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The Export Opportunity

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South Asia Economic Focus

Fall 2014

The Export Opportunity





This report is a product of the Office of the Chief Economist for the South Asia Region. Its preparation was led by Markus Kitzmuller (Economist, SARCE) under the oversight of Martin Rama (Chief Economist, South Asia Region). Substantive contributions to the focus section were made by Vincent Floreani, Gunjan Gulati and Jyotinder Kaur. The report greatly benefitted from inputs by Tehmina Khan and colleagues in the Development Economics Prospects Group (DECPG) under the supervision of Ayhan Kose (Director DECPG). Colleagues providing information for country briefs include Genevieve Boyreau, Roshan Darshan, Zabid Hussain, Omar Joya, Faruk Khan, Aurelien Kruse, Jose Lopez Calix, Denis Medvedev, Jaba Misra, Claudia Nassif, Saurav Shamsheer Rana, Nadeem Rizwan, Smriti Seth, Saurabh Shome, Muhammad Waheed, Ralph Van Doorn and Salman Zaidi under the supervision of Vinaya Swaroop (Practice Manager MFM Global Practice). The team is grateful for comments and suggestions provided by Sanjay Kathuria, Gladys Lopez Acevedo, Martin Melecky, and Gonzalo Varela. Gabriela Aguilar signed responsible for the layout, design and typesetting, Alexander Ferguson (Senior Manager SAREC) coordinated the dissemination, and Neelam Chowdhry provided valuable administrative support.

South Asia as used in this report includes Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.

The cutoff date for this report was October 4, 2014.

Table of Contents

Recent economic developments	9
Growth in advanced economies has been slower than expected	9
South Asian economies solidified their external positions	10
Export performance has improved across the region	14
Output growth is generally accelerating	15
Inflation remains high but shows signs of deceleration	17
The main risks and vulnerabilities remain domestic	19
Outlook and policy	23
Again one of the most dynamic regions in the world	23
Carrying the momentum forward	25
Focus: Will the growth of South Asian exports continue?	27
Exports are increasingly important for South Asia’s growth	27
South Asian exports are becoming more diversified	29
Emerging markets are becoming important clients	31
Current trends bode well for the region	33
Some countries may be suffering from Dutch disease	34
The end of quantitative easing should not affect the trend	36
South Asia country briefs	39
Afghanistan	40
Recent Economic Developments	40
Outlook and Policy	41

Bangladesh	43
Recent Economic Developments	43
Outlook and Policy	44
Bhutan	46
Recent Economic Developments	46
Outlook and Policy	46
India	48
Recent Economic Developments	48
Outlook and Policy	50
Maldives	52
Recent Economic Developments	52
Outlook and Policy	53
Nepal	54
Recent Economic Developments	54
Outlook and Policy	55
Pakistan	57
Recent Economic Developments	57
Outlook and Policy	58
Sri Lanka	60
Recent Economic Developments	60
Outlook and Policy	61
South Asia at a glance	64



Recent economic developments

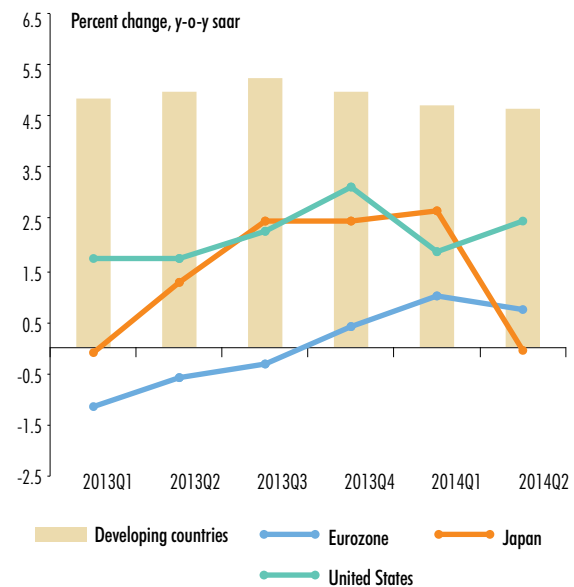
Global recovery remains below expectations and has proven uneven across major advanced economies. Monetary tightening in an increasingly dynamic US and potential deflation in a weak Eurozone constitute sources of risk for developing and emerging market economies alike. Nonetheless, developing country growth remains fairly robust. Notably, India's growth rate is slowly increasing and its inflation rate is on a declining trend. While South Asia's external position has been further solidified, key domestic challenges include reducing fiscal risks, supporting higher levels of investment, and sustaining export growth.

Growth in advanced economies has been slower than expected

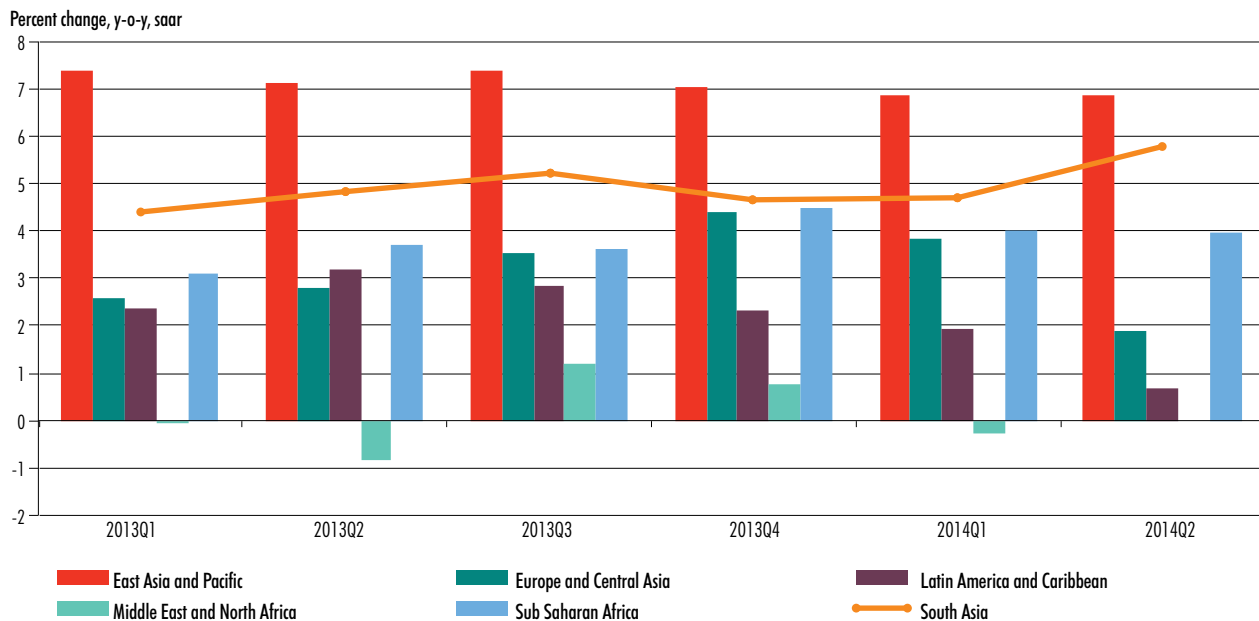
Trends across major advanced economies have started to diverge. On the back of solid employment and investment growth, the US economy regained momentum in 2014Q2. The Euro Area and Japan, on the other hand, appear to have lost dynamism (figure 1). A recent sales tax hike in Japan paired with weak export growth caused a significant slowdown in economic activity in 2014Q2. An accommodative monetary stance and commitment to reform are unlikely to outweigh the continued drag from fiscal consolidation. Meanwhile, the Euro Area saw flat growth, decreasing industrial production and growing risk of deflation, prompting the European Central Bank to announce additional easing measures.

Figure 1: Real GDP growth disappoints in Japan and the Euro Area while the US shows signs of acceleration

Real GDP for High Income Countries



Growth in major developing countries remains below trend but South Asia is on an upward trajectory. Developing country growth remained stable over 2014H1, due to solid industrial production performance and increasing capital inflows across all developing regions with the exception of Europe and Central Asia. South Asia is the only region actually seeing a marked increase in real GDP growth, with 6 percent (y-o-y) expected in 2014Q2, up from 5 percent in 2014Q1 (figure 2). This improvement should halve the gap with East Asia and Pacific, which

Figure 2: South Asia continues on a solid real GDP growth path over 2014H1

Source: World Bank DECPG

will continue growing at 7 percent in 2014H1. The two largest economies in the region, India and Pakistan, have seen an improvement in FY2013/14 and a reasonably good start into FY2014/15, carrying regional momentum forward. However, recent political tensions in Pakistan may weigh on these encouraging developments.

South Asian economies solidified their external positions

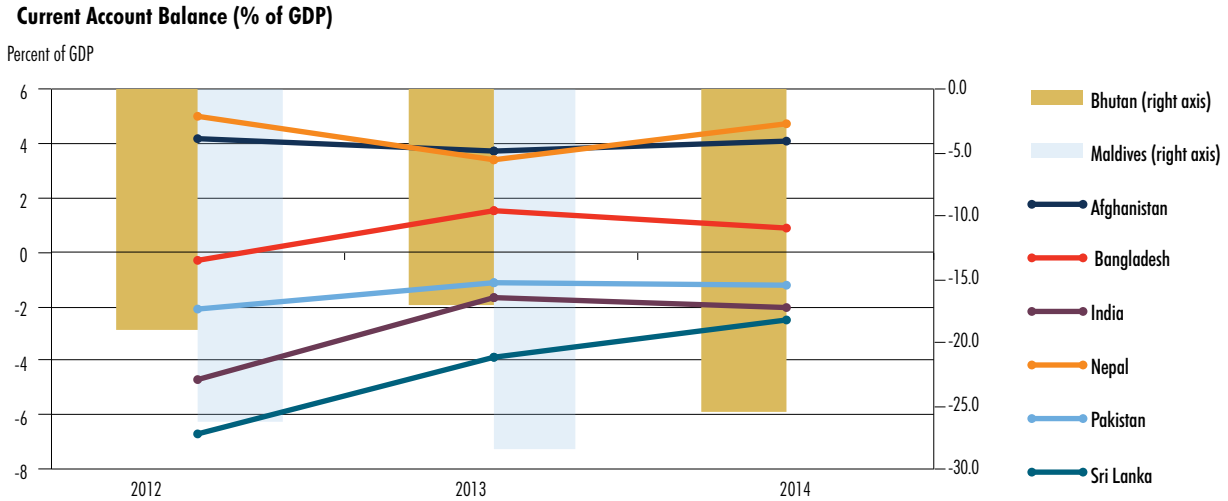
Pressures to finance current account deficits (CADs) have generally eased. Some of the countries in the region actually display current account surpluses (figure 3). In Nepal, as in the past, a large trade deficit is more than compensated by remittance inflows, yielding a current account surplus of 3.4 percent of GDP in 2013 and a projected 4.7 percent for 2014. In Afghanistan, aid flows continue to finance the large trade deficit, with the current account expected to stay in surplus at 4.1 percent of GDP in 2014. In Bangladesh the surplus shrank to 0.9 percent of GDP, down from 1.6 percent in FY13, due to a slowdown in remittance flows; but the balance remains in positive territory. India's CAD is broadly stabilizing around pre-global crisis levels. Pakistan's external balance moved from a deficit of US\$1.99bn in FY 2012/13 to a surplus of US\$3.8bn in FY2013/14, mainly driven by strong improvements on the capital and financial account side. Its current account deficit

of around 1.2 percent of GDP in FY2013/14 remained broadly stable vis-à-vis the previous years, with strong remittance growth offsetting a continuously negative trade balance. Sri Lanka saw pressures ease in 2014H1 on the back of robust export growth as well as remittance and tourism receipt inflows. Its provisional CAD for 2013 at 3.9 percent of GDP is projected to further decrease to around 2.5 percent in 2014.

Maldives and Bhutan remain the outliers, but their large CADs have quite distinct implications for external stability. When discounting hydro development related imports financed by India, Bhutan's CAD shrinks to 15 percent of GDP. While this is a sizeable figure, it remains well financed. Maldives saw a slight improvement but maintains a CAD above 20 percent of GDP in 2013 (The authorities recently revised the current account deficit downward to a still high 10.1 percent of GDP, using a new methodology. World Bank staff has taken note of the adjustment, but has not yet adopted the new numbers.)

India has managed to further reduce its vulnerability to US monetary policy tightening. After being singled out as one of the most vulnerable emerging economies in 2013H1, India experienced a remarkable spurt to a CAD of below 1 percent of GDP in 2013H2 on the back of restrictions on gold imports, increased export growth and a credible monetary policy stance. More recently, it maintained a relatively small and manageable CAD at 1.6 percent of GDP for FY2014/15Q1. The Indian rupee appreciated in both nominal and real terms

Figure 3: Current account balances across South Asia are broadly improving



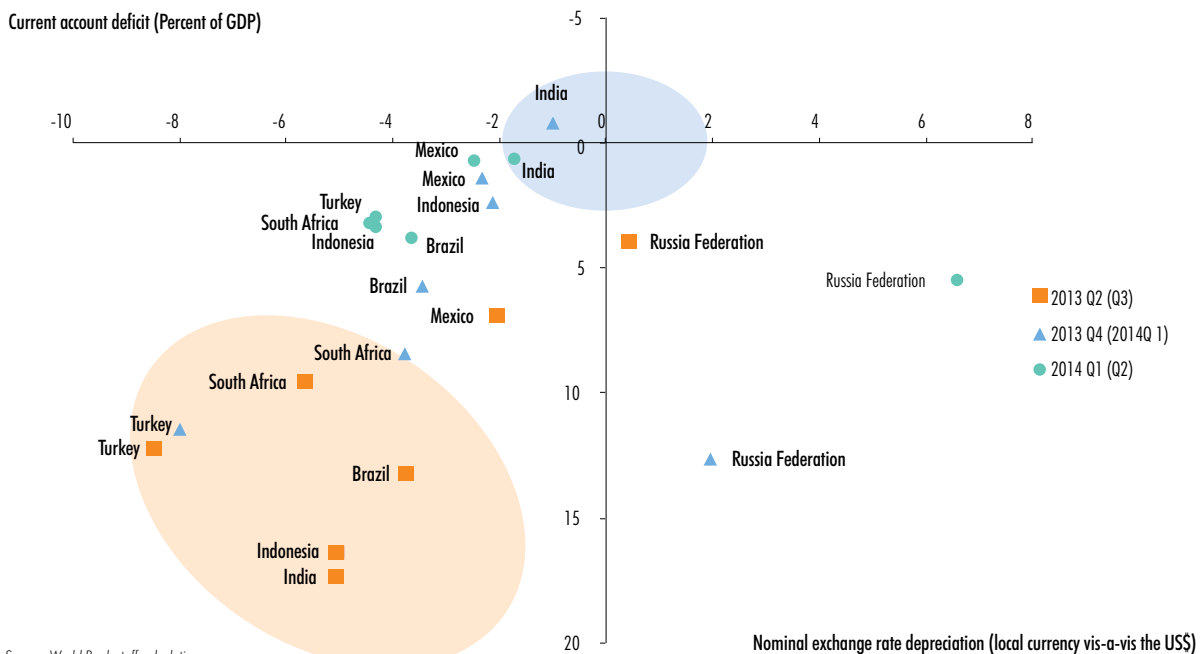
Source: World Bank and national authorities

around 6.4 percent, and recovered more than half of the loss it had experienced since the 2013 depreciation episode. This makes India a front runner in solidifying its external position and one of few large developing countries (alongside Mexico) being characterized by limited vulnerability to monetary tightening in high income countries and softer growth in China (figure 4).

Most South Asian countries solidified their foreign reserve positions. Benefitting from strong capital account inflows and a stable and manageable current account balance, India saw its foreign exchange (FX) reserves increase from an estimated US\$ 276.4 billion in

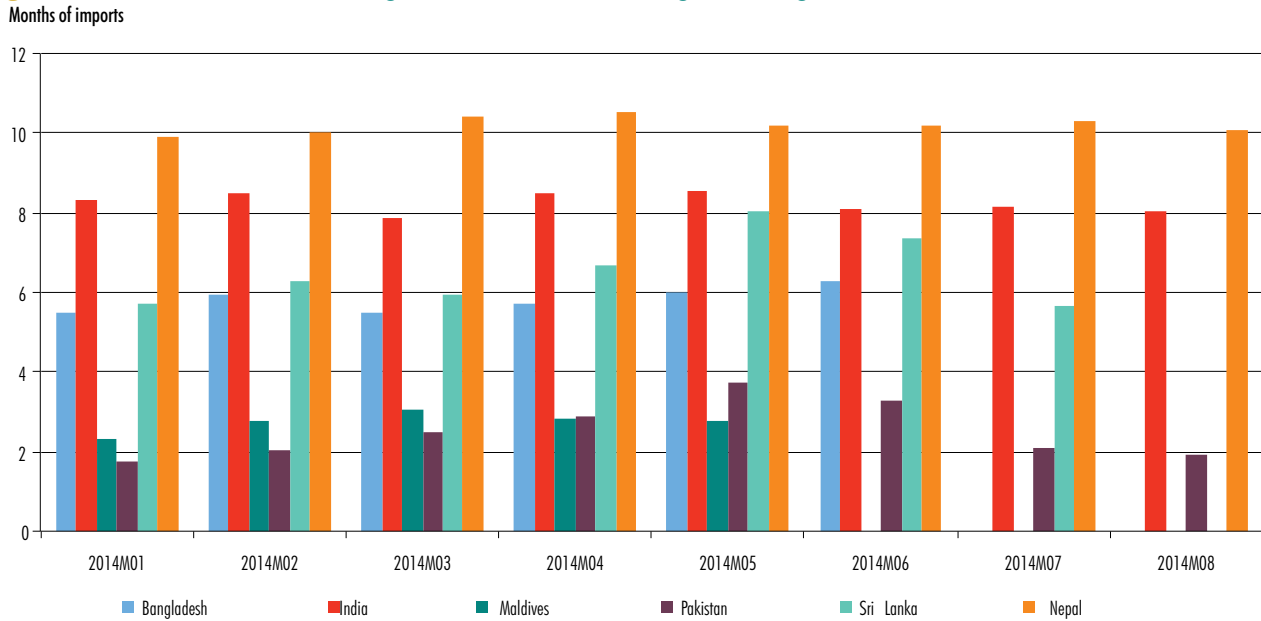
FY2013/14 to 321.1 billion projected for FY2014/15. Bhutan built up an impressive 17 months of import coverage reserve by June 2014, with the only caveat that 83 percent of them are in convertible currencies while it is mainly Indian rupees which are required for trade settlement and debt service. Nepal continues to maintain extraordinarily high reserve levels, most recently above 10 months of import coverage. Afghanistan's FX reserves stood slightly higher than a year ago at US\$ 7.3 billion or around 8 months of imports at the end of 2014H1. Bangladesh further bumped up its FX reserves to around 6 months of import coverage by June 2014. Similarly, Sri Lanka saw its gross official

Figure 4: India has maintained a stable external position over 2014H1



Source: World Bank staff calculations

Figure 5: Most countries in the region have abundant foreign exchange reserves



Source: World Bank and national authorities

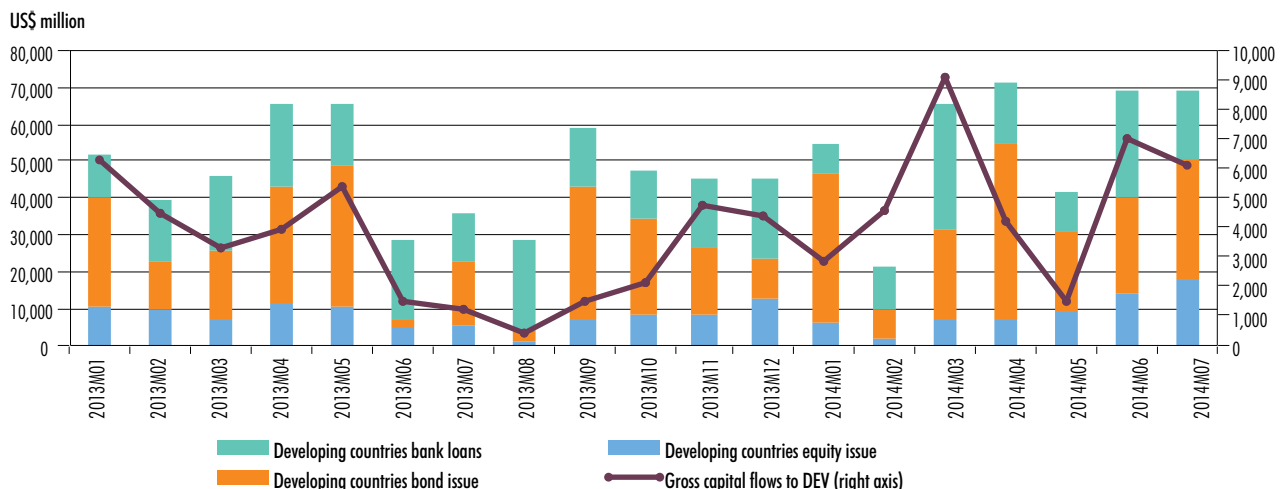
reserves reach around 6 months of imports by end July 2014. However, there are weak spots as well. In Pakistan, official reserves regained ground and stood at 2.1 months of import coverage by June 30, 2014, only to slightly drop again to 1.9 months by the end of August. Maldives saw its international gross reserves benefit from higher than expected revenue collection and tourism receipts, but remains in a precarious external position (figure 5).

Capital inflows to South Asia are generally on an upward trend. Flows to the region are increasingly aligned with flows to other developing areas (figure 6). However,

the composition of flows to South Asia continues to fluctuate considerably over time (figure 7). Regional patterns are greatly influenced by developments related to India, the most financially integrated economy in the region.

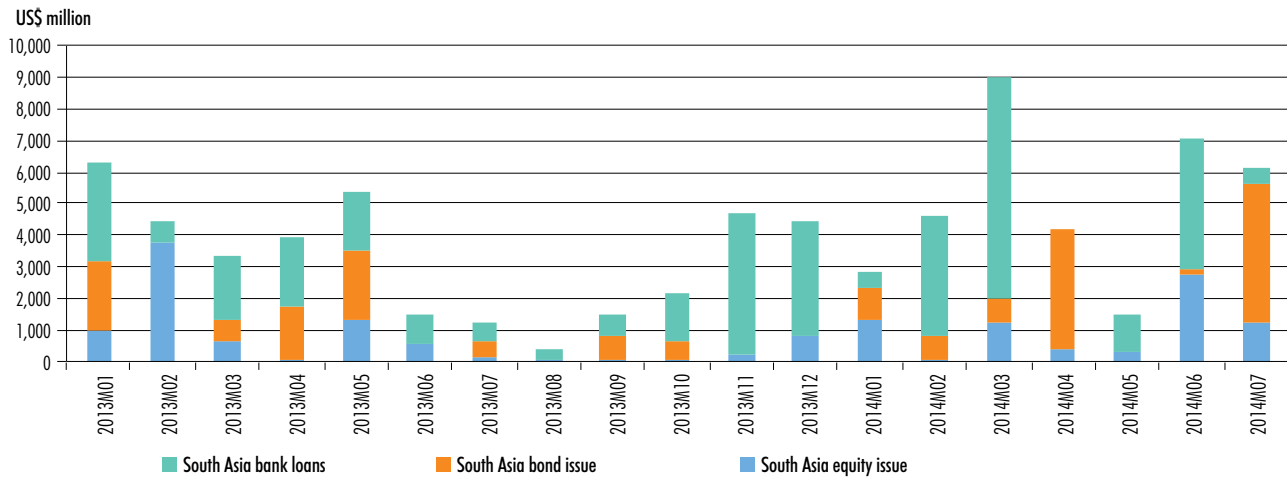
India has recently experienced increases in both foreign direct investment (FDI) and portfolio inflows. Capital flows to India reached 3.7 percent of GDP in FY2015Q1, compared to 2.4 percent in FY2014 (figure 8). The fact that this turnaround happened shortly after the country was singled out as one of the emerging economies with the most vulnerable external positions shows a remarkable confidence by investors in the Indian

Figure 6: Capital flows to South Asia remain volatile but have started to move in line with total flows to developing countries



Source: World Bank DECPG

Figure 7: Capital flows (in US\$ millions) to South Asia show significant fluctuations in their primary composition



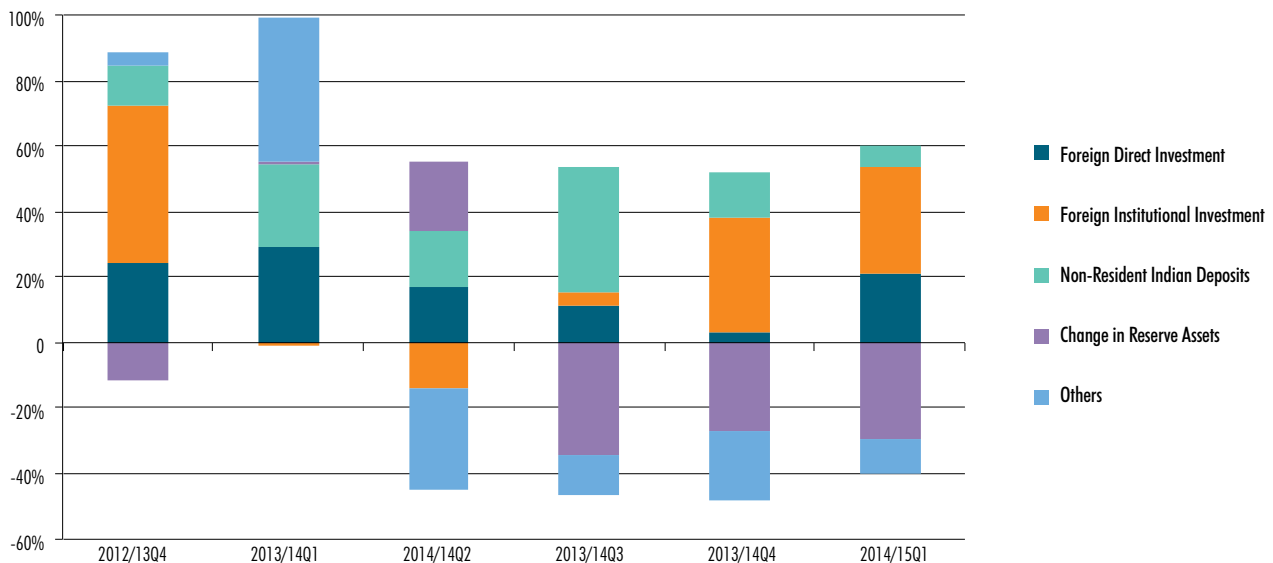
Source: World Bank DECPG

economy. Admittedly, Non-Resident Indian deposits have slowed recently to historic levels of around 0.5 percent of GDP, down from a surge of 2.1 percent in FY2014. But this decline was more than offset by FDI reaching 1.7 percent of GDP in 2014Q2 (up from 1.1 percent in FY2014) and Foreign Institutional Investment soaring to 2.6 percent of GDP (up from 0.3 percent).

Other major South Asian economies saw improvements in the volume and quality of their capital inflows. Pakistan registered a significant boost to its financial and capital account in the form of a US\$ 7.07 billion surplus for FY2013/14, up from only 0.8 billion

in FY2012/13. This was mainly due to grant receipts, a net increase in multilateral loans and the country's sizable Eurobond sale. Bangladesh could witness a financial account surplus in FY2014/15, in spite of a decline in FDI inflows and a sharp increase in outflows through trade credit, largely on account of a reversal from errors and omissions. Sri Lanka's capital account benefitted from strong FDI flows in 2014H1, up 102 percent compared to 2013H1, as well as issuance of sovereign bonds worth US\$ 1.5 billion (and maturing in 5 years), resulting in a balance of payments (BoP) surplus of US\$ 2 billion for 2014H1, compared to a deficit of 0.3 percent in 2013H1.

Figure 8: India has seen a reinvigoration of FDI and FII inflows



Source: Reserve Bank of India

Export performance has improved across the region

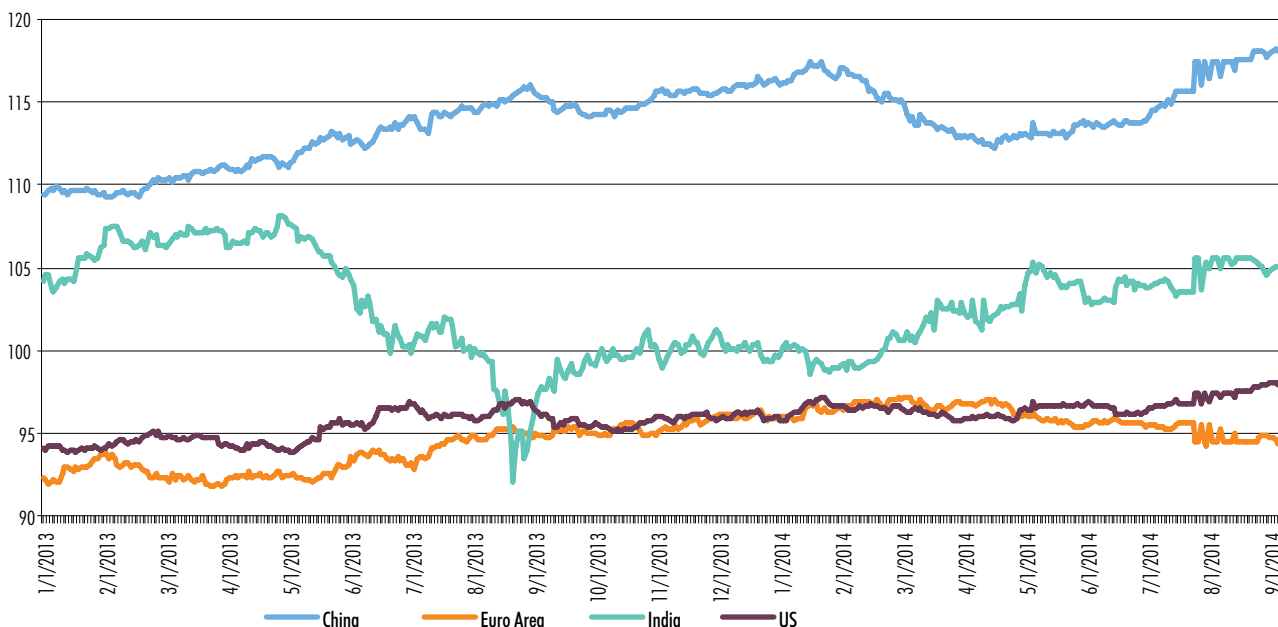
The depreciation of the Indian rupee, triggered by “tapering talk” in 2013 boosted competitiveness but the trend is reverting. India’s real effective exchange rate (REER) has recently started to show a trend appreciation, recovering by more than 9 percent and suggesting that the gain in competitiveness from the recent depreciation might have been temporary only (figure 9). Yet, export growth maintains momentum and is expected to strengthen to 7 percent in FY2015, led by manufacturing exports rising by an impressive 10.6 percent in FY2015Q1. With the US economy expected to recover relatively faster than the Euro Area in the near term, India has begun to shift its export destinations for major product groups such as refined petroleum products (around 20 percent of total exports) accordingly.

Other South Asian economies face competitiveness challenges and some struggle to solidify their export positions. Export performance was strongest in Sri Lanka. Growth in textile and garment exports, accounting for over 43 percent of total exports, accelerated to 20.6 percent y-o-y, driving up total export growth in 2014H1 to 16.8 percent y-o-y. Paired with weak import demand, buoyant sales abroad reduced the trade deficit to 4.6 percent of GDP in 2014H1,

down from 6.6 percent over 2013H1. This performance was enabled by gradual demand recovery in advanced markets and a stable nominal exchange rate in 2014. Bangladesh’s exports also continued to growth at two-digit rates. This was despite increasing appreciation pressures which prompted Bangladesh Bank to intervene in FX markets, purchasing US\$ 2.35 (2.8) billion during FY2014H1 (H2). At the other end, Pakistan’s exports suffered from the nominal appreciation of the rupee, and registered an anemic growth rate of 1.4 percent in FY2013/14. With sales abroad highly concentrated around textiles, the country could benefit from the Generalized System of Preferences (GSP) plus status granted by the EU, a destination that accounts for 25 percent of its total exports. However, continued political instability and large transport bottlenecks may prevent Pakistan from taking full advantage of this opportunity.

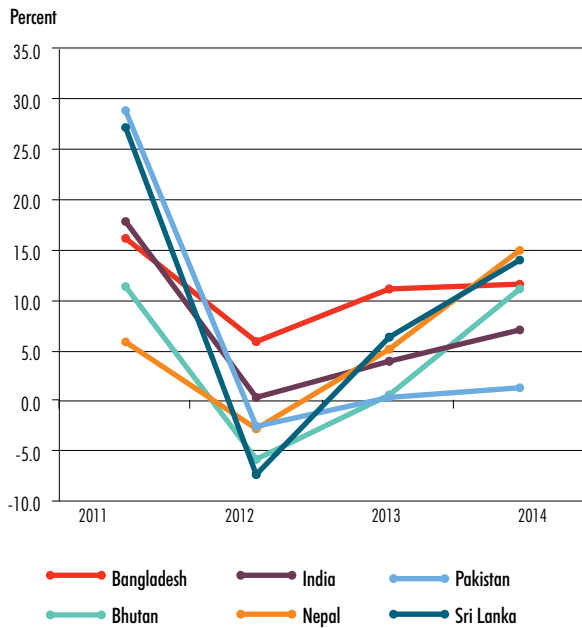
Some of the smaller countries in the region suffer from uncompetitive real exchange rates, due to massive FX inflows from remittances or natural resource exports. Nepal is one of them. Its trade deficit reached 27 percent in 2013 and is estimated to climb to around 30 percent of GDP in 2014 on account of a massive import bill. Export growth accelerated to 5.1 percent in FY2013/14, mainly boosted by a surge in pashmina, garments and carpets exports on the back of the Indian rupee depreciation (to which the Nepalese rupee is pegged). However, exports just account for 5.2 percent

Figure 9: After the depreciation of the summer 2013, India is experiencing a gradual appreciation (index 100 = 1/1/2010)



Source: Haver, World Bank DECPG

Figure 10: Export growth is improving across the region and is substantial in some countries



Source: World Bank and national authorities

of GDP (marginally up by 0.1 percentage points from the previous year) and are completely outweighed by imports reaching 36.1 percent of GDP and growing at 14 percent y-o-y in FY2013/14.

In spite of these challenges, exports are increasing across the region. Most of the countries are again in

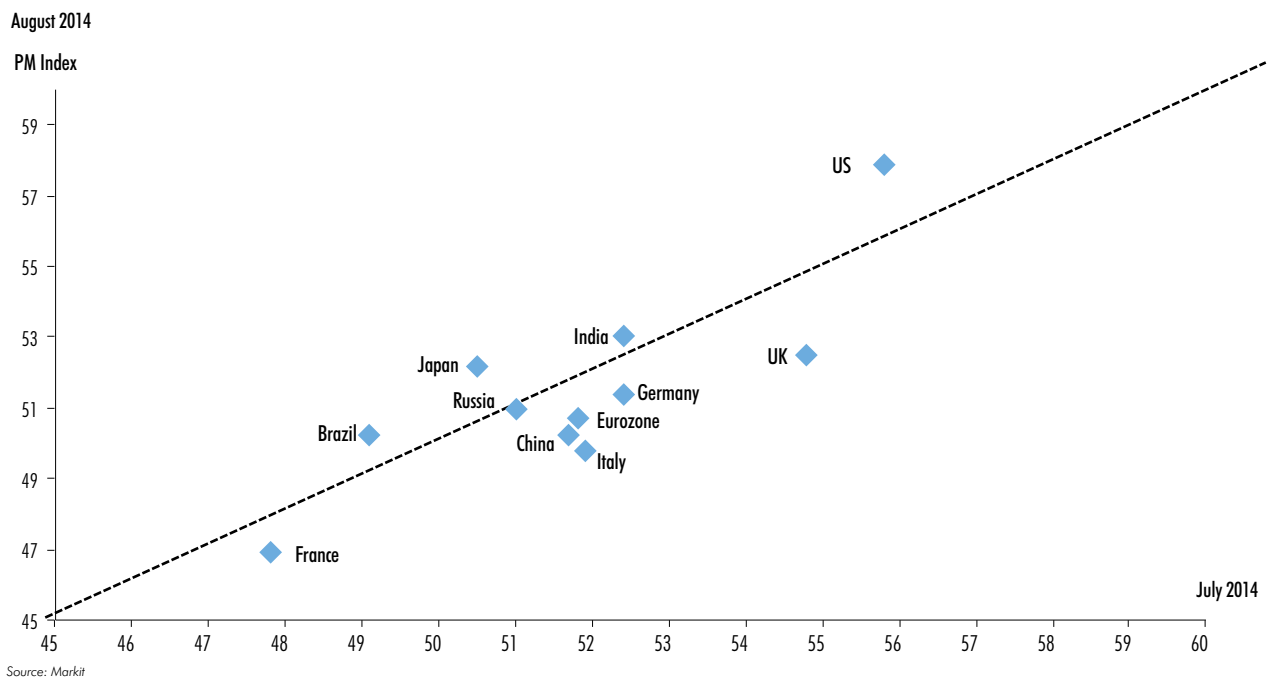
positive territory, and in four of them exports are growing at double-digit rates (figure 10). One important question going forward is whether this is a one-off improvement, especially in light of the unfavorable competitiveness trends, or a manifestation of an increasingly stronger position of the region in global markets. Such is the topic of the focus section of this report.

Output growth is generally accelerating

Industrial production growth continues to be volatile, but expectations are optimistic in India's case.

The Purchasing Manager's index remains consistently above 50, a number seen as the dividing line between expansion and contraction (figure 11). Moreover, the index is increasing over time, putting India in the company of the US, Japan and Brazil. The trend is less favorable across other major economies, including France, China and the UK. India's industrial GDP growth accelerated to 4.2 percent y-o-y in FY2014/15Q1, the highest outturn of the last eight quarters. Although the trend was broad based, upticks were noticeable for investment, growing strongly at 7 percent y-o-y, and for the capital and basic goods, growing in the double digits.

Figure 11: Purchasing managers (PM, manufacturing) remain optimistic about India



Source: Markit

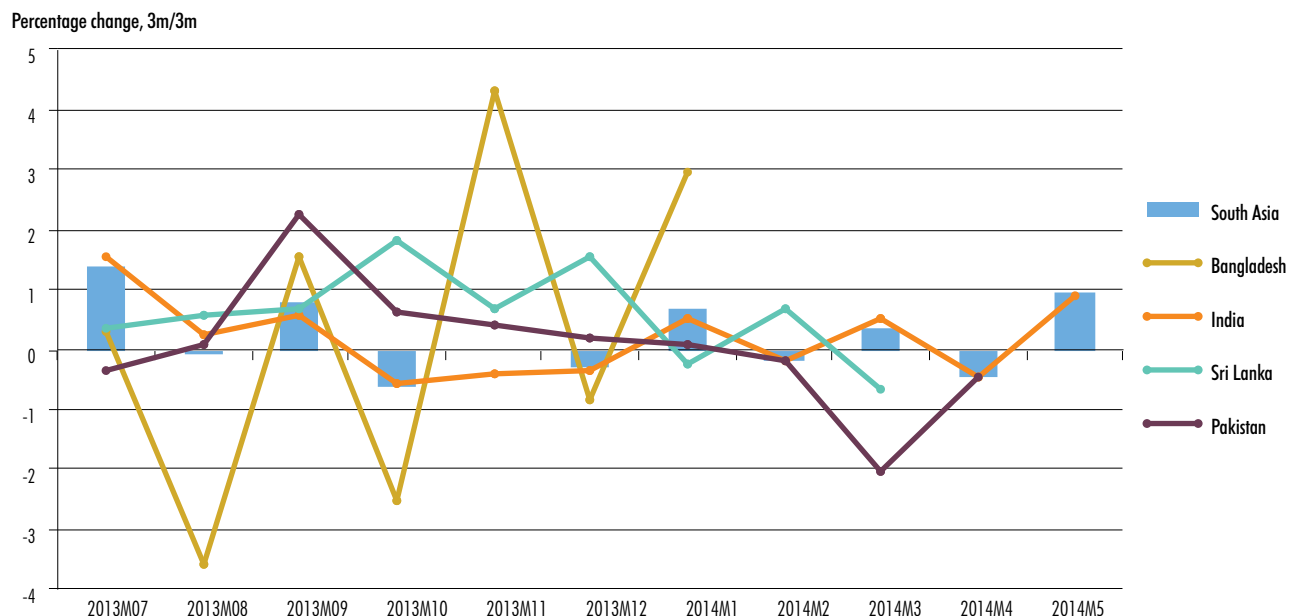
Trends in industrial production are more mixed across the region, with some countries experiencing stagnation and even contraction. There was a solid performance of Bangladesh's industry, notwithstanding a slowdown from 9.6 percent in FY2013 to 8.4 percent in FY2014. Within industry, manufacturing slowed down while construction accelerated. Industry was also the main contributor to growth momentum in Sri Lanka, with its output growing by 12.6 percent y-o-y in 2014Q1 based on contributions from construction, factory and mining industries. Performance was not as strong elsewhere. In Pakistan, industrial production has recently been a significant contributor to growth based on a sharp turnaround in construction, electricity generation, gas distribution and large-scale manufacturing (figure 12). However, in most sectors growth remained lower than last year. Nepal's industrial sector performance was lackluster, with industrial growth at 2.7 percent and manufacturing growth at a five-year low of 1.9 percent in FY2013/14. Maldives saw its secondary sector contracting by 1.2 percent in 2013, with construction leading the decline at 2.9 percent. And the political and security transition continued to take its toll in Afghanistan, with sharp contractions across sectors and the slump in investor and consumer confidence weakening growth in manufacturing and construction.

Agricultural sector output, subject to weather shocks and global price cyclicality, has remained a

volatile contributor to growth across South Asia. India's agricultural growth lost momentum in 2014, after a stellar performance in the last quarter of FY2013/14, as the winter crop suffered from untimely rains. In Pakistan, for the second year in a row, agricultural growth was below target, growing at 2.1 percent in FY2013/14 on the back of unfavorable weather. In Sri Lanka, an ongoing drought has taken a toll, with agriculture recording a modest growth of 0.2 percent y-o-y 2014Q1, thereby contributing a meager 0.3 percent to overall growth. In Nepal, on the other hand, agriculture was a major driver of growth in FY2013/14. Total production expanded by 4.7 percent compared to 1.1 percent in FY2012/13, reflecting strong crops for three major staples – paddy, maize and wheat. Afghanistan's agricultural production experienced a robust 2013 following favorable weather conditions but did not exceed record levels of 2012.

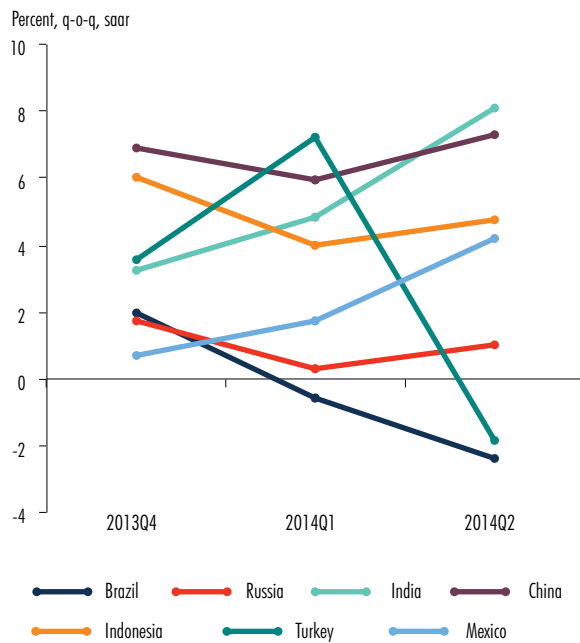
The overall South Asian growth motor seems to be shifting into gear, led by India's improving performance. While regional growth is estimated at 5.6 percent for calendar year 2014, Indian real GDP growth (at factor cost) rebounded strongly in FY2014/15Q1 – at 6.1 percent q-o-q saar – driven by a strong pick up in industrial activity and manufacturing. Pakistan's GDP growth reached 4.1 percent for FY2013/14, the highest rate in seven years; although with the caveat that recent political tensions and protests will likely dampen this figure. Bangladesh faced severe

Figure 12: Industrial production growth remains volatile across South Asian economies



Source: World Bank DECPG

Figure 13: India saw a strong growth performance over 2014H1 when compared to other emerging markets



Source: World Bank DECPG

disruptions in production, transport and services over FY2013/14H1. Provisional estimates suggest that GDP growth for FY2013/14 will be around 6 percent, although this may be overly optimistic. The Sri Lankan economy grew by 7.3 percent in 2013, slightly below the 7.5 percent average of the period 2010–13, but well above regional peers. In 2014Q1, Sri Lanka was able to solidify this momentum and recorded 7.6 percent growth compared to 6.1 percent in 2013Q1. Nepal's GDP grew 5.2 percent in FY2013/14, up from 3.5 percent in the previous FY, driven by rapid expansion in services and strong agriculture. In spite of substantial fiscal and external challenges, Maldives' authorities estimate GDP growth to pick up to 4.5 percent, driven primarily by tourism but also dynamic transport and construction sectors. Bhutan's economy is estimated to grow at 6 percent in 2013/14, driven mainly by hydro-related activities and tourism. Only Afghanistan has seen a sharp slowdown in its GDP growth, from 14.4 percent in 2012 to an estimated 3.7 percent in 2013 (based on the non-opium economy). This is mainly on account of large political and security uncertainties significantly dampening investment and consumption demand.

India's growth performance remains strong vis-à-vis emerging market peers. India came out as the second fastest growing emerging market in 2013, only

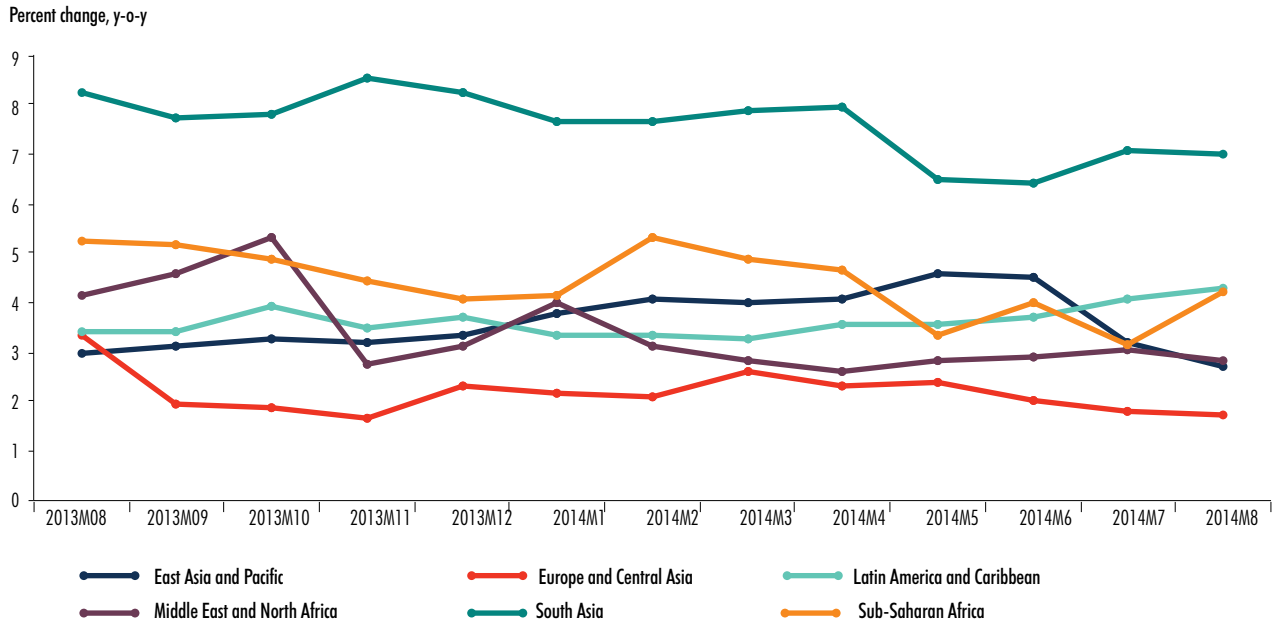
outperformed by China's continuously high but slightly decelerating expansion (figure 13). In 2014Q2, India's real GDP growth (at market prices q-o-q) was slightly above China's, topping other emerging markets. Indeed, Turkey and Brazil continue to struggle with the effects of US tapering; however, their external positions begin to show sustained signs of stability and reduced vulnerability.

Inflation remains high but shows signs of deceleration

The inflation rate of South Asia is the highest inflation among developing regions, although it is now on a slightly downward trend. The average inflation rate in South Asia is at least twice as high as in the rest of the developing world, and no other region comes nearly close to it (figure 14). But headline inflation is slowly declining in some of the countries where it used to be abnormally high, including Bhutan, India and Pakistan (figure 15).

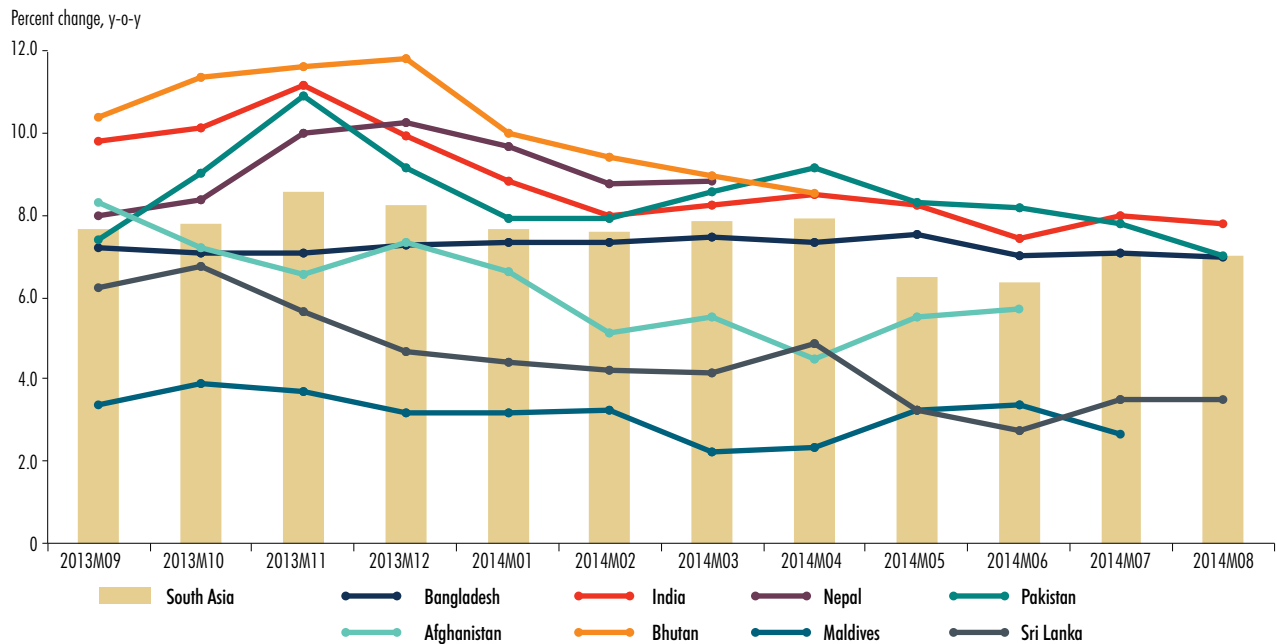
A relatively tight monetary policy stance and a deceleration in food prices lie behind the deceleration, although with specific shocks affecting different countries. Major central banks in South Asia have maintained their relatively tight monetary policy stance and key policy rates have remained constant in CY2014 (figure 16). Favorable food price developments further helped the deceleration. India's food price growth, having contributed around 56 percent to overall inflation in the current FY to date, moderated to single digits, leaving headline consumer price inflation at 7.8 percent y-o-y in August 2014. In Pakistan headline inflation remained in the single digits. While it accelerated to 8.6 percent in FY 2013/14, up from 7.4 percent in the previous fiscal year, this was mainly due to adjustments in administered (fuel and electricity) prices. Core inflation actually declined as a result of better supply conditions and slower aggregate demand. Fitting with the regional trend, Bangladesh's headline inflation remained high but stable, increasing to 7.4 percent in FY2013/14 relative to FY2012/13's 6.8 percent. The increase was driven by disruptions to the food supply chain due to political turmoil. In Sri Lanka, whose monetary policy stance is relatively loose, headline inflation recorded 3.5 percent y-o-y in August 2014, slightly up from a 28 months low of 2.8 percent y-o-y in June. Nepal's inflation remained fairly high at 9.1 percent y-o-y for FY2013/14, but this is

Figure 14: South Asia's inflation remains highest among all developing regions



Source: World Bank DECPG

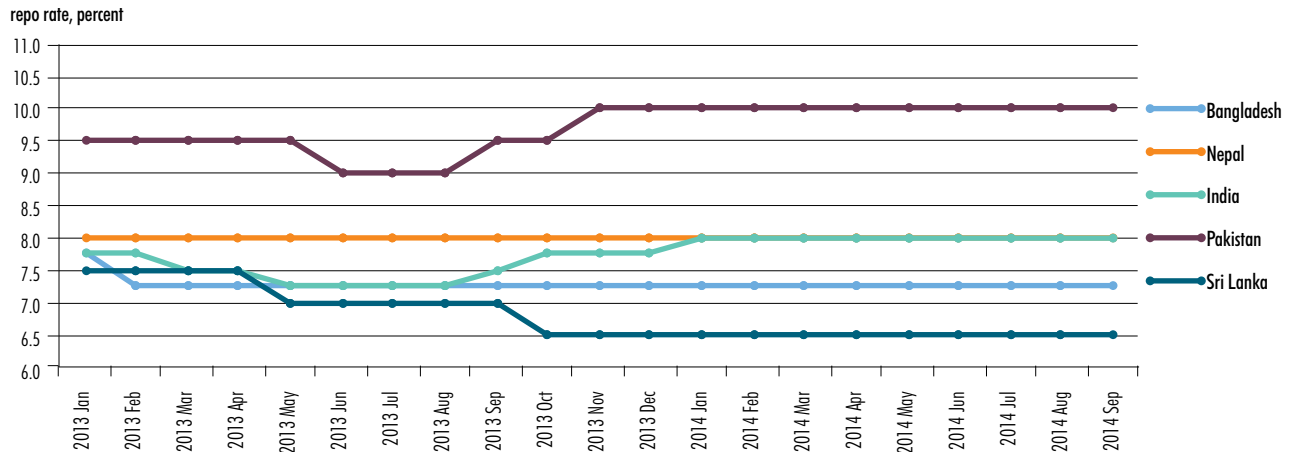
Figure 15: The inflation rate is on a slowly declining trend across several South Asian economies



Source: The World Bank and national authorities

lower than the 9.9 percent average of FY2012/13. In Afghanistan inflation softened to 5.6 percent by June 2014, down from 7.3 percent in December 2013, mainly due to continuously decreasing non-food prices. Notably, rental prices (and more broadly real estate prices) have been strongly impacted by the economic downturn, declining by a record 9.1 percent in June 2014 y-o-y.

Figure 16: Policy rates across South Asia continue to reflect a relatively tight monetary stance



Source: National central banks

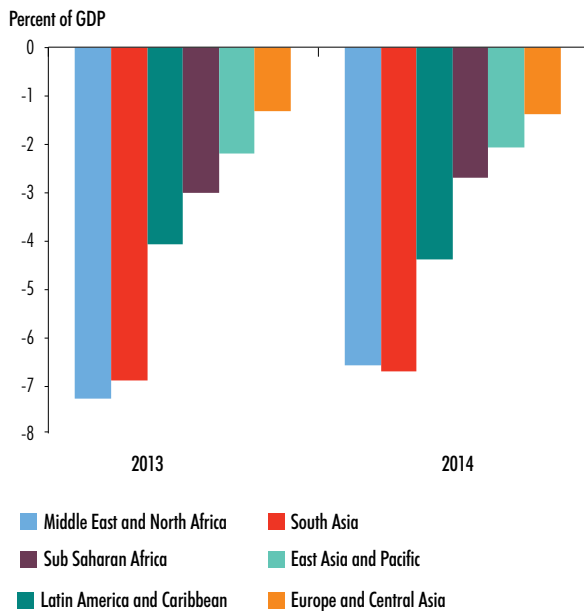
The main risks and vulnerabilities remain domestic

With South Asia’s external position solidifying, downside risks are increasingly dominated by domestic factors. Besides the financial sector vulnerabilities discussed in the previous issue of this report, the main challenge is on the fiscal side. Budget deficits and public debt remain fairly stable and even show some signs of consolidation; however, their size continues to constrain the policy space. The average budget deficit

across South Asian countries was 6.7 percent of GDP in 2014, down from 6.9 percent in 2013 (figure 17). This puts South Asia in the top spot across all developing regions for 2014. As for public debt, South Asia maintains its leading position with the estimated ratio of gross government debt to GDP increasing from 65.3 percent in 2013 to 67.6 for 2014 to 68.6 percent in 2015 (figure 18).

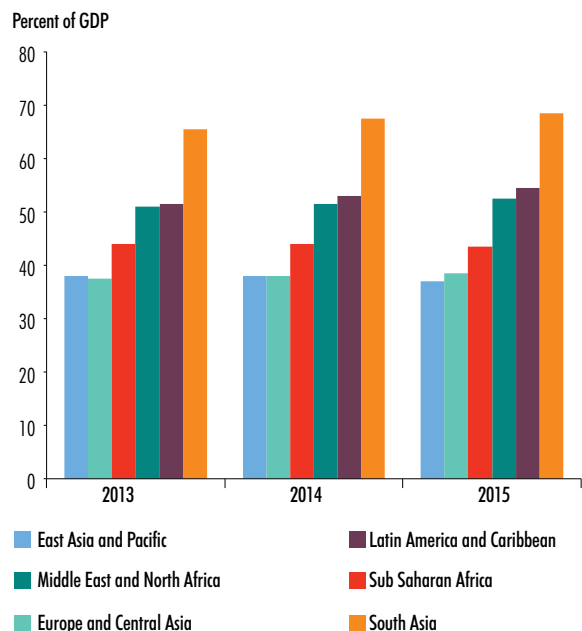
Progress to reduce budget deficits is gradual yet recent consolidation shows a degree of commitment to fiscal discipline. Nepal is the only country in the

Figure 17: Despite fiscal consolidation budget deficits remain entrenched and large in South Asia



Source: The World Bank DECPG

Figure 18: South Asia’s public debt ratios continue to be the highest across developing regions

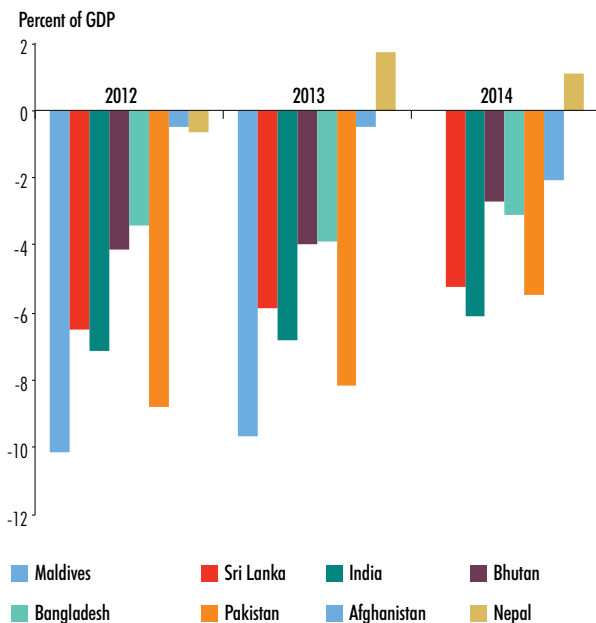


Source: IMF World Economic Outlook & World Bank staff calculations

region running a fiscal surplus. For FY2013/14, the surplus is expected to reach 1.1 percent of GDP, after 1.7 percent in FY2012/13 (figure 19). Other countries face deficits, some of which are large. Bangladesh's fiscal deficit narrowed to 3.1 percent of GDP in FY2013/14, down from 3.9 percent in the previous FY. Bhutan's fiscal deficit is estimated to stay at around 4 percent in 2013/14, although it is expected to ease to 2.7 percent of GDP as more revenues from a cement project, an electricity scheme, and a revision of electricity export tariffs materialize. In India, the gross fiscal deficit of the central government was 4.6 percent of GDP in FY2014, a reduction from the 4.8 percent figure of FY2013 and less than the FY2014 target of 4.8 percent. In Sri Lanka, despite an improvement vis-à-vis 2013, meeting the 2014 target deficit of 5.2 percent may be difficult, having reached 3.5 percent of full year GDP by the end of April. In Pakistan, provisional data for FY2013/14 indicate that the government was able to lower the fiscal deficit to 5.5 percent of GDP, 0.3 percentage points below the target.

Besides Maldives, nowhere is the budget situation more challenging than in Afghanistan, where declining government revenues are leaving an increasingly large fiscal gap. Revenue collection continued its decline in 2014, after having fallen to 9.7 percent of GDP in 2013, down from 10.3 percent in 2012. This decline reflects important weaknesses in customs. As a result, the government's cash balance has been basically

Figure 19: Budget deficits remain sizeable but there is some progress in fiscal consolidation



Source: The World Bank and national authorities

depleted and a financing gap is building up. By August 2014 it amounted to US\$ 362 million. Even with severe austerity measures, Afghanistan will need around US\$ 300 million in additional financing to cover civilian salaries, pensions, and critical operating and development spending while maintaining security. If government revenue did not reach the revised targets, or if projected civilian grants linked to progress on economic reform fall short of expectations, the financing gap could be even larger.

Most of the fiscal consolidation is taking place on the expenditure side, whereas revenue generation and collection continue to pose broad challenges.

In India the revenue of the central government was at a two-year high of 9.3 percent of GDP in FY2014, but all individual revenue lines (corporate tax, income tax, services tax, excise tax, and customs duties) remained below targeted levels, a weakness that may continue to put pressure on the FY2015 budget. Subsidy expenditures exceeding budget estimates complicate the situation further. So far, the expectation is to compensate for these shortfalls through strong non tax revenues from asset divestiture (1.7 percent of GDP) and through cuts in social services and infrastructure investments containing expenditures at 12.4 percent of GDP. Fiscal consolidation among Indian states, on the other hand, remains on track. In Pakistan fiscal consolidation was enabled by one-time accruals to non-tax revenue (such as State Bank of Pakistan profits) outweighing tax revenue below expectations. The contribution of expenditure compression was only marginal. Provinces contributed significantly to lowering the fiscal deficit, showing a combined fiscal surplus of 0.6 percent of GDP in FY2013/14, significantly above the 0.2 percent requested by the federal government. In Bangladesh fiscal policy remains plagued by implementation weaknesses. There was a revenue shortfall for the second year in a row, forcing a revision of targets. The shortfall was compensated by sluggish expenditure growth, although this was mainly due to poor implementation of the public investment program. In Sri Lanka revenue targets for the first four months of 2014 were not met due to tax collection being 15.6 percent below budget.

Nepal and Maldives continue to enjoy unusually strong government revenue. In Nepal, revenue mobilization performs outstandingly. Thanks to VAT, excise tax and non-tax revenues, government resources grew by 19.8 percent in FY2013/14, well above target, reaching 18.4 percent of GDP. Revenue buoyancy is not the only explanation for Nepal's budget surplus, however. Continued under-execution of public capital

expenditure, bunching and absorptive bottlenecks are the other side of the equation. Unlike Nepal, Maldives runs a huge budget deficit. But while its spending was an extraordinary 42.6 percent of GDP in 2013, its government revenue was still the highest among all South Asian countries, at 32.8 percent of GDP.

Public debt remains sustainable across most countries in the region, but continues to resist swift reductions. The highest indebtedness is in Bhutan, where public and publicly guaranteed debt stood at 93.2 percent of GDP by end FY2013/14, with rapid hydropower development further fuelling the debt buildup. However, the risk of debt distress continues to be low due to the commercial viability of hydro projects and the risk sharing agreements in force with India. Indebtedness is high in Sri Lanka as well, but the public debt position improved over 2014H1 to 74.3 percent of GDP, down from 78.3 percent at the end of 2013. In India, general government debt registered a minor decline, from 51.7 percent of GDP in the previous fiscal year to 50.6 percent in FY2014. Combined with an only marginal decline in state-level debt, the overall public debt to GDP ratio is expected to fall slightly, from 66.9 percent of GDP in the previous fiscal year to 66.4 percent in FY2014. Similarly, Pakistan's debt ratio improved to 63.7 percent in FY2013/14, down by only 0.6 percentage points from the previous fiscal year, and still above the 60 percent limit stipulated in the 2005 Fiscal Responsibility and Debt Limitation Act. Public debt is much lower in Bangladesh, and it is on a downward trend, from 37.4 percent of GDP in FY2012/13 to 35.5 percent in FY2013/14, and a projected 34.4 percent for FY2014/5. Similarly Nepal's vulnerability to debt distress is ranked as low, with debt to GDP at historic lows of 30.5 percent of GDP (down from 60 percent a decade ago). Maldives public debt defies this generally encouraging picture. In calendar year 2013 it reached 86.2 percent of GDP, and it is growing. Limited sources of financing make Maldives a country at a high risk of external debt distress.

Some countries have managed to decrease the risk profile of their public debt portfolios. Pakistan achieved an important improvement in its debt risk profile in FY2013/14 by shifting towards the longer end of the yield curve. An outstanding Rs. 1.2 trillion in short-maturity treasury bills were retired and replaced with long-maturity Pakistan Investment Bonds in the amount of Rs. 1.8 trillion, thereby increasing the share of medium-to long-term domestic debt and lowering rollover and refinancing risks. And a healthy flow of multilateral and bilateral monies followed Pakistan's

signing of a three-year US\$ 6.64 billion Extended Fund Facility with the IMF in September 2013. Sri Lanka slightly reduced the weight of short-term debt within its overall position (from 23.7 to 22.4 percent) through the issuance of 30-year treasury bonds. Nepal's public debt is not only low: 64 percent of it is external borrowing on highly concessional terms, resulting in a low debt service. Maldives remains the exception, with short-term domestic debt increasing from 55 percent of total debt in 2010 to 57 percent in 2013, thereby increasing exposure to refinancing risks.



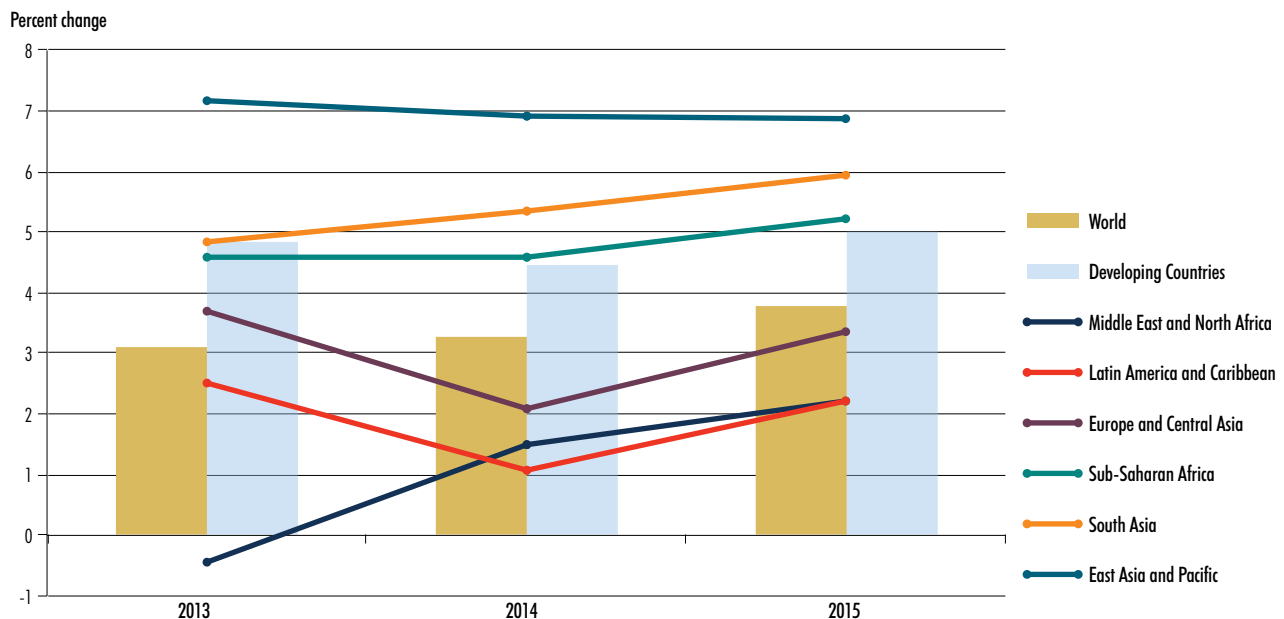
Outlook and policy

The overall short and medium term outlook for South Asia points towards broad macroeconomic stability and continued growth acceleration with potential downside risks concentrated on the fiscal side. The continuation of these positive trends will increasingly depend on strong investment and export performance, hence on the policy reform momentum. Addressing fiscal weaknesses and embracing economic reforms are challenging tasks. But success would allow South Asia to significantly catch up with the fastest growing region - East Asia and the Pacific – which is projected to gradually slow down.

Again one of the most dynamic regions in the world

South Asia is the second fastest growing region in the world, and given East Asia's slight downward trajectory it could stand a chance to move to first position. The main pillars of the regional growth forecast remain a continued pick up in gross fixed investment and high and sustained export growth. Based on a quite strong competitiveness dividend that extended well into 2014H1, South Asia is expected to grow at 5.4 percent in real terms in 2014 and further to 6 percent in 2015

Figure 20: South Asia's projected growth trajectory hints at convergence with the leading regional peer, East Asia and Pacific



Source: World Bank DECPG

(figure 20). This greater dynamism will be on the back of a pickup in gross fixed investment and international trade (table 1). The region's CAD is expected to slightly increase over the next 2 years, stabilizing around a manageable 2 percent of GDP from 2015 onwards. The increase in the CAD will be mostly driven by faster import growth, after 2013 and 2014 have seen exports growing significantly above imports.

Table 1: South Asia's growth performance will depend on continued export and investment strength

Percent change	2013	2014	2015	2016
SAR real GDP growth (calendar year) October 2014	4.8	5.4	6.0	6.4
Private Consumption	4.2	5.1	5.8	6.1
Government Consumption	6.0	5.7	5.6	5.4
Gross Fixed Investment	0.9	5.8	8.4	8.5
Exports, GNFS	7.2	6.2	6.4	6.9
Imports, GNFS	0.9	4.5	6.7	7.2
Statistical Discrepancy	1.1	1.3	1.0	0.9
Change in inventories	0.8	-0.6	0.0	0.0
SAR Current a/c balance (Percent of GDP, calendar year)	-1.3	-1.6	-2.0	-2.1

Regional trends are driven by India, which shows potential for accelerated growth in the short and middle term. With over 80 percent of regional GDP being concentrated in India, the largest regional economy clearly sets the pace for South Asia. Its GDP growth is expected to accelerate from 4.7 percent in FY2013/14 to 5.6 percent in FY2014/15 to 6.4 percent in FY2015/16 (all GDP at factor costs). In the short term, continued dynamism in the US should support Indian merchandise and service exports, remittance inflows are expected to continuously strengthen domestic demand, and declining oil prices should boost private sector competitiveness. In the medium term, further pursuing a dynamic structural reform agenda and improving the investment climate, paired with maintaining prudent macroeconomic policy and a solid external position could enable India to reap its demographic dividend and match its growth performance on the previous decade.

Economic dynamism is expected to extend beyond India, with most countries in the region experiencing a stronger performance in the near future. South

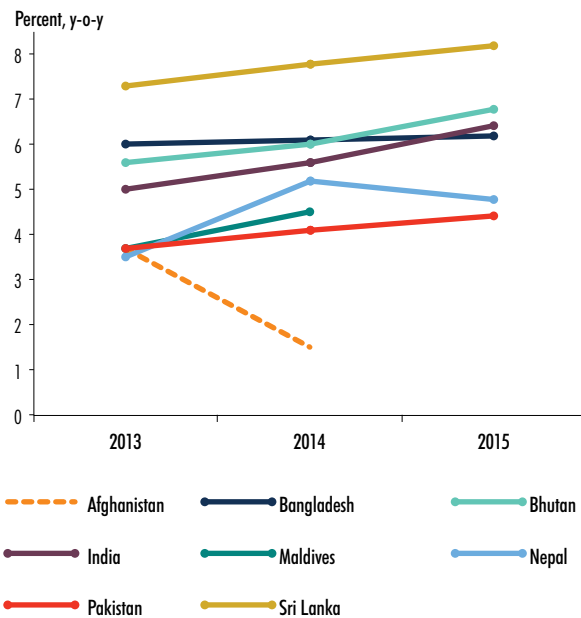
Asia's second largest economy, Pakistan, is expected to continue its path towards gradual growth recovery, manageable inflation and fiscal consolidation. Real GDP growth is projected to reach 4.3 – 4.6 percent in FY2014/15, driven by services and large scale manufacturing on the supply side, and strong remittance flows, improving private investment and renewed export dynamism on the demand side (table 2 and figure 21). However, this outlook is based upon the important assumption that August 2014 events have not damaged investor confidence, dampened economic activity and growth or increased overall country risk. Bangladesh's GDP growth is expected to recover in FY2014/15 and projected to rise to 6.2 percent. This forecast assumes continued macroeconomic stability and a boost for domestic consumption from remittances and domestic demand from public infrastructure investments. The outlook for Sri Lanka remains positive with an expected GDP growth of 7.8 percent in 2014. This is in the expectation of a favorable macroeconomic outlook, including subdued inflationary pressure, an improving external position, and further fiscal consolidation and debt reduction. In Nepal, short term growth in FY2014/15 is expected to be in the 4.5-5 percent range (below last year's estimates of 5.2 and well below the government target of 6 percent). Uncertainties are greater in Afghanistan's case. If uncertainty is reduced and confidence is restored, Afghanistan may be able to turn the wheel and live up to a projection of 1.5 percent in 2014. However, a substantial downside risk remains and it is concentrated around security and fiscal stability.

Table 2: Growth is expected to pick up across most of South Asia (by calendar year)

	2011	2012	2013	2014	2015
Afghanistan	6.1	14.4	3.7	1.5	
Bangladesh	6.7	6.5	6.0	6.1	6.2
Bhutan	8.1	5.6	6.0	6.8	
India (factor cost)	6.7	4.5	4.7	5.6	6.4
Maldives (CY)	6.5	1.3	3.7	4.5	
Nepal (CY)	3.9	4.6	3.5	5.2	4.8
Pakistan (factor cost)	3.6	3.8	3.7	4.1	4.4
Sri Lanka (CY)	8.2	6.3	7.3	7.8	8.2

Note: (1) These real GDP growth estimates and projections are based on respective country FYs unless otherwise noted (CY); (2) Afghanistan 2012 (9 months only), from 2013 calendar year growth;
Source: World Bank and national authorities

Figure 21: Growth is expected to pick up across most of South Asia (by fiscal year)



Source: World Bank and national authorities

Carrying the momentum forward

Political developments in South Asia bear great potential for growth and development while remaining a very real source of downside risk. While India experienced a “Modi dividend” based on expectations for reform, the true-medium term benefits will have to be earned through structural reforms and prudent macroeconomic management. Bangladesh has recently found its way back to political stability and may deliver a renewed focus on growth. Other South Asian countries continue to grapple with the effects of political uncertainty and turmoil. While Pakistan showed satisfactory progress in FY2013/14, recent events have disrupted this path by inflicting estimated short term losses of 2.1 percent of GDP (early September estimates). This is the sum of the FX reserve losses due to State Bank of Pakistan foreign exchange intervention and a 9 percent decline in the Karachi stock exchange. Although early signs of a growth slowdown are visible, particularly in relation to exports, the most pressing question is whether investor confidence has been damaged. Afghanistan remains on a fragile path to a brighter and more stable future, with much depending on the government’s ability to address the current revenue shortfall.

The reform drive has strengthened in recent times across the region, but challenges in the fiscal and

structural realms will require continued and reinforced attention. Pakistan’s implementation of structural reforms started on solid grounds, with a well-defined agenda centering on five key areas: reform of the power sector, raising government revenue, privatization of state-owned enterprises (SOEs), enhancing the business environment, and strengthening support for the poor. But major steps remain to be taken, including on power tariffs and SOE divestiture. Bangladesh set quite ambitious targets for increasing revenue generation and improving the quality of the Annual Development Program. On the latter, implementation remains difficult against a background of increasing project numbers, with public investment standing at 2 percent of GDP while infrastructure needs are estimated at 7 to 10 percent of GDP. Nepal’s most urgent growth priority is to address its crippling energy shortage, which stands in sharp contrast with its enormous power generation potential. However, the most dramatic policy challenges are faced in Maldives – managing fiscal and debt accounts – and in Afghanistan – preserving fiscal sustainability.

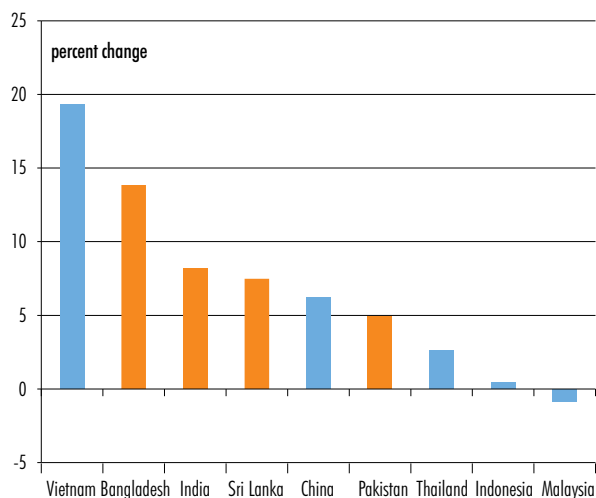
With external vulnerabilities remaining manageable, the main focus should be on sustaining faster growth through investment and exports. Relative contributions to real GDP growth in the region will be increasingly skewed towards these two components of aggregate demand.



Focus: Will the growth of South Asian exports continue?

Export performance across South Asia has been quite strong in recent times. Various economies outperformed their East Asian peers in terms of export growth over the last year (figure 22). Short-term tailwinds could explain this outcome. The Indian rupee depreciated substantially in 2013, when the end of Quantitative Easing was announced by the US Federal Reserve, and demand in the US – a major trading partner for the region – is picking up. But there could be more permanent factors at play. China's soft landing might have opened up room for South Asian countries in world markets, and a much anticipated rebalancing of the global geography of trade may be at play. Going forward, trade will have to be a strong contributor to

Figure 22: South Asian countries outperformed many "export tigers" in 2013 (export growth based on US\$ value)



Source: World Bank

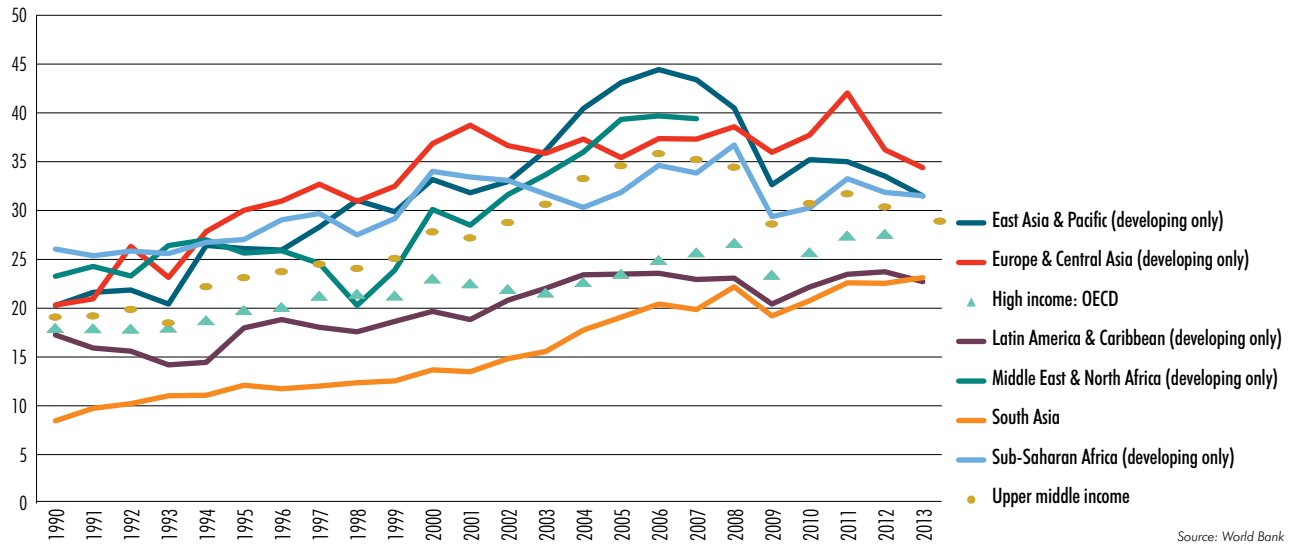
GDP growth in the middle term. Disentangling the contribution of short-term factors and longer-term trends is important to understand whether the recent export surge is a one-off or rather the region is on its way to become a major export powerhouse.

Exports are increasingly important for South Asia's growth

Exports have been growing faster than GDP across developing countries. As of end 2012, their share of GDP was 30 percent, significantly higher than in advanced countries, where the share was only 27 percent. The export-to-GDP ratio rose across all developing regions in the period since 1990, with the fastest increase taking place in South Asia countries, where the ratio grew by 173 percent – albeit from a low base. With the onset of the global recession in 2009 and the subsequent decline in both export volumes and prices, export's contribution to GDP declined in advanced and developing economies alike. But the trend continued in South Asia countries, with the exports share of GDP increasing from 8.5 percent in 1990 to 22 percent in 2008 and further to 23 percent in 2013 (figure 23). Over the period 2000–2013 the increase was faster than in any other major region of the world. In 2013, the exports-to-GDP ratio of South Asia overtook that of Latin America and the Caribbean.

Exports tend to be pro-cyclical, growing more strongly than the overall economy in booms while decelerating more rapidly than GDP during periods

Figure 23: South Asia's openness is catching up with that of other regions

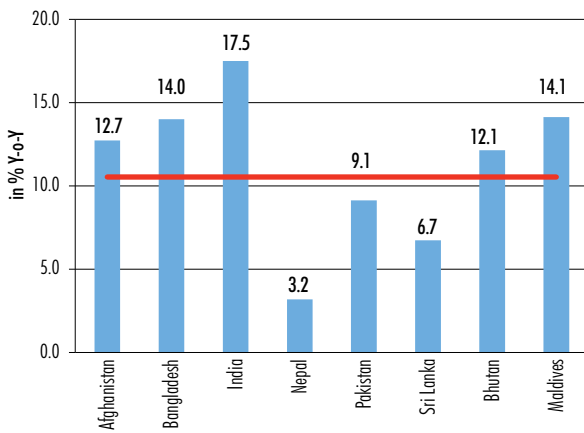


Source: World Bank

Figure 24: India leads but is not alone

Average merchandise export growth (2000-2013)

Current US\$



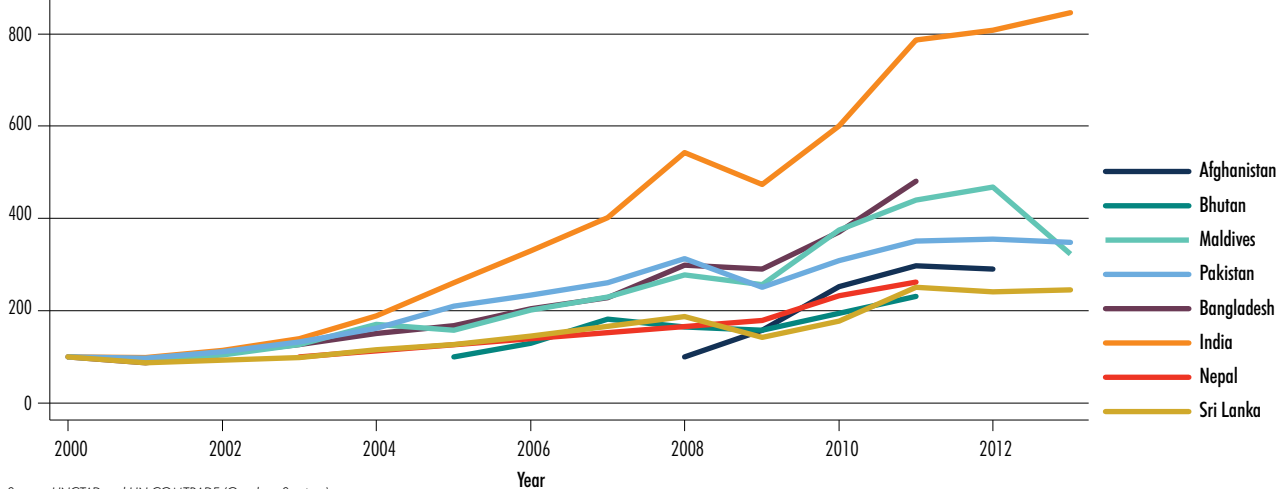
Source: World Bank

of weak economic activity. South Asia was not an exception to this general pattern, but the exports-to-GDP ratio fell from 22 percent in 2008 to 19 percent in 2009, less than in other developing regions.

Within the region, the dependency on exports is higher in middle income than in the low income countries. However, the ratio is rapidly growing in the low income group as well. Following India's exports' boom, many South Asian economies have displayed some dramatic exports' growth rates since 2000 (figure 24). And the trend is not driven by more favorable prices: export volumes are growing, especially since the global crisis (figure 25). While the performance varies across individual countries, only Maldives stands out as an exception.

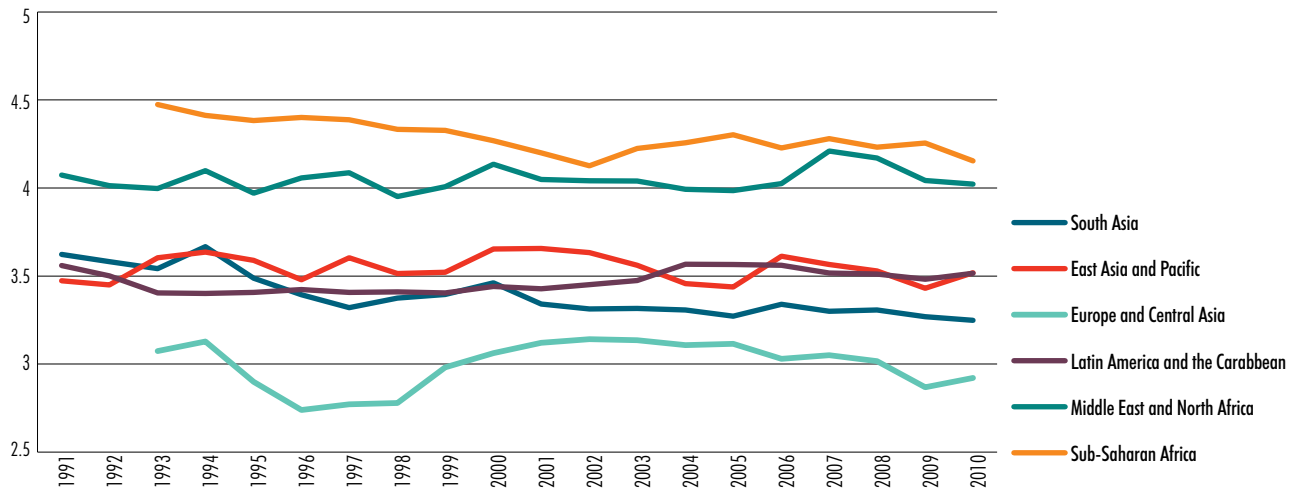
Figure 25: Export volumes are growing across most of the region

index 100=2000



Source: UNCTAD and UN COMTRADE (Goods + Services)

Figure 26: South Asia's concentration of exports by product declined over the last decade



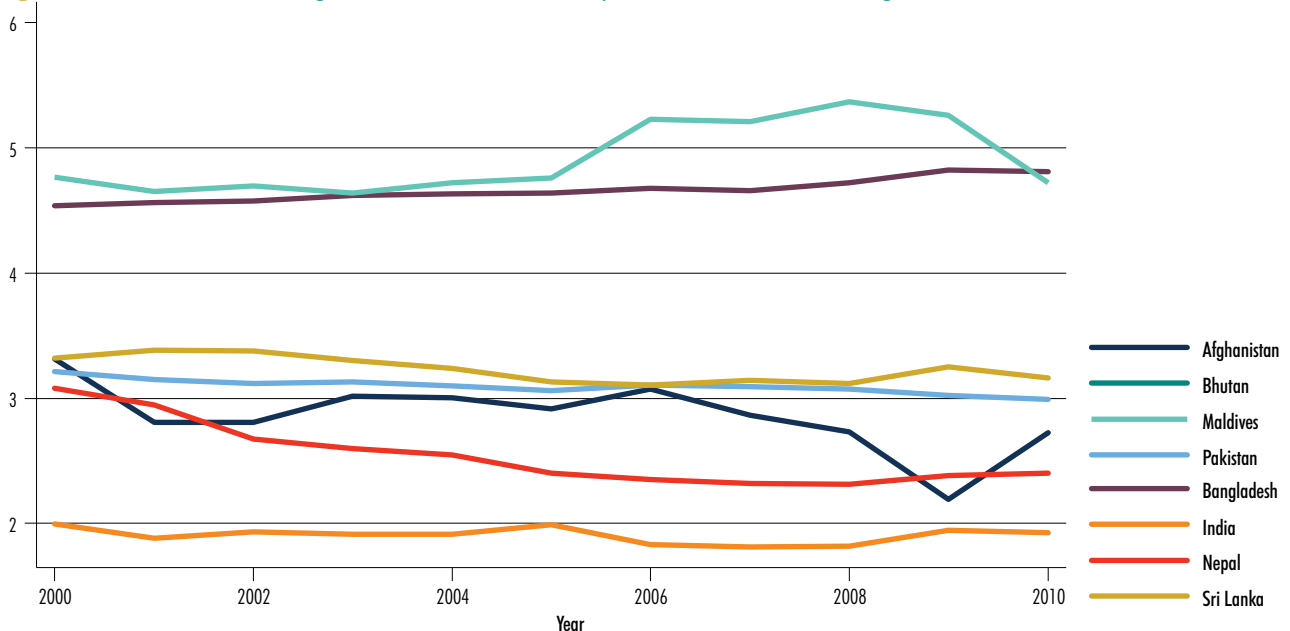
Source: IMF

South Asian exports are becoming more diversified

Across countries in the region, exports are not only growing faster than GDP, and growing in volumes rather than just in prices: they are also becoming more diversified in terms of traded products and trading partners. An export concentration index can be computed as a Theil index, which measures whether the majority of a country's export earnings comes from small number of export products or destinations (indication of export concentration) and whether the sources of export earnings are more evenly spread

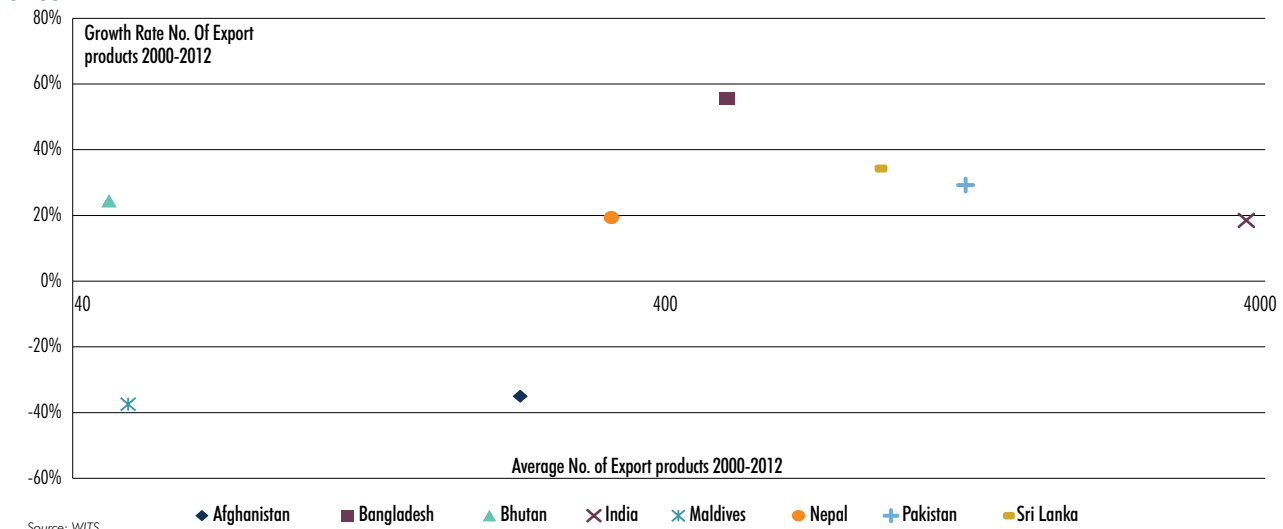
across a given range of export goods or destinations (indication of export diversification). The lower the index, the more diversified exports are along these two dimensions. This calculation shows that South Asia has become over time one of the most diversified developing regions in the world, second only to Europe and Central Asia (figure 26). The region's export concentration declined from 3.7 in early 1990s to 3.3 in 2010, while in most other regions it remained relatively stable. Within the region, the extent of export diversification varies across countries. As of 2010, diversification was highest in India, followed by Nepal and Afghanistan. Bangladesh and Maldives were the least diversified (figure 27).

Figure 27: India has the highest diversification of exports, Maldives and Bangladesh the lowest



Source: IMF

Figure 28: Smaller countries export fewer products but diversification trends vary across countries with similar sizes



Except for Afghanistan and Maldives, export diversification by product increased across the region between 2000 and 2012. However, the nature of the changes varied considerably across countries. Some diversified their exports between 2000 and 2012 while others actually increased their degree of specialization. Thus, Afghanistan and Maldives became more concentrated, whereas Bangladesh diversified. Overall, India and Pakistan have the highest level of diversification as measured by the number of traded products, whereas Maldives and Bhutan display the lowest (figure 28). The size of the economy is a natural candidate to explain some of the differences. Smallest countries can be expected to export fewer products (figure 29). But differences across countries of similar size are revealing. Bhutan’s exports became

more diversified at a time when exports from Maldives were becoming more concentrated. A similar contrast exists between Nepal and Afghanistan. And Bangladesh seems to be catching up in diversification with Pakistan.

Exports of services are often overlooked by trade analysts. And admittedly, with the notable exception of Maldives, services still represent a small share of the overall exports in South Asia (figure 30a). But the economies exhibiting the highest diversification in their exports of goods are also the ones with the fastest growth of exports in services (figure 30b). If such growth proves sustainable, services export could represent a strong pillar of South Asian export growth in the coming years.

Figure 29: The composition of exports by product is substantially different across countries

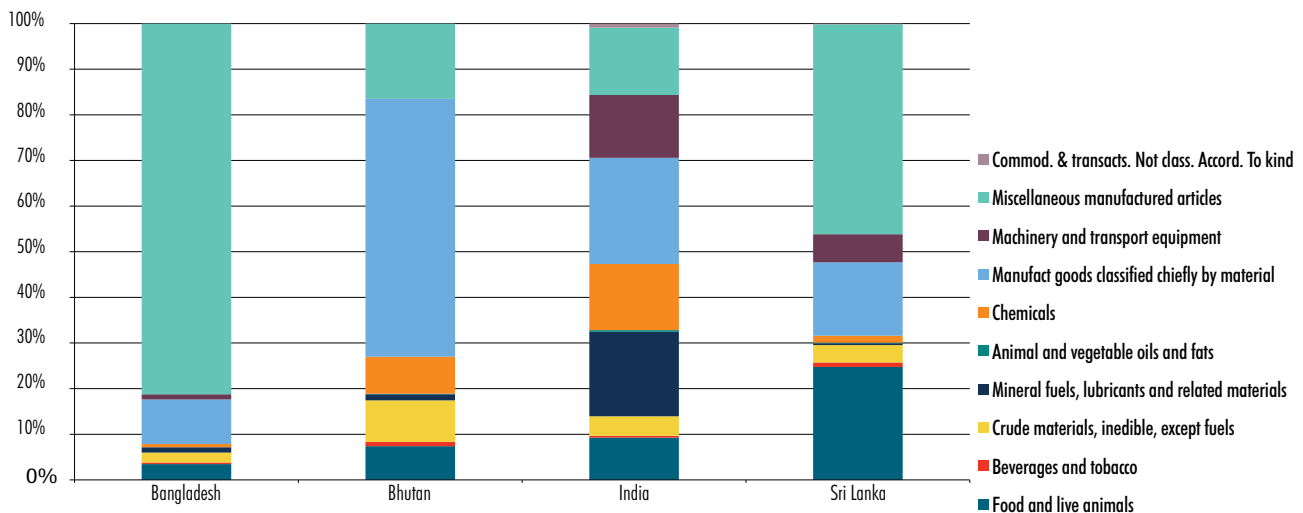
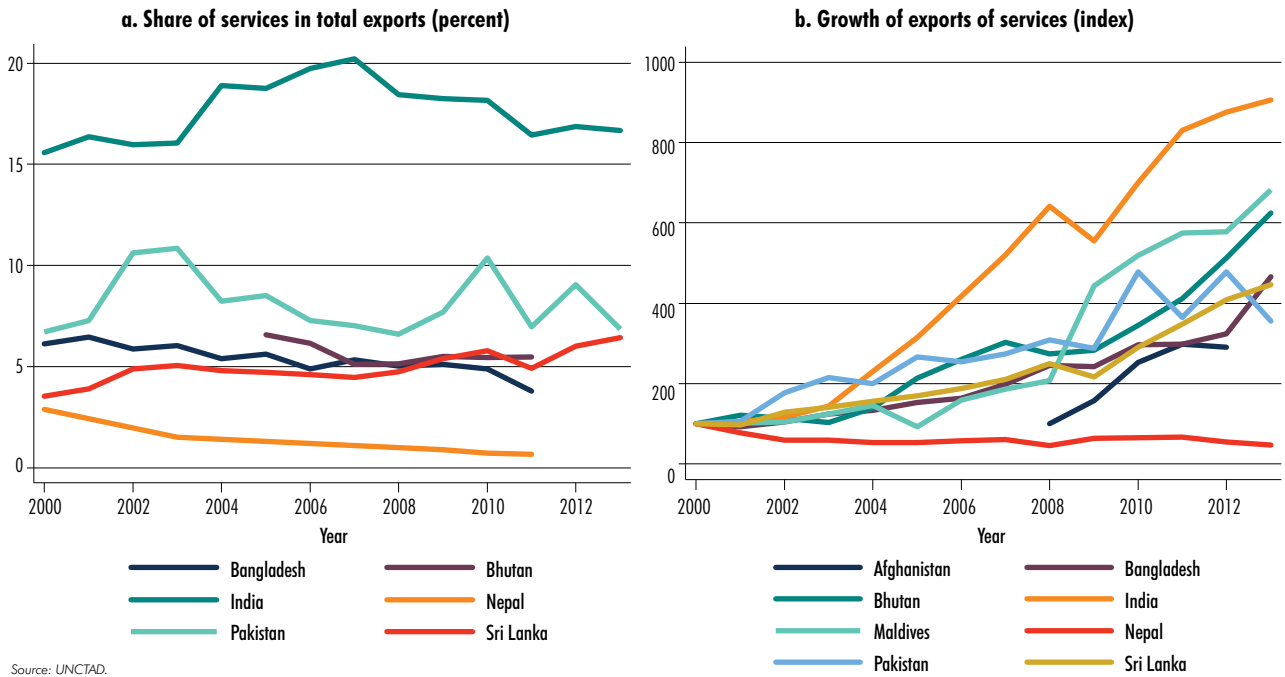


Figure 30: Exports of services are growing as fast as exports of goods



Services can be quite different in their degree of sophistication. Successful export diversification would entail moving towards higher value added services. The experience of countries in South Asia is quite diverse in this respect. In Nepal, exports in services have remained concentrated around traditional service types such as tourism and transport. In India, on the other hand, the growth of technology and business services continues at a steady pace (figure 31).

Emerging markets are becoming important clients

Traditionally, the geographic diversification of exports involves an increase in the absolute number of trading partners as well as a decrease in the share of the most important ones. Most South Asian economies seem to be following the second rule (figure 32)

Figure 31: The sophistication of the services exported varies greatly

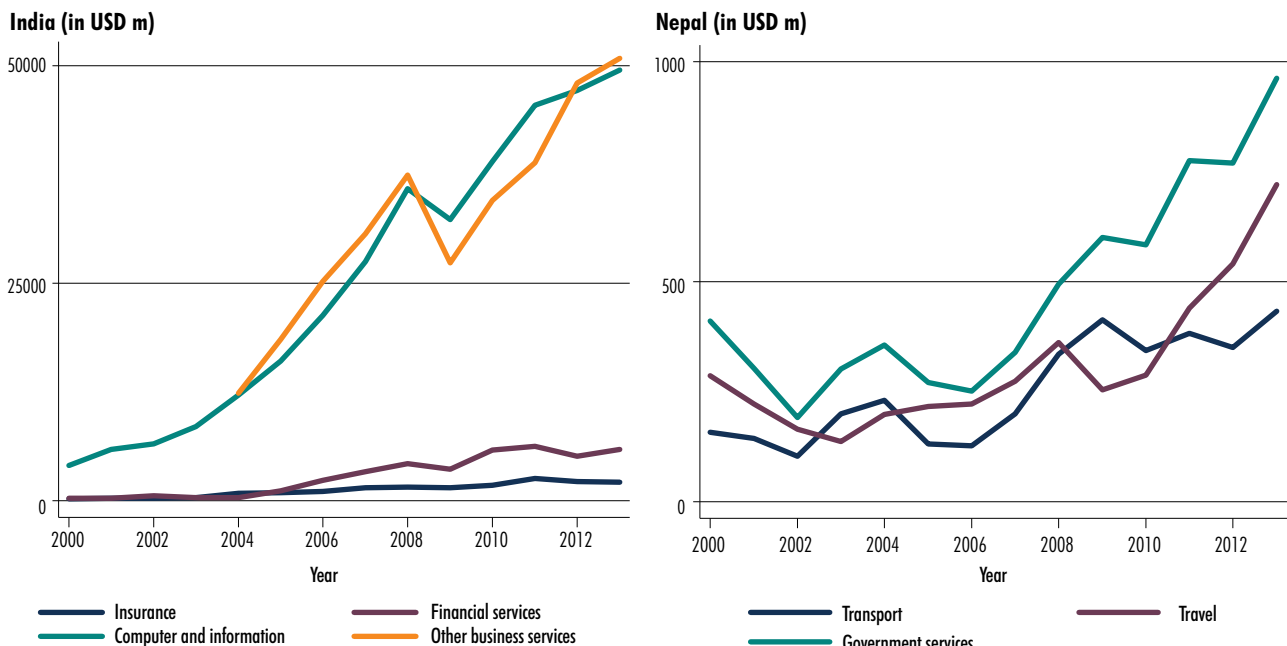
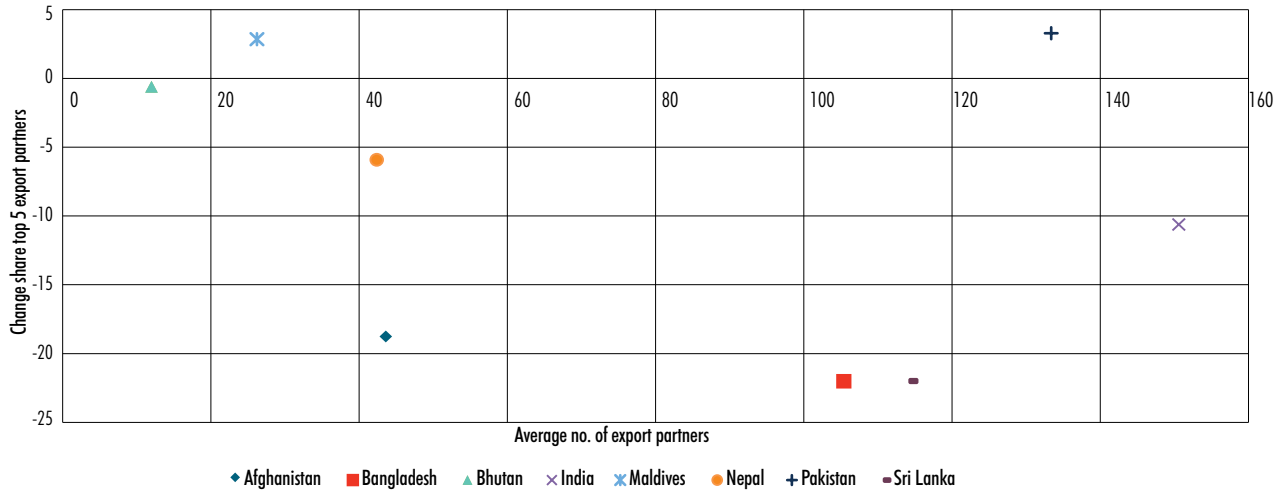


Figure 32: The share of the most important trading partners in total exports is generally declining

Geographic diversification and concentration (2000-2012)



Source: WITS. Data on export partners is for 2012 or most recent year.

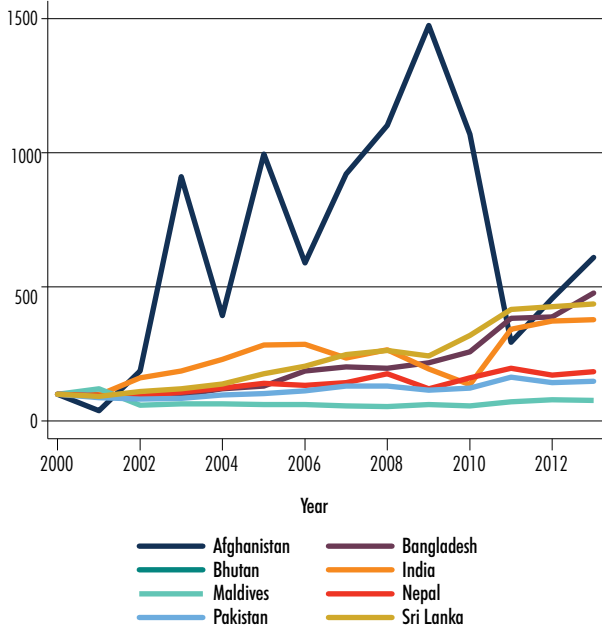
while they show mixed results on the first one. However, some South Asian economies maintain export portfolios which are fairly and become even more concentrated geographically. Pakistan and Maldives stick out against the trend of decreasing concentration in that their pool of trading partners has become more concentrated over time, i.e. the share of their top 5 partners in overall exports has been increasing between 2000 and 2012. On average, India and Pakistan have the largest number of

trading partners, whereas Bhutan and Maldives have the smallest over the same time period.

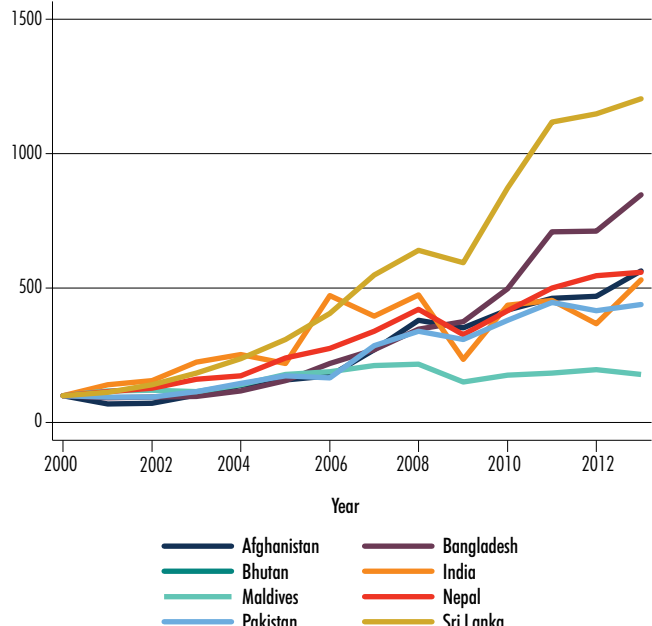
But geographic diversification is also at play in a different way. With the exception of Afghanistan, it is associated with a growing share of exports going to emerging economies, in particular China (figure 33). This shift in export partners is in line with broader worldwide output trends.

Figure 33: Exports to advanced countries have stagnated, exports to emerging economies have boomed

Exports to advanced economies (index 100=2000)



Exports to emerging economies (index 100=2000)



Source: IMF Dots

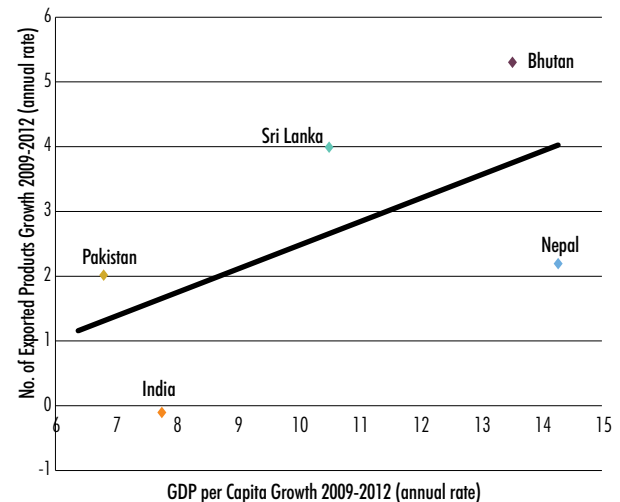
Current trends bode well for the region

The speed at which exports become more diversified by trade product is positively correlated in South Asia with the countries' overall GDP growth rate (figure 34). The region has seen an increase in diversification together with sustained economic development over the last decade. In principle, economic development could drive export diversification but it could also be the other way round. In practice, there is some evidence of effects going in both directions (Melitz and Ottaviano 2008).

Greater diversification by traded products and trading partners helps exporting countries to be more resilient against international shocks. Lack of diversification especially in primary and agricultural goods may make countries vulnerable to external shocks and thus weaken their growth through terms of trade deterioration. Reduced export and output volatility, on the other hand, greatly contributes to overall macroeconomic stability (IMF 2014). Countries that have achieved product and geographic diversification can rely on a stronger export base as revealed by lower terms of trade and export growth volatility. Through a reduced dependency on specific goods and partners, diversified economies are more resilient. Bangladesh, Pakistan and India face the highest terms-of-trade volatility among countries in the region (table 3). Yet the volatility of their GDP growth is among the lowest.

The countries featuring the most diversified trade patterns are also the ones which have increased their

Figure 34: Growth in export diversification by traded product and in GDP are positively correlated



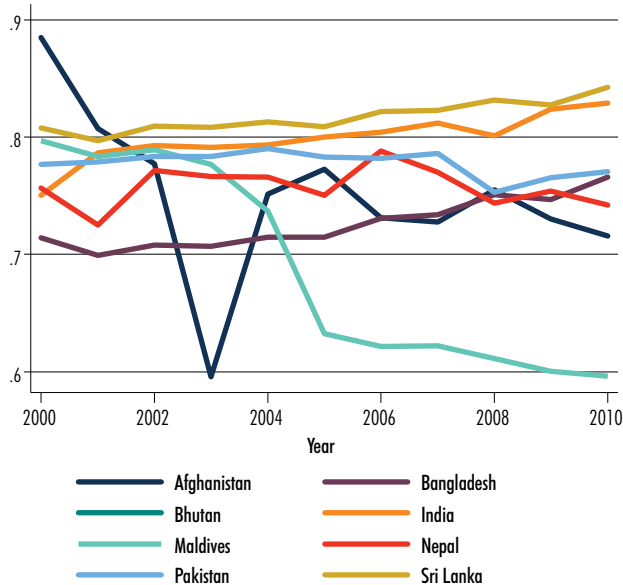
Source: WITS and WDI (2011 figures for Bhutan and Nepal), annualized

overall export quality the most. Higher export quality, as measured by unit values, suggests the potential for producers to enjoy higher margins. The most diversified countries also display greater market penetration. This may be a reflection of strong and well-established trade networks with their partners (figure 35).

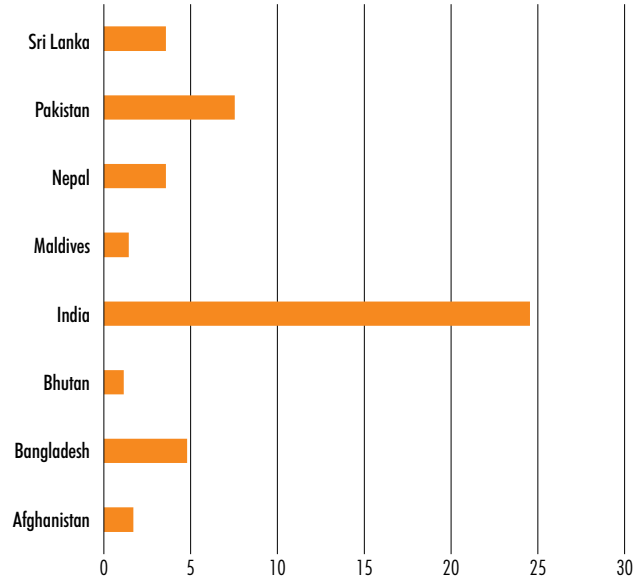
Table 3: The impact of terms-of-trade volatility is mediated by the extent of exports diversification

	Exports Growth Volatility	Terms of Trade Volatility	GDP Growth Volatility	Products Concentration Index	Geographic Concentration Index
Afghanistan	0.31	14.05	5.74	2.73	0.15
Bangladesh	0.14	18.03	0.53	481	0.11*
Bhutan	0.1	15.47	2.2	-	0.82
India	3.36	16.20	2.46	1.92	0.05
Maldives	0.17	5.41	7.33	4.72	0.1
Nepal	0.12	10.24	1.51	2.4	0.42
Pakistan	0.14	18.94	2.19	2.99	0.05
Sri Lanka	0.17	10.67	2.85	3.16	0.08

*2007 Figure
Sources UNCTAD, UN COMTRADE, WEO, WITS and IMF (2010)

Figure 35: South Asian countries differ in their exports quality and degree of market penetration**Exports Quality Index (Adjusted Unit Values)**

Source: IMF for panel a; WITS for panel b (Bangladesh 2007, Bhutan 2011, Nepal 2011)

Market Penetration (depth of products-destinations trade relations)

Some countries may be suffering from Dutch disease

Real exchange rates are an important determinant of exports. Typically, when terms of trade improve, the resulting inflow of foreign exchange into a country leads to an appreciation of its exchange rate (figure 36). This appreciation, in turn, reduces the competitiveness of domestic products in international markets.

When currency appreciation is substantial, countries may suffer from so-called Dutch Disease, an expression coined in reference to the consequences of oil revenue from the North Sea on the economy of Netherlands in the 1960s. Dutch Disease is a decline in manufacturing growth relative to services, and in the long term lower GDP growth.

These effects operate through two main channels. The first is the reallocation of resources for a given level of demand. Higher wages in the sector benefitting from the foreign currency bonanza attract labor and other resources from other sectors, causing their employment and output to decline. Because the decline in output cannot be offset through greater inputs in the case of non-tradable sectors – such as construction or services – the result is an increase in their price. The second channel is the increase in demand. The foreign

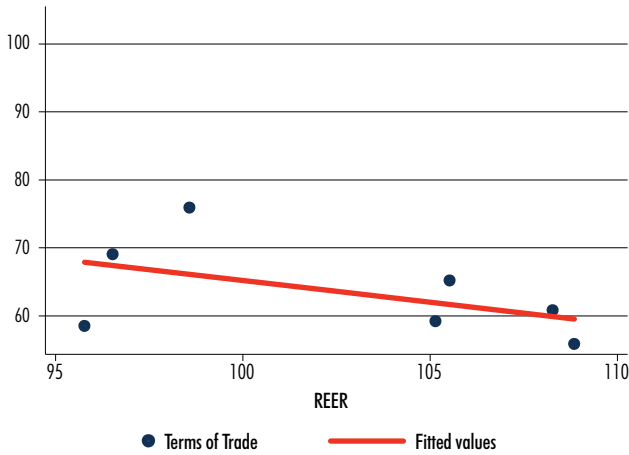
exchange bonanza boosts domestic demand across sectors, increasing both the imports of tradable goods – in particular manufactured goods – and the domestic prices of non-tradable goods.

The South Asian countries potentially suffering from Dutch Disease are Afghanistan, Bhutan, Maldives and Nepal. However, in their case the main driver of expensive prices for non-tradable goods and services and reduced competitiveness is not a positive terms-of-trade shock. Instead, each of them has benefitted from a massive source of foreign exchange inflows which is relatively independent from international trade. Afghanistan has received massive amounts of foreign currency because of the reconstruction and security effort financed by the international community. In Nepal, foreign exchange inflows come from the massive migration of young men to Gulf countries in recent years. In both cases, increases in the flow of foreign exchange have been followed by real exchange rate appreciations within one or two years (figure 37). Finally in both Bhutan and Maldives the foreign exchange bonanza takes the form of a natural resource boom, through exports of power from hydroelectric dams in one case and through high-end tourist resorts in the other.

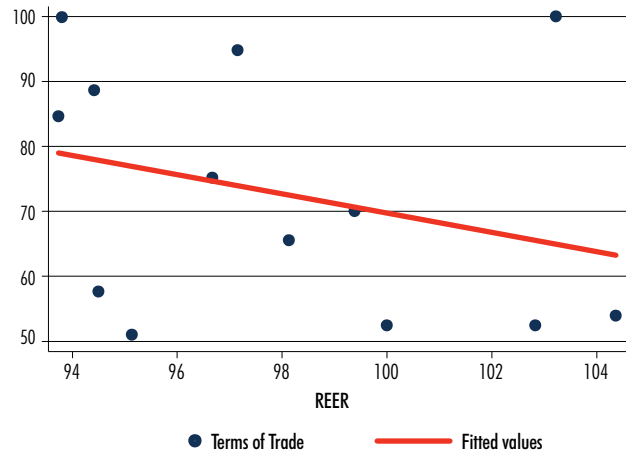
In line with the Dutch Disease interpretation, these four countries have experienced dramatic growth in their real wages, to an extent that is

Figure 36: Abundance of foreign exchange is associated with currency appreciation

a. Bangladesh (2006-2012)



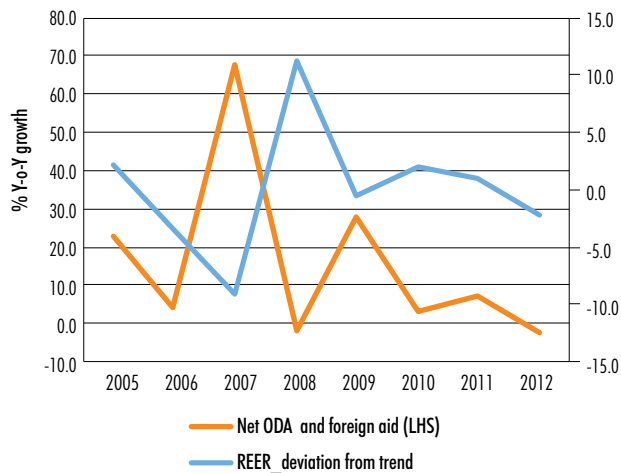
a. Pakistan (2000-2012)



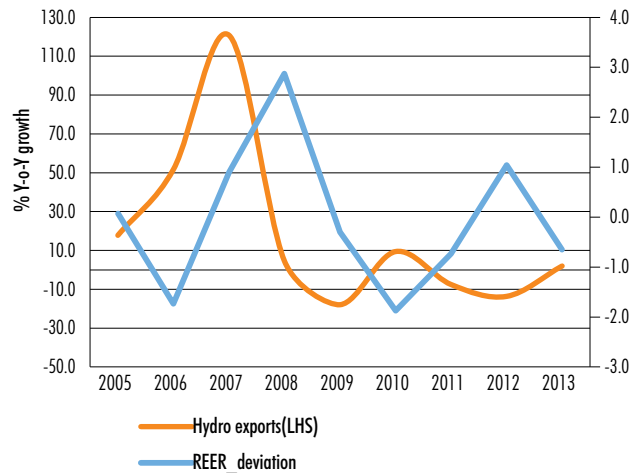
Source: World Bank.

Figure 37: Abundance of foreign exchange is associated with currency appreciation

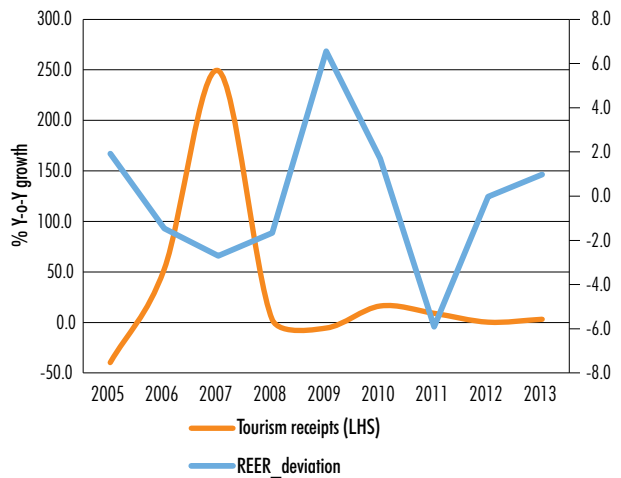
Afghanistan



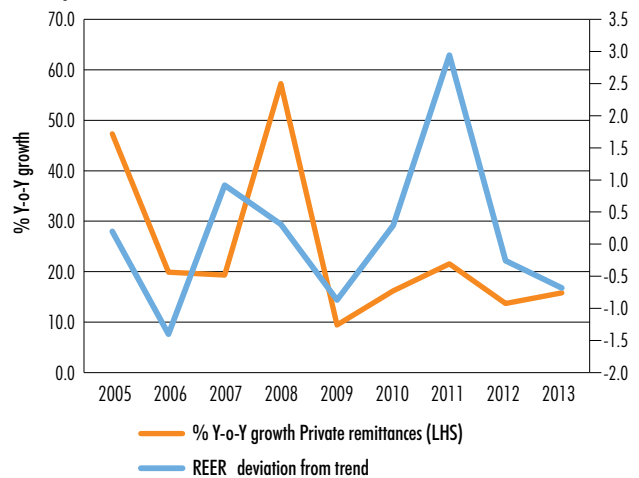
Bhutan



Maldives

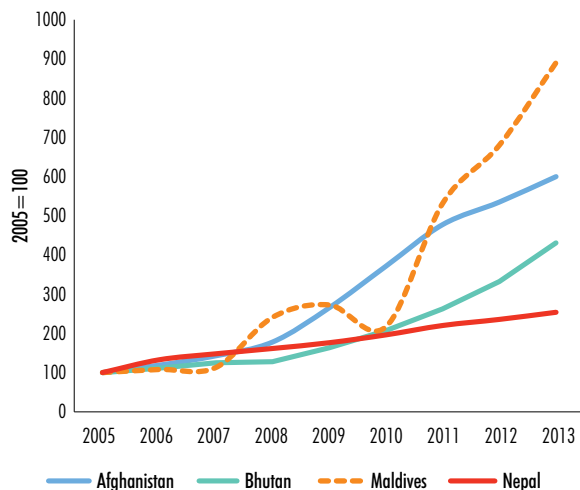


Nepal



Source: IMF IFS, WDI and own calculations.

Figure 38: Exchange rate appreciation translates into fast growth of real wages



Source: WDI. Real wages are measured as compensation of employees divided by consumer price index.

bound to undermine the competitiveness of their products in international markets (figure 38). Some of the increases in real wages happened through increased public sector spending, as in the cases of Bhutan and Maldives. Indeed, the inflow of foreign exchange transits in their case through the budget, and resisting the pressures to increase social spending, expand public sector employment and increase civil servants' wages have been difficult to resist.

The end of quantitative easing should not affect the trend

With the exception of Afghanistan, none of the other countries should expect a decline in the long-term inflow of foreign exchange in the coming years. But short-term exchange rate volatility cannot be ruled out, especially in India's case. Its exports, measured as a share of GDP, have increased steadily in recent years, in spite of several large fluctuations in the value of the rupee. That could be an indication of export resilience, perhaps supported by their sustained diversification across traded products and trading partners. But given that India is the most financially open of all South Asian countries, one concern is how its export performance could be affected by the effective ending of quantitative easing policies in the US.

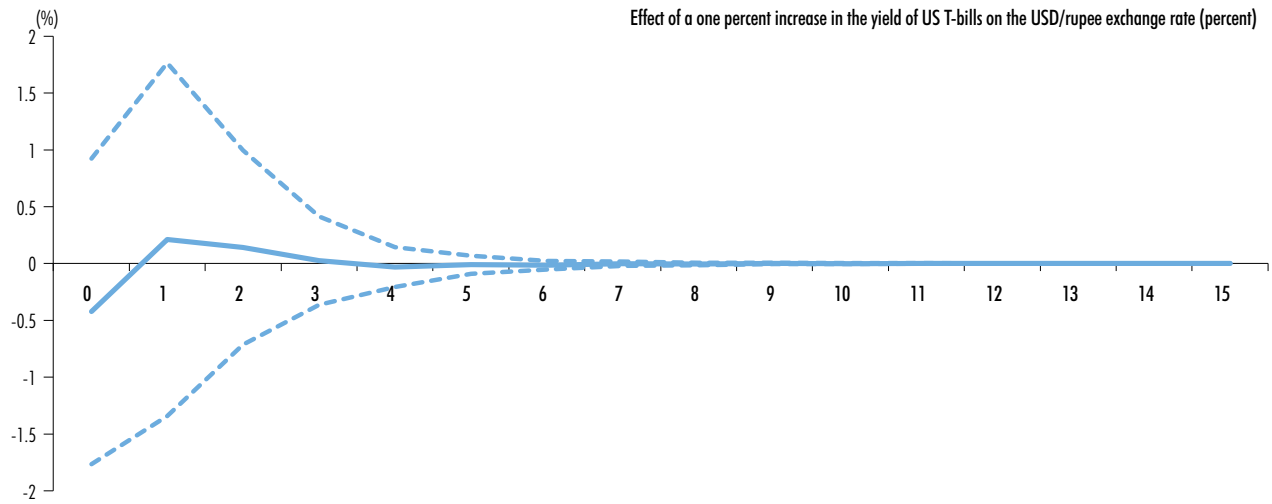
In 2013, when "tapering talk" started, the yield of 10-year US Treasury Bills increased by 100 basis points, leading to a substantial depreciation of the Indian rupee. The question is whether the shift from talk to action could trigger equally dramatic effects. The answer very much depends on whether markets have already internalized this change, or they will be a surprise effect once again. A widely held view is that emerging countries should expect another round of currency depreciation (Eichengreen and Gupta 2014, IMF 2014).

However, it is not clear that this is the scenario India should expect. An analysis of recent macroeconomic dynamics in India suggests that the effects of tapering were fully internalized by markets towards October or November 2013 (Ikeda and others 2014). Simulated "impulse responses" based on this analysis suggest that actual tapering will lead to some depreciation of the Indian rupee, but the predicted effect is not statistically significant.

In sum, South Asia's strong export performance does not seem to be a one-off effect based on a temporary gain in competitiveness prompted by macroeconomic developments. Across many countries, exports have become more diversified, a trend that not only increases the region's resilience against external shocks, but is also associated with quality upgrading and a higher value added of exports. Real exchange rates have the ability to make or break export performance. In some cases (in particular in Nepal and Afghanistan) export growth may be suffering from real exchange rate appreciation due to large and sustained FX inflows. This local variant of Dutch Disease makes domestic products more expensive and prevents the reallocation of resources towards tradable sectors. But except in these cases, the prospects for continued growth in exports are encouraging. And there is little risk that they will be damaged by further monetary tightening in the US, as the impact of tapering has been fully internalized by markets already.

With East Asian labor costs increasing and overall growth slowing down, South Asia has a unique opportunity to become an export powerhouse, especially in light manufacturing sectors. And the analyses above suggest that the region is well placed to seize this opportunity. But the chances of success will be much greater if policy makers focus on improving competitiveness. More efficient regulation, less red tape, improved infrastructure and better logistics are among the key ingredients for it to happen.

Figure 39: The end of quantitative easing in the US will not trigger a substantive depreciation of the Indian rupee



Source: Ikeda and others (2014)



South Asia country briefs

In alphabetical order

Afghanistan

Bangladesh

Bhutan

India

Maldives

Nepal

Pakistan

Sri Lanka

Afghanistan

Recent Economic Developments

Real GDP growth (non-opium) fell sharply to an estimated 3.7 percent in calendar year 2013 from 14.4 percent the year before, as uncertainty over the political and security transition led to a considerable slowdown in the non-agricultural sectors. Annual growth had averaged 9.4 percent through 2003-2012. Agricultural production was robust in 2013 but did not exceed the record levels of 2012. Several indicators point to a further slowdown of economic growth to about 1.5 percent in 2014.

The services sector, which accounts for about half of GDP, slowed to 5.3 percent from 16 percent growth in 2012, with a sharp slowdown in wholesale and retail trade and government services. Transport and communications, about half of the services sector output, also weakened but fared somewhat better from the continued repatriation of international forces and increased number of broadband subscribers. Roads and building construction returns suggest that that sector also slowed in 2013. Meanwhile, manufacturing growth declined to 2 percent from 7.3 percent in 2012, largely because of a slump in food and beverages.

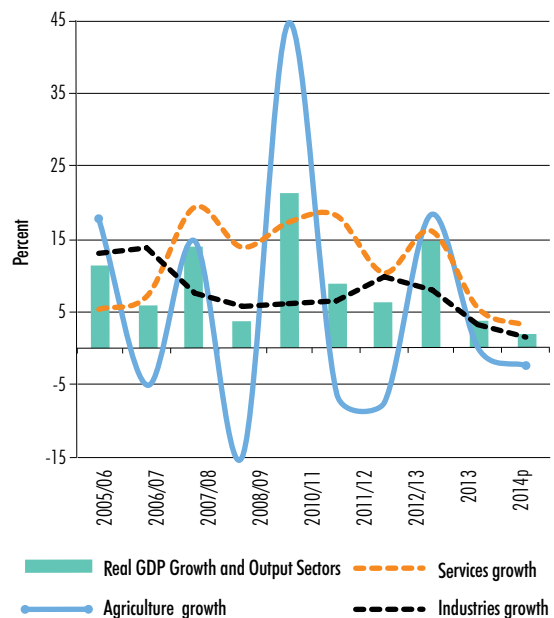
Political events of the last several months in Afghanistan have overshadowed economic developments. The protracted election process has compounded the uncertainty that had been building around the political and security transition. An agreement on a unity government, signed on September 21, provides Afghanistan with a way forward, although how such a government will function in practice remains to be seen. The new government will need to quickly establish itself as a cohesive and effective unit in order to address the considerable development challenges facing the country (see Outlook and Policy below).

Afghanistan is on course for a fiscal crisis, with declining revenues leading to an unfinanced fiscal gap in 2014. Domestic revenues have continued to weaken in 2014. The authorities are targeting revenues of Afs 105 billion (US\$1.82 billion), or 8.7 percent of GDP for fiscal 2014—some Afs 28.8 billion (US\$500 million) short of the target set out in the approved 2014 budget,

which would signify a further revenue decline of 9.7 percent of GDP in 2013, which was itself down from a peak of 11.6 percent in 2011. The economic slump is partly responsible for the slowdown, but weakening tax and customs compliance are also taking a toll.

Despite instituting austerity measures, the authorities have continued to run down cash balances and incur arrears on operations & maintenance and discretionary development spending; the unfinanced fiscal gap is estimated to be about US\$500 million this year. While part of this could be financed from cash balances, it is estimated that at least US\$300 million in additional financing will be needed to cover civilian salaries, pensions, and critical operating and development spending in 2014. If revenues do not reach the revised target of Afs 105 billion for the year, or projected civilian grants linked to the reform progress do not materialize in full, the financing gap and additional financing needed will be larger.

Real GDP Growth and Output Sectors



The new government faces the dual challenges of restoring confidence in its economic prospects and attending to a host of formidable medium-term development challenges. In addition to stalled growth and the fiscal crisis, the medium-term development challenges include aid dependence, job creation for 400,000 new labor-market entrants each year, high and persistent poverty, low levels of human development, and high levels of corruption. In addition, fragility and conflict are pervasive and undermine economic prospects as well as social cohesion and stability.

Outlook and Policy

Economic growth is projected to pick up modestly, contingent on reduced uncertainty and reforms to restore confidence. The growth projections remain highly fluid. With the economy stalled in 2014, the timing and strength of any growth uptick is hostage to the political and security challenges and progress (or lack thereof) in the pace of reforms.

The cohesion and effectiveness of the national unity government remains untested and parliamentary elections are scheduled for 2015. The political and security uncertainty is thus expected to persist through the first half of 2015 and serve as a drag on private investment and growth in the non-agricultural sectors. At the same time, generating significant growth from the agriculture sector in 2015 will require exceptional weather, given that agricultural production has already been strong during 2014.

The Afghan authorities will need to prioritize the reform process in order to restore private sector confidence so as to revive economic growth in 2015. Similarly, the government must direct public development expenditures towards essential infrastructure and service delivery in order to prop up economic activity through the period of uncertainty. Restoring fiscal stability without sharp cuts in development expenditures will be critical. Only with these assumptions realized will Afghanistan be able to achieve the projected 4 percent economic growth in 2015.

In the medium term, post-transition growth is projected to reach about 5 percent per year during 2016-18—just over half the average annual growth during 2003-12 that was fueled by the surge in international aid and security spending. The post-transition growth outlook is contingent upon a relatively stable political and security environment, with agriculture, services, and extractive industries likely to be among the significant sectors driving growth.

Afghanistan has the potential to build on its agricultural foundation that accounts for about one-quarter of GDP and is closely linked to other parts of the economy, such as food and beverages (which account for almost all of manufacturing), and parts of transport and retail. Agricultural success can be based on the country's historical position as an important exporter of fruits, nuts, vegetables, and other higher value-added products. This will require investments in

irrigation and extension services to improve capacity, as well as efforts to build and improve downstream agro-processing activities.

The extractive industries sector, while currently accounting for a very small share of GDP, has significant potential in light of Afghanistan's deposits of copper, iron ore, and hydrocarbons. Unlocking this potential will require progress on the legislative framework as well as securing financing for the necessary infrastructure.

The medium-term growth outlook is subject to serious risks which will need to be carefully managed. The fragile political and security environment has been a considerable constraint to private investment and growth. Continued violence, economic crime and systemic corruption also have often undermined progress in Afghanistan's governance and state-building agenda. Much will depend, therefore, on Afghanistan's success in achieving peace, stability and reconciliation. Without this, the growth prospects discussed above are unlikely to materialize.

To restore medium-term fiscal stability, the authorities need to act immediately to improve revenue performance and direct additional resources to cover the unfinanced gap. The authorities can still infuse these reforms into the 2015 budget and the revised medium-term macroeconomic framework. A centerpiece of the plan needs to be immediate reforms to improve revenue performance. This will require (i) reducing leakages and strengthening tax and customs enforcement; and (ii) expediting implementation of the new value-added tax with a 10 percent rate instead of a 5 percent rate. The natural resources sector also has the potential to contribute to revenues in the medium term, but the timeline for this has become more uncertain in light of weak progress in recent years. Projections (predicated on strong reforms) call for an increase in revenues from 8.7 percent of GDP in 2014 to 9.6 percent in 2015 and 12.8 percent by 2018 (or about one percentage point of GDP per year). While this is an ambitious target, it will still leave Afghanistan with an unfinanced deficit of about 2 percent of GDP during 2014-18. If additional resources are not identified to cover this unfinanced fiscal gap, Afghanistan will have trouble paying for civilian salaries and critical operating and development spending.

Budget expenditures are projected to rise to 30.5 percent of GDP in 2016 from the current 27.3 percent, as more security and development spending moves

on-budget from what was previously being undertaken directly by donors. Afghanistan has considerable public expenditure needs in security, service delivery, essential infrastructure, and operations and maintenance. Prioritizing these expenditure needs within the limited resource envelope will be critical to maintaining a pro-development stance. In light of mandatory security spending, a more aggressive expenditure consolidation path would directly squeeze essential civilian operating and development spending. The resulting financing needs of the budget are, therefore, likely to remain substantial for the foreseeable future. Donors have already committed to considerable assistance (US\$16 billion over 2012-2016) for Afghanistan under the Tokyo Mutual Accountability Framework of 2012, contingent on the government carrying out its commitments—though it appears additional resources and an acceleration of reforms will be needed in light of recent developments.

In order to address the country's medium-term challenges, the government will need to focus reforms on three main areas: (i) establishing fiscal stability; (ii) restoring investor confidence and creating private-sector jobs; and (iii) strengthening social cohesion, service delivery and land tenure. Above all, a high level commitment to tackle corruption and strengthen governance across the board will be critical to delivering on success in these priority reforms.

Bangladesh

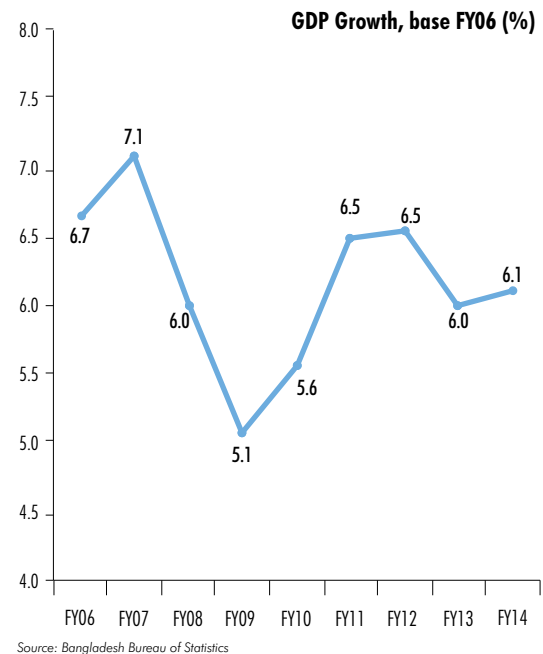
Recent Economic Developments

GDP growth appears to have recovered with the return of political stability to Bangladesh. The provisional estimate for GDP growth in FY14 was 6.1 percent, above the 6.0 percent reported for FY13 by the Bangladesh Bureau of Statistics (BBS). This confounds the consensus expectation of a dip below 6 percent, as the economy had appeared to stutter in the face of political turmoil and declines in private consumption, remittance receipts, and private investment in the first half of FY14.

While accelerated growth in the services and agriculture sectors did outweigh a dip in industrial growth, this would not have been sufficient to raise GDP growth in such a challenging year above that of the relatively normal FY13. It is possible that the BBS has overestimated public investment (Tk 986 billion, or about US\$12 billion, in FY14), which would partially explain the anomaly; the BBS uses budget data to estimate public investment, and these are quite at odds with public investment data reported in the national accounts. The proxies and methods used to estimate production and expenditures may fail to capture the impact of disruptions in an abnormal year.

The industrial sector remains the primary driver of GDP growth, notwithstanding the decline in industrial growth to 8.4 percent in FY14 from 8.4 percent in FY13. The slowdown was due mainly to a falloff in manufacturing, to 8.7 percent from 10.3 percent in FY13. The improvement in the services sector was the biggest surprise, with the BBS estimating growth at 5.8 percent in FY14 from 5.5 percent in FY13. Services were worst hit by the political turmoil, yet the BBS estimates show improvements in all nine of the sub-sectors presumably affected.

Overall macroeconomic stability was maintained, albeit with some erosion of competitiveness. Inflation remains high but stable. Overall consumer inflation increased to 7.4 percent in FY14 over 6.8 percent the year before, driven by an increase in food inflation. The rise was partly due to supply disruptions caused by the political unrest of late-2013. The gap between rural and



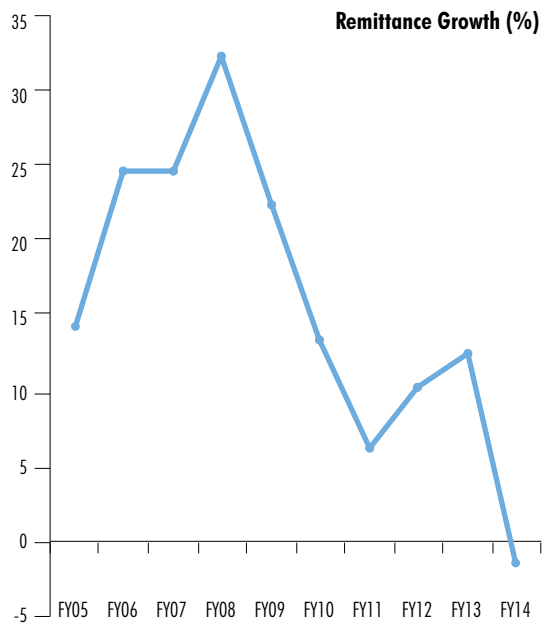
urban food inflation narrowed. Stable international oil prices and prudent monetary management helped to reduce non-food inflation to 5.5 percent in FY14 from FY13's 9.2 percent.

A rise in export growth helped to lower the trade deficit, and foreign exchange reserves continued to accumulate despite the 1.6 percent decline in remittance. The decline was sufficient, however, to narrow the current account surplus. The overall balance of payment surplus increased to about US\$5.5 billion in FY14 from US\$5.1 billion in FY13, creating upward pressure on the nominal exchange rate. Bangladesh Bank (BB) remained an active buyer of foreign exchange in order to forestall a significant nominal exchange rate appreciation, but the real effective exchange rate appreciated by 8.5 percent nonetheless. BB's interventions, meanwhile, drove up foreign exchange reserves to over US\$21 billion by mid-September, equivalent to over six months of imports.

Macroeconomic policies stayed their course, but the financial sector is not yet out of the woods. Monetary management was challenged by fast reserve accumulation, but BB managed to keep reserve and broad money growth within target by stepping up sterilization operations. BB's net domestic assets and reserve money targets were met. Private sector credit growth remained subdued, reflecting both the impact of lingering political uncertainty and hesitance on the part of bankers in the face of a recent rise in non-performing loans. With comfortable banking sector liquidity, deposit and

lending rates have declined. BB raised the banks' cash reserve ratio by 50 basis points to 6.5 percent in late June 2014.

The banking sector's credit and risk management status is unsatisfactory. Asset quality in the state-owned commercial banks deteriorated in FY14. Deposits continued to grow at a healthy rate, thereby ensuring adequate liquidity, although their share of total assets in the banking system and asset stocks have declined. High liquidity levels are also reflected in below-average loan-to-deposit ratios. BB has begun implementing new provisions relating to lending and banks' exposure to stock markets, which is calculated to prevent excessive risk-taking by the banks.



Source: Bangladesh Bank

Fiscal policy is plagued by shortfalls in revenue collection and implementation of the development budget. The overall fiscal deficit in FY14 was held in check despite underperformance in tax collections due to weak imports and slow economic activity. Public debt relative to GDP has continued to fall. The overall FY15 budget deficit target is less than 5 percent of GDP, notwithstanding somewhat ambitious revenue targets. The fuel subsidy bill has moderated, but there has been little visible improvement in implementation of the Annual Development Program. Nevertheless, the budget for FY15 is envisaged to increase by 34 percent over that of the revised plan for FY14.

Restructuring of the garment industry has made progress, although the overall pace of structural

reforms is slow. The fourth review of the IMF's extended credit facility arrangement was successfully completed, but the pace of structural reforms has generally lagged. Working conditions for factory workers have improved significantly, as have amendments to the labor and EPZ laws, and the government's capacity to assess factory safety and effect agreement on common standards in assessment of structural building safety. However, more needs to be done to speed up implementation of the new VAT law, liberalization of exchange regulations, infrastructure management, and financial supervision.

Bangladesh has continued to make remarkable progress in poverty reduction and shared prosperity. While there has been no empirical measurement of the extent of poverty reduction in recent years, simulations by the Planning Commission suggest poverty likely declined to less than 25 percent of the population in FY14, from 31.5 percent in FY10 (based on the national poverty line of US\$1.13 per person per day). Employment and wage growth have apparently boosted shared prosperity by increasing the income of the bottom 40 percent of the population, and Bangladesh has graduated from the Low Human Development (LHD) category to Medium Human Development (MHD) category, according to UNDP Human Development Report 2014. The challenge now is to consolidate the gains by accelerating economic growth in an inclusive and sustainable manner.

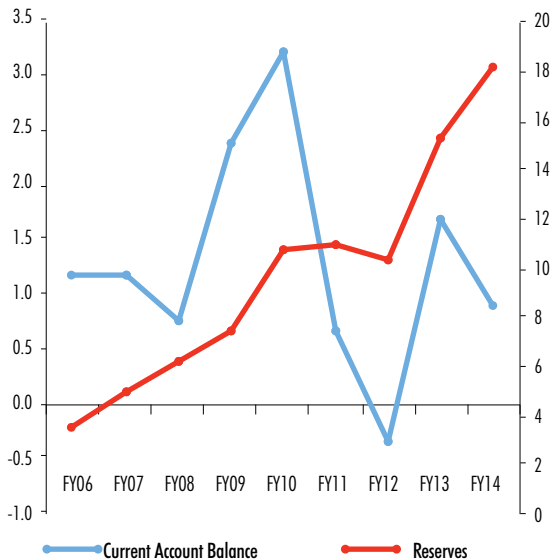
To achieve inclusive growth in the near term, Bangladesh will need to sustain GDP and remittance growth recovery, create jobs, contain inflation, and make progress in improving the quality of service delivery in health and education. Private investments need to increase significantly in order to sustain growth in the near and medium terms. At the same time, the quality of public investment needs to be substantially enhanced to alleviate infrastructure and energy constraints on private investments and expand service delivery.

Outlook and Policy

The overall growth outlook is favorable for FY15. Key indicators are the return of political stability since early January, signs of an uptick in remittance inflows from the near-2 percent decline in FY13, continued strength in exports (so long as compliance reforms are speedily implemented), and buoyant consumption demand over that of last year. Growth is

projected to rise marginally to 6.2 percent in FY15. Key factors for achieving this will be macroeconomic stability, better governance in the banking system, development of markets for long term finance, further trade liberalization, and stronger attention to efficient implementation of infrastructure investments with necessary institutional changes relating to regulation and policy formulation.

**Current Account Balance, base FY06
(% GDP) & Forex Reserves (US\$ billion)**



Source: Bangladesh Bureau of Statistics & Bangladesh Bank

Achieving the FY15 budget's very ambitious growth target of 7.3 percent will require the total investment-to-GDP ratio to rise by over 5 percentage points—to 33.8 percent (FY06 base) from 28.7 percent in FY14. This cannot happen without a major rise in the private investment rate. The other source of growth could be increased capacity utilization, but the potential is limited because Bangladeshi manufacturing firms report very high levels of capacity utilization, according to the IFC's Enterprise Survey 2013—averaging 84 percent compared to 73 percent for all 122 countries in the survey. Labor productivity increases in Bangladesh historically have mostly come from capital accumulation. Total factor productivity growth has remained rather small.

Underlying inflationary pressures, as reflected in non-food inflation, though still high, are expected to maintain a downward trend on continued policy restraint. The government's ability to contain inflation will depend on international price trends as well as domestic supply conditions and macroeconomic policies.

Policy priorities should be to:

- (i) Swiftly complete transformation of the garment industry.** Much more needs to be done in effective implementation of wage increases and the new labor legislation, recruiting more factory inspectors, and completing building inspections with swift remediation measures such as relocation of closed factories. Only about half of all factories been inspected and just 17 have been closed. Non-availability of land, gas, and electricity, and reluctance of workers to move to new locations are major impediments.
- (ii) Finish crucial and ongoing infrastructure projects.** These include the Dhaka-Chittagong and Dhaka-Mymensingh highways; double-tracking of the Dhaka-Chittagong railway; the Padma Bridge; the Dhaka metro rail; and two Bibiyani gas field-based power plants. The government should prioritize the most transformative projects for completion within specified timelines.
- (iii) Enact the Public Private Partnership law.** Enact the PPP law and equip the PPP office with experienced, knowledgeable staff to develop, negotiate, and supervise PPP projects. A proper legal framework providing internationally attractive guidelines and incentive policies is essential, and
- (iv) Award contracts to develop Special Economic Zones.** Finalize the awarding of contracts for the proposed economic zones to be developed under the Bangladesh Economic Zone Authority and provide related services such as power, gas, road-connectivity, and security.

Bhutan

Recent Economic Developments

The economy grew by an estimated 6 percent in FY13/14, though still constrained by lower-than-expected hydropower generation and administrative strictures on credit, foreign exchange, and imports limiting expansion of aggregate demand.

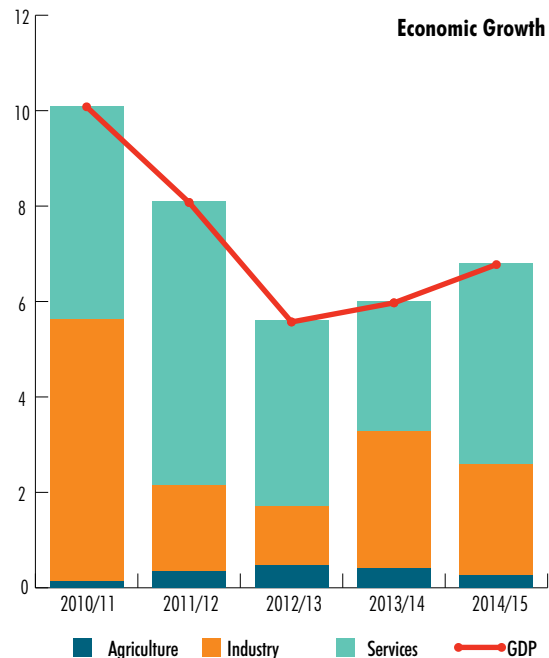
Hydropower generation (river-flow dependent) in the first half of 2014 was 2 percent (annualized) down on the same period of 2013 due to weaker rainfall.

As a result, export revenues from the sale of electricity declined. Electricity tend to fluctuate greatly as no new hydropower projects have become operational since 2006, but receipts are expected to improve over the coming months and years (see Outlook and Policy below). India receives almost 90 percent of Bhutanese electricity production. Continued power shortages in India will ensure strong demand for electricity from Bhutan. Exports of minerals and mineral-based products account for more than half of total exports, with hydropower exports comprising a further 45 percent, and manufactured products a tiny 5 percent.

Tourism expanded markedly with the introduction of a package of promotional measures that brought a doubling of arrivals in the usually dormant months of June and July. It raised the half-yearly number of convertible-currency tourists by 12 percent, y-o-y, netting the country US\$67.5 million in convertible currency, a 7 percent increase, y-o-y, over the same period in 2013.

Bhutan's external debt—93.2 percent of GDP of GDP by end-FY13/14—remains high, but risk is moderate, since two-thirds of the debt is linked to commercially profitable hydropower projects. Gross international reserves had improved to US\$997.9 million at end-June 2014, of which 17 percent was in rupees, needed for servicing debt and trade payments.

Consumer price inflation slowed to 8.1 percent in June 2014, y-o-y, from 11.3 percent at the end of 2013. The decline was driven mainly by an easing of India's inflation, but domestic factors are expected to drive the Bhutanese rate back up to 10 percent in FY14/15.



Private credit growth slowed markedly to an annualized average of 6-7 percent between early 2013 and June 2014, due to the strict tightening of credit and foreign exchange availability following a shortage of rupees. The credit growth is expected to rebound in FY14/15 in line with a relaxation of controls. Bhutan runs a large current account deficit (about 25 percent in June 2014) financed by donor loans.

The tight liquidity experienced by the banking system in 2012 has eased. Excess liquidity characterized the financial system from 2008-mid 2011 due to a large build-up of hydropower inflows and grants (and only partial sterilization of these funds by the Royal Monetary Authority).

Outlook and Policy

Bhutan's GDP growth is projected to rise to 7.3 percent in FY14/15, supported by construction of new hydropower projects, increased tourism receipts and easier credit conditions. This is based on the lifting of administrative restrictions and raising of the civil service wage bill in July this year. The estimates for FY14/15 set GDP growth at 6 percent, with an increase in hydropower generation and growth in services.

In spite of the uncertainty and volatility in the external sector, economic growth is projected to be 6.8% in FY 2014-15. This growth will be driven by expansion

in construction (including hydropower) and a rebound of aggregate demand, boosted by the increase in public wages and allowances concomitant with the lift of bans over housing/construction loans.

The deficit in FY14/15 is expected to ease to 2.7 percent of GDP from 4.0 percent in FY13/14, as more revenues kick in from projects and new taxation measures, despite the upward revision of public compensation.

Aggregate demand will regain momentum in the next 12 months. Consumption will rebound following the lift of administrative measures to curb imports and the raise in civil service salaries in July 2014, while investment will be sustained with continued inflows into the hydropower sector. Private consumption contributes around two-thirds of total consumption, while private investment, boosted by hydropower, is more than 75 percent of GDP. In addition, a liquidity injection in the financial institutions and establishment of cottage, small and medium industries as a part of the economic stimulus package is expected to reinvigorate growth especially in the manufacturing and service sectors (see previous issues of the World Bank Bhutan economic update).

The service industry is expected to pick up again during the second half of 2014, driven by strong tourism and relaxation of credit restrictions in the financial sector. The World Bank estimates that hotel, restaurants and trade/retail will grow at 15 percent in 2014.

The outlook is positive but macroeconomic pressures on domestic demand will need close management. GDP growth should reach 7.3 percent in FY15/16 due largely to ongoing construction of four hydropower projects, the commissioning of the Dagachhu project by mid-2014, Dungsam Cement coming on line, the possible lift of the bans on imports and housing credit, disbursements from India for the 11th Five-Year Plan (2013-2018) which will lead to higher public capital spending, the economic stimulus plan, increased public wages expected in the FY14/15 budget, and innovative tourism promotions. This activity could bring overheating and macro imbalances; it will be important to tighten monetary and fiscal policies.

The financial sector remains adequately capitalized, with a capital adequacy ratio 18.20 percent in March 2014, above the institutional requirement. Yet vulnerabilities arise from asset-liability mismatches, with a significant proportion of the deposit base being

(short-term, seasonal and volatile) corporate deposits, whereas bank credit is concentrated in loans with longer time horizons to finance investment and projects (as in construction, particularly funding of large infrastructure projects). Strengthening supervision will be critical in the short-to-medium term to manage these financial sector vulnerabilities.

India

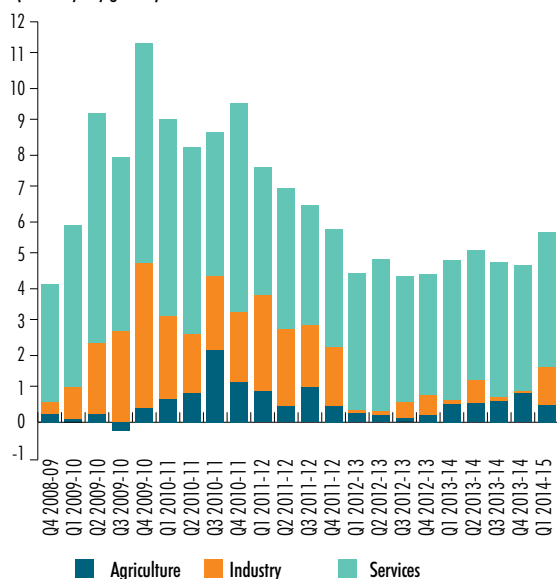
Recent Economic Developments

Growth rebounded strongly in Q1 FY2015, spurred by substantial improvement in industrial activity and aided by a recovery in investment and exports. The acceleration in industrial activity to 4.2 percent (y-o-y) was the fastest since Q4 FY2012.

The services sector remains the primary growth engine of the Indian economy, accounting for more than half of GDP. Services grew at 6.5 percent SAAR in Q1 FY2015, consistent with the trend average of 6.6 percent SAAR since Q2 FY2012, though well below the double-digit growth rates seen between 2009 and 2011.

Activities related to construction, electricity, gas and water supply grew robustly and demand for capital and basic goods increased. Investment accelerated sharply to 7 percent y-o-y in Q1 FY2014 from an average growth of 0.3 percent y-o-y since Q1 FY2013. Agricultural activity slowed in Q1 FY2014 as the untimely rains in March adversely affected the winter crop.

Pickup in industrial activity accelerated the pace of growth
(Percent y-o-y growth)



Source: Central Statistics Office and World Bank Staff estimates

Capital flows are back, signaling growing investor confidence. Portfolio investments by foreign institutional investors and foreign direct investment increased, with the reserve coverage rising to almost seven months of imports. The exchange rate has remained stable since last year's depreciation, which stimulated exports and slowed imports. This, combined with import restrictions on gold, helped narrow the current account deficit to 1.6 percent of GDP in Q1 FY2015, near pre-global crisis levels. Inflation has moderated from double digits with an easing of food and fuel price growth.

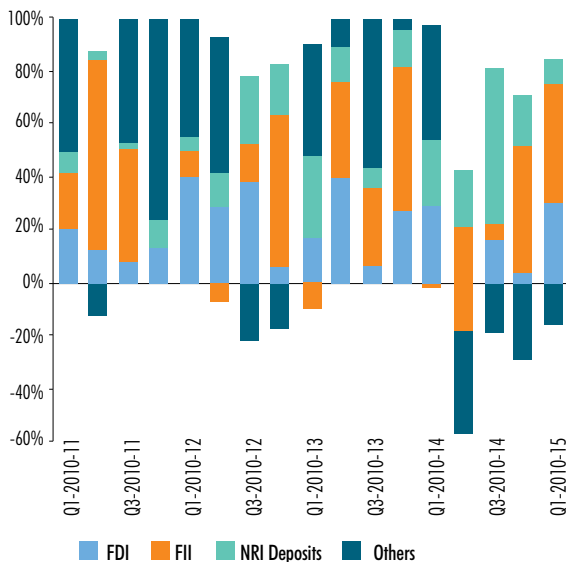
Credit growth decelerated to 10.5 percent y-o-y in August, continuing a decline since March, 2014. The Reserve Bank of India kept the repo rate unchanged at 8 percent while lowering the statutory liquidity ratio from 23 percent to 22 percent, in line with its established policy of providing sufficient liquidity for economic recovery while remaining vigilant against inflation.

Financial sector stresses have plateaued, but the sector's overall health will need to be closely watched. While gross non-performing assets remain high, overall stressed assets are showing signs of containment with the banking sector focused on ensuring that further slippages into bad loans are arrested in a timely manner. However, profitability continues to be strained as balance sheets of banks are still weighed down by impaired loans which could constrain their ability to raise capital in the medium term. The corporate sector is showing signs of revival, supported by positive business sentiment, while the Indian stock market has outperformed developed and peer emerging markets over the last six months. On the regulatory front, the Reserve Bank's new guidelines boosted recovery mechanisms (such as sales to asset reconstruction companies), and with regard to infrastructure—the bulk contributor to NPAs—the measures brought a relaxation of norms to encourage long-term financing.

The fiscal deficit of the central government outperformed the target. The FY2014 fiscal deficit came in at 4.6 percent of GDP, 0.2 percent of GDP better than target. This was achieved through a combination of expenditure compression—primarily in social services and infrastructure—and larger non-tax revenues, including one-time telecom spectrum auction receipts and dividends from Coal India. While revenues and grants reached 9.3 percent of GDP, the highest level in two years, they still lagged behind budget estimates. This trend has continued into the current fiscal term, as

weak tax revenue collection has resulted in the central government incurring 62 percent of the annual fiscal deficit in the first four months of the year, compared with an average of 57 percent for the same period in the previous three years. The combined fiscal deficit of all states increased to 2.3 percent of GDP during FY2013, compared to the budget estimate of 2.1 percent. However, even with the increase, the states remain below the deficit targets recommended by the 13th Finance Com-

Current account deficit financed comfortably by FDI and GII inflows
(composition of the capital to finance the current account deficit, percent)



mission and consolidation appears still to be on track.

Subsidy spending exceeded the budgeted amount in FY2014, but the FY2015 subsidy burden is likely to ease as diesel under-recoveries hit historic lows. In FY2014, subsidy expenditures came in at 2.3 percent of GDP, exceeding the budgeted target by 0.3 percentage points—largely because oil subsidies exceeded the budgeted amount, despite the authorities rolling over 0.3 percent of GDP worth of subsidies from FY2014 to the next fiscal year. Although this move left little space for subsidy spending in FY2015, a decline in global oil prices and gradual increases in the domestic prices of diesel have driven diesel under-recoveries to an all-time low of Rs 0.08 per liter in September.

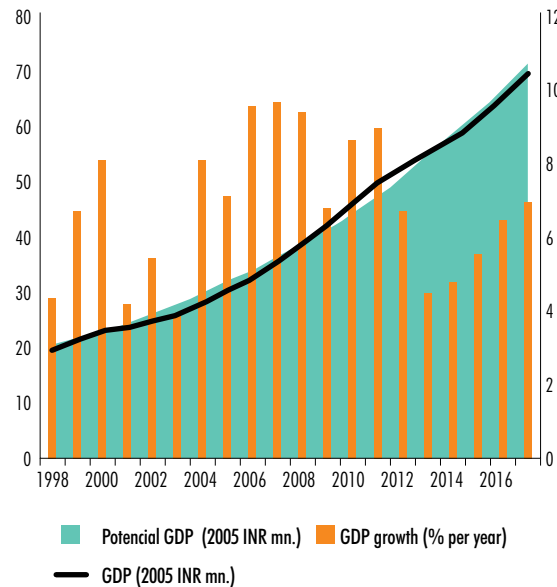
The pace of reforms has gained momentum. Eschewing a big-bang approach to reforms, the authorities focused on efficient and effective implementation, including actions to expedite decision making and clearance procedures for large projects. New reform steps include actions to simplify land acquisition, reform labor laws,

facilitate regulatory compliance, and improve financial inclusion. The authorities also raised FDI limits in key sectors and took measures to deepen financial markets. In addition, a new Expenditure Management Commission was established to rationalize public spending (including subsidies), while the long-standing Planning Commission will be disbanded in favor of an economic advisory body.

Defense and railways are set to become more open to FDI. Following the proposals made in the Union Budget 2014-15, the Cabinet raised the FDI limit in defense manufacturing to 49 percent and fully opened up the railway infrastructure segment—including high-speed trains, signaling systems, electrification, manufacturing and maintenance of rolling stock—to foreign investment.

Financial regulations have been strengthened to increase transparency and deepen financial markets. The Parliament approved the Securities Law (Amendment) Bill, 2014 aimed at empowering the Securities and Exchange Board of India (SEBI), the financial market regulator, by expanding its jurisdiction over

GDP is likely to remain below potential even with the expected acceleration in growth



Collective Investment Schemes; allowing it to call for documents, attach assets and detains entities under probe; and establishing special courts to expedite cases. A proposed new holding structure for public sector banks could improve their performance; in May, the Report on Governance of Boards of Banks in India made key proposals to level the playing field between

public and private sector banks, empower bank boards, and separate ownership and management functions.

As many as 75 million poor households could gain access to bank accounts. Over 60 percent of India's population is unbanked and a staggering 90 percent of small businesses have no linkages with formal financial institutions. The recently launched Pradhan Mantri Jan Dhan Yojana (PMJDY), or people's wealth program, seeks to address these challenges by opening bank accounts for 75m poor rural and urban families by January 2015, in public or private banks. All such accounts will be linked to a domestic debit card network, RuPay. The program is expected also to offer accident insurance cover of up to Rs 0.1 million (US\$1650) and a Rs 5,000 (US\$83) overdraft facility once the account has been active for six months and has been linked to Aadhaar identity number.

Outlook and Policy

Growth is expected to improve to 5.6 percent in FY2015. India's long-term growth potential remains high due to favorable demographics, relatively high savings, and policies and efforts to improve skills and education, facilitate domestic market integration, and incentivize manufacturing activities. In the medium term, with the economy still below potential and reforms on a gradualist path, growth is expected to accelerate from 5.6 percent in FY2015 to 6.4 percent and 7.0 percent in FY2016 and FY2017. Inflation is expected to decline, with monetary policy switching to inflation targeting while the current account deficit is expected to widen somewhat as import demand and capital inflows rise. Fiscal consolidation is expected to continue with stronger revenue mobilization, while the oil subsidy burden could decline to 0.6 percent of GDP if benign global crude prices persist.

Risks to the outlook could be mitigated, to a large extent, by continued progress on the reform agenda. Externally, the baseline scenario is predicated on an exports boost from improving growth and job prospects in the United States and largely stable /declining crude prices. External shocks, including financial market disruptions arising out of changes in monetary policy in high income countries (particularly in the US), slower global growth, higher oil prices, and adverse investor sentiment arising out of geo-political tensions in the Middle East and Eastern Europe could have adverse consequences for the baseline trajectory. Domestically,

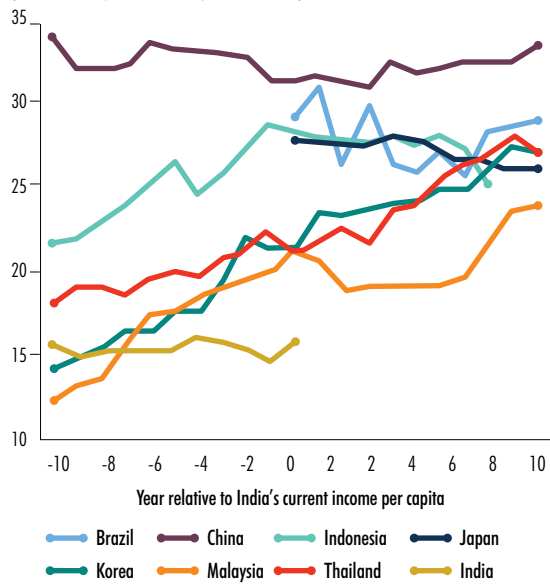
risks include challenges to energy supply and fiscal pressures from weak revenue collection in the short term and the impact of the 7th Pay Commission's recommendations on public sector remuneration in the medium term. On the other hand, further progress on the reform agenda—particularly the implementation of the Goods and Services Tax (GST; see below) which could transform India into a common market and dramatically boost competitiveness—could help offset both domestic and external risks to the outlook.

Supply chain delays and uncertainty are a major yet underappreciated constraint to manufacturing growth and competitiveness in India. Regulatory impediments to the movement of goods across state borders raise truck transit times by as much as one quarter, and put Indian manufacturing firms at a significant disadvantage with international competitors. State border check-points, tasked primarily with carrying out compliance procedures for the diverse sales and entry tax requirements of different states, combine with other delays to keep trucks from moving during 60 percent of the entire transit time. Long transit times and high variability or unpredictability in shipments add to total logistics costs in the form of higher-than-optimal buffer stocks and lost sales, pushing logistics costs in India to two-three times international benchmarks.

Implementation of the GST is a crucial reform for improving competitiveness of India's manufacturing sector. The new tax system will replace all indirect taxes levied on goods and services by the central and state governments. Its transformational impact could be enhanced by a systematic dismantling of inter-state check-posts. The reform offers a unique opportunity to rationalize and re-engineer logistics networks in India, given the inherent inefficiencies with taxes based on the crossing of administrative boundaries. GST will free up decisions on warehousing and distribution from tax considerations so that operational and logistics efficiency determines the location and movement of goods. Freight and logistics networks will realign according to the location of production and consumption activities, creating the hub-and-spoke models that are needed to improve freight and logistics performance. Simply halving the delays due to road blocks, tolls and other stoppages could cut freight times by some 20-30 percent and logistics costs by an even higher 30-40 percent. This would be tantamount to a gain in competitiveness of some 3-4 percent of net sales for key manufacturing sectors, helping India return to a path of high growth and enabling large-scale job creation.

India's manufacturing share is low by international benchmarks

(manufacturing value added, percent of GDP)



Maldives

Recent Economic Developments

Real GDP grew by 3.7 percent in 2013, driven by tourism and related sectors. Though a lackluster performance, it was something of a rebound from the precipitous dip to 1.3 percent in 2012, from an average of 6.5 percent over the preceding five years.

Tourism, the mainstay of the Maldives economy, has lost momentum, growing at 9.7 percent y-o-y in Q1 2014—almost 5 percentage points slower than in Q1 2013. This gives cause for concern as tourism, with linkages across sectors such as transport, communications, and construction, accounted for an estimated 60 percent of the economy in 2013. The tourist composition has undergone a structural shift from mainly European to Chinese and Middle Eastern tourists. The average length of stay and spending has fallen steadily since 2008.

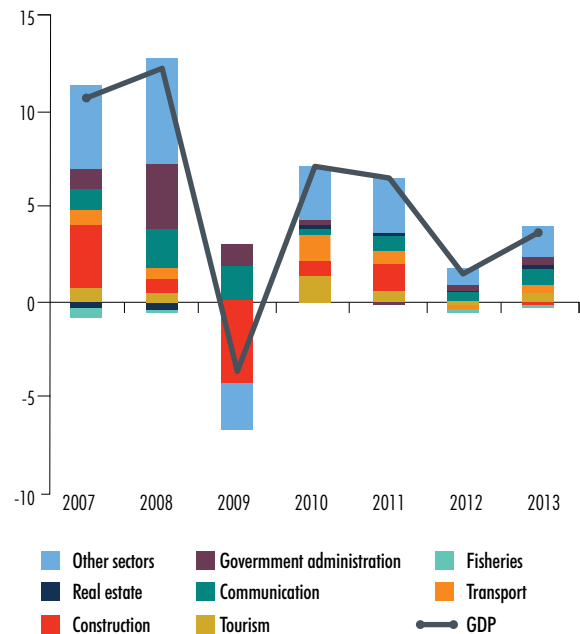
Growth has been less inclusive, since the agriculture and fisheries sector, which provide the majority of employment in the outer atolls, are only weakly linked to the tourism sector. These sub-sectors employ the largest proportion of Maldivians in the outer atolls, but contributed only 3.2 percent of GDP in 2013.

In the services sector, communications (10.3 percent of 2013 GDP) grew by 7.6 percent; transport (9.3 percent of GDP) grew by 5.1 percent. Manufacturing declined by 5.3 percent and construction by 2.1 percent, resulting in a 1.2 percent contraction in the secondary sector.

Inflation moderated to 4 percent of GDP in 2013, from 10.9 percent in 2012, and continued to fall in the first quarter of 2014, driven by the decrease in the government controlled price of fish and vegetables.

The fiscal deficit was around 10 percent of GDP in 2013, and the trend continued in Q1 2014 with expenditure outgrowing revenue by a wide margin. Although Maldives has the highest revenue-to-GDP ratio in South Asia, it is spending beyond its means, leading to persistent fiscal imbalances. The government has resorted to extraordinary means to finance the

GDP Growth Breakdown (% & share of total)



deficit, such as building up arrears, monetization, and ad hoc borrowings from the banking and private sectors at high interest rates.

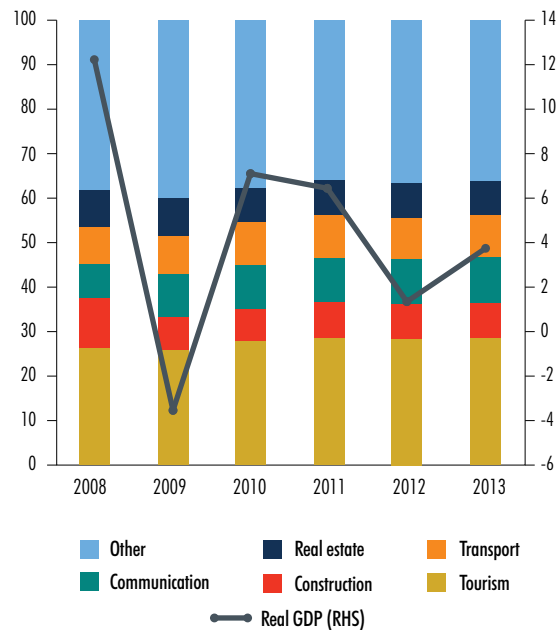
The current account has been persistently in deficit around 20 percent of GDP (despite the authorities having lowered it to a still-high 10 percent of GDP). Although the goods trade deficit is roughly offset by tourism revenue, net income outflows (such as dividends and interest payments on external debt) and remittance outflows lead to an overall structural current account deficit.

The Maldives is considered to be at high risk of external debt distress with the total public and publically-guaranteed debt level reaching 78 percent of GDP at end-2013. A large share of this is in Treasury bills yielding 7 percent.

While Maldives has reduced poverty over the past two decades, poverty and inequality are on the rise again in Male, the capital island city. With improved living conditions other atolls have been more successful in reducing poverty and vulnerability.

Maldives has made great progress in primary and lower-secondary education access and gender parity. Improving the quality of education remains a major challenge, especially in the context of providing technical, management and soft skills. The lack of these skills has contributed to high youth unemployment.

Tourism and Related Sectors (% of total and %)



The overall business environment ranks highly against other South Asian countries, but performance is uneven with low ranks, particularly in registering property, trade logistics, and access to electricity.

The Maldives remains vulnerable to environmental threats such as climate change and solid waste management.

Outlook and Policy

GDP growth is projected to rise to 4.5 percent in 2014 with likely improved performance by construction and the transport industry compensating for the slowdown of tourism. Inflation is likely to remain moderate due to stable international prices.

The immediate macroeconomic challenges for Maldives are the fiscal and external imbalances driven by high and rising public spending that lead to high debt, limited fiscal space and depleted reserves, and an undiversified economy, primarily dependent on tourism and fisheries. The path towards fiscal and debt sustainability will require short-term measures to address the current cash crunch, as well as long-term structural measures that are important but will entail political and social costs. An array of measures could be combined in a policy package accompanied with a communication strategy to sensitize the public on the need to adopt and implement these reforms.

The current account is at risk of further deterioration owing to the large remittance outflows. This is indirectly related to the public spending structure of the government that focuses largely on wages, benefits, and transfers that raise reservation wages, and fails to invest in quality education—policies that both lead to increased reliance on expatriates.

Inflationary pressures are expected to remain subdued in 2014 because of high dependence on imports (58 percent of the CPI basket) in a relatively stable international price environment. While the deficit on goods is projected to be sufficiently compensated by the service account surplus, particularly tourism receipts, the current transfers balance is projected to be in deficit due to the large outflow of remittance. An improvement of the trade balance seems unlikely following the import expansion by 15.6 percent, y-o-y, between January and July and a dramatic contraction of exports by 13 percent.

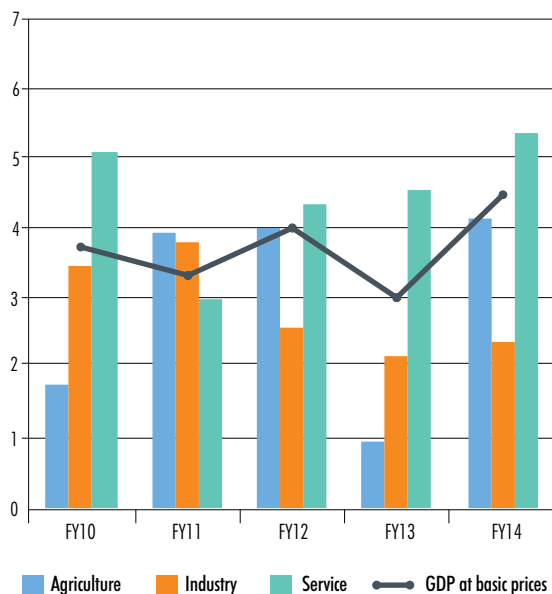
With the rise of private credit growth, increased demand looks likely to further pressure the trade balance through an increase in imports. Exports on the other hand, dominated by fish exports and re-export of jet fuel, are highly seasonal, and with the 13 percent contraction, y-o-y, in both domestic and re-exports between January and July 2014, the external sector does not display an optimistic outlook.

Nepal

Recent Economic Developments

GDP growth increased to 5.2 percent in FY14, driven mostly by services and agriculture. This unexpected rebound—from 3.5 percent in FY13—reflected both a base effect after the disappointing FY13 performance, and the impact of positive growth in agriculture and services. The two sectors posted 4.7 percent and 6.1 percent growth respectively, jointly accounting for 92 percent of total GDP growth—their strongest performances in six years. But this growth spurt is unlikely to last, because the two stimulatory sectors are exogenously dependent; while remittance will likely continue to grow in the coming fiscal year, overall growth will likely be depressed by poor agricultural outcomes.

GDP Growth and Sector Drivers



Source: CBS

GDP Growth and Sector Drivers

Industrial growth, meanwhile, sank to an anemic 2.7 percent, reflecting the sector's decline to 8 percent of growth in FY14, from 11.5 percent the year before; cutting industry's share of total GDP to 14.8 percent, from 15.2 percent. Symbolic lines have been crossed in the past two years: the services sector now accounts

for more than 50 percent of total value added, while industry has fallen below 15 percent.

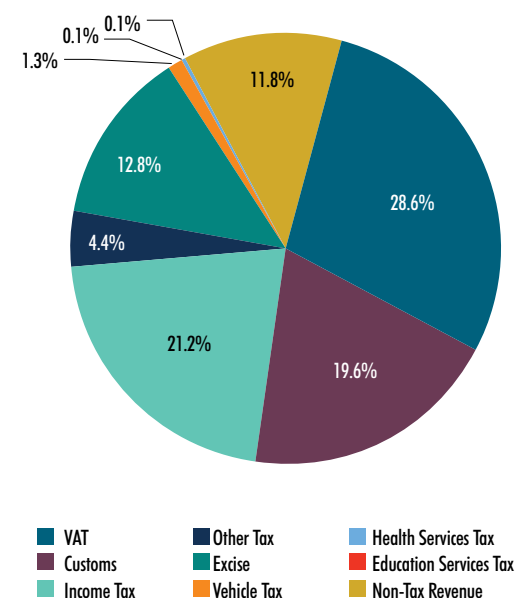
For the second consecutive year the government has run a fiscal surplus—the only South Asian country to do so in FY14. This has allowed the government to draw down its debt, which looks a healthy fiscal position. But it also reflects enduring bottlenecks in budget and project management; the government continues to underutilize resources for capital investment and may need to reign in pressures to increase spending through recurrent outlays; recurrent outlays did indeed grow significantly in FY14. While this by no means threatens macroeconomic stability in the short run, government must beware of raising inflationary expectations and eventually crowding out space for investment.

The fiscal position is generally sound, thanks to impressively high and stable revenue growth and broadly prudent management of expenditures. Total public debt has fallen to historically low levels. External trade imbalances are more than compensated for by private inflows. As a result, reserves are accumulating steadily. Low interest rates afforded by relatively loose monetary policy have not translated into major new inflationary pressures and financial sector consolidation has progressed.

Nevertheless, inflation remains high, at 9.1 percent in FY14, and excess liquidity is becoming increasingly structural. Price growth in Nepal is determined largely by price movements in India, but its effective management has been complicated by the persistence of substantial excess liquidity in the financial system. Moreover, the significant inflows of foreign currency into Nepal have not been channeled to productive investments in equal proportion (despite low interest rates) and monetary policy has been reactive. The Nepal Rastra Bank has adopted a more proactive stance for the future, which is certainly required to tame inflationary pressures and prevent asset bubbles in the stock and real estate markets.

Growth in revenue collection has been impressive, largely due to international tax collections, which have increased from 6.7 percent of GDP in FY12 to 8.05 percent in FY14. Import VAT accounts for 66 percent of the total, reflecting the steady growth in imports. Much of the credit must go to the government's aggressive tax administration reform programs initiated in 2012—a three-year Reform Action Plan and five-year Strategic Plan, outlining a broad tax reforms and laying out clear goals for the Internal

Revenue composition FY14



Source: MoF

Revenue Department. One outcome of this was the registration of 84,000 additional individual taxpayers in FY13.

Economic activity continues to be driven by consumption on the expenditure side, at the expense of investment. In FY14, final consumption amounted to 91.1 percent of GDP (with domestic consumption expenditure at 63 percent), while grossed fixed capital formation stood at only 23.1 percent. Government consumption recorded a sharp increase of 18 percent—compared to negative 6.9 in FY13—while private consumption grew by 3.4 percent (78 percent of GDP). Although public investment increased in volume, by 17.9 percent in FY14, government gross fixed capital formation remained low as a share of output, increasing to 4.7 percent in FY14 from 4.2 in FY12.

The trade deficit has continued to grow, reflecting Nepal's depressed competitiveness. Though large and growing, the trade deficit is more than matched by remittance inflows. In FY14, Nepal recorded a balance of payments surplus equivalent to 6.6 percent of GDP, allowing the country to build its external reserves to some US\$6.9 billion. This is sufficient to cover the import of goods and services for some 10 months. In other words, there is little risk that Nepal will run out of foreign currency in the short or the medium term. What is more worrisome for Nepal is that imports do not appear to support the domestic production process and that Nepali firms seem unable to capture a significant share of expanded domestic consumption.

The challenge, therefore, is to restore Nepal's external competitiveness. This can be done through a mix of across-the-board policies to improve the business environment as well as selected policies to encourage domestic manufacturing and export orientation (see Outlook and Policy).

Outlook and Policy

Economic growth in FY15 is expected to be in the 4.5-5.0 percent range, with the outcome depending ultimately on remittance growth and political developments. The main difference in future growth compared to last year is likely to come from the agricultural sector—due to the late monsoon, lower-than-average overall rainfall and the impact of floods and landslides—with weak cereal production undermining overall GDP growth. If all sectors perform as well in FY15 as they did in FY14, but with agricultural output growth down by 1 percentage point, overall GDP growth would reach 4.8 percent.

The main challenges facing the government include:

In the short term: (i) streamlining budget execution, particularly for infrastructure and agricultural modernization; (ii) containing growth in recurrent spending; (iii) deepening financial sector consolidation and managing excess liquidity;

In the medium term: (i) improving the business environment for domestic and foreign investors, and; (ii) reviving export-oriented activities.

Upside and downside scenarios essentially hinge on two factors:

(i) Whether political stability endures and helps investment to pick up. Though overall stability has improved greatly after the successful Constituent Assembly elections, the constitutional writing process is underway with much uncertainty, deterring Nepali investors from taking advantage of the cheap credit available. Such unpredictability is a hindrance also to large-scale investment in heavy infrastructure. Government needs to build a track record of business-friendly policy, through actions such as the power trade agreement with India, and breakthrough on the Upper Karnali project development agreement, but only if such progress is followed through and implemented.

(ii) The evolution of remittance growth. Given the phenomenal growth of remittances in past years and the fact that over 4 million Nepali are already working overseas it is difficult to imagine remittance continuing to increase significantly year after year. Nevertheless, the number of would-be migrants is increasing: government data indicates some 530,000 Nepali obtained permission to work abroad in FY14, compared to 454,000 in FY13, a significant increase.

In any case it appears unlikely that the government's target of 6 percent growth will be reached. With the agricultural sector expected to slow to 3.7 percent in FY15 (based on an expected sector output decline of 20 percent) and industrial sector growth likely to remain at 2.7 percent, the services sector would need to expand at 8.4 percent, a feat that has not been achieved in the past decade (the past eight years have averaged 5.5 percent). Likewise, if services sector growth maintained the good performance of FY14 (6.2 percent), the industrial sector would have to expand by 10.5 percent, which is even more unlikely (the average of the past 8 years is 2.9 percent) even if public capital spending increases substantially.

The government has articulated a clear economic policy vision, but consistent implementation will be key. The broad vision outlined in the Budget speech needs to be distilled into concrete, implementable, and time-bound plans. This implies significant technical background work as well as resolute efforts at prioritization. Also, the decision making process remains slow and haphazard and must be streamlined so that key policies can be implemented with speed and certainty. Reforms on paper are good starting point, but if the government cannot implement them, it would only be *déjà vu* of wasted time and broken promises.

Pakistan

Recent Economic Developments

Pakistan's economy was gathering pace in FY2013/14 until mid-August when a succession of political blows knocked steam out of the recovery. The re-emergence of GDP growth—4.1 percent, the highest in seven years—was a key feature of the year. Dynamic services and manufacturing sectors supported by better energy availability and improved investor expectations were the primary drivers.

The promising progress stemmed from the government's solid economic reform program. This in turn was reinforced by an IMF Extended Fund Facility (EFF) and two World Bank Development Policy Credits with a focus on restructuring the energy sector, fostering private and financial sector developments, and improving social protection and revenue mobilization.

The risk of a balance of payment crisis was minimized with a significant strengthening of the reserve position. This stemmed mainly from strong remittance and significant foreign capital inflows, which also brought stability in the foreign exchange market. Strong fiscal consolidation was achieved; the fiscal deficit was contained at around 5.5 percent of GDP through improved tax collection, high non-tax revenues, and restricted (current and development) expenditures. Price stabilization followed, with average inflation remaining in single digits.

Sectorally, industrial growth was based on a sharp turnaround in construction, electricity generation, and gas distribution, and a better performance of large-scale manufacturing (about 4 percent growth). Agricultural growth, however, was slower than in the previous year. Services contributed about 60 percent of growth through relatively better performance in wholesale and retail trade, as well as transport, storage, and communication (which together account for half of services' value added).

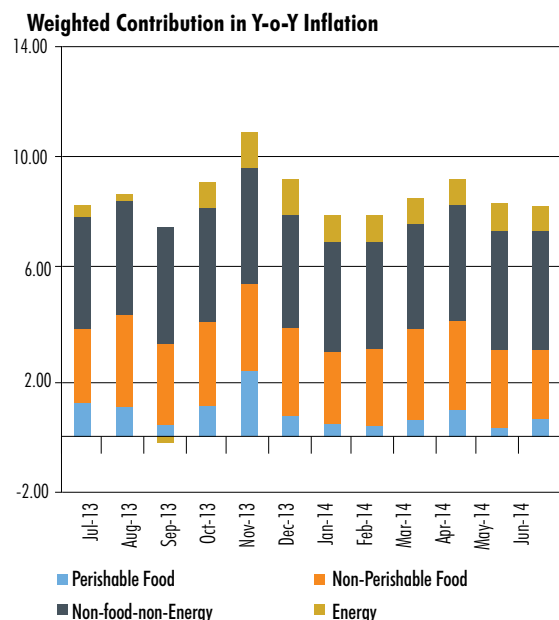
Increased remittance, capital, and financial inflows supported a buildup of reserves. Remittance touched US\$15.8 billion. The capital and financial account registered a sizeable surplus of US\$7.07 billion in

FY2013/14, compared to just US\$0.8 billion in FY2012/13. Official reserves coverage had increased by end-June to about two month of next year's projected imports of goods and services. Foreign inflows led to an appreciation of the real effective exchange rate.

Export competitiveness suffered from a nominal appreciation of the rupee, registering anemic growth of 1.4 percent, while imports grew by 3.9 percent. Year-on-year export growth during the second quarter decelerated sharply to -0.17 percent compared to 3.1 percent in the first half of FY2013/14. Exports remained concentrated in textiles, which seem likely to benefit from GSP-plus status in the European Union, which is Pakistan's largest export market with 25 percent of the total share. Non-textile exports, particularly other manufacturing group goods such as machinery, transport equipment, jewelry, handicrafts, and cement products, experienced a sharp decline due to power shortages and a drop-off in international prices.

The previously loose fiscal stance underwent a significant correction. The government reduced the fiscal deficit to 5.5 percent of GDP in FY2013/14 from 8.3 percent in FY2012/13. Tax revenues increased by almost 1 percent of GDP and expenditures were compressed by 1.3 percent of GDP.

Improved business confidence brought a strong recovery in credit to the private sector, after five lackluster years. Lower demand for commercial bank credit by the government, due to a lower fiscal deficit,



provided necessary space to the private sector to borrow from the banking system.

Price stability—with CPI inflation at a single digit—was preserved. Better supply conditions, reduced external vulnerability and fiscal consolidation contributed to the softening of underlying inflationary pressures.

The structural reform agenda made promising progress. The government reduced power subsidies by adjusting power tariffs toward cost recovery levels. In order to overcome the inter-corporate circular debt issue, the stock and flow of payables at all levels of the energy sector will now be identified by a technical and financial audit; a roadmap to limit the accumulation of new arrears and reduce their stock has been designed. In June, the government completed capital market transactions by selling shares of United Bank Limited (UBL) and Pakistan Petroleum Limited (PPL). It also auctioned 3G telecoms licenses. The FY2014/15 budget launched a three-year package of revenue measures to expand the tax base, eliminate tax exemptions for higher incomes, adjust the sales and excise tax rates for special categories, and raise additional revenues equivalent to more than 1 percent of GDP. The budget also reduced statutory tariff slabs from eight to six, which will subsequently be brought to four in the medium term. It expanded the scope and significantly increased the benefits of the Benazir Income Support Program (BISP) cash transfer program while introducing conditional cash transfers to support school enrolment. To build reserves and in a sign reflecting investors' confidence toward these reforms, after a gap of seven years, the government raised US\$2 billion by placing sovereign bonds in international debt markets.

The political events following the mid-August Long-March and Sit-in may have affected the economy. The Bank is in no capacity to make judgments of the possible outcomes of these events and their medium term impact on the economy. However, besides appraising its short-term effects, two questions left are how much the business-prone investor-friendly image that Pakistan was carefully rebuilding has been compromised, and how quickly reform momentum can be recovered. Signs of partial deterioration of the economy are multiple and mixed. On the one hand, growth may have slowed down in the first quarter of FY2014/15 as the virtual paralysis of the government machinery may have affected trade, construction and services. The international reserve position has suffered small losses. Accelerated rupee depreciation of 3.0 percent in August 2014 forced the State Bank of Pakistan

(SBP) to intervene by about US\$375 million. Investment decisions and visits by China and Sri Lanka presidents were postponed. On the other hand, on the public expenditure side, the cost of additional security, as mentioned by the government, has rather been small (Rs 357.6 million equivalent to 0.1 percent of GDP), and tax receipts kept robust, growing at 25 percent last August despite a call for civil disobedience made by the demonstrator

Outlook and Policy

The macroeconomic framework for FY2014/15 projects sustained growth recovery with low inflation, supported by fiscal consolidation, and rebuilding of the external position. This will largely depend on improvements in the power load-shedding problem, a less cumbersome business environment, low access to finance, and stable commodity prices.

GDP growth is expected to range between 4.3 percent and 4.6 percent in the current fiscal year. Relatively stable or declining international commodity prices and a stable real exchange rate are expected to help contain imported inflationary pressures. On the supply side, growth is expected to continue to be driven by the services and large-scale manufacturing sectors. This would be enhanced by improvements in the operating climate, as mentioned above: decreased power load-shedding, improved business conditions, and better availability of credit through fiscal consolidation. On the demand side, growth will be supported by substantial remittance inflow, strengthened private investment, renewed export dynamism, and increased public investment. Inflation, which already has remained below double digits for the last two fiscal years, is expected to reach 7.5-8.0 percent with continued fiscal prudence and monetary tightening.

Fiscal consolidation is expected to continue in line with the government's demonstrated intent to raise tax revenue, curtail federal government grants and subsidies, and increase development spending on key public infrastructure and human resource development. Revenues and grants are projected to increase from 15.1 percent of GDP in FY2013/14 to 15.0 percent in FY2014/15 due to the government's sound tax reform strategy. On the expenditure side, the privatization program and actions to improve governance and efficiency of state-owned enterprises will result in significant reduction in demand for government grants

to these institutions, whereas adjustments in electricity tariffs and reduction in power-sector losses through administrative and technological measures will lead to substantial reduction in power subsidies. This will help to contain consolidated recurrent expenditure at 16.0 percent in FY2014/15. The overall fiscal deficit will therefore decline further from 5.5 percent of GDP to 5.1 percent in the coming year.

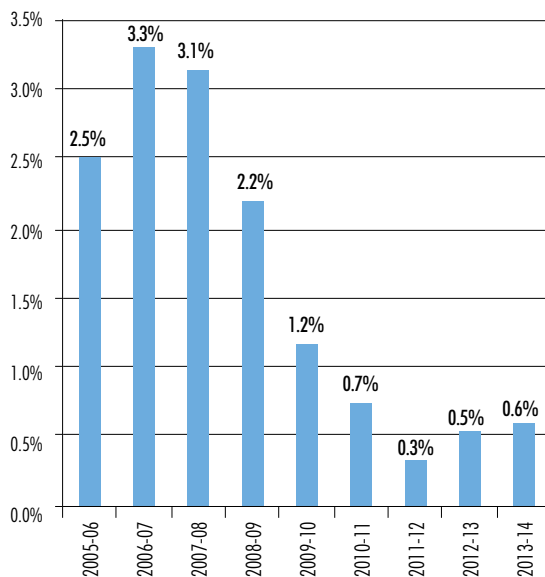
The current account deficit, at 1.2 percent of GDP in FY2013/14, is expected to increase initially to 1.4 percent next year as the economic recovery draws in more imports of raw materials (including oil), but the deficit should gradually decline thereafter.

Export recovery and strong dynamism in remittance inflow is expected to support the current account in the medium term. Nevertheless, higher investment inflows are expected due to lower country risk, privatizations, and the setting up of special economic zones (especially attractive to Chinese and Japanese investors); such multilateral flows will support the financial account. Gross official foreign exchange reserves are expected to build from 2.1 months of imports by the end of FY2013/14 to about 3.0 months of imports by the end of FY2014/15.

It also remains to be determined how much the pro-reform momentum, so carefully gathered during the past fiscal year and entering a decisive second year, will be affected by the civil unrest; but new investors' confidence-building measures will have to be nurtured to reinvigorate the reform agenda. Due to

the political situation, the government might find difficult to implement certain structural reforms needed for growth acceleration and poverty reduction or might consider delaying them. In an early sign of the ongoing difficulties, and unlike the past three favorable and timely reviews of the IMF program, the fourth review initially scheduled for Board presentation by the end of September is at a standstill. At least three areas of reform may get delayed or modified: approval of adjustment in power tariffs; the privatization agenda; and reforms requiring legislative approval. Alternatively, the government may consider strengthening some areas of the program such as power, with more decisive and less incremental actions, inclusion and governance. Strengthening media communication efforts on the benefits of reforms may also contribute to regaining the momentum.

FDI as % of GDP



Source: State Bank of Pakistan

Sri Lanka

Recent Economic Developments

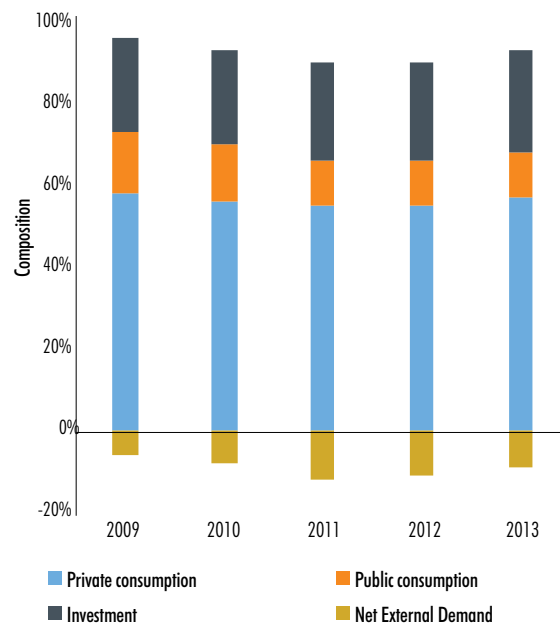
Sri Lanka achieved GDP growth of 7.6 percent in Q1 2014, improving last year's 7.3 percent rebound after a slight dip in 2012, thereby reaffirming the peace dividend from the end of internal conflict five years ago. The Central Bank of Sri Lanka's has forecast a healthy full-year growth forecast of 7.8 percent, and the country is on track to achieve per capita GDP of US\$4,000 by 2015, in line with the government's growth aspirations.

Headline inflation ran to a 28-months low of 2.8 percent in June 2014. Although ongoing drought conditions affecting many parts of the country could trigger supply disturbances leading to temporary price fluctuations, inflation expectations remain benign, supported by relatively stable international commodity prices and contained demand pressures against a backdrop of sluggish private credit growth.

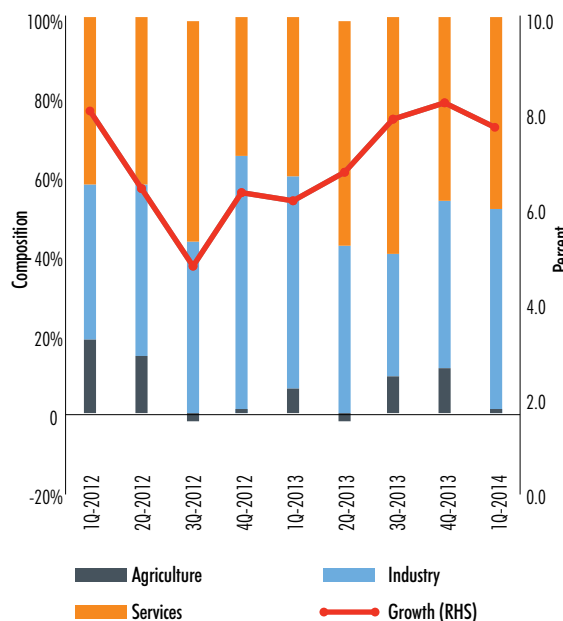
The budget deficit for the first four months of 2014 stood at 3.5 percent of GDP against a full year target of 5.2 percent of GDP. Revenue targets were not met due to subdued performance by all tax types, although expenditures were managed broadly in line with budget estimates. The government maintains that it will meet the full year deficit target through improved revenue collection in the second half of the year. Public debt declined to 74.3 percent of GDP at the end of the first half of 2014. However, treasury guarantees given to some state and private establishments to borrow from banks, are rising fast. The authorities need to prioritize the increasing of tax revenues, management of public debt, and rationalization of contingent liabilities.

External sector performance improved in the first half of 2014. Robust performance of exports contracted the trade deficit for the first half of the year to 4.6 percent of GDP, annualized, from 6.6 percent in 2013. Healthy inflows through workers' remittance and tourism receipts continued to cushion the current account. The overall balance of payments, supported by issuance of sovereign bonds and increased FDIs, recorded a surplus of US\$2.0 billion during the first half of 2014, compared to a deficit of US\$0.2 billion in the corresponding period of 2013. Improved external

Contributions to Growth: Demand Side...



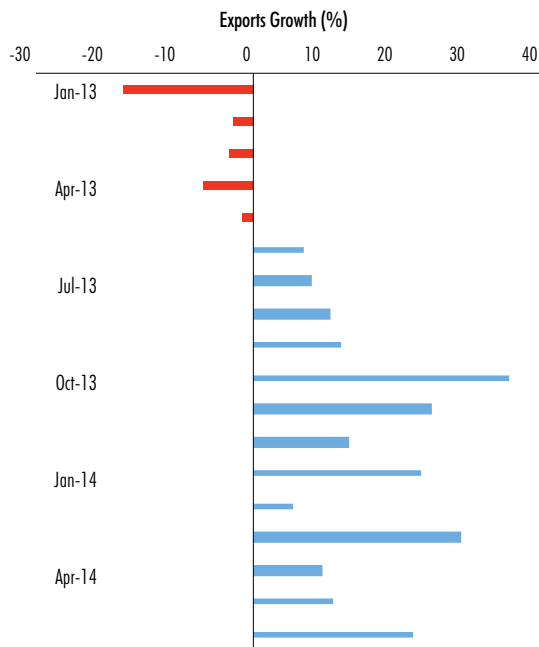
...Supply Side



performance and issuance of new external debt helped the Central Bank to strengthen the reserve position.

The financial sector reported mixed performance in the first half of 2014. Despite historically low interest rates, growth of credit from commercial banks to the private sector decelerated to 2.0 percent, y-o-y, in June 2014. The banking sector remained well capitalized and adequately liquid. However, asset quality ratios and profitability ratios have been deteriorating in recent quarters compared to those of the early post-conflict years. Buoyed by a low interest regime, the Colombo

Stock Exchange reached a three-year high with a year-to-date return of 18.5 percent in mid-August 2014. The financial-sector consolidation plan unveiled by the Central Bank at the beginning of 2014 has progressed well, with consolidation plans of 29 financial institutions approved.



A period of sustained growth saw a significant reduction in poverty levels; nevertheless, significant poverty pockets exist. The national poverty headcount ratio declined to 6.7 percent in 2012/2013 from 15.2 percent in 2006/07, but 13 districts, comprising 36 percent of the population, remain below the national poverty headcount. Unemployment is low, at 4.4 percent, yet high unemployment rates among the youth and educated populations remain concerns. The country has comfortably surpassed most of the United Nations' MDG targets set for 2015.

Outlook and Policy

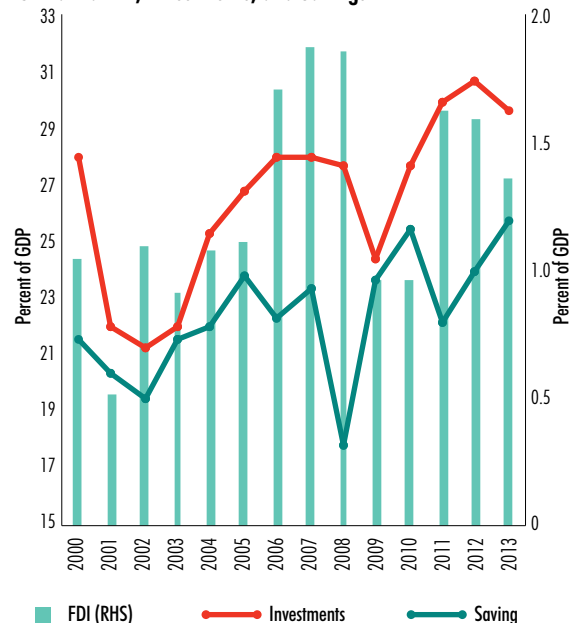
The short-term macroeconomic outlook remains positive overall. The Central Bank expects 7.8 percent GDP growth for 2014, to be supported by major contributions from expansion of infrastructure facilities and growth in trade and services; especially in the areas of tourism, transport, telecommunication, ports and financial services. However, the growth sustainability over the medium to long term will depend upon the

structural adjustments in the external and fiscal sectors and implementation of sound macro-management policies. Physical infrastructure investments need to be followed by investments in human capital. FDI promotion and efforts to enhance competitiveness are important measures to attain the government's sustained growth aspirations.

Inflationary pressures are expected to remain subdued in 2014. Although ongoing drought conditions affecting many parts of the country could trigger supply disturbances leading to temporary price fluctuations, inflation expectations remain benign, supported by relatively stable international commodity prices and contained demand pressures against a backdrop of sluggish private credit growth.

Authorities are committed to fiscal consolidation and debt reduction. A slight improvement in revenue collection and continued fiscal consolidation would help reduce the deficit to 5.3 percent of GDP. The authorities have a track record of broadly achieving fiscal targets despite missing the mid-year targets. Looking further ahead, increased revenue will depend largely on the government's ability to support the growth through public investments.

Sri Lanka FDI, Investments, and Savings



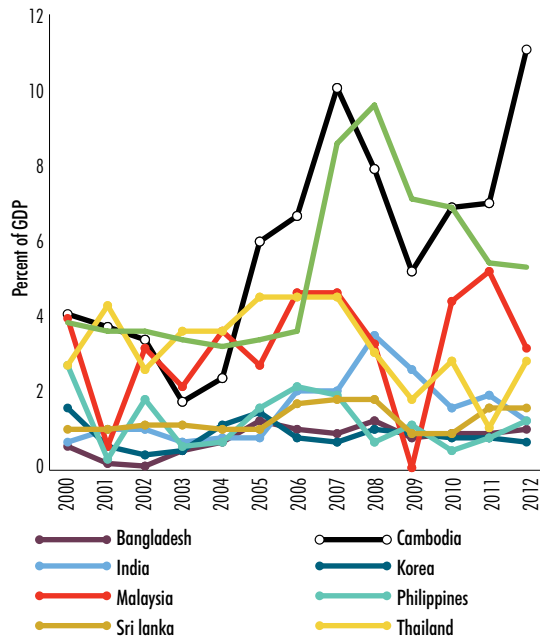
Sri Lanka FDI, Investments, and Savings

The external sector is expected to improve with a reduced current account deficit; the balance of payments is returning to surplus this year because of

strong capital inflows to the fiscus. The trade balance should improve as exports rise and imports contract, and this along with remittance and tourism receipts should help to reduce the current account deficit. However, medium- to long-term sustainability will depend on structural adjustments for diversifying the export base, liberalizing the trade regime, promoting competitiveness, and expanding the existing-product value chains.

Adverse weather conditions could undermine Sri Lanka's domestic macro-performance. Adverse weather could hamper performance in the agriculture sector, which employs one-third of the labor force. The effects of such an eventuality would be felt by industry and service sectors as well through value chain effects and reduced disposable income, given that agriculture produce is linked to a few key export-oriented industries and related services.

FDI Attraction by Selected Asian Countries



Risks to the outlook from the international environment appear moderate, based on the apparent recovery of advanced economies. Nevertheless, Sri Lanka has other risks to watch out for. As the advanced economies taper down their extraordinary stimulus measures with recovery, global interest rates will likely rise and lead to a tightening of financial conditions across the world. Although the improved growth outlook of advanced economies should increase demand for emerging market products, such as garments from Sri Lanka, it could also have negative spill-overs. At the same time, there are signs of slowdown in emerging markets after their pre-crisis highs. Given the significant and rising contribution of the emerging markets to the global economy, a slowdown could have negative effects on global growth through reductions in trade, finance, and commodity market channels. Political tensions in Ukraine, and the Middle East could also spill over to other parts of the world in the form of disruptions to production or transportation of natural gas and crude oil; although commodity prices are expected to remain benign.



South Asia at a glance

		AFG (1)	BGD (3)	BTN (6)	IND (8)	MDV (11)	NPL (13)	PAK (16)	LKA (19)	SAR (21)	
BALANCE of PAYMENTS	Real GDP Growth	2011	6.1	6.5	8.1	6.7 (9)	6.5	3.9	3.6	8.2	7.1
		2012	14.4	6.5	8.1	4.5 (9)	1.3	4.6	3.8	6.3	5.2
		2013	3.7	6.0	5.6	4.7 (9) (e)	3.7	3.5	3.7	7.3 (prov)	4.8
		2014	1.5 (p)	6.1	6	5.6 (9) (p)	4.5 (p)	5.2 (e)	4.1	7.8 (p)	5.4 (e)
		Q1	..	..	..	4.6	..	..	..	7.6	4.7
	Q2	..	..	..	5.7	..	..	..	7.8	5.8	
	Inflation (y-o-y)	2011	10.2	10.9	3.5	8.4	11.3	9.6	13.7	6.7	9.9
		2012	6.4	8.7	5.5	10.4	10.9	8.3	11.0	7.6	8.5
		2013	7.7	6.8	8.0	9.7	4.0	9.9	7.4	6.9 (prov)	7.7
		2014	6.1 (2) (p)	7.3 (p)	8.0	..	..	9.1 (e)	8.6	7.5 (p)	5.6
		Jul	..	7.1	..	8.0	2.6	8.1	7.8	3.5	7.1
		Aug	..	7.0	..	7.8	..	..	7.0	3.5	7.0
	REER	2011	126.2	108.9	98.6 (p)	96.23 (10)	135.0	45.95	102.8	57.3	102.8
		2012	127.0	105.2	..	90.76 (10)	120.3	40.31	104.4	47.8	104.4
		2013	125.3	111.6	..	84.7 (10)	..	..	102.2	..	102.2
		2014	122.7	106.7 (p)	..	..	..	..	107.8	..	107.8
		Q2	..	..	..	..	..	..	110.5	..	110.5
		Q3	..	..	..	..	..	..	110.7	..	110.7
	Current Account (% of GDP)	2011	3.5 (2)	0.7 (4)	-23.5	-4.2	-19.7	-1.0	0.1	-7.8	-3.6
		2012	4.2 (2)	-0.3 (4)	-19.0	-4.7	-26.3	5.0	-2.1	-6.7	-4.5
		2013	3.7 (2)	1.6 (4)	-17.1 (prov)	-1.7 (e)	-28.4	3.4	-1.1	-3.9 (prov)	-1.3
		2014	4.1 (2) (p)	0.9 (4) (p)	-25.6 (p)	-2.0 (p)	..	4.7 (e)	-1.2	-2.5 (p)	-1.6
	Trade Balance (% of GDP)	2011	-42	-5.8 (5)	-29.7 (7)	-6.7	3 (12) (e)	-23.5	-8 (17)	-16.5	-2.6
		2012	-41.9	-6.8 (5)	-25.9 (7)	-7.0	-3.1 (12) (e)	-24.4	-7.4 (17)	-15.9	-1.6
		2013	-40.8	-4.4 (5)	-25.2 (7)	-3.9	-6 (12) (p)	-27.3	-6.6 (17)	-11.3	6.3
		2014	-39.3 (p)	-3.6 (5) (p)	-23.5 (7) (p)	..	-6 (12) (p)	-30.9 (e)	-6.7 (17)	..	1.7
	Import Growth	2011	2.7	41.8	36.9	24.2	24.0	5.8 (14)	19.2 (17)	50	17.2
2012		11.2	9.9	39.4	1.1	20.4	16.5 (14)	0.2 (17)	-5.32	8.2	
2013		-4.1	0.8	-3.3	-6.6 (e)	1.1 (e)	20.6 (14)	4.2 (17)	-6.19	0.9	
2014		-2.0 (p)	8.9	2.4	7.9 (p)	-2.6 (e)	27.3 (14)	3.7 (17) (e)	12.30	4.5 (p)	
Export Growth	2011	1.5	41.5	11.4	17.9	55.1	5.8 (14)	28.9 (17)	27.1	14.6	
	2012	2.7	5.9	-5.8	0.3	22.6	15.4 (14)	-2.6 (17)	-7.4	6.6	
	2013	-5.2	11.2	0.5	3.9 (e)	-1.8 (e)	3.6 (14)	0.4 (17)	6.3	7.2	
	2014	-7.9	11.7	11.2	7.0 (p)	-2 (e)	17.4 (14)	1.4 (17)	14.0	6.2 (p)	
	Q1	..	14.7	..	..	..	..	..	..	..
	Q2	..	..	..	..	..	..	..	..	..
Reserves in Months of Import	2011	7.3	3.9	25.4 (prov)	6.8 (10)	2.7	5.8	2.9	3.5	..	
	2012	7.1	3.3	27.8 (p)	7.2 (10)	2.4	7.2	..	4.3	..	
	2013	8.2	4.6	23 (p)	7.4 (10)	2.5	7.4	1.5	4.2 (prov)	..	
	2014	8.5 (p)	5.4 (p)	17	..	..	8.2 (e)	..	4.4(p)	..	
	Jul	..	..	..	8.1	..	10.3	2.1	5.7	..	
	Aug	..	..	..	8.1	..	10.1	1.9	..	..
Remittances (US\$ billion)	2011	0.01	12.06 (5)	-0.08	28.99	-0.21	4.18	12.24	5.2 (20)	97 (22)	
	2012	0.11	13.30 (5)	-0.06	30.07	-0.25	4.74	13.98	5.9 (20)	109 (22) (e)	
	2013	..	14.96 (5)	..	34.00	..	4.93	13.90	6.2 (20) (e)	..	
	2014	..	14.73 (5) (p)	..	..	..	5.35	15.83	7.4 (20) (p)	..	

		AFG (1)	BGD (3)	BTN (6)	IND (8)	MDV (11)	NPL (13)	PAK (16)	LKA (19)	SAR (21)	
GOVERNMENT FINANCES	Fiscal Deficit (% of GDP)	2011	-0.4 (2)	-3.8	-1.1	-7.6	-16.3	-1 (14) (15)	-6.5 (18)	-6.9	-7.5
		2012	-0.5 (2)	-3.4	-4.1 (prov)	-7.1	-10.1	-0.6 (14) (15)	-6.8 (18)	-6.5	-7.2
		2013	-0.5 (2)	-3.9	-4 (e)	-6.8 (e)	-9.7	1.7 (14) (15)	-8.2 (18)	-5.9 (prov)	-6.9
		2014	-2.1 (2) (p)	-3.1 (p)	-2.7 (p)	-6.1 (p)	..	1.1 (14) (15)	-5.5 (18)	-5.2 (p)	-6.7
	Public Debt to GDP (%)	2011	13.2	38.3	72.0	67.0	72.4	34.5	59.6	78.5	57.0
		2012	11 (e)	37.4	90.0	66.9	81.0	36.3	64.0	79.1	61.1
		2013	..	35.5	86.2	66.4 (e)	86.2	31.5	64.4	78.3	65.3
		2014	..	34.4 (p)	93.2	66.7 (p)	..	30.5 (e)	63.7	..	67.6
CONSUMPTION and INVESTMENT	Consumption (% of GDP)	2011	120	74.3	64.1 (e)	73.6	..	88	92	70	..
		2012	..	73.7	63.2 (e)	74.6	..	97.4	..	70	..
		2013	..	72.8	60.7 (p)	73.6 (e)	..	95.8	..	67	..
		2014	..	71.4 (p)	..	72.6 (p)	..	95.2	..	..	..
	Investment (% of GDP)	2011	25	22.2	59.4 (e)	31.8	..	37.8	12.5	30	27
		2012	..	22.5	61.8 (e)	30.4	..	28.2	11	31	..
		2013	..	21.7	65 (p)	28.4 (e)	..	32.8	..	30	..
		2014	..	21.4 (p)	..	29.6	..	36.1	..	..	..
	FDI (US\$ billion)	2011	..	0.8	0.02	22.1	0.3 (e)	0.1	1.6	0.8	35.7
		2012	..	1.0	0.02	19.8	0.2 (e)	0.1	0.7	0.9	29.7 (e)
		2013	..	..	0.02	21.6 (e)	0.2 (p)	0.01 (H1)	1.3	0.8	36.9 (e)
		2014	..	..	..	22.0 (p)	..	..	1.5	..	..
	Portfolio Investment (US\$ billion)	2011	..	0.01	..	16.6	..	0.0	-0.14	-0.29	-4.8
		2012	..	0.06	..	26.7	..	0.0	0.03	0.5	11.5 (e)
		2013	..	..	..	4.8 (e)	..	..	0.03	..	16.4 (f)
		2014	..	..	..	25.0 (p)	..	..	2.77	..	..

Notes:

e	Estimate
f	Forecast
p	Projections
prov	Provisional

Afghanistan

- 1 2013 onwards is calendar year, preceding years correspond to solar year (Apr-Mar)
 2 Including grants

Bangladesh

- 3 These numbers are for fiscal year unless otherwise mentioned. For example; for 2012 numbers, 2011-2012 values are used.
 4 Including transfers
 5 WB Staff Calculations

Bhutan

- 6 These numbers are for fiscal year unless otherwise mentioned. For example; for 2011 numbers, 2010-2011 values are used.
 7 WB Staff Calculations

India

- 8 These numbers are for fiscal year unless otherwise mentioned. For example; for 2012 numbers, 2012-2013 values are used.
 9 Real GDP Growth (at market prices)
 10 WB Staff Calculations

Maldives

- 11 These numbers are for calendar year unless otherwise mentioned.
 12 WB Staff Calculations

Nepal

- 13 These numbers are for calendar year unless otherwise mentioned.
 14 These numbers are for fiscal year unless otherwise mentioned. For example; for 2012 numbers, 2011-2012 values are used.
 15 Including grants

Pakistan

- 16 These numbers are for fiscal year unless otherwise mentioned. For example; for 2013 numbers, 2012-2013 values are used.
 17 WB Staff Calculations
 18 Excluding grants

Sri Lanka

- 19 These numbers are for calendar year unless otherwise mentioned.
 20 WB Staff Calculations

SAR

- 21 These numbers are for calendar year unless otherwise mentioned.
 22 Remittances numbers are taken from GEP 2013 Jan report and they are calendar year numbers (US\$ billions)



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