Three months into 2023, the macroeconomic outlook for South Asia presents a balance of good and bad news. To start with the good news, global energy prices, and thus fertilizer prices, have fallen from their peaks, which has eased domestic inflationary pressures, reduced import bills, and reversed some of the large terms-of-trade losses during the past year. China's economy has reopened, reducing disruptions in global value chains and boosting global production potential. Services exports, both tourism and business services, have continued to recover strongly. In Maldives, tourism now exceeds pre-pandemic levels, as tourism from China has increased sharply in recent months. In India, the services sector is the fastest-growing sector, together with the construction sector, which has been boosted by new government priorities. And lastly, most South Asian countries have finally started fiscal consolidation by reducing inefficient subsidies, raising tax revenues, and tightening expenditures. In Bangladesh and Sri Lanka, fiscal consolidation is supported by recently agreed IMF programs, while negotiations in Pakistan are ongoing.

However, these positive developments only mitigate the negative impact of intensified pressures on the balance of payments and the financial sector. Rising global interest rates have caused capital outflows from South Asia, putting downward pressure on the value of their currencies. Uncertainty in global financial markets, with recent bank runs on a few regional banks in the United States and Europe, has the potential to exacerbate imbalances in South Asia's financial markets. Countries in South Asia with latent non-performing loans following forbearance measures during the COVID-19 pandemic are more vulnerable to spillovers from volatile global financial markets. Loan moratorium programs during the pandemic have delayed the recognition of distressed assets. But non-performing loan ratios have started rising, for example in Bangladesh due to high import costs and weak regulatory enforcement, and in Sri Lanka due to rising rates and increased macroeconomic uncertainties. Increased borrowing by the government from domestic banks has crowded out private credit in Pakistan, while rising sovereign-bank linkages in Maldives, Pakistan and Sri Lanka have further increased the financial sector’s vulnerability.

Policy makers in South Asia, especially those with large external debt, face difficult tradeoffs as they respond to pressures on their currencies. Letting currencies depreciate seems at first sight an unattractive option, as it increases foreign debt-to-GDP ratios, increases debt-service obligations in local currencies, and fuels domestic inflation. Therefore, several countries have used foreign exchange reserves to support their currencies, but such a policy
quickly runs into its own limitations as reserves reach dangerously low levels. Counteracting the pressures by raising domestic interest rates is often not powerful enough by itself. For example, the State Bank of Pakistan has increased its policy rate more than other central banks in South Asia, from 7 to 20 percent, but the currency has still depreciated by 27 percent since June 2022. The depreciation-inflation spiral has kept real interest rates in Pakistan in negative territory. Similarly, in Sri Lanka the real interest rate is still negative, despite an 11-percentage-point increase in the official interest rate.

In an attempt to stabilize currencies, policy makers have resorted to imposing import restrictions and tightening capital controls to reduce balance-of-payments pressures. Analysis in this report shows that these restrictions can be circumvented and can even backfire. Especially in countries that receive large remittances, Hundi or Hawala informal exchange systems can facilitate under-invoicing of imports or informal capital outflows. This attracts remittances to the informal market with an informal exchange rate that has effectively brought about depreciation. For example, analysis shows that in Bangladesh a 1-percent deviation between the formal and informal exchange rate shifts 3.6 percent of remittances from the formal to the informal financial sector. That means that import restrictions and capital controls cannot fully prevent capital outflows and depreciations, while a dual exchange rate creates additional distortions in domestic markets.

Against the balance of positive terms of trade but negative financial market developments, average growth in South Asia is expected to moderate in 2023. Apart from Bhutan, the growth outlook in the current fiscal year has been adjusted downward for all countries. The largest downward adjustment (1.6 percent) is projected for Maldives and Pakistan. The latter is now expected to grow at a mere 0.4 percent in the current fiscal year, implying negative per-capita GDP growth. The contraction of Sri Lanka’s economy is expected to continue this year, with a negative GDP growth of 4.3 percent this year after a contraction of 7.8 percent last year. India’s growth has been adjusted downward by 0.7 percentage point to 6.3 percent, as rising borrowing costs and the consolidation of current fiscal spending dampen consumption. In Bangladesh, real GDP growth is expected to decelerate to 5.2 percent, a downward adjustment of 0.9 percentage point since our last forecast in October 2022.

At an aggregate level, translating fiscal-year forecasts into the current calendar year, South Asia is now expected to grow by 5.6 percent in 2023, which is 0.5 percentage point slower than expected six months ago. Private consumption and government consumption are the weakest components of this GDP growth. Government consumption is expected to shrink because of the consolidation of current expenditures in several countries. Private consumption is being held back by still elevated food prices, among other factors. The floods in Pakistan and export bans still in place in Afghanistan, Bangladesh India, and Pakistan are keeping prices in regional markets high. This report shows that the elevated food prices hurt
households in lower income deciles more than richer households. The report contains several simulations to illustrate the uncertainty surrounding the forecasts. Further increases in international interest rates, additional financial sector shocks, and renewed increases in energy prices would be most harmful for countries in South Asia.

Going forward, broad reform programs are needed to put countries in South Asia on a more robust growth path. A sustainable fiscal outlook must be at the center of these reform programs, all the while it has become more challenging by the need to respond to disasters that are occurring more frequently and are becoming more devastating.

Fiscal sustainability cannot be achieved merely by reducing subsidies and other expenditures, or increasing tax rates. Ultimately, a sustainable fiscal outlook can only be achieved by broadening the tax base, which means that more people should be given opportunities to participate in the productive economy. In previous issues of the South Asia Economic Focus, we have analyzed why female labor force participation is exceptionally low and why so many people are stuck in an unproductive informal sector in South Asia, both keeping the tax base extraordinarily low.

In the current report, we provide further evidence that South Asia’s production potential is not being fully utilized. The analysis shows that inequality of opportunity is significantly higher than in other regions of the world. This means that education and labor-market outcomes in South Asia are more determined by factors outside the control of individuals than in other parts of the world—factors such as the education of parents, geographic location of birth, caste, or other circumstances. It also means that intergenerational mobility is low in South Asia. Not only is inequality of opportunity unfair, but it is also inefficient. It prevents an optimal allocation of resources and fuller utilization of production capacity. Reducing inequality of opportunity and increasing economic mobility is an essential part of broadening the tax base. Therefore, eliminating obstacles to mobility is not merely a long-term agenda, but should be a central part of current reform programs that aim to make the fiscal outlook more sustainable. The focus on more inclusive growth also makes it easier for the population to support current necessary reform programs.