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Global Economic CRISIS and South Asia

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The financial crisis that erupted in September 2008 is extraordinary by any standard since the 1930s, including the debt crisis of the 1980s and the Asian and Russian crises of the late 1990s. Its epicentre has been the United States (US)—the centre not the periphery in neo-Marxian terminology. The debate over whether it is a crisis of the capitalist system itself[1] or a regulatory crisis of the capitalist system[2] remains germane for time to come. But the reality is that the financial crisis and its upshot, namely a huge financial meltdown and a string of bankruptcies, have already spilled from the financial sector to the real economy.[3]

At the start of the financial crisis, there was a firm view in some quarters, including the US Treasury, that it would not cross the financial frontier. Some believed that developing countries were "decoupled" from the financial crisis as their banking systems were barely exposed to toxic assets and their economies had a comfortable foreign exchange position.[4] But, as the vicious circle between the financial and real sectors intensified, the so-called "decoupling" hypothesis proved wrong. For example, the International Monetary Fund (IMF) sharply revised its growth projection for emerging and developing economies for 2009 from 6.7 percent in July 2008 to 1.5 percent in July 2009.[5]

Following the crisis, growth in virtually all countries has decelerated sharply from the rates observed during the last five years. The IMF projects the global output to shrink by 1.4 percent in 2009, the deepest global recession since the 1930s. The brunt of the crisis is here to stay for some time as the IMF states that "the world economy is stabilizing,... however, the recession is not over and the recovery is likely to be sluggish".[6]

Casualties of the crisis

During the five years preceding the crisis, developing countries as a group experienced an impressive economic boom, growing at a rate of 7 percent per year. It was driven by a mix of increased integration with the global economy, exceptional financing with low interest rates, high commodity prices, and, in particular, for a significant number of countries, large flows of remittances.

The impacts of the crisis on developing and least-developed countries are evident in the reversal of the factors that led to their impressive growth[7], as well as the progress made in the achievement of the Millennium Development Goals. Although developing countries were not significantly exposed to the first round of the financial crisis, its second round, turning into an "economic crisis", has hurt them through various channels, including collapsing trade, volatile commodity prices, capital flow reversals, increased borrowing costs, declining remittance incomes, and strains on official development assistance (ODA).

The Director-General of the World Trade Organization (WTO) announced that trade has become a casualty of the global economic crisis.[8] While the WTO projects that the volume of world merchandise trade could plunge by 9 percent for 2009, the United Nations predicts an even steeper fall of 11 percent. Likewise, the World Bank projects the volume of world trade to decline by 9.7 percent in 2009—the first fall after 27 years of uninterrupted expansion and the worst decline since the 1930s—and exports of developing countries by 6.5 percent. The United Nations Conference on Trade and Development projects a disappointing trade performance of least-developed countries (LDCs) in 2009 with a decline of exports by 9–16 percent. Landlocked developing countries could experience an export fall in the range of 9–13.5 percent.[9] With the Doha Round of WTO negotiations long in limbo and developed countries in recession, it is doubtful that the pledge made by developed countries in the WTO Ministerial Conference in 2005 in Hong Kong to provide duty-free and quota-free market access to LDC exports on 97 percent of tariff lines will be effectively operationalized anytime soon.

The decline in international trade is due not only to contractions in economic activities and declines in export prices but also the protectionist measures adopted by developed and developing countries through financial, investment, job protection and trade measures,[10] and the collapse of the market for trade credits. The availability of trade finance has declined substantially in the aftermath of the crisis and the World Bank estimates that 85–90 percent of the fall in world trade since the second half of 2008 is due to a fall in international demand, and 10–15 percent due to a fall in the supply of trade finance.[11]

Similarly, another casualty of the crisis is the decline in resource flows to developing countries. In 2008, total net international flows of private capital to the developing world fell by 39

Table 1 Projections for the global economy

	2007	2008	2009*
World trade volume (growth in %)	7.5	3.7	-9.7
Export growth in advanced economies (growth in %)	6.2	2.0	-15.0
Export growth in emerging and developing economies (growth in %)	9.5	4.1	-6.5
Manufacturing unit export prices (growth in %)	5.5	7.5	1.9
Net private inflows to developing countries (US$ billion)	1,157.5	706.9	n.a.
Private debt flows to developing countries (US$ billion)	498.9	107.9	n.a.
Net FDI inflows to developing countries (US$ billion)	520.0	583.0	n.a.
Net portfolio equity inflows (US$ billion)	138.6	15.7	n.a.
Workers' remittances (US$ billion)	265.0	305.0	n.a.

* forecast

Source: IMF. 2009. World Economic Outlook Update. Washington, D.C.: International Monetary Fund; World Bank. 2009. Global Development Finance: Charting a Global Recovery. Washington, D.C.: The World Bank.

Table 2 South Asia: Linkages with the global economy, 2007 (as % of GDP)

	Exports of goods and services	Imports of goods and services	Budget balance	Foreign aid	External debt	Net FDI flows	Workers' remittances
Afghanistan	12[a]	56[a]	-1.7[b]	35.70[b]	19.69[b]	2.88[b]	n.a.
Bangladesh	20	27	-1.3	2.19	32.20	0.95	9.59
Bhutan	58	51	1.9[c]	n.a.	70.45	n.a.	n.a.
India	21	24	-1.4	0.11	18.77	1.95	2.99
Maldives	87[d]	65[d]	-8.8	3.49	53.02	1.41	0.22
Nepal	13	31	n.a.	5.79	35.31	0.05	16.80
Pakistan	14	21	-4.1	1.54	28.46	3.73	4.19
Sri Lanka	29	40	-6.5	1.82	43.33	1.86	7.81

a. data for 2005, b. data for 2006, c. data for 2004, d. data for 2003
Source: www.worldbank.org.

percent and net portfolio equity flows by 90 percent. Similarly, private debt flows declined substantially. Although net foreign direct investment (FDI) flows increased, the growth rate has slowed markedly *(Table 1)*.

There is strong evidence of reduced dynamism of remittance flows to developing countries. The growth rate fell and its importance relative to gross domestic product (GDP) reduced in 2008. The World Bank estimates that although remittance flows to developing countries increased, their share in GDP declined from 2.1 percent in 2007 to 1.9 percent in 2008. Future flows are bound to be affected by the simultaneous economic recession in high-income countries and lower growth in developing countries.[12]

The impact of the present crisis on remittance is unique. The simultaneous economic slowdown in both source and destination countries appears to be ending the counter-cyclical character of remittance. With rising unemployment, many host countries have tightened immigration controls and introduced tougher requirements for migrant workers due to public pressures and national policy priorities.[13]

Historically, developed countries have failed to keep their word on ODA to developing countries. Even before the onset of the financial crisis, developed countries as a group were falling short by around US$39 billion a year of their Gleneagles commitments to significantly increase aid.[14]

Along with a fear that aid flows may come under pressure in view of declining gross national income in donor countries, a few donors have already signaled their intention to scale back their ODA budgets.

South Asia: Shambles in waiting

Despite its decent integration into the global economy, economic integration within South Asia is much lower than that of other regional blocs such as the Association of Southeast Asian Nations (ASEAN) and the Southern Common Market (MERCOSUR) (*Box*). Before the crisis erupted, South Asian economies had experienced respectable growth rates of more than 5 percent, except for Afghanistan and Nepal, with decent integration into the global economy through goods and services trade, foreign aid, FDI, remittance and tourism *(Table 2)*.

The dependence on export earnings is high for small economies, for example, Bhutan, the Maldives and Sri Lanka, whereas the dependence on remittance is high for Bangladesh and Nepal. Similarly, foreign aid is crucial for conflict-ridden countries such as Afghanistan and Nepal. All these indicate South Asia's vulnerability to external shocks. When the crisis struck, these countries had been experiencing net deficits in exports of goods and services (except for Bhutan), increasing budget deficits, and swelling external debts limiting the policy option to abate the adverse impacts of the crisis.

Box Regional economic integration in South Asia

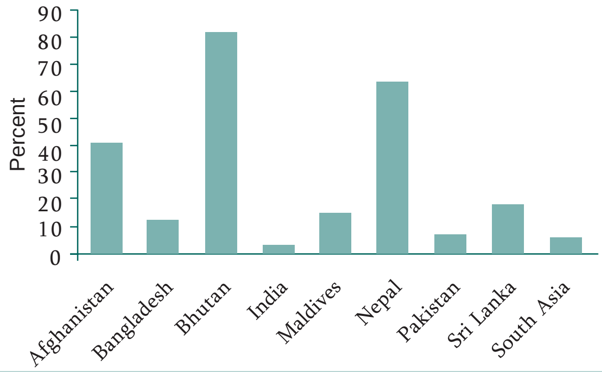
With intra-regional merchandise trade standing at 4.8 percent of the region's total world merchandise trade in 2008, South Asia is one of the least-integrated regions in the world. This is in contrast to the figures of 25 percent in ASEAN and 14 percent in MERCOSUR. This has increased South Asia's vulnerability to economic shocks emanating from outside the region.

On the one hand, excessive trade concentration with a single economy characterizes countries like Bhutan, Nepal and Afghanistan, which do the bulk of their merchandise trade within South Asia (81.79 percent, 63.27 percent and 40.68 percent, respectively), but are dependent on a single economy (India for Nepal and Bhutan; Pakistan for Afghanistan). The bilateral preferential trading arrangements between India and Nepal and between India and Bhutan partly explain the high share of intra-regional trade in Bhutan's and Nepal's total trade. On the other hand, in India, Pakistan, Bangladesh and Sri Lanka, intra-regional trade makes up 2.41 percent, 6.18 percent, 11.52 percent and 17.33 percent of their total international merchandise trade, respectively. This points to the need for the former group of countries to diversify their trade relations within the region, and the latter to pursue more intense trade linkages within the region.

SAFTA, which came into force in mid-2006, has remained largely ineffective in spurring intra-regional trade due mainly to long sensitive lists (accounting for almost 53 percent of the goods traded among member countries)[1], various para-tariff and non-tariff barriers, onerous rules of origin that are difficult for LDCs to meet, and the scope of liberalization being limited to goods in spite of the potential gains from liberalization of services and investment. It should be noted, though, that recorded trade data underestimate the real trade flows among South Asian countries, with studies showing informal trade to be high.[2]

The liberalization of investment regimes and trade in services is critical for realizing the full potential of regional synergies or industrial restructuring.[3] Available data indicate that intra-regional trade in services is not significant in South Asia, and India accounts for the bulk of the existing services trade.[4] South Asia is yet to exploit the advantage of the geographical proximity of its countries by building new partnerships in various sectors like energy, banking, information technology, telecommunications, transportation, education, health, and capital markets.[5] FDI in South Asia is predominantly from outside the region, the exceptions being Bhutan and Nepal. In these two countries, India is the predominant source of FDI. In Sri Lanka, India is the largest among South Asian investors. However, in spite of India's huge internal market, investments from other South Asian countries have been quite insignificant, both in relative and absolute terms, accounting for less than 9 percent of total FDI in India. Bangladesh is the largest investor in India from the region, followed by Sri Lanka, Nepal and the Maldives.[6]

Share of intra-regional trade in total foreign trade, 2008 (%)



Note: Only merchandise trade; indirect data for Bhutan.
Source: Calculated from Direction of Trade Statistics, www.imf.org.

The World Bank estimates that South Asia achieved respectable growth in 2008,[15] compared to other regions, for example, East Asia and Pacific's 3.4 percent, and Central Asia's 2.9 percent. However, as consumption and investment demand contracts, the growth rate for 2009 is projected at 4.6 percent, almost half the rate achieved two years ago. The projected growth rate for the Maldives is negative and less than 5 percent for India, Nepal, Pakistan and Sri Lanka *(Table 3)*. The nearly 9 percent growth rate projected for Afghanistan is largely an outcome of the massive amounts of foreign aid being pumped into the economy, and a low base.

Thanks to the relatively closed capital accounts and minimal exposure to toxic assets, the banking sector in South Asia has remained unscathed during the financial crisis. However, there was a brief impact on capital markets due to psychological impacts on investors and deleveraging by commercial banks in developed countries.

Private capital flows to South Asia collapsed in the aftermath of the crisis. Net capital inflows, inclusive of public and private flows, declined, the decline being sharper in private capital flows *(Table 4)*. The contraction was led by the halving of portfolio equity inflows plunging private creditor bond issuance and syndicated bank loans, which reduced by 84 percent and 67 percent, respectively.[16]

In contrast, net FDI inflows registered a growth of 59 percent in 2008 and contributed about nearly two thirds of total net inflows. This sharp increase in net FDI inflows was driven by surges in FDI to India and Pakistan—largely accumulated prior to the onset of the crisis—which registered gains of 52 percent and 59 percent, respectively.[17]

South Asia registered export growth of 15.1 percent in 2008. However, as the export structure is highly income elastic, with the collapse in demand in destination countries, exports are projected to shrink by 2.6 percent in 2009. Data for the first quarter of 2009 show different levels of contraction. In India, Pakistan and Sri Lanka, exports contracted at double-digit annual rates of 33 percent, 27.5 percent (both as of March 2009) and 11.6 percent (as of February), respectively. In Bangladesh, exports increased by 3 percent during the first three months of 2009, and, in Nepal, by 19.8 percent, measured in domestic currency, during July 2008 to April 2009.[18]

Similarly, merchandise imports have also contracted sharply due to declining domestic demand and steep fall in international commodity prices, particularly oil. As a result of a relatively worse export performance, current account deficits are projected to increase.

Despite the contraction in global economic activities, South Asia registered growth in remittance inflows in 2008, although the pace of growth declined to 27 percent in 2008 from 31 percent in 2007. Such growth could be a temporary phenomenon since migrant workers who have lost jobs have returned home with accumulated savings, and declining commodity prices, in particular oil prices, along with the contraction in investment demand in destination countries may result in a further slowdown, or even a decline, in remittance inflows.

Data for the first quarter of 2009 show that although remittance flows to Bangladesh continued to grow, the rate of increase declined sharply from an annual rate of 50 percent in August 2008 to 9.6 percent in 2009. In Nepal, the flow registered a growth rate of 55.5 percent, measured in domestic currency, during the period from July 2008 to April 2009, compared to the corresponding period of 2007/08.[19] In Sri Lanka, net remittance inflows declined by 3.8 percent in March 2009 over a year ago.

Tourism also registered a sharp decline in 2009. However, the decline was mostly due to the domestic environment in some countries. In Bhutan, where tourism contributes 7 percent of GDP growth, tourist arrivals declined by 37.8 percent (year-on-year) in March 2009, compared with the growth of 40 percent in 2008. In the Maldives, tourism declined by about 10 percent. In Sri Lanka, the recently ended civil war contributed to an 11 percent fall in tourist arrivals in 2008. Nepal experienced a highly volatile tourist flow in the first quarter of 2009, a decline of 17.6 percent in March 2009 over the previous year and a growth of 15.8 percent in April.[20]

Addressing the crisis

Given the not-so-encouraging economic scenario in the aftermath of the economic crisis, and the increasing possibility of the economic impacts being further transmitted into the social sector, a big challenge for South Asian countries is to stall and mitigate the adverse impacts of the crisis, and move forward on a sustained development path. This calls for concerted actions at all levels—global, regional and national.

Global responses

Global crises call for global responses. In order to mitigate the impacts of the crisis, a total of US$18 trillion has so far been mobilized by the international community to recapitalize

Table 3 Growth projection for South Asia

	Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
2008	3.35	5.87	6.55	7.28	5.67	4.70	5.95	5.95
2009	8.96	5.00	5.66	4.53	-1.33	3.60	2.50	2.20

Source: IMF. World Economic Outlook Update. Various issues. Washington, D.C.: International Monetary Fund.

Table 4 South Asia indicators (annual % change)

	2007	2008	2009*
GDP at market prices (at 2000 US$ prices)	8.4	6.1	4.6
Private consumption	7.3	3.8	3.7
Public consumption	6.3	17.5	8.9
Fixed investment	13.6	11.4	6.3
Exports	8.1	10.4	-2.6
Imports	8.0	15.2	0.4
Current account balance/GDP ratio (%)	-20.5	-59.1	n.a.
Net private and official flows (US$ billion)	116.5	77.0	n.a.
Net private flows (US$ billion)	112.5	66.5	n.a.
Net FDI inflows (US$ billion)	29.9	47.5	n.a.
Workers' remittances (US$ billion)	52.1	66.0	n.a.

* forecast

Source: www.worldbank.org.

banks, nationalize financial institutions, and provide guarantees on bank deposits and other financial assets. As of April 2009, fiscal stimulus plans totaled US$2.7 trillion, to be spent over 2009–2011.[21]

G20 leaders, at their London Summit in April 2009, pledged to address the recession by, among others, restoring confidence, growth and jobs; repairing the financial system to restore lending; strengthening financial regulation to rebuild trust; funding and reforming international financial institutions; promoting global trade and investment; and rejecting protectionism. They also pledged US$1.1 trillion in financing, of which US$50 billion is for social protection, trade and development in low-income countries.[22]

Nobel laureate Joseph Stiglitz has rightly identified the causes of the financial crisis as "the fruit of a pattern of dishonesty on the part of financial institutions, and incompetence on the part of policymakers".[23] The global response should include not only reinvigorating economic activities but also correcting the systemic failure in the market mechanism, in particular the financial architecture. Thus, the global response to the crisis, in order to be effective, should focus on four major issues.

First, the magnitude of the current crisis is clearly associated with inadequate regulation and supervision of banks and financial markets. Therefore, a new financial architecture with adequate representation of developing and least-developed countries should be designed to create a stronger, broader and more globally consistent macro-prudential supervisory, regulatory and oversight framework.

Second, the stimulus packages, announced on an unprecedented scale, need to be implemented without any protectionist intent, in a coordinated and harmonized manner, to promote sustainable and inclusive development. In the implementation process, it should be ensured that developing and least-developed countries benefit from the stimulus packages.

Third, it is essential that the commitment repeatedly made by G20 leaders to avoid protectionist measures, including creating new barriers to investment and export restrictions in the immediate future, is fulfilled. A successful conclusion of the Doha Round of trade negotiations under the WTO is also essential. It is imperative to ensure that LDCs reap net benefits of duty-free and quota-free arrangements. The exercise of WTO-consistent rights to utilize the policy space by developing and least-developed countries should not be interpreted as protectionism. The trade finance needs of such countries should also be addressed with improved lending terms.

Fourth, there should be improved commitments on ODA to needy developing and least-developed countries. In addition, conditionalities on access to resources should be relaxed and debt relief programmes, including a moratorium on debt services, need to be accelerated. The aid-for-trade initiative also needs to be effectively operationalized to enhance the capacity of developing and least-developed countries to take advantage of better market access conditions.

Regional responses

The global crisis has compelled South Asian countries, which in general have stronger extra-regional than intra-regional trade and financial ties, to critically assess the development in South Asian Association for Regional Cooperation (SAARC). Had there been more intense economic relations among SAARC members in areas of trade and investment, the prospect of "decoupling" from the crisis would have been better. Therefore, it is imperative that they intensify regional trade and economic integration.

First, they must downsize their sensitive lists under the Agreement on South Asian Free Trade Area (SAFTA) and dismantle para-tariff and non-tariff barriers. Second, the rules of origin should be relaxed and simplified particularly for the LDCs. Third, they need to strengthen regional trade linkages, including by reshaping the existing production supply chain and promoting intra-industry trade. Fourth, they should finalize the agreement on investment cooperation. Fifth, they have to establish a mechanism for monetary cooperation and the harmonization of macroeconomic policies. Sixth, they should further intensify cooperation in the services sector, for example, by concluding services negotiations in SAFTA. Seventh, measures, including those related to trade facilitation, should be taken to formalize the informal trade among South Asian countries, which would not only increase government revenues, needed to finance stimulus and relief packages, but also contribute to increasing intra-regional trade by creating a competitive and transparent environment.

National responses

Unlike developed economies, South Asian countries do not have automatic stabilizers or social safety nets that take effect to minimize adverse effects during economic slowdowns.[24] Hence, national policy responses in South Asia should focus on a mix of financial, fiscal, monetary and trade policies. However, the availability of policy instruments depends on balance-of-payments situations, recent fiscal stances, the status of public-sector debts and the stage of development of capital and bond markets. South Asian countries fall in different scales on the above parameters and, thus, the policy package to be adopted varies accordingly.

Countries with weak external and fiscal indicators, for example, Pakistan and Sri Lanka, have limited headroom for counter-cyclical measures and huge stimulus packages. For countries with a strong debt and foreign exchange reserve position but a relatively weak fiscal stance (for example, India), the room for manoeuvre lies more in monetary than in fiscal policy. It may include easing domestic financing, facilitating private-sector access to foreign exchange, and reducing interest rates.

Nonetheless, South Asian countries need fiscal adjustments to avoid pro-cyclical fiscal impacts and to ratchet up domestic demand. Some countries have already announced stimulus packages. India and Bangladesh have announced stimulus packages equivalent to 3.5 percent and 0.7 percent of their GDP, respectively. However, these should focus on social-sector spending, including food security and employment-generating infrastructure development.

Social safety net programmes in South Asia suffer from weaknesses that adversely affect their effectiveness in reaching the poorest people and households. Bhutan and Afghanistan do not have public safety nets while Pakistan, Sri Lanka, and Nepal have one or two cash transfer-based safety net programmes.[25]

On the other hand, India and Bangladesh have several safety net programmes. Programme coverage varies, from 2 percent of the population in Pakistan to 30 percent of the population in India to almost 40 percent of the population in Sri Lanka.[26] As it is easier to scale up an existing safety net programme than to design a new one, particularly when responding to a current crisis, the strategy should be to expand the existing ones but with the necessary arrangements to ensure that the targeted beneficiaries benefit.

Since South Asian countries significantly depend on international trade, trade policy instruments may not be sufficient on their own to ease the adverse impacts of the crisis. An appropriate policy mix plays a significant role towards this end.

First, non-traditional exports can be encouraged, through a mix of exchange rate depreciation and sectoral incentives. Second, backward and forward linkages of existing manufacturing activities can be strengthened. Third, bilateral and regional trade can be encouraged. Payments agreements among central banks can also facilitate such trade without the need for hard currencies. Fourth, the role of domestic markets can be reassessed and recognized in the industrialization process. Fifth, the countries should refrain from resorting to protectionism. Finally, they should learn from the global financial crisis how regulatory failure creates a domino effect in the economy. They must rebuild and strengthen their regulatory systems to ensure confidence in the market mechanism, establish transparency in corporate governance, and dismantle flawed incentives.[27] ■

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Box notes

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SOUTH ASIA WATCH ON TRADE, ECONOMICS & ENVIRONMENT

South Asia Watch on Trade, Economics & Environment (SAWTEE) is a regional network that operates through its secretariat in Kathmandu and 11 member institutions from five South Asian countries, namely Bangladesh, India, Nepal, Pakistan and Sri Lanka. The overall objective of SAWTEE is to build the capacity of concerned stakeholders in South Asia in the context of liberalization and globalization.

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