South Asia country forecasts

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2019	2020	2021e	2022f	2023f	2024f	Percentage point differences from January 2022 projections: 2022f	2023f
Calendar year basis [1]								
Afghanistan [2]	3.9	-1.9	..	..	..	..	..	..
Maldives	6.9	-33.5	31.0	7.6	10.2	7.1	-3.4	-1.8
Sri Lanka	2.3	-3.6	3.7	-7.8	-3.7	1.0	-9.9	-5.9
Fiscal year basis [1]	**2018/19**	**2019/20**	**2020/21e**	**2021/22f**	**2022/23f**	**2023/24f**	**2021/22f**	**2022/23f**
Bangladesh	7.9	3.4	6.9	6.4	6.7	6.9	0.0	-0.2
Bhutan	4.4	-2.4	-3.7	4.4	4.7	6.7	-0.7	-0.1
India	6.5	3.7	-6.6	8.7	7.5	7.1	0.4	-1.2
Nepal	6.7	-2.1	1.8	3.7	4.1	5.8	-0.2	-0.6
Pakistan (factor cost)	3.1	-0.9	5.7	4.3	4.0	4.2	0.9	0.0

Source: World Bank.
Note: e = estimate; f = forecast. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.
1. Historical data are reported on a market price basis. National income and product account data refer to fiscal years (FY) with the exception of Afghanistan, Maldives, and Sri Lanka, which report in calendar year. The fiscal year runs from July 1 through June 30 in Bangladesh, Bhutan, and Pakistan; from July 16 through July 15 in Nepal; and April 1 through March 31 in India.
2. Forecast for Afghanistan (beyond 2020) are excluded because of a high degree of uncertainty.

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