SOUTH ASIA

Output in South Asia is expected to expand 6.8 percent in 2021, a pace on par with average growth for the previous decade (2010-19). Stronger-than-expected momentum at the beginning of the year has been disrupted by a large surge of COVID-19 cases. Despite continued recovery, output in 2022 is forecast to be 9 percent below pre-pandemic projections. Poverty rates have risen, and by the end of this year more than half the new global poor are expected to live in the region. The outlook could be weaker if vaccination does not proceed as quickly as assumed. Moreover, financial sector balance sheets are at risk of deteriorating, as policy measures put in place at the peak of the pandemic are scaled back, which could constrain the provision of credit and investment needed to support the recovery.

Recent developments

COVID-19 cases have surged in South Asia (SAR) with peaks in daily new confirmed cases this year higher than anything seen before in three-quarters of economies (figure 2.5.1.A). The situation is particularly serious in India, where the number of daily deaths and cases is now higher than in any other country during the pandemic. For the region as a whole, peaks in daily new confirmed cases and deaths in 2021 are multiple times higher than last year. Although nearly all countries in the region have begun vaccinations, progress has been slow, and the region's largest economies—Bangladesh, India, and Pakistan—have vaccinated only a small fraction of their populations (figure 2.5.1.B). Bhutan and Maldives, however, have managed to vaccinate more than half of their populations.

The recovery in SAR has been faster than expected. Activity in most sectors has overtaken pre-pandemic levels, despite rising COVID-19 cases—including in construction, one of the initially hardest hit sectors (figure 2.5.1.C). Output in retail and wholesale trade, and hotels and restaurants, however, was still lower than the pre-pandemic level. Tourist arrivals to SAR have risen from their trough but remain 70 percent below pre-pandemic levels. Bhutan and Maldives, two economies highly exposed to tourism, experienced larger-than-expected output declines in 2020. External balances improved in 2020, with the region's current account shifting to surplus for the first time in over a decade as imports plunged more than exports (figure 2.5.1.D). The current account balance, however, has already shifted back to deficit as stronger domestic demand boosted imports.

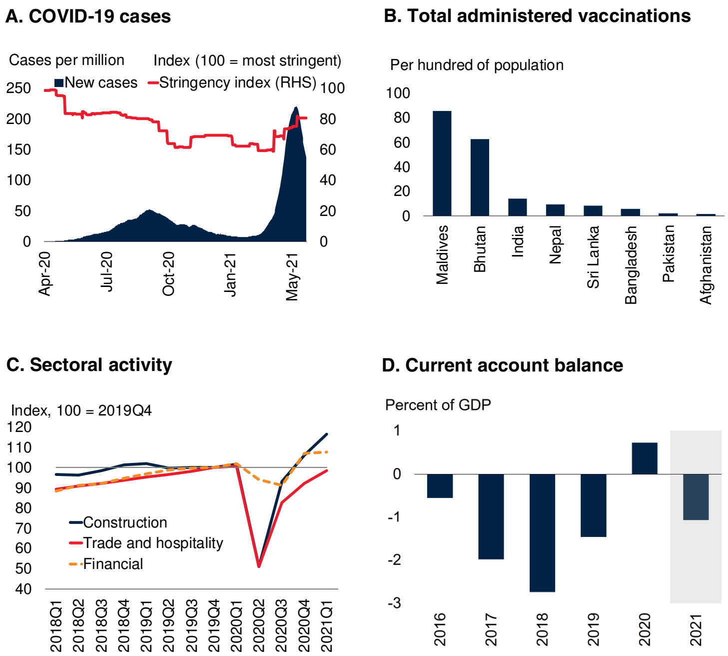
In India, an enormous second COVID-19 wave is undermining the sharper-than-expected rebound in activity seen during the second half of FY2020/21, especially in services. With surging COVID-19 cases, foot traffic around work and retail spaces has again slowed to more than one-third below pre-pandemic levels since March, in part due to greater restrictions on mobility. Recoveries in Bangladesh and Pakistan face new headwinds from a recent rise in COVID-19 cases accompanied by rising restrictions to stamp out the new surge. Mobility around places of work and retail has again dropped below pre-pandemic levels.

Benign global financial conditions have helped boost asset prices and narrow sovereign spreads; however, sentiment remains fragile. Equity prices in May were about 20 percent above pre-pandemic

Note: This section was prepared by Franz Ulrich Ruch.

FIGURE 2.5.1 SAR: Recent developments

New COVID-19 cases have risen sharply, most notably in India, and restrictions on mobility have been tightened in some countries. Vaccinations have begun in earnest with limited progress in the region's large economies. Economic recovery is underway, but activity in some sectors is still below pre-pandemic levels. External balances have shifted back to deficit after import compression brought about the first surplus in a decade.



Sources: Haver Analytics; John Hopkins University Coronavirus Resource Center; Our World in Data; University of Oxford Coronavirus Government Policy Tracker; World Bank.

Note: EMDEs = emerging market and developing economies; SAR = South Asia.

A.B. Last observation is May 25, 2021. "Stringency index" shows a real 2019 GDP-weighted average for 7 economies and last available country observation extended to the latest date.

C. Lines show real 2019 GDP-weighted averages for India, Maldives, and Sri Lanka. "Trade and hospitality" includes wholesale and retail trade, and hotels and restaurants.

D. Based on data for 8 economies weighted using 2019 GDP at 2010-19 prices and market exchange rates.

levels in most of the region's large economies, and sovereign spreads were effectively back to pre-pandemic levels except in Sri Lanka. Despite low global interest rates and domestic forbearance measures, credit growth has slowed significantly, partly reflecting impaired bank, corporate, and household balance sheets. Sri Lanka, facing resurging COVID-19 cases and mounting government debt, experienced significant exchange rate depreciation since the onset of the pandemic—despite the halving of foreign exchange reserves and curbs on non-essential imports—and sovereign spreads remain about 14 percent above the risk-free rate.

Following an aggressive policy response in 2020 that included cuts in interest rates, increases in government expenditure, the extension of loans and guarantees, and steps to ensure financial stability, fiscal and monetary policies remain accommodative. A number of new measures have been implemented this year as economies have calibrated policy responses to support the still-uneven recovery. In India, the FY2021/22 budget marked a significant policy shift. The government announced health-related spending would more than double and set out a revised medium-term fiscal path intended to address the economic legacy of the pandemic. Following deteriorating pandemic-related developments, the Reserve Bank of India announced further measures to support liquidity provision to micro, small, and medium firms and loosened regulatory requirements on the provisioning for nonperforming loans. Debt relief under the Debt Service Suspension Initiative has been extended to December 2021 and will provide additional fiscal space for Afghanistan, Maldives, Nepal, and Pakistan (G20 2021).

Outlook

Growth in South Asia is expected to rebound to 6.8 percent in 2021, 3.6 percentage points higher than previously projected, partly reflecting stronger-than-expected momentum from the end of last year (figure 2.5.2.A). India accounts for nine-tenths of the upgrade to growth in 2021, as strong services activity more than offsets the economic effects of the worsening pandemic. The region's outlook for 2021 is underpinned by a rebound in private consumption, which is expected to account for about half of overall growth (figure 2.5.2.B). Near-term growth prospects have not improved in some countries, however. Projections for Afghanistan (suffering from drought, elevated political uncertainty, and security challenges) and Bhutan (with growth held back by weak tourism and the postponement of infrastructure spending) for 2021 have been downgraded by more than 1.0 percentage point. The recovery has also done little to narrow gaps with pre-pandemic trends. In 2022, regional GDP is expected to be 9 percent lower than projected prior to the pandemic. The shortfalls are expected to be largest in tourism-dependent Bhutan and

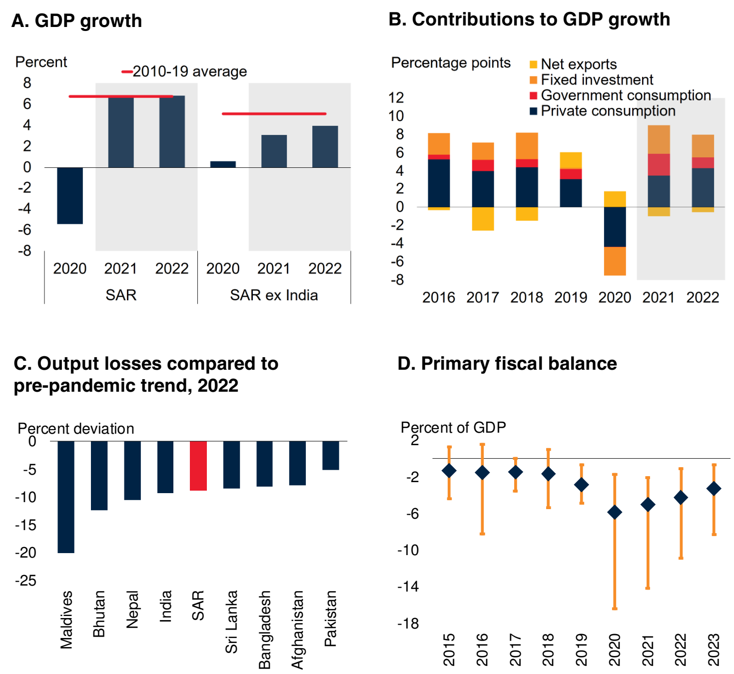
Maldives, at over 12 percent, and smallest in Pakistan at 5 percent (figure 2.5.2.C).

For India, GDP in fiscal year 2021/22, starting April 2021, is expected to expand 8.3 percent. Activity will benefit from policy support, including higher spending on infrastructure, rural development, and health, and a stronger-than-expected recovery in services and manufacturing. Although the forecast has been revised up by 2.9 percentage points, this masks significant expected economic damage from an enormous second COVID-19 wave and localized mobility restrictions since March 2021. Activity is expected to follow the same, yet less pronounced, collapse and recovery seen during the first wave. The pandemic will undermine consumption and investment as confidence remains depressed and balance sheets damaged. Growth in FY2022/23 is expected to slow to 7.5 percent reflecting lingering impacts of COVID-19 on household, corporate and bank balance sheets; possibly low levels of consumer confidence; and heightened uncertainty on job and income prospects.

In the region excluding India, the recovery is expected to be weaker than its historical growth average, with GDP growth at 3.1 percent in FY2021/22 and 4.0 percent in FY2022/23. In the decade prior to the pandemic, growth in the subregion exceeded 5 percent; however, COVID-19 outbreaks and mobility restrictions, weak confidence, and potential output losses make this growth performance seem unattainable in the near term. In Bangladesh, the recovery is expected to be gradual, with growth of 3.6 percent in fiscal year 2020/21, starting July, and 5.1 percent in FY2021/22 as private consumption, the main engine of growth, is supported by normalizing activity, moderate inflation, and rising ready-made garment exports. In Sri Lanka, the resurgence of COVID-19 cases, severe fiscal pressures, and depressed tourism are holding back the recovery. In Maldives, reviving tourism activity, with international arrivals now 30 percent below pre-pandemic levels (compared with virtually no arrivals at the trough), and a strong vaccination drive, are expected to contribute to a boost in GDP growth to 17.1 percent in 2021. The forecast for Pakistan has been revised up on

FIGURE 2.5.2 SAR: Outlook

Growth in SAR is expected to rebound to 6.8 percent in 2021 and 2022, compared to average growth of 6.7 percent in the previous decade. Growth would have been even stronger if not for the economic impact of surging cases. The rebound will be supported by firming consumption and investment, with net exports again turning negative as imports compression unwinds. Despite the rebound, output in 2022 will still be well below pre-pandemic projections. Fiscal and monetary policy is expected to remain accommodative in 2021. Government consumption is projected to contribute over 2 percentage points to 2021 regional growth, reflecting in part additional policy support in India.



Source: World Bank.

Note: EMDEs = emerging market and developing economies; SAR = South Asia.

B. Includes countries that report expenditure components of GDP in their national accounts and excludes change in inventories and residuals.

C. Percent deviation in 2022 output between the January 2020 (pre-pandemic forecast) and June 2021 *Global Economic Prospects* forecasts.

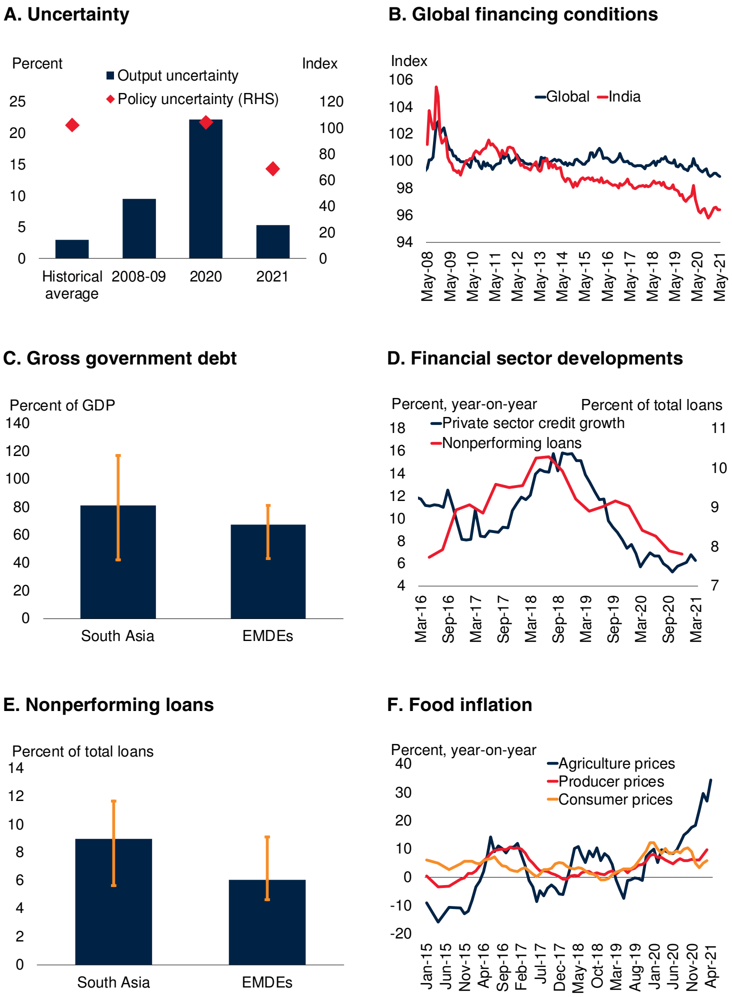
D. Unweighted average for 9 SAR economies. Orange lines reflect the minimum and maximum values.

improving remittance inflows and a rebound in confidence, but the economy is expected to grow by only 1.3 percent in fiscal year 2020/21, reflecting contracting investment, fiscal consolidation, and depressed activity amid recurring COVID-19 flare-ups.

Fiscal and monetary policies are expected to remain accommodative in the forecast period. Real policy interest rates—an indicator of the policy support provided by central banks—are expected to remain negative in 2021. South Asian countries are expected to run an average primary fiscal

FIGURE 2.5.3 SAR: Risks

Amid a worsening pandemic, uncertainty about near-term growth remains elevated. Financing conditions remain benign but can reverse quickly on changes in risk perceptions amid elevated government debt levels. Deteriorating domestic bank balance sheets, already weakened by high nonperforming loans, risk undermining output growth. Rising food inflation remains a significant risk to regional incomes.



Sources: Baker, Bloom and Davis (2016); Bloomberg; Choudhary, Pasha, and Waheed (2020); Goldman Sachs; Haver Analytics; International Monetary Fund; World Bank.

Note: EMDEs = emerging market and developing economies; SAR = South Asia.

A. "Output volatility" from a Bayesian VAR model with stochastic volatility for India based on Ha et al. (2019). "Policy uncertainty" is a GDP-weighted average of Pakistan and India with the index normalized such that the mean prior to 2011 is equal to 100. "Historical average" is 2002Q2-2019Q4 for output volatility and August 2010 to December 2019 for policy uncertainty.

B. Based on Goldman Sachs Financial Conditions Indexes for the United States, United Kingdom, Japan, Euro Area, India, Indonesia, Brazil, Mexico, the Russian Federation, and Turkey. Lines show 2019 GDP-weighted averages. Last observation is May 2021. Higher values reflect tighter financial conditions.

C. Unweighted average. Based on 2021 forecasts for 8 South Asia economies and 134 EMDEs. Orange lines reflect interquartile range.

D. Lines show real 2019 GDP-weighted averages. Sample includes Bangladesh, India, Pakistan, and Sri Lanka.

E. Unweighted average. Based on the latest available quarterly data for 2020 for 6 economies in South Asia and 67 EMDEs. Orange lines reflect minimum and maximum values.

F. Consumer and producer food prices are real 2019 GDP-weighted averages for 6 South Asian economies, depending on data availability. Agricultural food prices are adjusted using exchange rates weighted by 2019 real GDP. Last observation is Apr 2021.

deficit of about 4 percent of GDP in 2021 (figure 2.5.2.D). Two-thirds of the region's economies are expected to have a larger primary deficit in 2021 than last year. High levels of public debt in the region—above 80 percent of GDP, on average—limit the ability of some economies to increase spending without the risk of negative market reactions. In India, fiscal policy shifted in the FY2021/22 budget toward higher expenditure targeted at health care and infrastructure to boost the post-pandemic recovery. The renewed outbreak, however, may require further targeted policy support to address the health and economic costs.

One of the most challenging legacies of the pandemic in South Asia will be its impact on poverty. The region is expected to see tens of millions more extreme poor—living below $1.90 per day—by the end of this year and to have more than half of the new global poor created by COVID-19 (Mahler et al. 2021; World Bank 2021l). Further deprivation could be caused by higher food prices, with global agricultural commodity prices already increasing by 30 percent over the past year (Sahibzada et al. 2021, World Bank 2021k, World Bank 2021l). Prospects for longer-term poverty reduction have also been adversely affected by the pandemic's impact on potential growth. With fixed investment in 2022 expected to be 10 percent below pre-pandemic trends, physical capital growth will likely be slower in the decade ahead than in the past decade. With schools closed in SAR for about one-third of the time so far during the pandemic—affecting about 390 million students—and an estimated 12 percent of labor hours lost, human capital will also be eroded (ILO 2021; World Bank 2021l).

Risks

With the recovery in its infancy and the pandemic still spreading rapidly, the outlook remains highly uncertain. Output uncertainty in the region in 2021 is not as high as last year, but it is still almost double its historical average (figure 2.5.3.A). Downside risks still dominate the outlook.

Downside risks emanate from high government debt, upward pressure on food prices, financial sector challenges, and—in particular—the uncertain path of COVID-19 cases and vaccinations. Export bans on vaccines, limited raw materials required in their production, inadequate financial resources, vaccine hoarding, and ineffective vaccination campaigns create space for the pandemic to worsen in the region and for variants to emerge and undermine the recovery. Renewed COVID-19 outbreaks may also disrupt cross-border supply chains and undermine the moderation in policy uncertainty. Most SAR economies are also lagging on vaccine procurement.

Global and domestic financial conditions remain accommodative, with abundant liquidity and low interest rates (figure 2.5.3.B). In India, domestic financial conditions are easier than they have been in decades. These conditions may change, however, if rapid recoveries in advanced economies lead to tightening monetary policy in these economies before recoveries are entrenched in EMDEs, including those in SAR. An unexpected rise in global inflation from unprecedented advanced economy policy support may also reverse easy financing conditions (chapter 4). Domestically, high debt levels may create the conditions for borrowing costs to surge if expectations change abruptly (figure 2.5.3.C).

Domestic financial sector stress remains a significant downside risk in the region. Nonperforming loans (NPLs) as a share of total loans were already elevated prior to the pandemic (Bangladesh, Bhutan, India), contributing to a precipitous slowdown in credit growth (figure 2.5.3.D-E). Although previous efforts to clean up bank balance sheets yielded some gains in bringing down NPLs, temporary forbearance measures extended in 2020 may have concealed a more severe deterioration in balance sheets experienced during the pandemic. Going forward, asset quality and bank profitability may worsen as temporary forbearance measures are removed or renewed outbreaks damage balance sheets, undermining credit and investment growth in these economies.

The intersection of higher food prices and resurgent COVID-19 outbreaks poses significant risks to vulnerable communities and could further undermine food security and economic growth. Although the region has seen food price inflation for consumers decline from over 10 percent in September 2020 to about 6 percent in March 2021, inflation for producers remains elevated and global agriculture prices rose rapidly (figure 2.5.3.F). Rising agricultural prices, which are expected to increase by double-digit rates in 2021, may lead to faster than assumed food price inflation for consumers, eroding real incomes and reducing consumption. SAR is particularly vulnerable to the impact of higher food prices, with food accounting for 44 percent of expenditure in the consumer basket, compared to 32 percent in EMDEs on average.

TABLE 2.5.1 South Asia forecast summary

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

	2018	2019	2020e	2021f	2022f	2023f	Percentage point differences from January 2021 projections: 2021f	2022f
EMDE South Asia, GDP [1, 2]	**6.4**	**4.4**	**-5.4**	**6.8**	**6.8**	**5.2**	**3.6**	**3.0**
GDP per capita (U.S. dollars)	5.2	3.2	-6.5	5.6	5.7	4.1	3.5	3.0
(Average including countries that report expenditure components in national accounts)[3]								
EMDE South Asia, GDP [3]	6.5	4.4	-5.4	6.8	6.8	5.2	3.6	3.0
PPP GDP	6.5	4.4	-5.5	6.9	6.9	5.2	3.7	3.1
Private consumption	7.1	5.0	-7.0	5.7	7.1	5.3	3.1	2.8
Public consumption	8.3	10.2	-0.2	19.5	8.5	7.6	13.3	5.3
Fixed investment	10.1	0.5	-10.9	11.7	8.9	5.5	6.9	3.4
Exports, GNFS [4]	10.4	1.5	-7.9	12.1	6.8	9.1	8.0	-0.5
Imports, GNFS [4]	13.1	-4.9	-12.6	13.8	7.5	10.2	8.6	-1.7
Net exports, contribution to growth	-1.5	1.7	1.7	-1.0	-0.6	-0.8	-0.5	0.2
Memo items: GDP [2]	**2017/18**	**2018/19**	**2019/20e**	**2020/21f**	**2021/22f**	**2022/23f**	**2020/21f**	**2021/22f**
South Asia excluding India	6.1	5.3	2.6	0.6	3.1	4.0	1.2	1.0
India	6.8	6.5	4.0	-7.3	8.3	7.5	2.3	2.9
Pakistan (factor cost)	5.5	2.1	-0.5	1.3	2.0	3.4	0.8	0.0
Bangladesh	7.9	8.2	2.4	3.6	5.1	6.2	2.0	1.7

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.

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)

	2018	2019	2020e	2021f	2022f	2023f	Percentage point differences from January 2021 projections: 2021f	2022f
Calendar year basis [1]								
Afghanistan	1.2	3.9	-1.9	1.0	2.6	3.0	-1.5	-0.7
Maldives	8.1	7.0	-28.0	17.1	11.5	8.3	7.6	0.0
Sri Lanka	3.3	2.3	-3.6	3.4	2.0	2.1	0.1	0.0
Fiscal year basis [1]	**2017/18**	**2018/19**	**2019/20e**	**2020/21f**	**2021/22f**	**2022/23f**	**2020/21f**	**2021/22f**
Bangladesh	7.9	8.2	2.4	3.6	5.1	6.2	2.0	1.7
Bhutan	3.8	4.3	-0.8	-1.8	5.0	5.6	-1.1	2.7
India	6.8	6.5	4.0	-7.3	8.3	7.5	2.3	2.9
Nepal	7.6	6.7	-2.1	2.7	3.9	5.1	2.1	1.4
Pakistan (factor cost)	5.5	2.1	-0.5	1.3	2.0	3.4	0.8	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 is 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.

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