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# The Financial Tsunami: Implications for South Asia

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**Poverty Reduction, Economic Management, Finance and Private Sector  
Development**

**South Asia Region**

**The World Bank**



# Outline

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- **Sketch of the financial tsunami**
- **How was South Asia positioned to receive the financial tsunami?**
- **What are possible implications for South Asia's economic prospects?**
- **Immediate and medium term policy response, lessons being learned**

# Sketch of the Financial Tsunami

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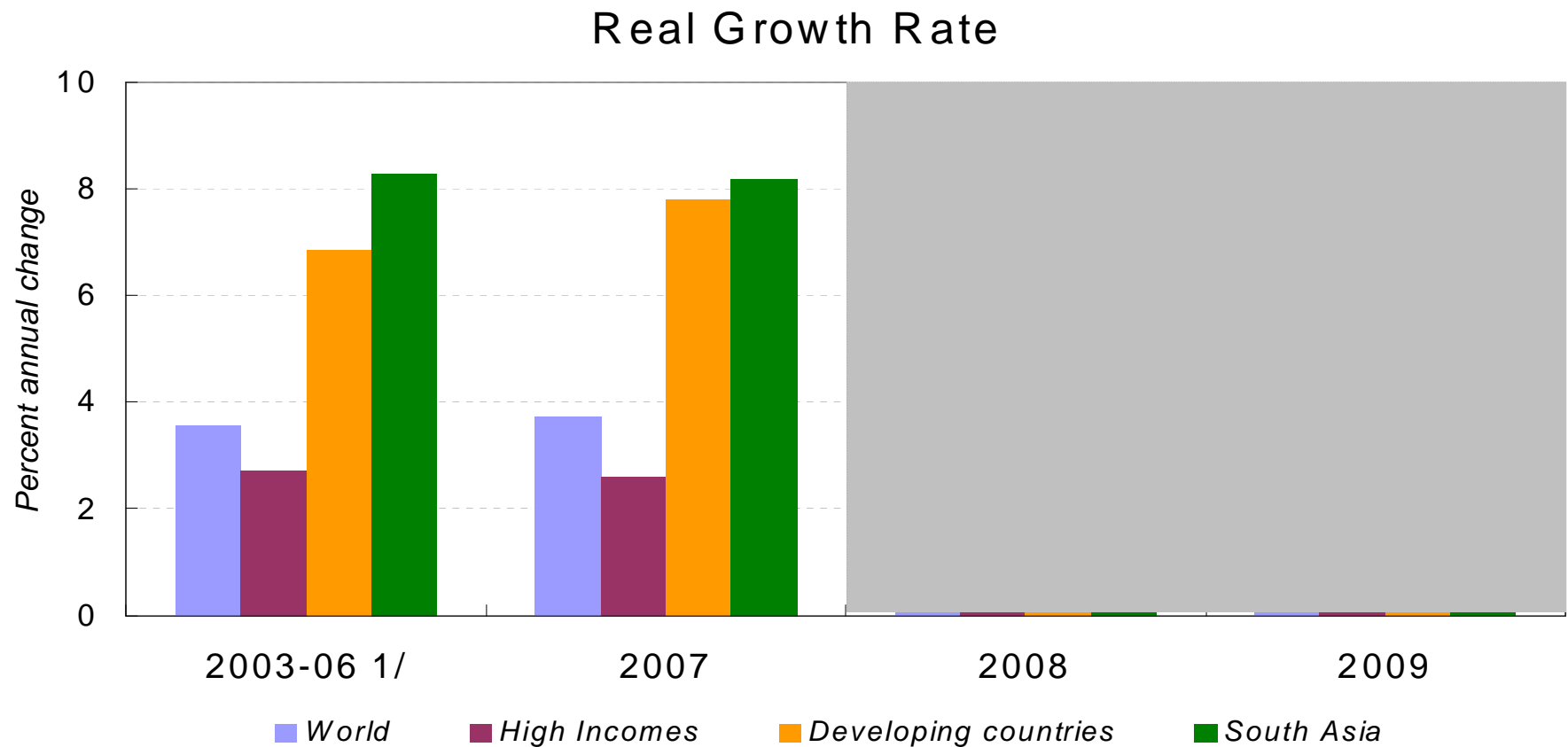
- Originated in the US, still has a long way to go and no country is really isolated from it
- Many factors contributed but two possibly dominate—the rapid growth in global liquidity and the permissive regulatory environment
- When the credit crisis intensified, policy mistakes were made
  - Bail out packages never got ahead of the markets
  - Lehman's collapse led to a breakdown in trust among financial intermediaries
- From that point onwards, the challenge became how to prevent a collapse of the global financial system and deep recession
- The speed with which the crisis is affecting economic activity around the world is staggering.

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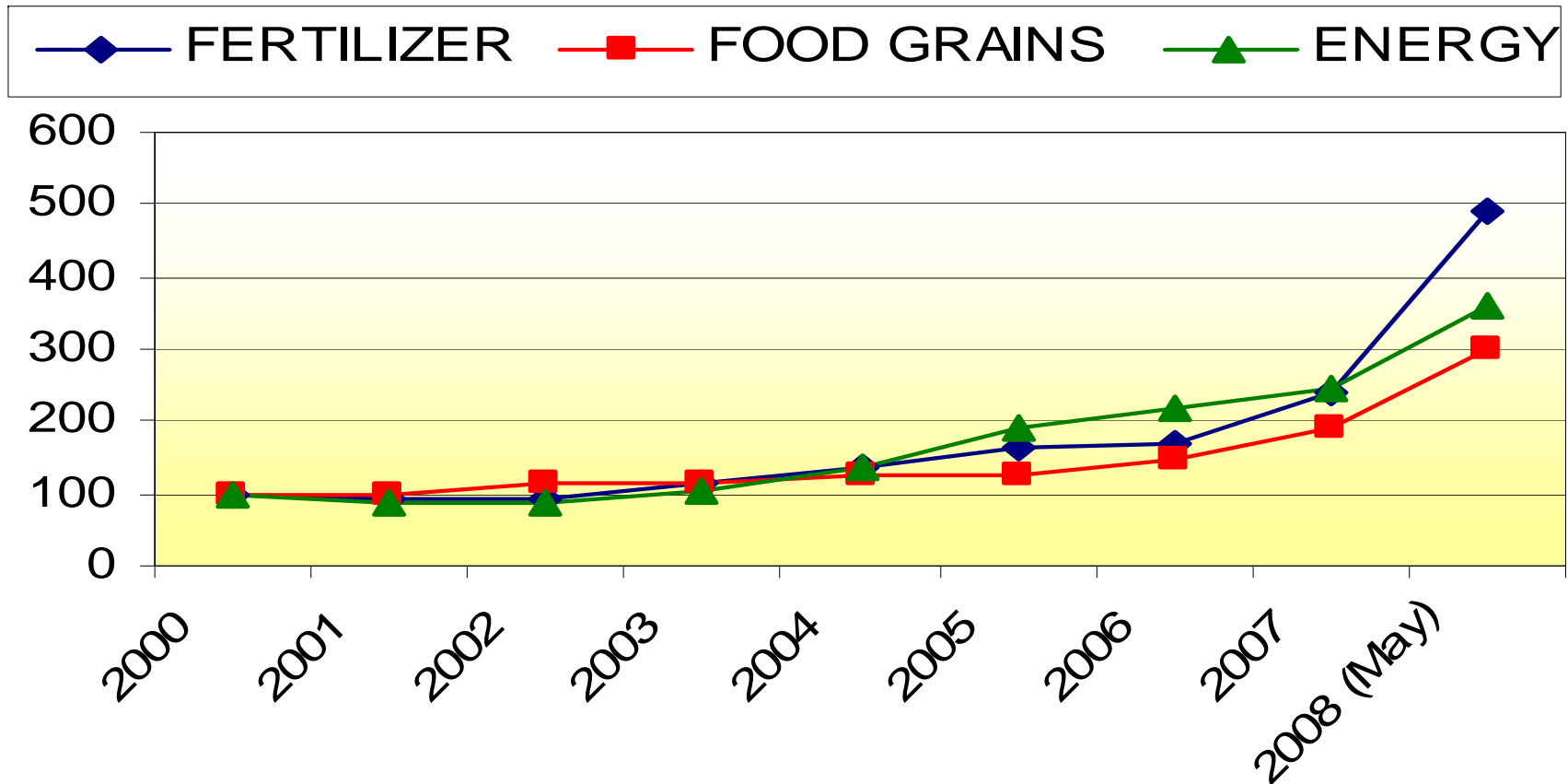
# Global Economic Growth: Before the Tsunami



Source: World Bank Global Development Finance 2008.  
1/ Average of 2003-2006

# The Twin Shocks: Food and Fuel Prices

**World Bank Weighted Index of Commodity Prices**



# Regional Impact of the Twin Shocks

## Terms of Trade Impact

Jan 2003 to May 2008<sup>1</sup>

	All commodities	Food	Energy
South Asia	-9.6	0.2	-9.1
East Asia and Pacific	-1.0	0.4	-0.4
Sub-Saharan Africa	25.5	-2.0	22.7
Latin America and Caribbean	10.1	0.9	5.1
Europe and Central Asia	12.8	-0.6	10.5
Middle East and North Africa	36.4	-2.7	44.9
EAP Oil Importers	-13.3	-1.4	-24.4
China	-3.9	-0.1	-1.8
SSA Oil Importers	2.5	-1.6	-4.6

Source: World Bank staff estimates.

Notes: 1. As a share of 2002 GDP.

# South Asia: Impact of the Twin Shocks

## Terms of Trade Impact in South Asia Region

Jan 2003 to May 2008<sup>1</sup>

	All commodities	Food	Energy
Bangladesh	-7.7	-3.1	-2.6
India	-9.5	0.5	-9.5
Sri Lanka	-10.2	-2.4	-7.7
Maldives	-34.1	-3.9	-19.6
Nepal	-21.2	-3.4	-11.0
Pakistan	-11.3	1.6	-11.8

Source: World Bank staff estimates.

Notes: 1. As a share of 2002 GDP.



## South Asia: Deteriorating Current Accounts

*% share of GDP*

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
Bangladesh ( BGD )	0.3	-0.5	-0.3	2.0	1.2	0.8
India ( IND )	1.5	0.1	-1.0	-1.0	-1.6	-3.8
Sri Lanka ( LKA )	-0.6	-3.4	-3.2	-5.3	-3.9	-7.8
Nepal ( NPL )	1.9	-0.6	0.0	-0.1	-1.2	1.2
Pakistan ( PAK )	4.3	-0.8	-3.3	-5.4	-5.8	-8.9
South Asia ( SAS )	1.6	-0.1	-1.2	-1.5	-1.9	-4.2

# South Asia: High or rising fiscal deficits

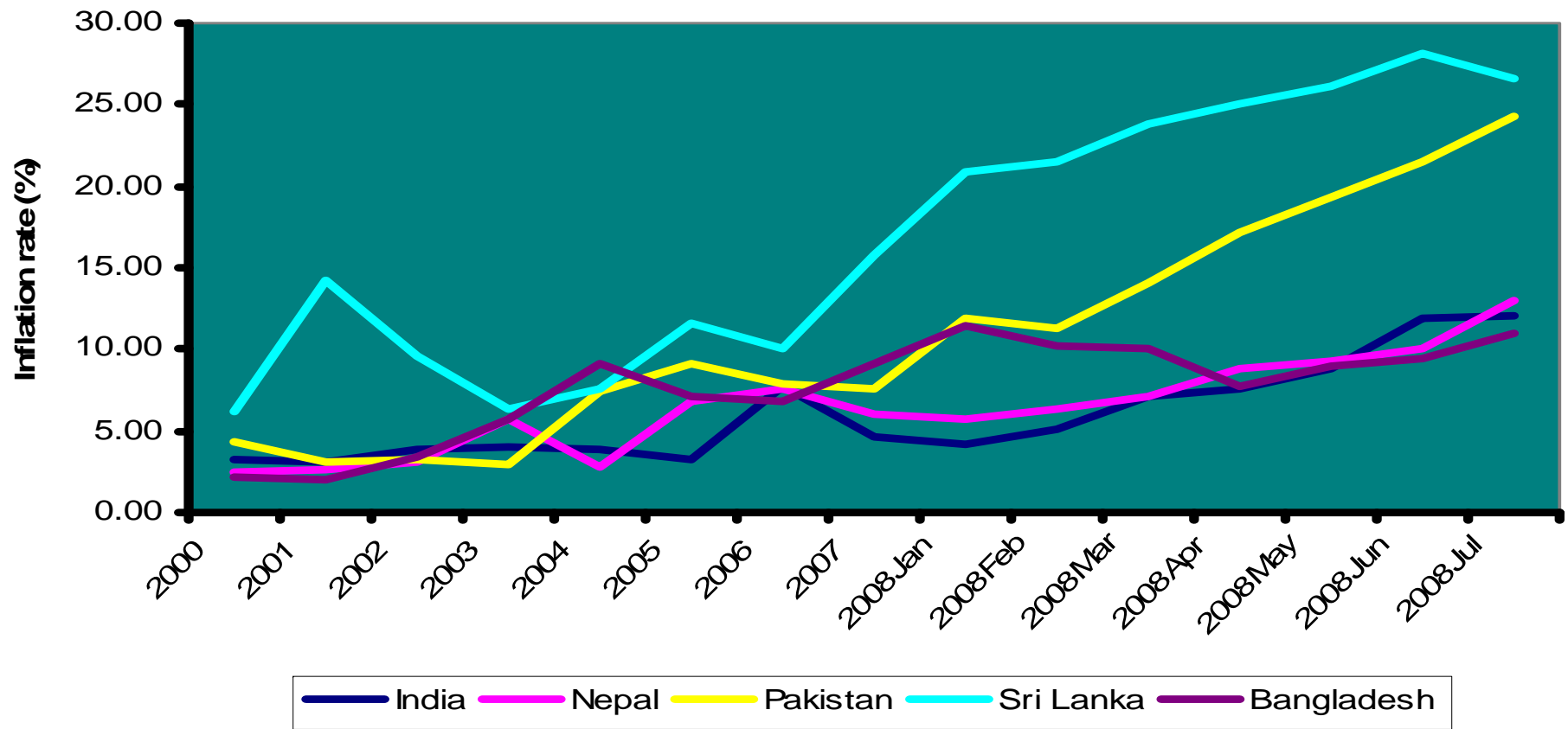
*% share of GDP*

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
Bangladesh ( BGD )	-3.4	-2.9	-3.4	-3.3	-3.7	-4.7
India ( IND )	-9.1	-7.2	-6.8	-6.5	-6.8	-8.5
Sri Lanka ( LKA )	-7.6	-7.7	-8.4	-8.1	-7.7	-7.5
Nepal ( NPL )	-1.8	-0.9	-0.8	-1.6	-1.4	-2.8
Pakistan ( PAK )	-1.0	-2.1	-0.4	-4.2	-4.2	-7.4
South Asia ( SAS )	-7.7	-6.3	-5.9	-6.1	-6.3	-8.1

# South Asia: Inflationary Pressures

Annual % rates

Figure 5: Trend in Inflation in South Asia



# Outline

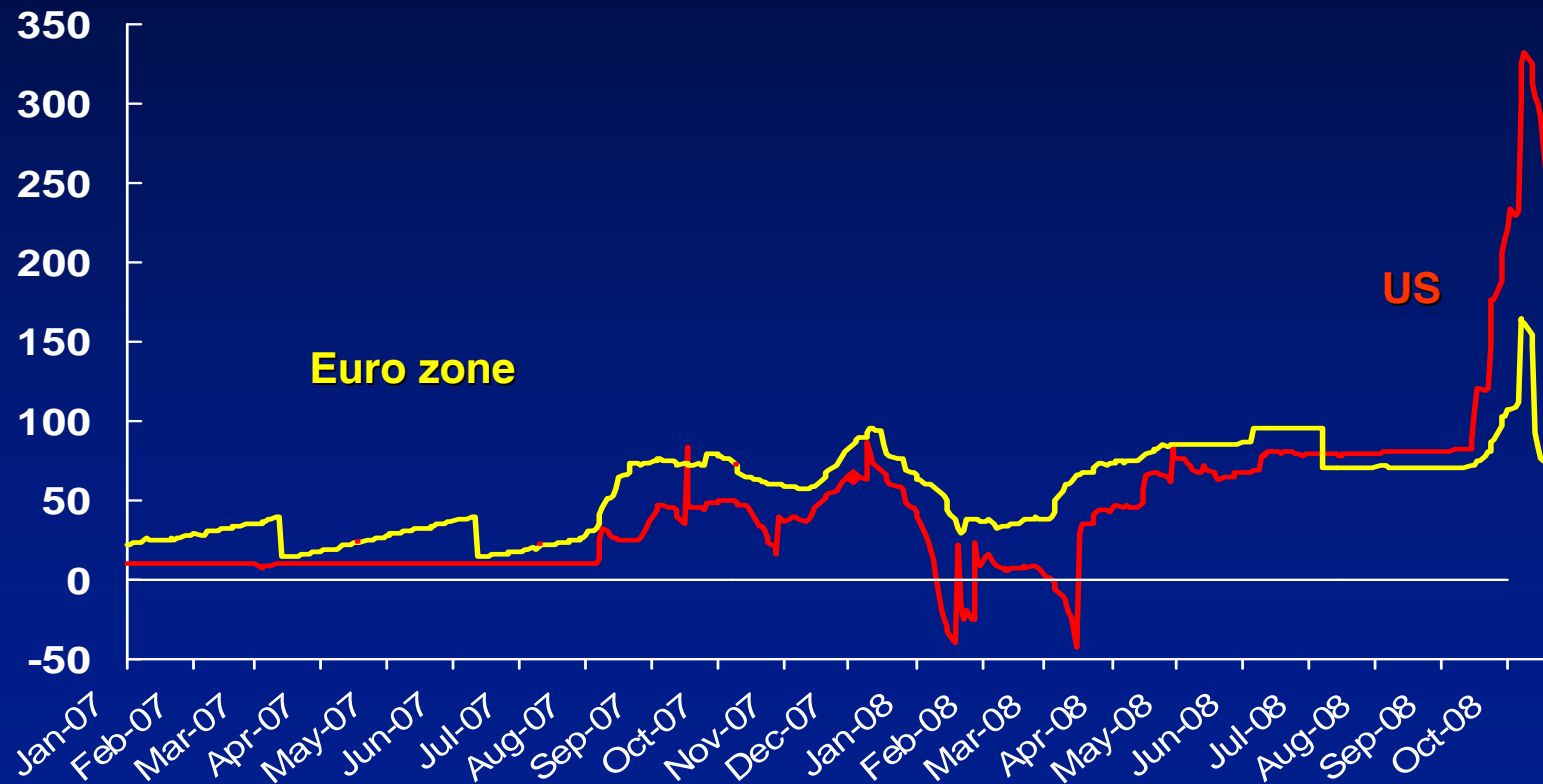
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# The financial tsunami... with massive bailouts and liquidity injections with some impact so far

Spread between 3-month Libor and policy interest rates

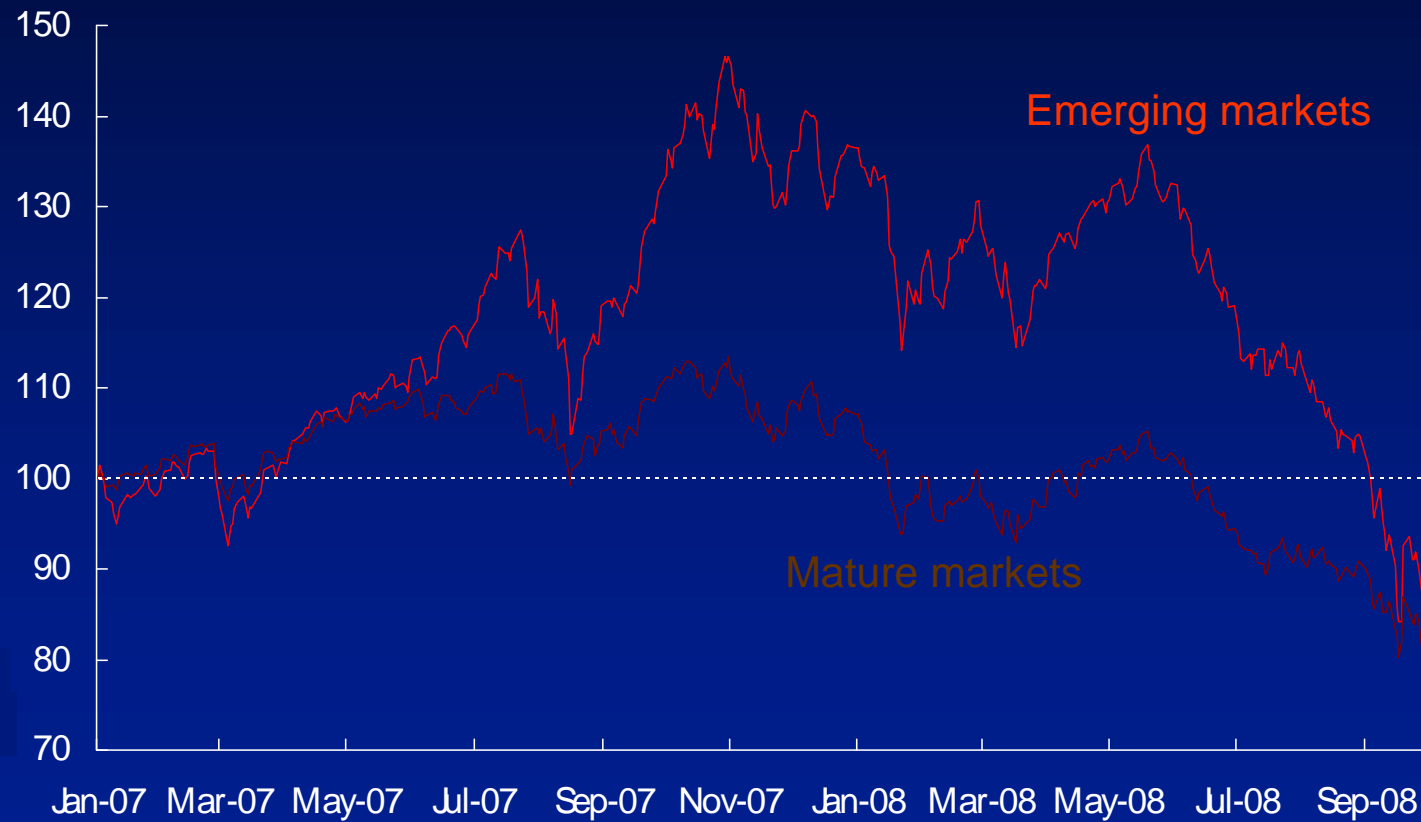
*Basis points*



Source: Datastream.

# ...global equity markets falling

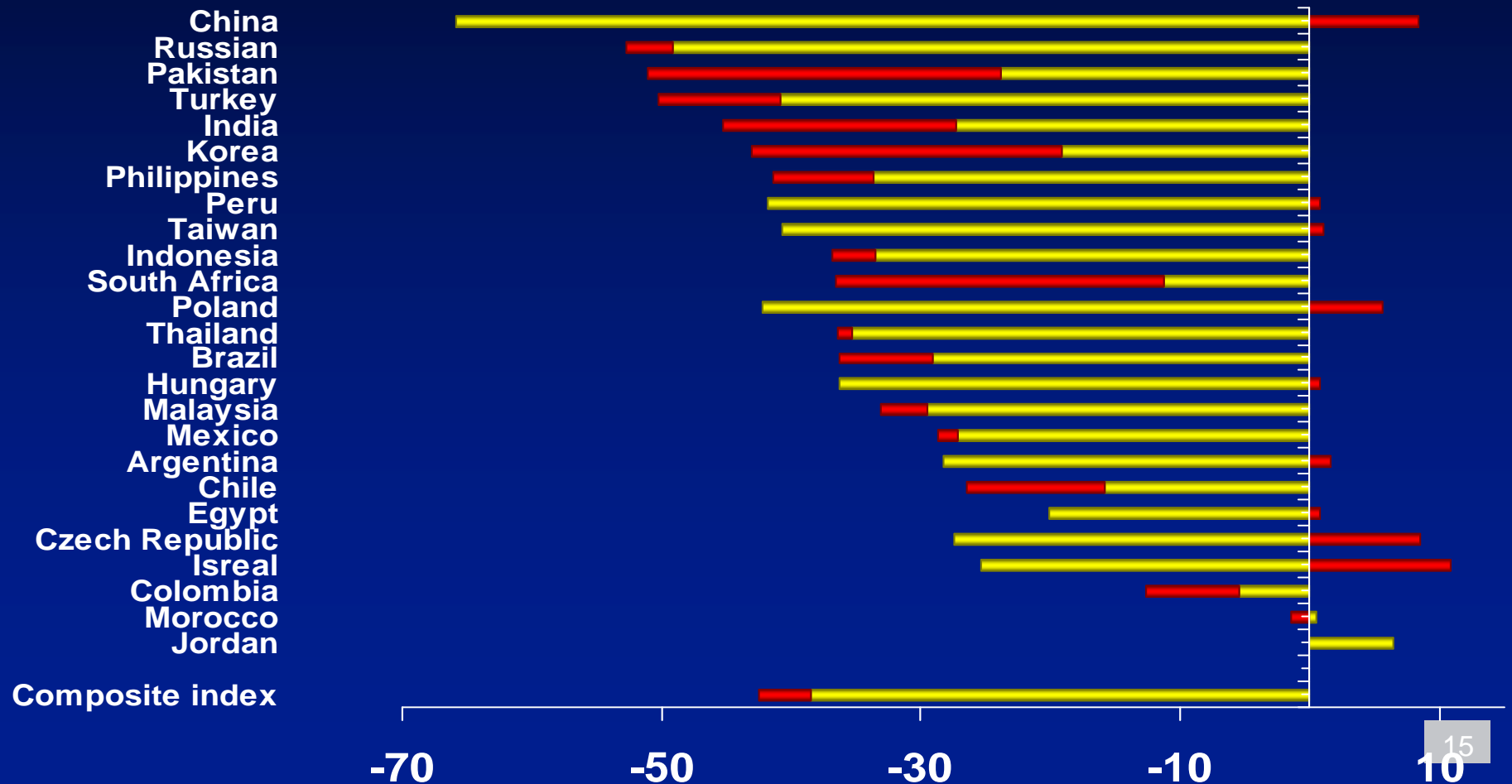
MSCI equity price indexes  
(Jan. 2007 = 100)



# ... with emerging markets taking a big hit

Percent change in equity prices (in \$US) since Oct, 2007

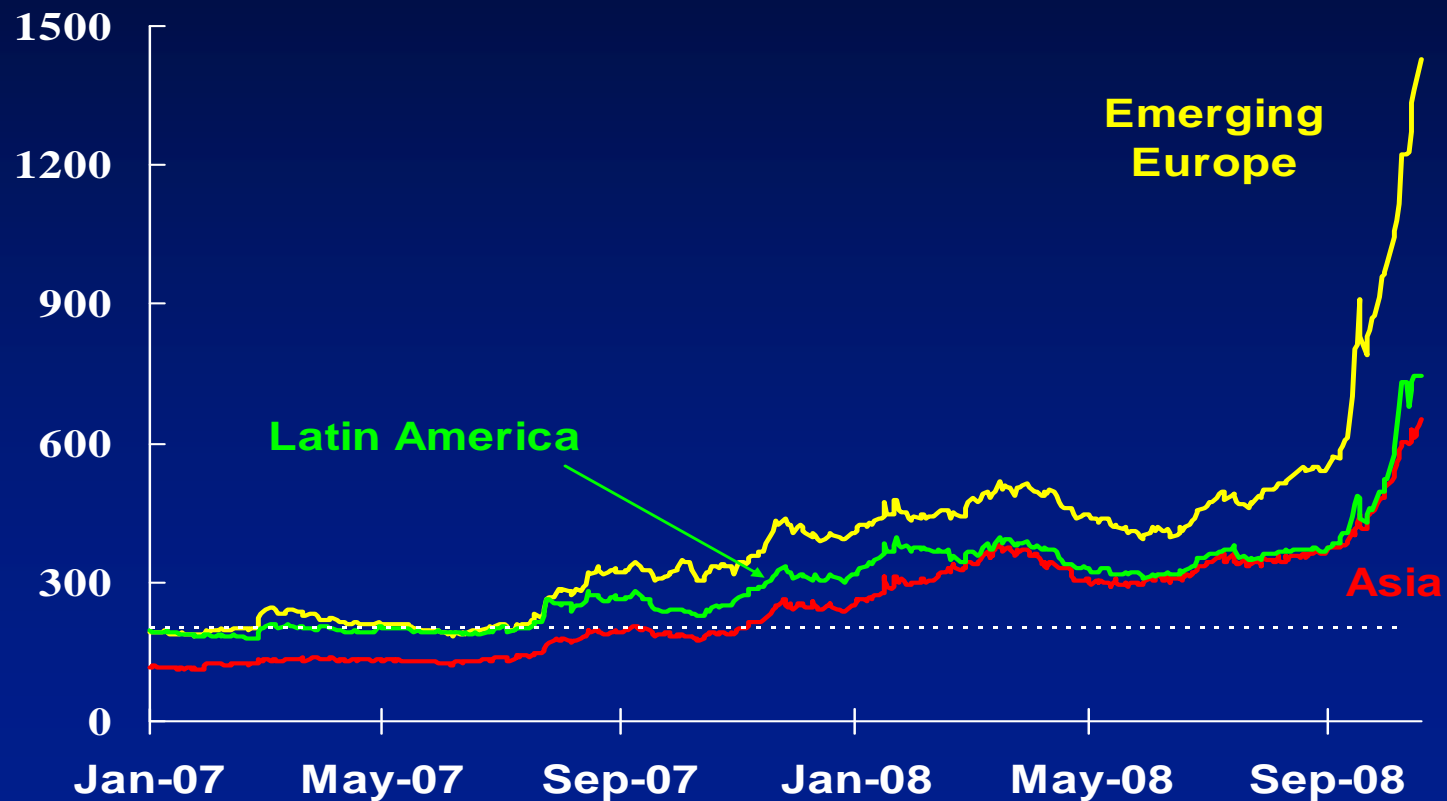
■ Equity price change ■ Exchange rate change



# ...corporate bond spreads have surged

Emerging-market corporate bond (CEMBI) spreads  
Jan 2007 – Oct 20, 2008

*Basis points*



Source: JPMorgan



# EMBI bond spreads have surged

*S&P rating outlook downgraded to "negative" for Pakistan and Sri Lanka*

Emerging-market bond index (EMBI) spreads over U.S. Treasuries  
Jan 2007 – Oct 23, 2008

*Basis points*



Source: JPMorgan

# ...private debt and portfolio equity flows to developing countries have been falling

Bank lending, bond and equity issuance  
Jan. 2004 – Sep. 2008

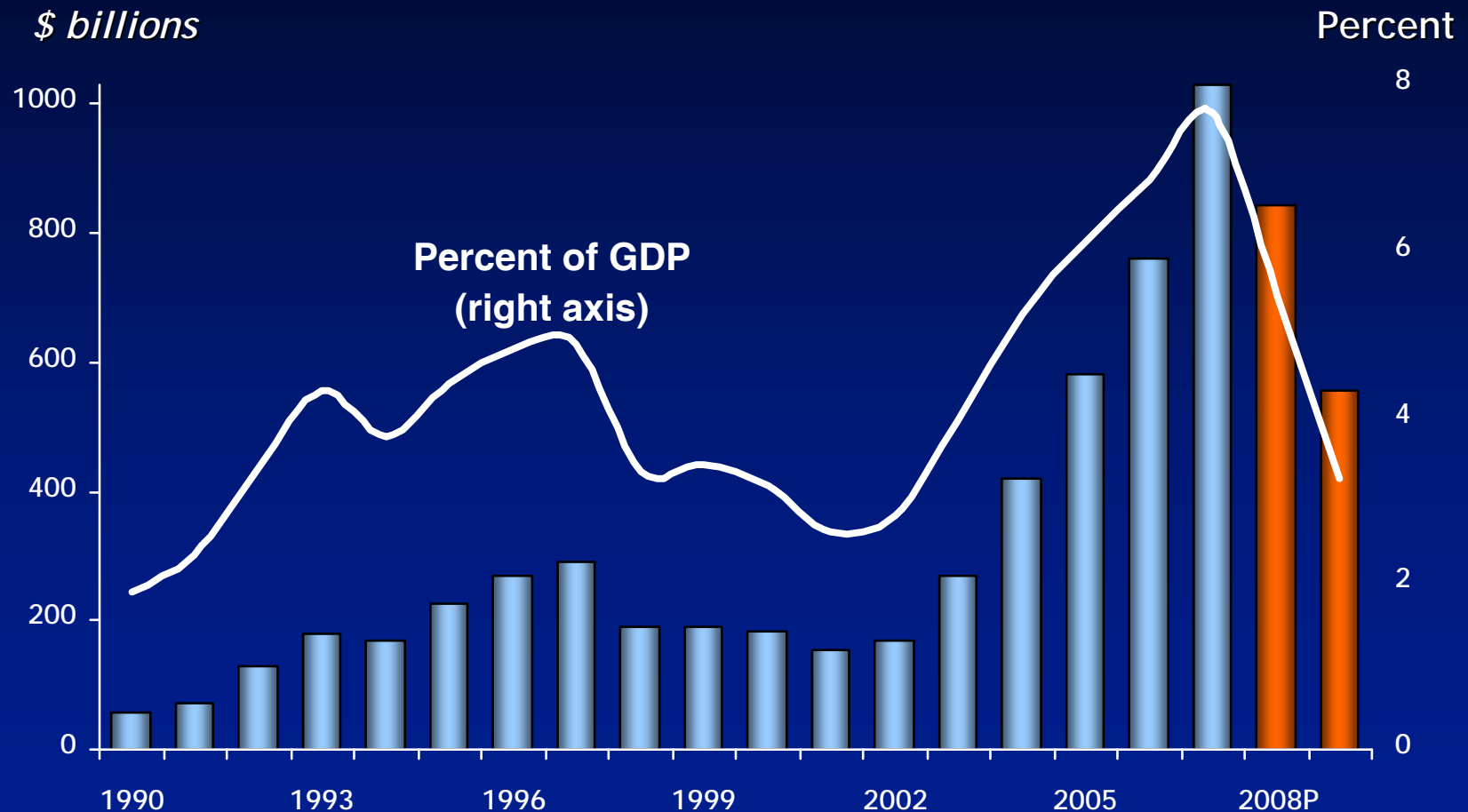
\$ billions  
(12-month moving average)



Source: World Bank.

# Private capital flows expected to decline further

Net private debt and equity flows to developing countries  
1990-2007, projected 2008-09

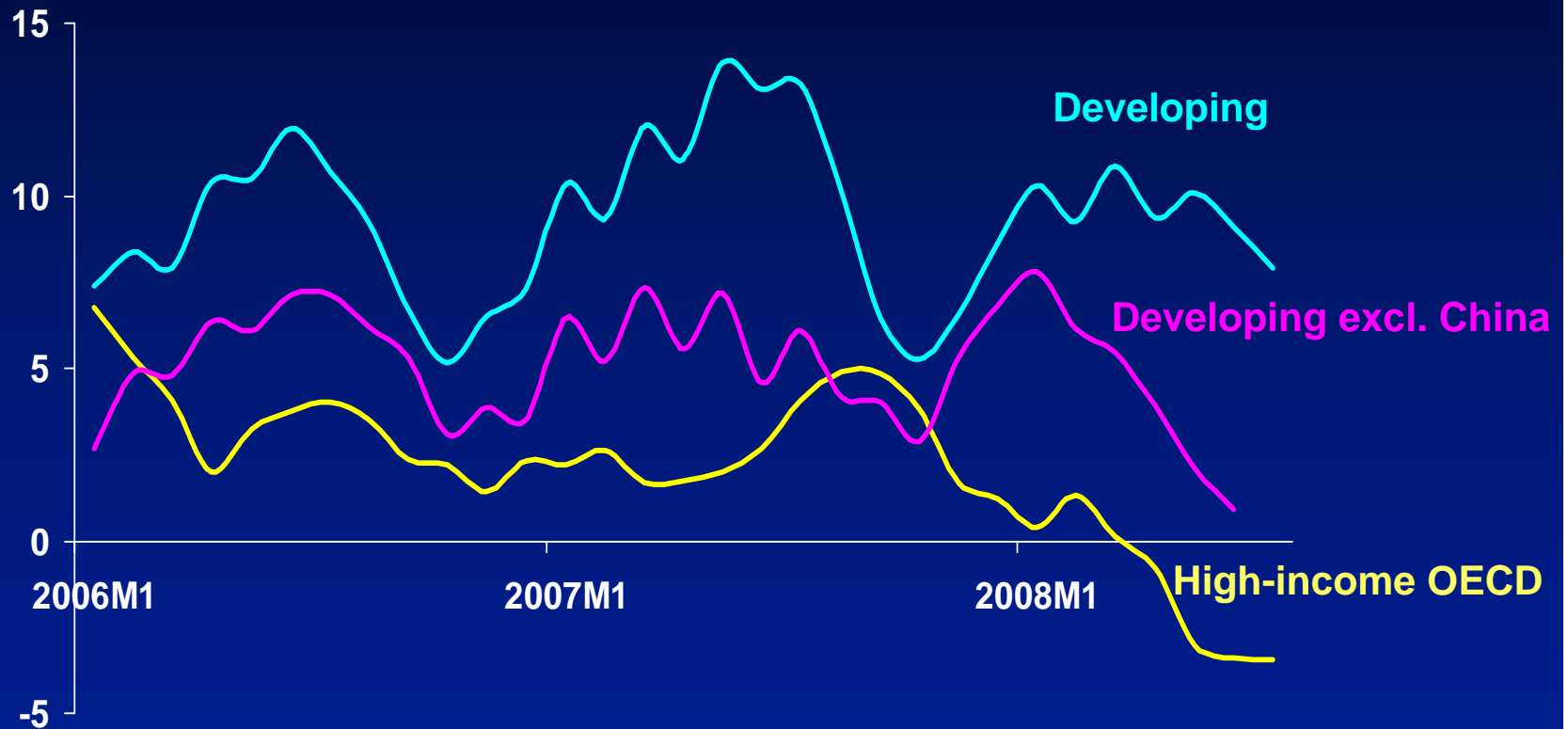


Source: World Bank.

# Momentum in industrial production weakened in recent months

Annualized growth of industrial production

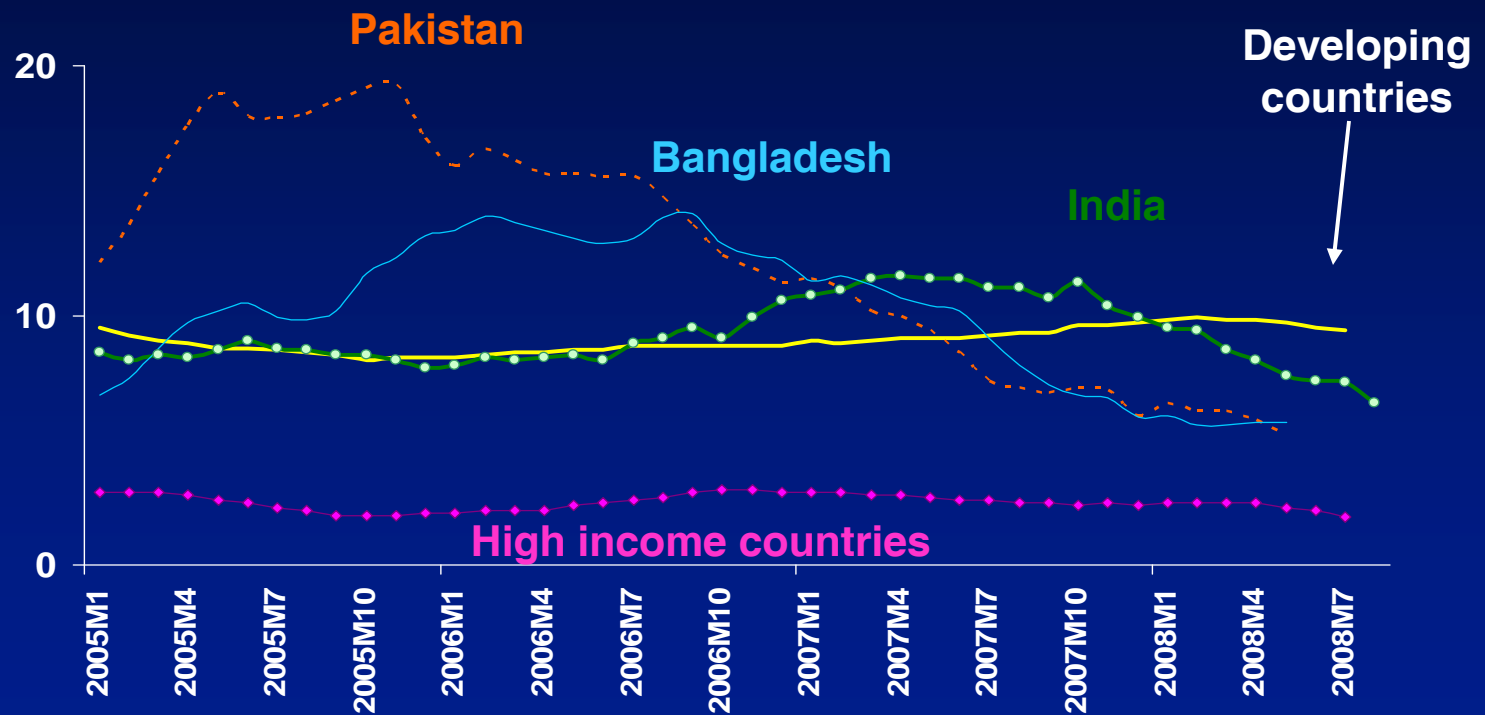
Percentage change  
(3m/3m)



# ...with South Asia following suit

Annual growth of industrial production

Percentage change  
(12m/12m)

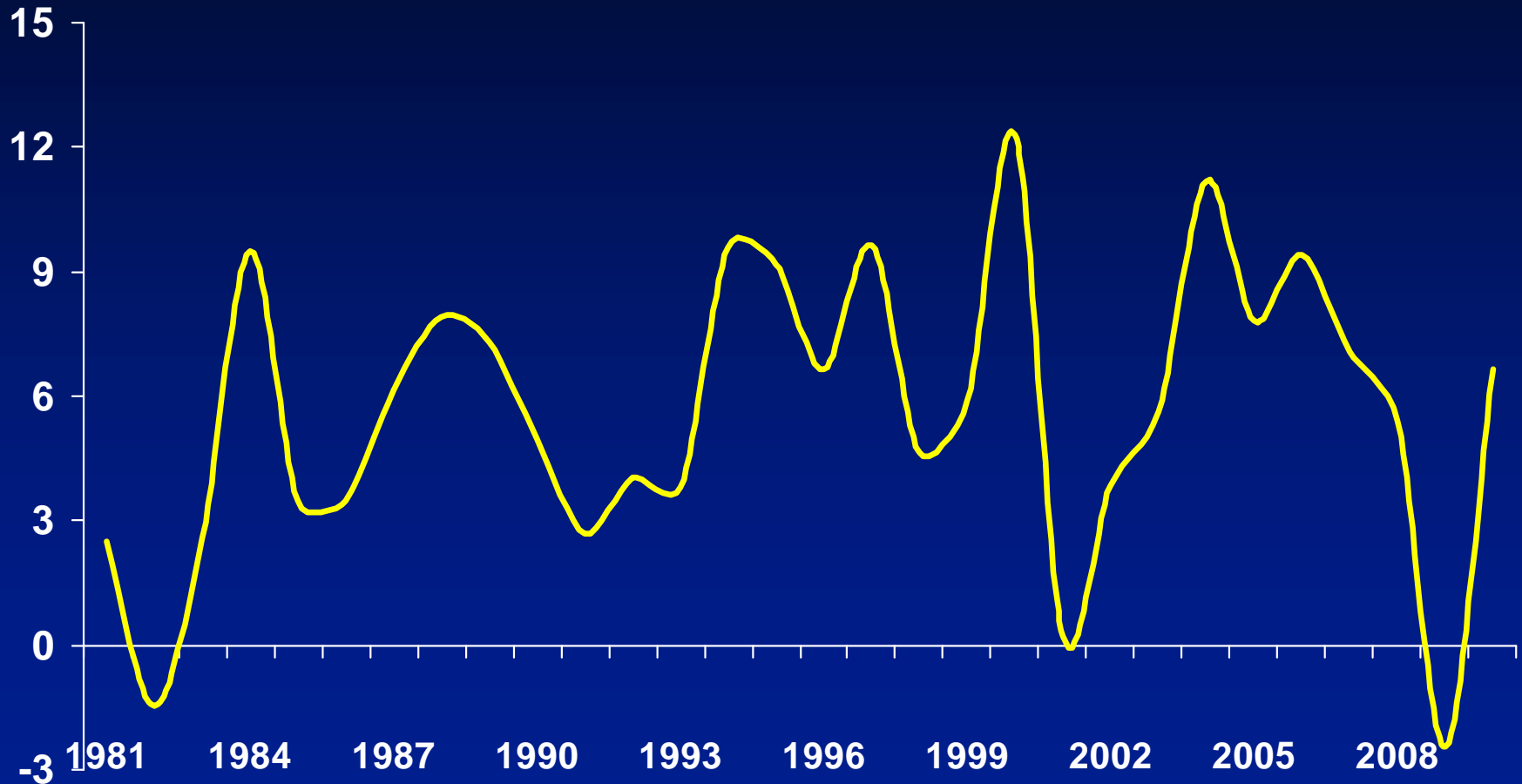


Source: World Bank

# World trade expected to contract, for the first time since 1982

Percentage change

Annual growth of global trade volumes

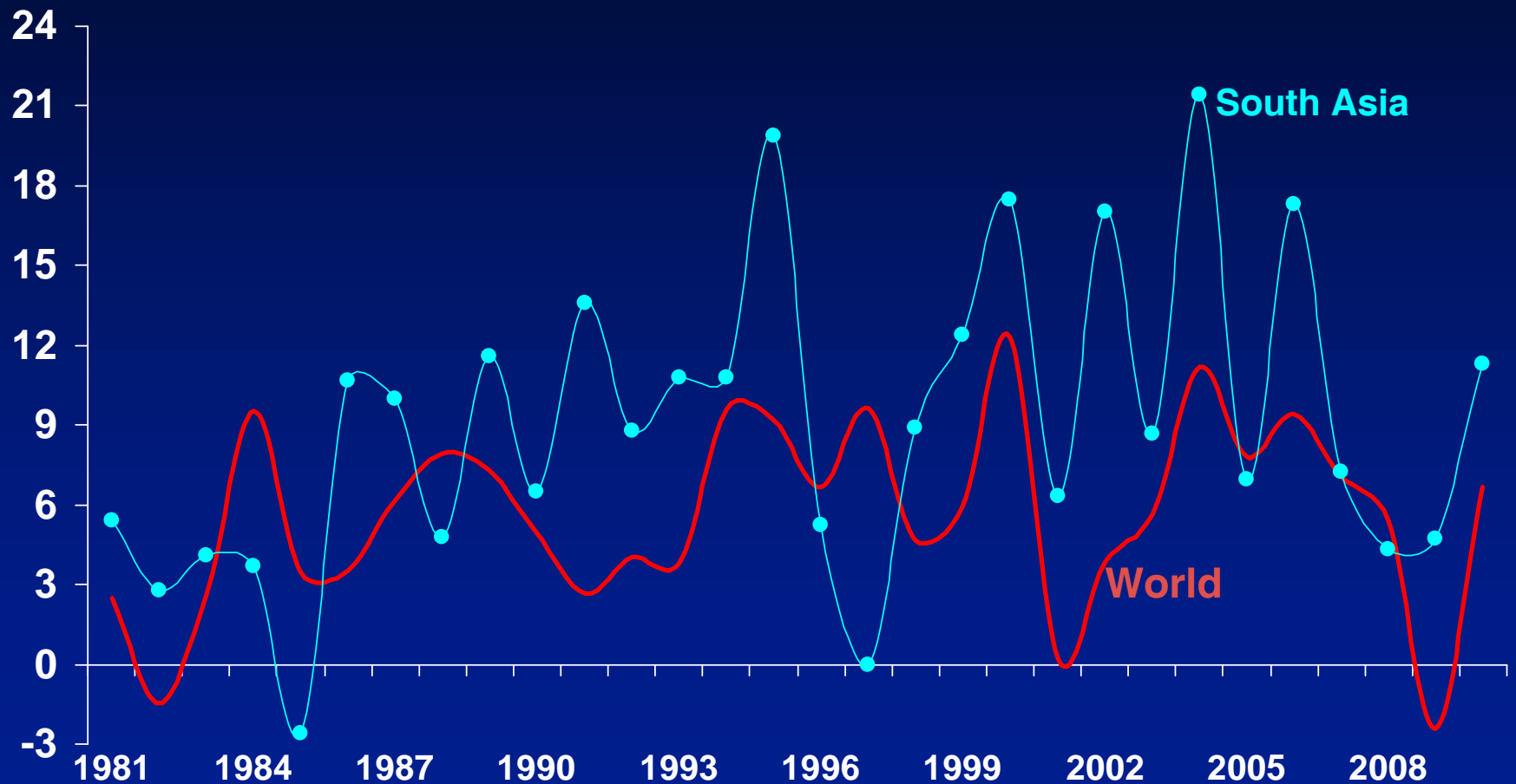


Source: World Bank

# ...with a slowdown for South Asia

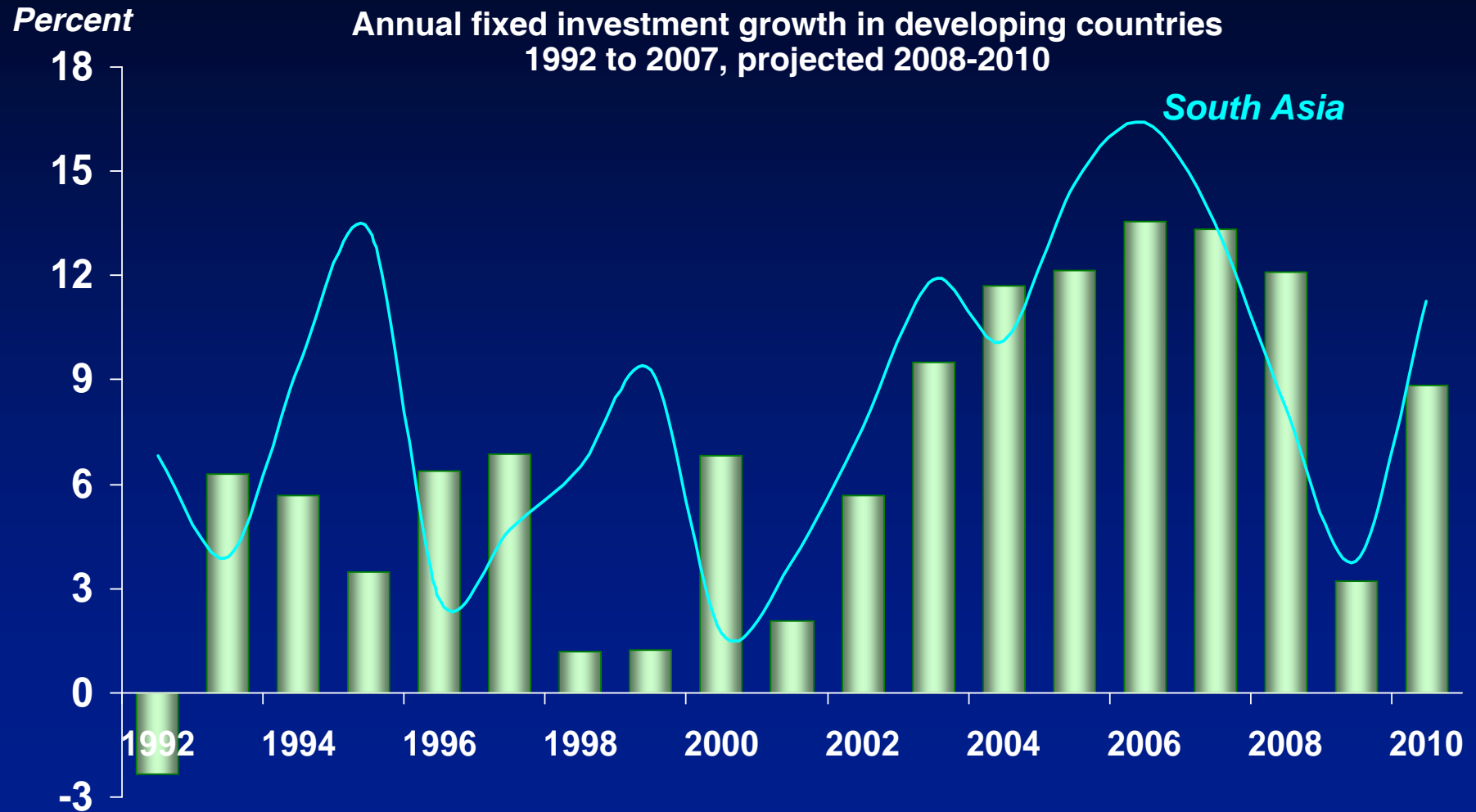
Percentage change

Annual growth of global trade volumes



Source: World Bank

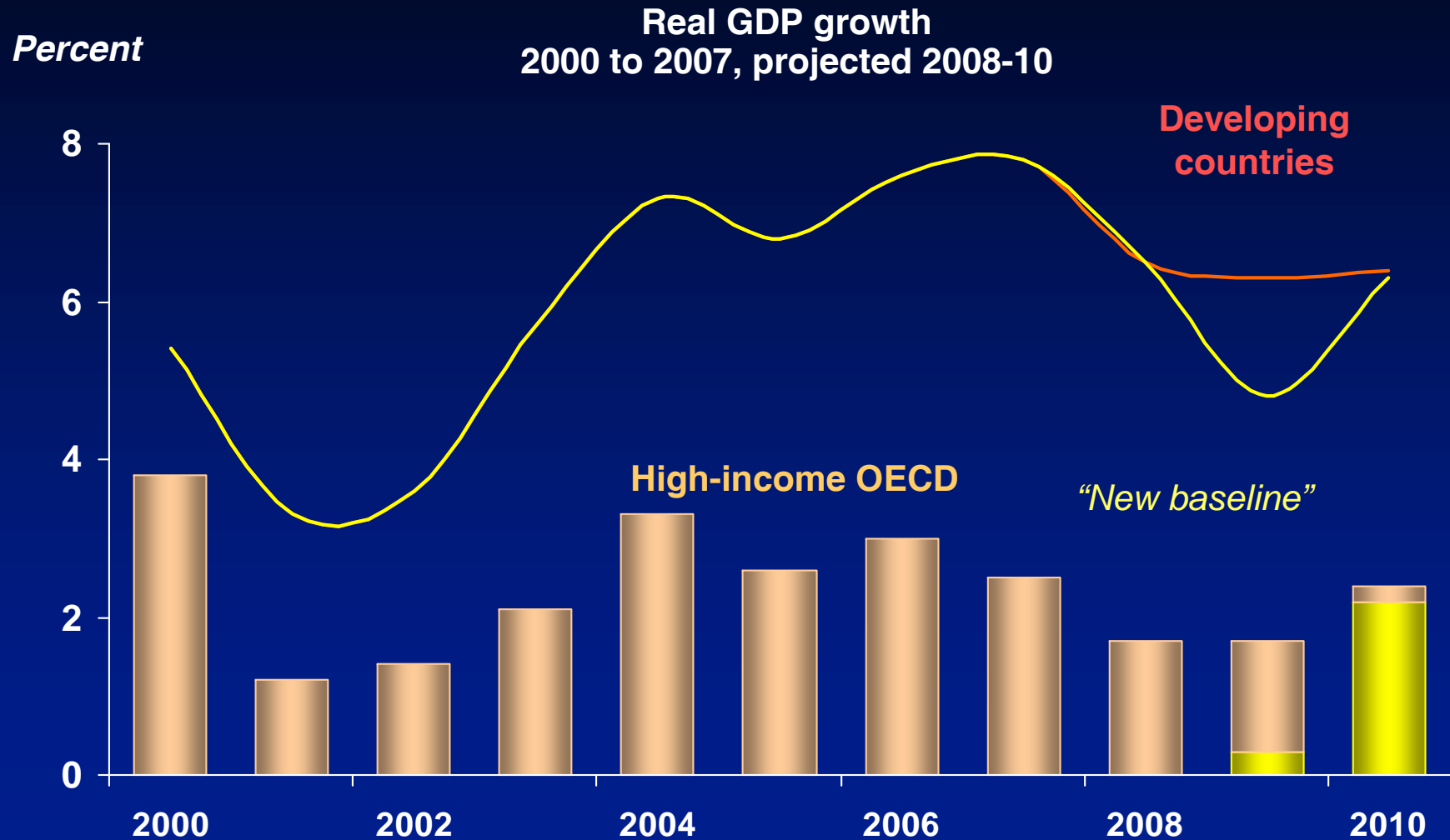
# Investment loses force in developing countries...



Source: DEC Prospects Group.

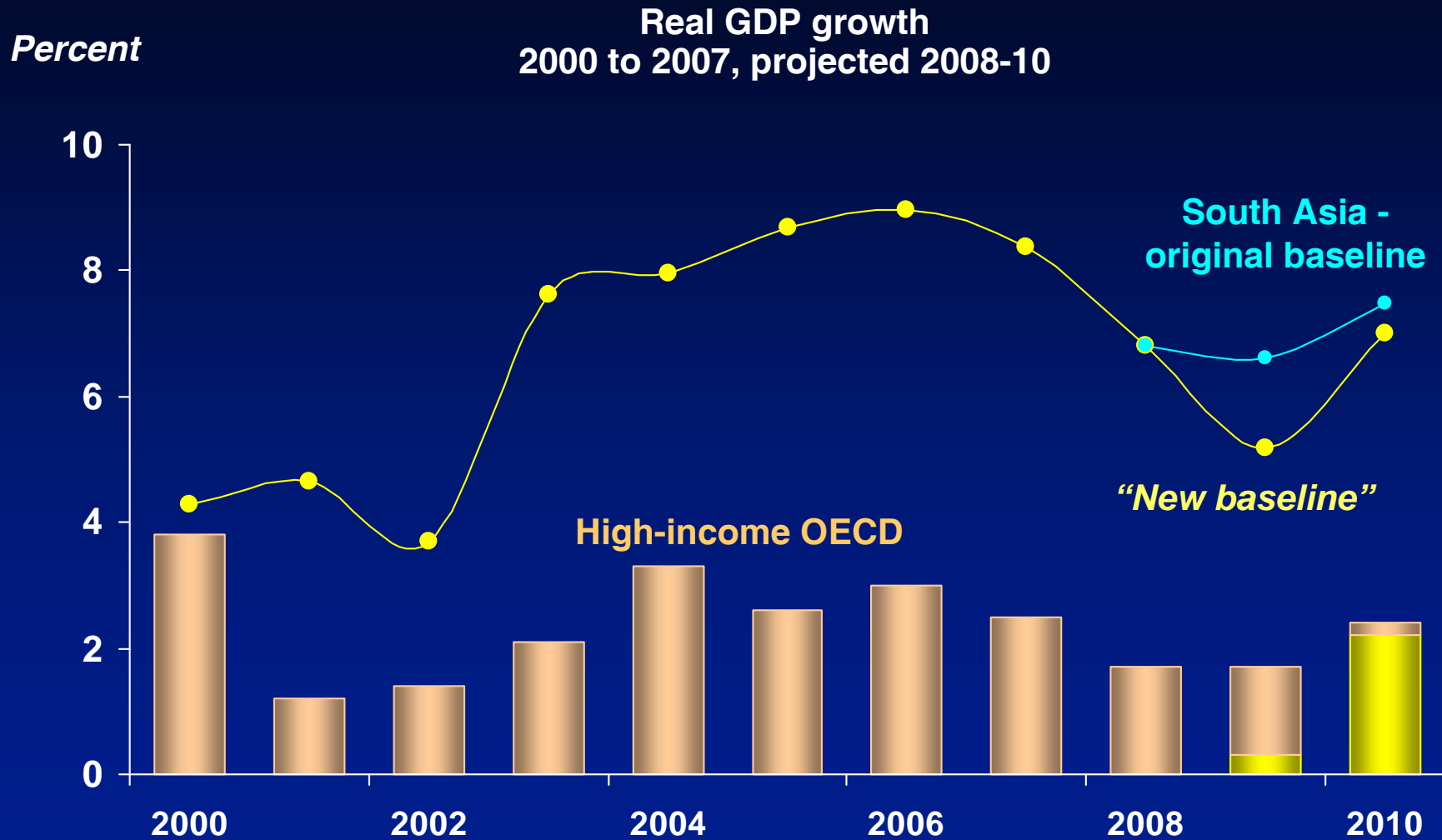


# A revised global economic growth baseline...



Source: DEC Prospects Group.

## ...also in South Asia...



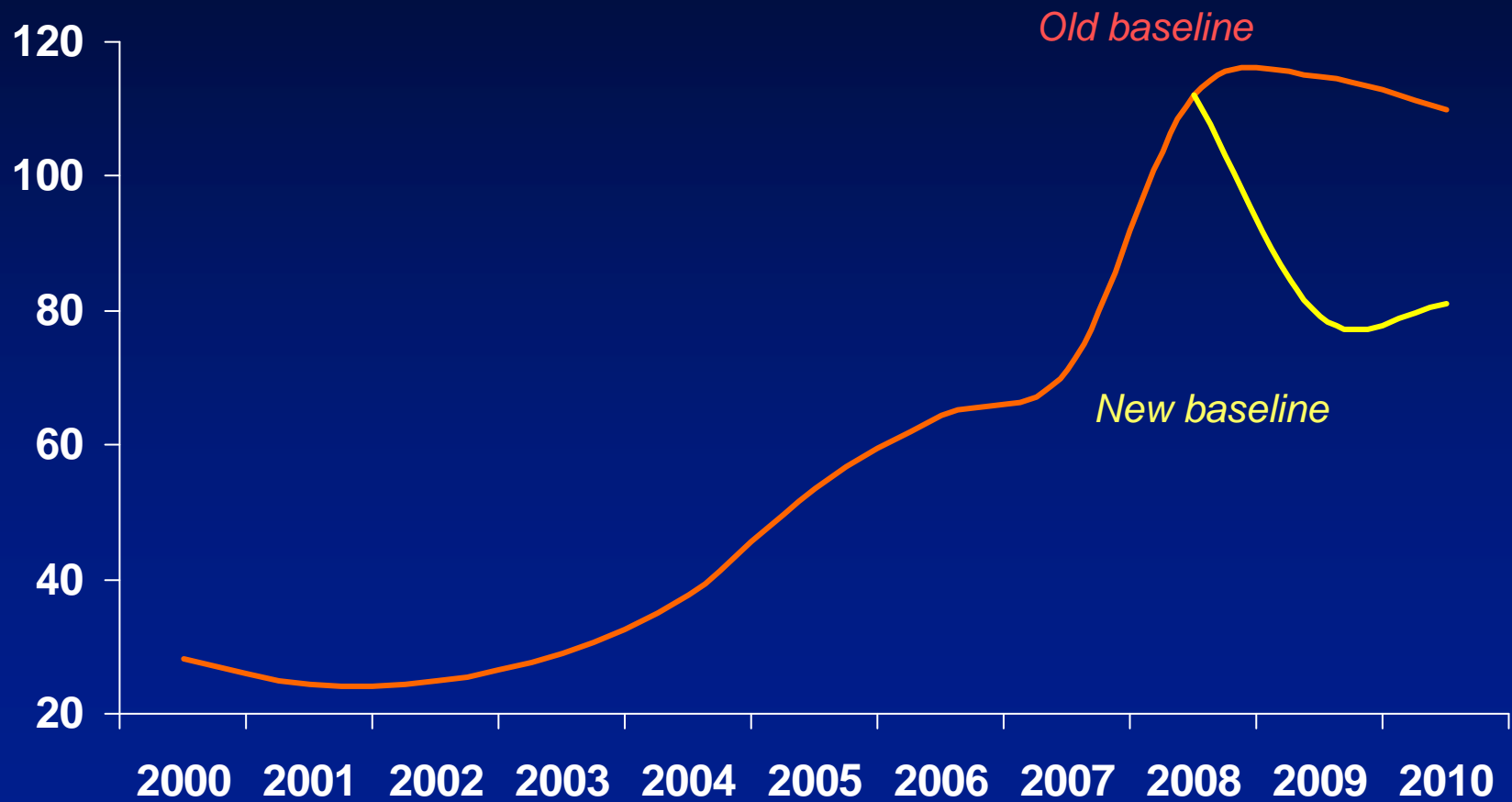
Source: DEC Prospects Group.

# South Asia: Current versus original economic growth forecast

<b>Current Forecast</b>						<b>Survey ("Old Base")</b>	
	2006	2007	2008	2009	2010	2009	2010
Real GDP (% ch)	9.0	8.4	6.8	5.2	7.5	6.6	7.5
Contr. To GDP Growth							
Prv. Cons	3.8	4.6	3.7	2.7	3.2	3.0	3.2
Govt. Cons	1.1	0.5	0.9	1.0	0.8	1.0	0.8
Fixed Inv.	4.2	3.7	2.3	1.1	3.2	2.5	3.3
Stk. Bldg.	0.3	-0.2	0.0	0.0	0.0	0.0	0.0
Exports	3.1	1.4	0.8	0.9	2.1	1.2	2.2
Imports	3.9	1.4	1.3	0.5	1.8	1.1	1.9
Discrepancy	0.5	-0.2	0.3	0.0	0.0	0.0	0.0
<b>Difference = Current - Survey</b>							
Real GDP (% ch)						-1.4	0.0
Contr. To GDP Growth							
Prv. Cons						-0.3	0.0
Govt. Cons						0.0	0.0
Fixed Inv.						-1.4	-0.1
Stk. Bldg.						0.0	0.0
Exports						-0.3	0.0
Imports						-0.5	-0.1
Discrepancy						0.0	0.0

# Oil Price Forecast

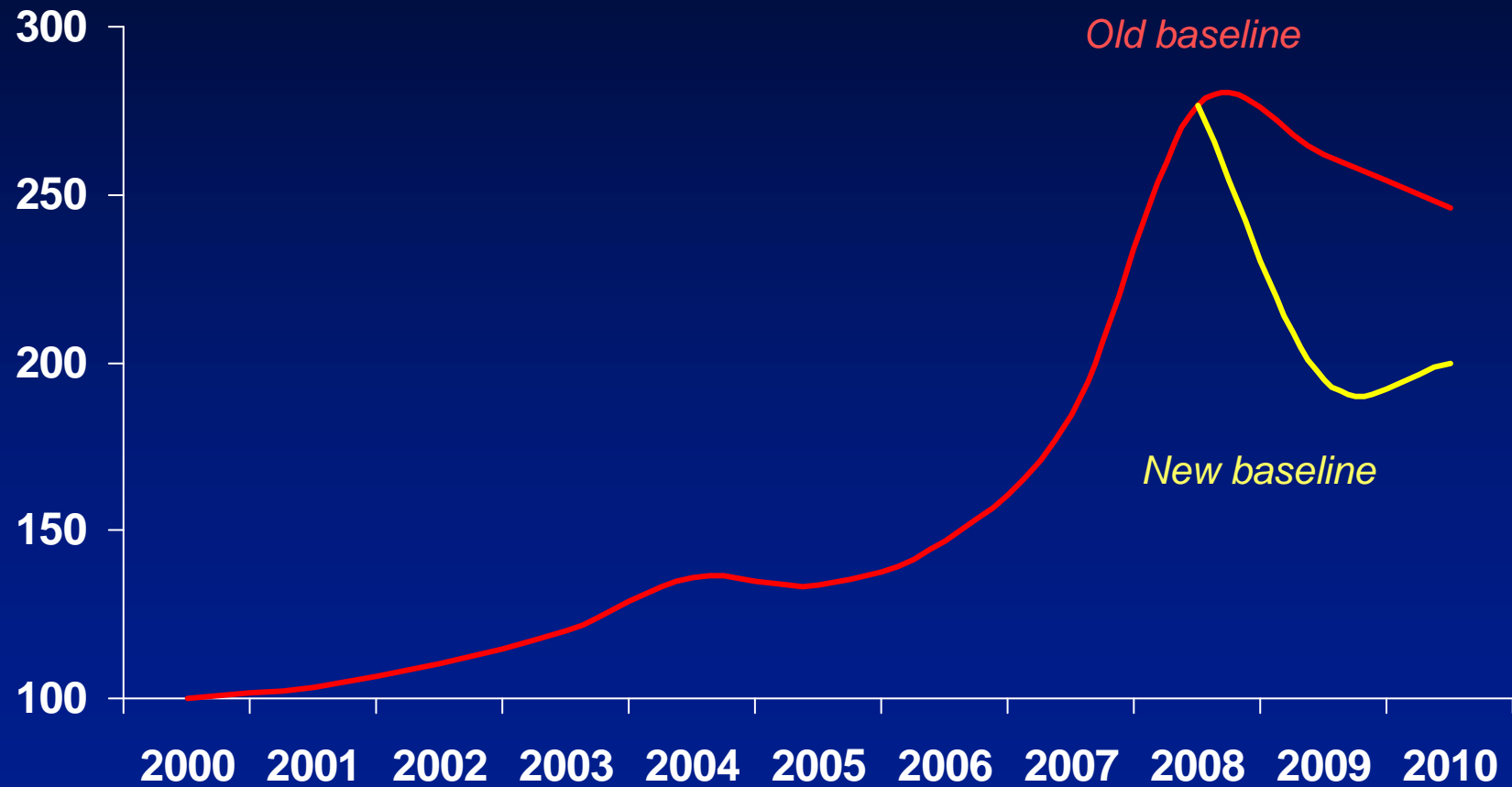
\$/barrel



Source: DEC Prospects Group.

# Food price forecast

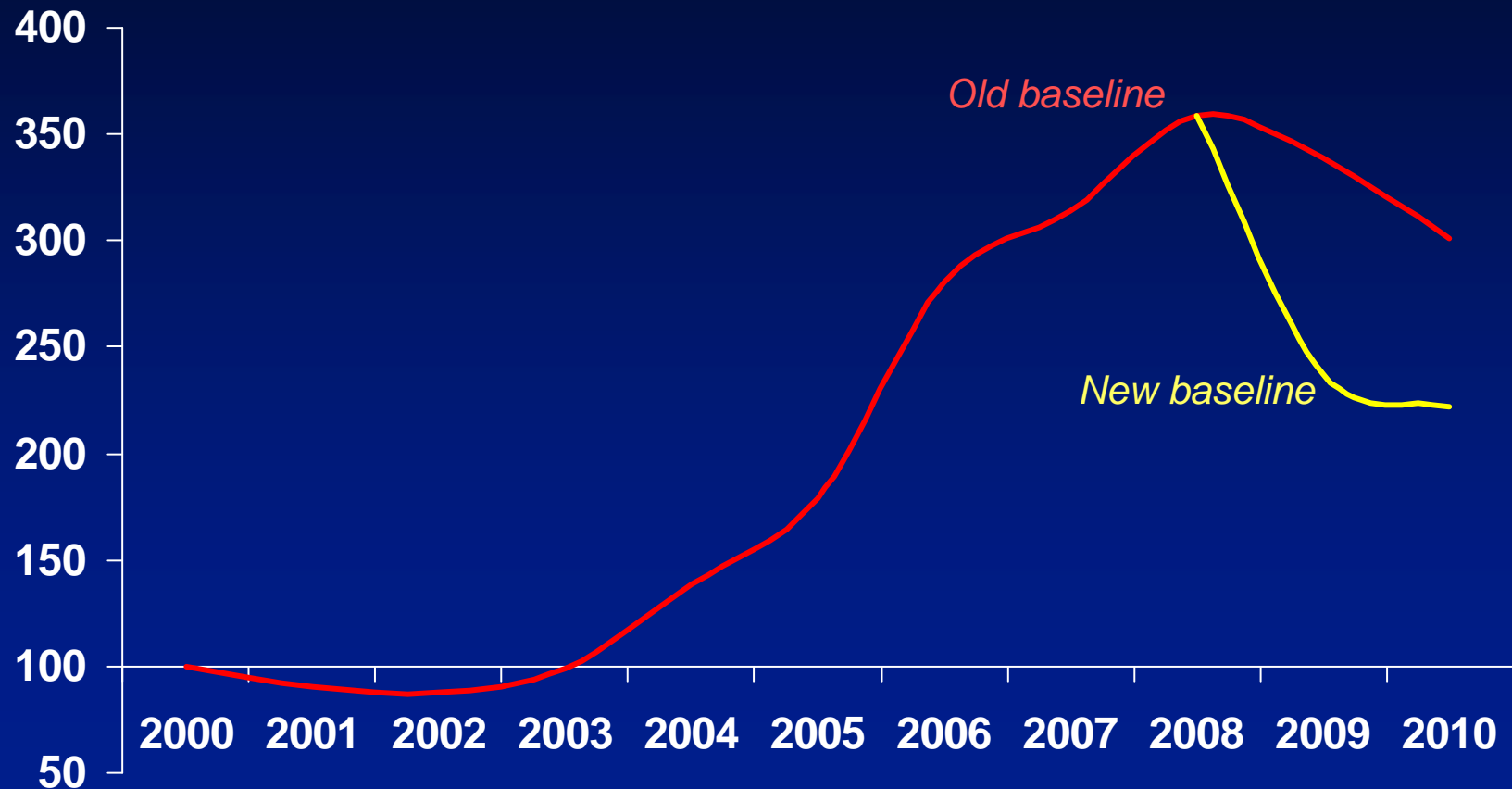
Index (2000 = 100)



Source: DEC Prospects Group.

# Metals & minerals price forecast

Index (2000 = 100)



Source: DEC Prospects Group.

# South Asia: Revised Macroeconomic Prospects

South Asia Country Forecasts	Est.				Forecast		
	91-00	2005	2006	2007	2008	2009	2010
<b>Bangladesh</b>							
Real GDP Growth Rate (%)	4.8	6.0	6.6	6.4	6.2	5.5-6	6.2
Current Account Bal (% of GDP)	-0.4	-0.3	2.0	1.2	0.8	0.5	0.6
<b>India</b>							
Real GDP Growth Rate (%)	5.5	9.2	9.7	9.0	7.0	5.5-6	7.5
Current Account Bal (% of GDP)	-1.2	-1.0	-1.0	-1.6	-3.7	-1.8	-2.0
<b>Nepal</b>							
Real GDP Growth Rate (%)	5.0	3.1	3.7	2.6	5.5	3.5-4	4.9
Current Account Bal (% of GDP)	-6.3	0.0	-0.1	-1.2	1.2	0.5	0.4
<b>Pakistan</b>							
Real GDP Growth Rate (%)	3.9	7.7	6.2	6.0	6.0	3-3.5	4.5
Current Account Bal (% of GDP)	-3.7	-3.3	-5.4	-5.8	-8.9	-3.9	-2.8
<b>Sri Lanka</b>							
Real GDP Growth Rate (%)	5.2	6.0	7.7	6.8	6.3	4-4.5	5.5
Current Account Bal (% of GDP)	-4.6	-3.2	-5.3	-4.4	-7.8	-6.1	-5.9

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# Immediate Policy Response

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- Ensure adequate liquidity in both domestic and foreign currency, and reduce scope for currency mismatches
- Strengthen crisis preparedness - Contingency planning, stress testing, development of protocols, legal powers of authorities, close monitoring of financial institutions and re-examine Deposit Insurance/Guarantees on bank debt as needed.
- Manage fiscal and monetary policies to regain and maintain macroeconomic balances
- Supplement with international policy coordination

# Medium Term Policy Challenges

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- Accelerate ongoing efforts to deepen and develop domestic financial markets; fill missing markets
- Address weaknesses in institutional and regulatory infrastructure
  - bank restructuring and asset resolution frameworks
  - credit bureaus and rating agencies
  - prudential regulations
  - payment and settlement systems
- Governments should consider whether controlling asset price inflation should be added to the mandate of monetary policy authorities

## Lessons from the recent crisis

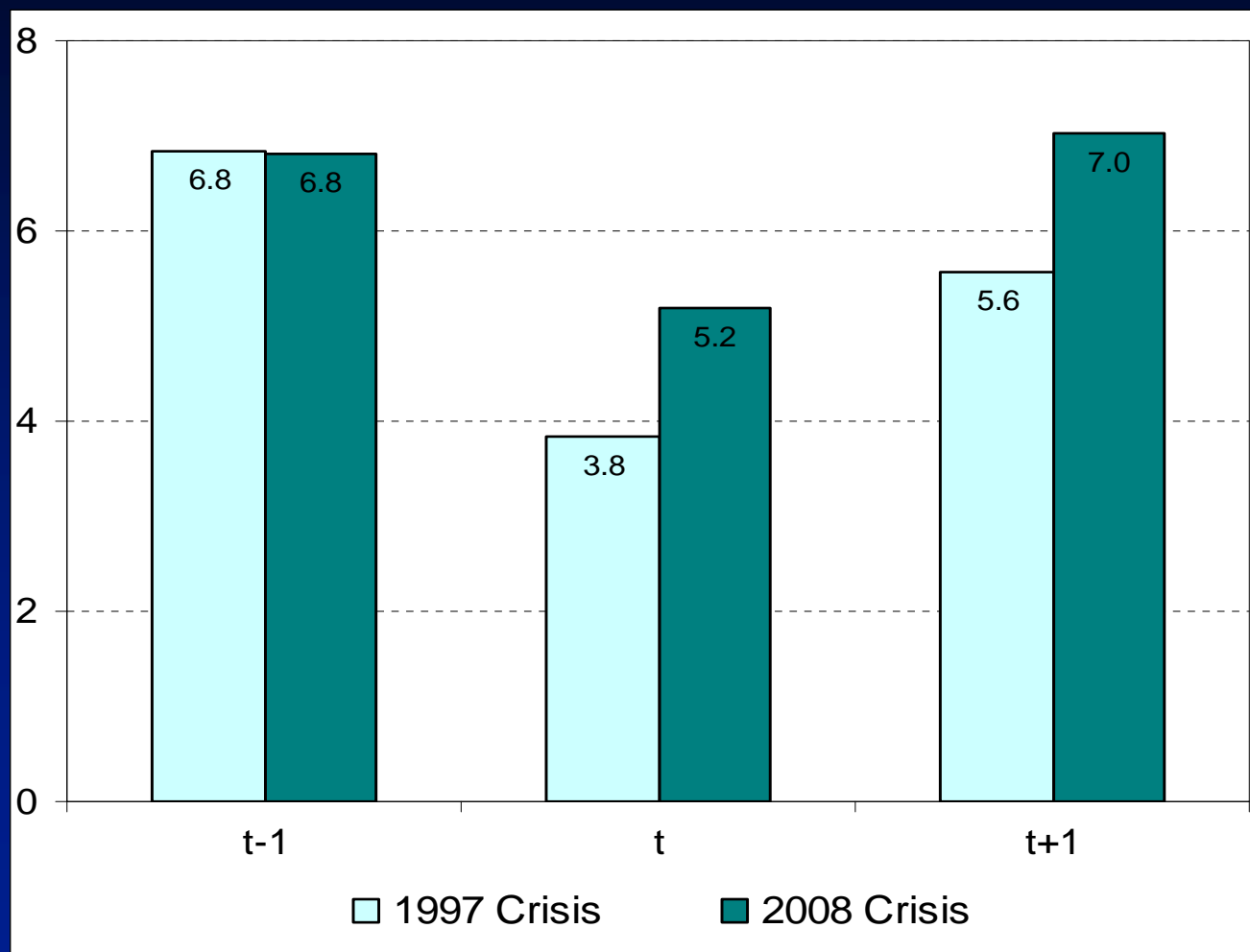
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- Realization that South Asia's financial markets are much more integrated with global markets
- Need for an ever greater emphasis on domestic market development
- Financial supervision needs to keep up with financial innovation
- Coordinated response from governments and regulators/ and among countries pays off

**END**

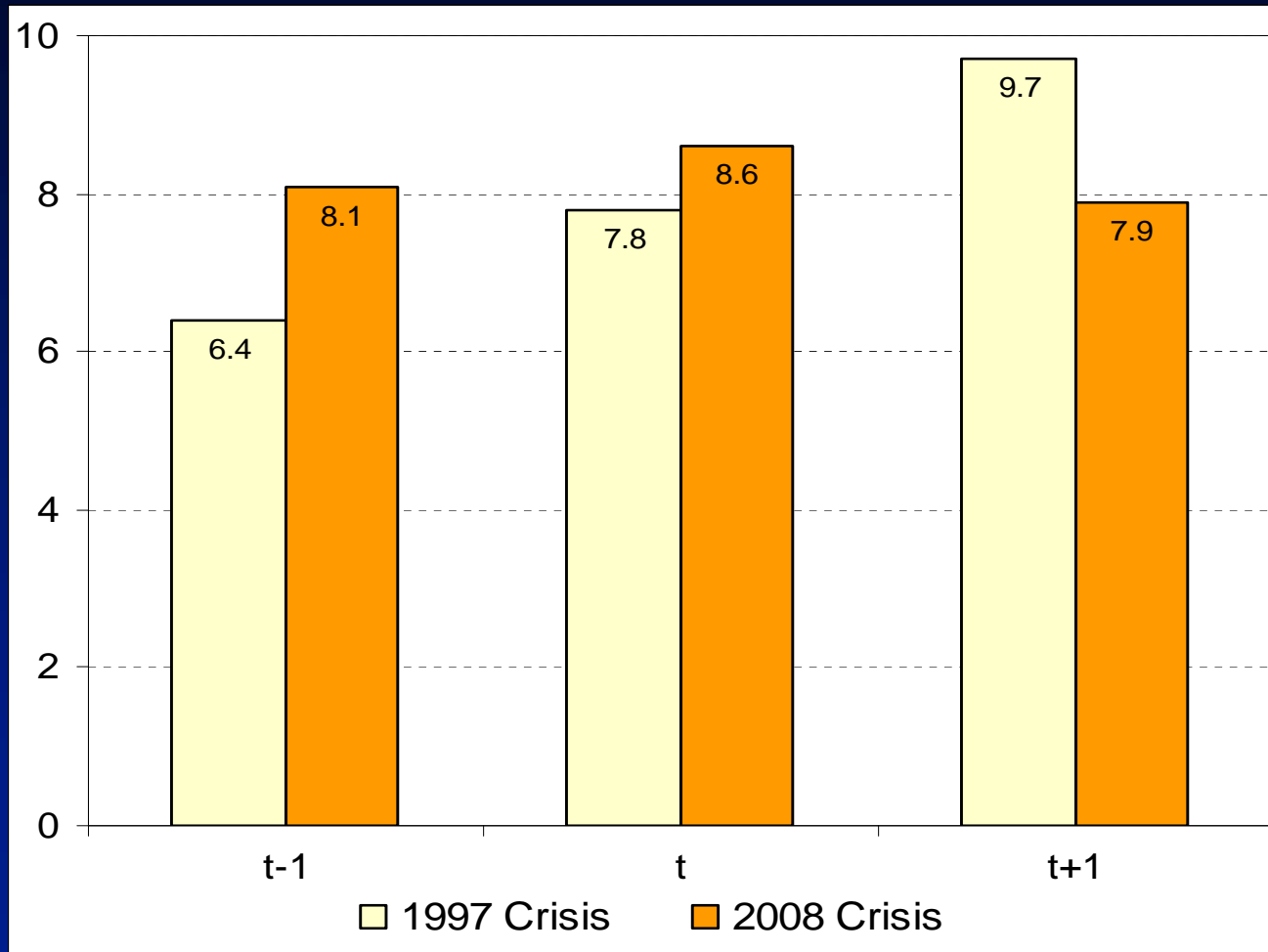
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## South Asia's growth paths in crisis: 1997 (East Asia Crisis) and projected for 2008-10 Real GDP growth in percent



Source: World Bank

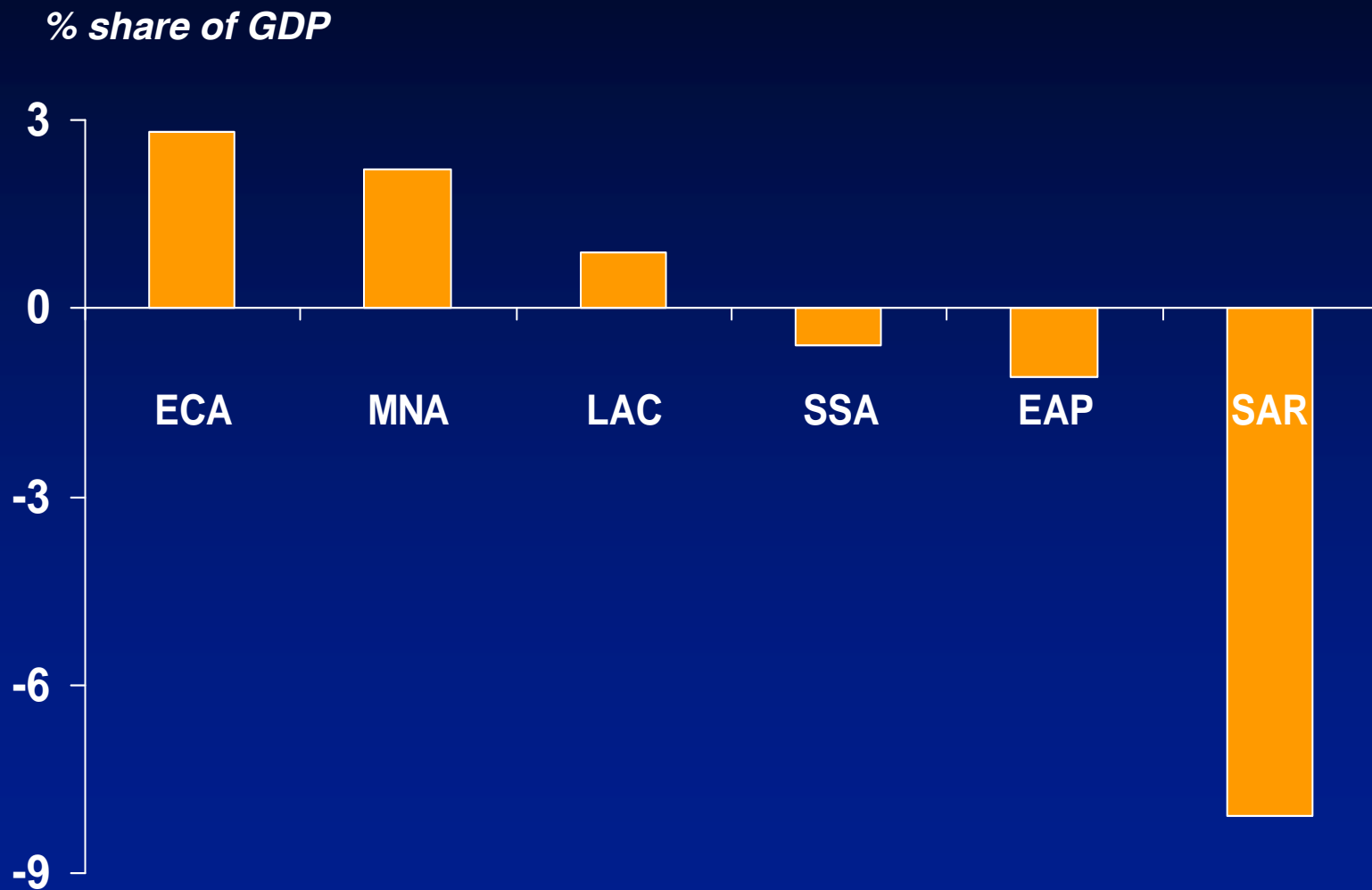
# South Asia's growth paths in crisis: 1997 (East Asia Crisis) and projected for 2008-10 *General fiscal deficit as percent share of GDP*



Source: World Bank

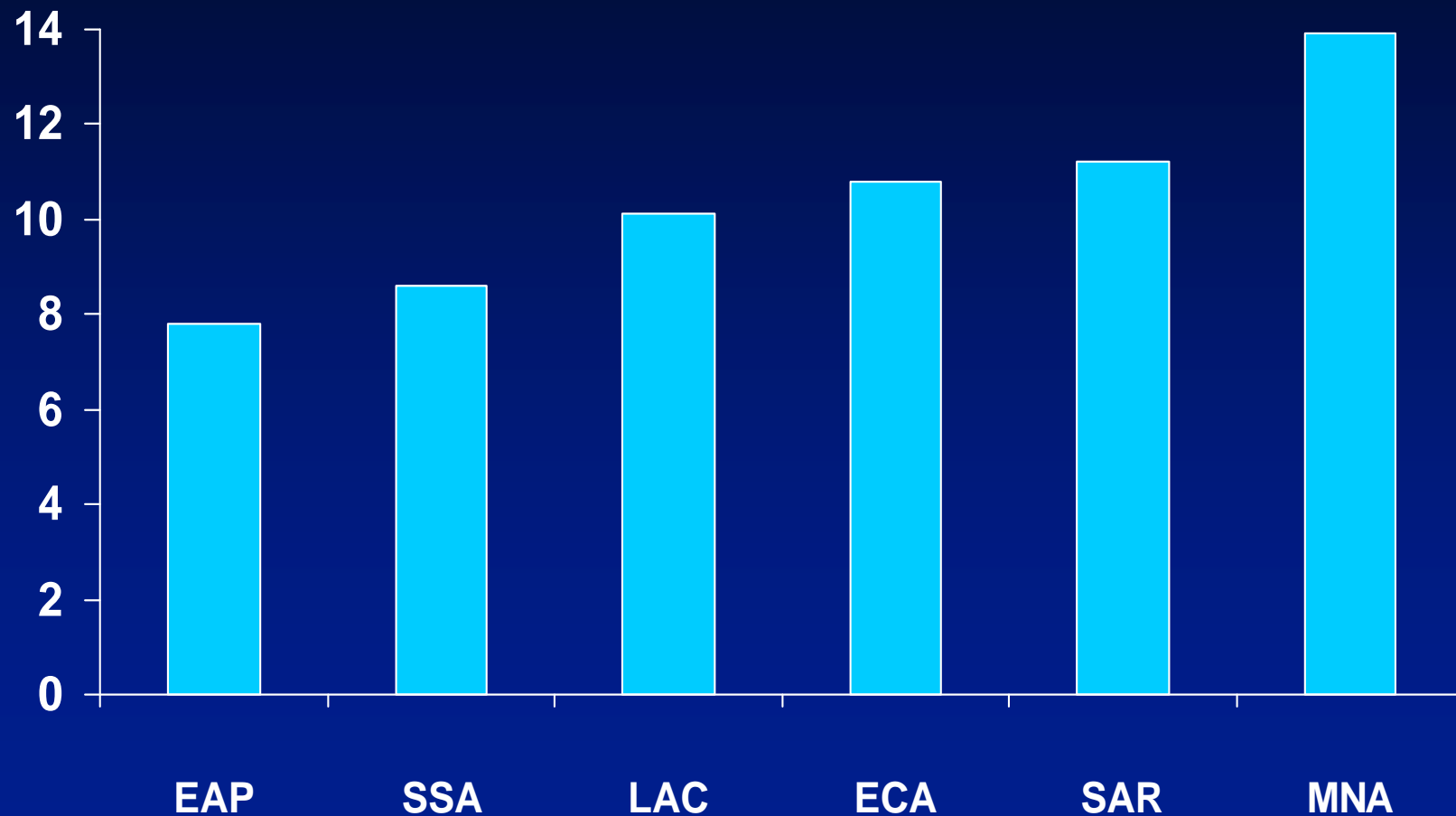
# South Asia: Least fiscal space among LMIC regions

*projected 2008*



# South Asia: Among highest inflation of LMIC regions *projected 2008*

*Median GDP deflator (LCU)*





## Risks to outlook for South Asia

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- **Deeper and more prolonged credit crunch:**
  - contraction in investment and export growth (instead of sharp slowdown)
  - FDI and remittances inflows could fall-off markedly instead of moderation
  - Weaknesses in domestic banking sectors could emerge
- **Quicker recovery:**
  - Inflationary pressures would return to forefront