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SOUTH ASIA ECONOMIC FOCUS SPRING 2017

Globalization Backlash

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This report is a joint product of the South Asia Regional Chief Economist office (SARCE) and the Macro and Fiscal Management Global Practice (MFM). Its preparation was led by Robert Beyer (Economist) under the oversight of Martin Rama (Chief Economist, South Asia Region), with substantive contributions by Muhammad Faisal Baig, Martin Melecky, and Yan (Sarah) Xu (all with SARCE). The report greatly benefitted from inputs by Boaz Nandwa, Temel Taskin and other colleagues in the Development Economics Prospects Group (DECPG) under the supervision of Ayhan Kose (Director DECPG). Csilla Lakatos (DECPG), Maryla Maliszewska (Trade & Competitiveness Global Practice), and Hiau Looi Kee (Development Economics Research Group) undertook analyses that enriched the report crucially. We are grateful to Enrique Blanco Armas, Frederico Gil Sander, Volker Treichel and Ralph Van Doorn (all with MFM) and Jose Guilherme, Esperanza Lasagabaster, Sanjay Kathuria, Ruchita Manghnani, Michele Ruta, and Sebastian Saez (all with T&C) for insightful comments and suggestion, as well as to Rupa Duttagupta and Aqip Aslam (both with International Monetary Fund) for the sharing of macro modelling code. The country briefs were prepared by Kishan Abeygunawardana, Damir Cosic, Sudyumna Dahal, Adnan Ghumann, Zahid Hussain, Tenzin Lhaden, Yoichiro Ishihara, Mohammad Omar Joya, Frederico Gil Sander, Smriti Seth, and Ralph Van Doorn, under the supervision of Manuela Francisco (Practice Manager, MFM). Alejandro Espinosa at Sonideas was responsible for the layout, design and typesetting of the report, Alexander Ferguson (Senior Manager, South Asia External Communications), Yann Doignon and Joe Qian coordinated its dissemination, and Neelam Chowdhry provided administrative support. Special thanks go to Markus Kitzmuller (MFM) who had led the production of the report since its inception in 2013 and arranged a smooth handover of the task.

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 April 13, 2017.

South Asia Chief Economist Office
Macro and Fiscal Management Global Practice


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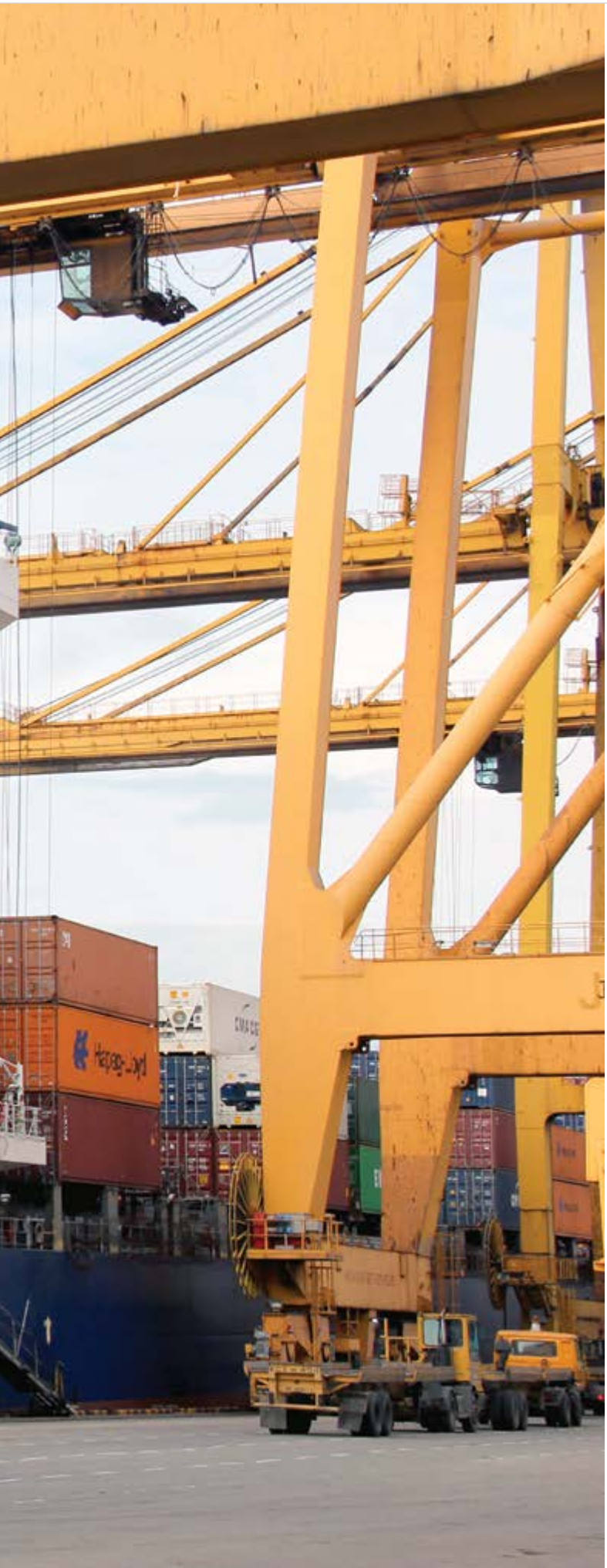

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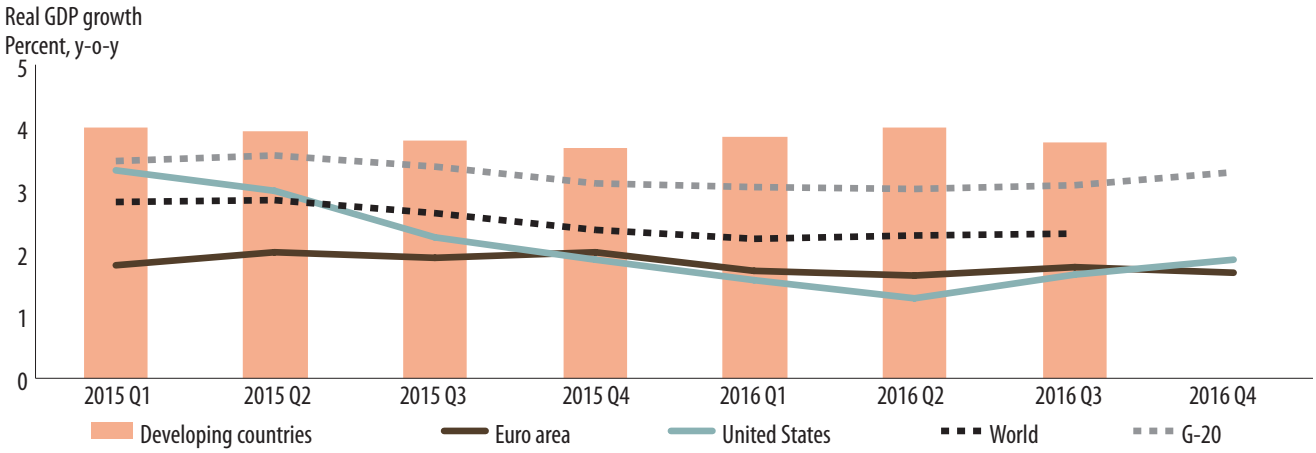
Recent economic developments

South Asia remains the fastest growing region in the world. With a strong performance in the eastern part of the region – in particular in Bhutan, Bangladesh and India – the region defied disappointing world growth in 2016. Inflation slowed down in the second half of 2016, mainly due to lower food prices, but appears to be turning up again. Despite recent real exchange rate appreciation, current account balances are mostly in order throughout the region. After a sharp decline triggered by lower oil prices, remittance inflows are stabilizing in most countries and international reserves are mostly at comfortable levels. Progress on fiscal consolidation has been more gradual and public debt levels remain high.

World growth is low but turning around

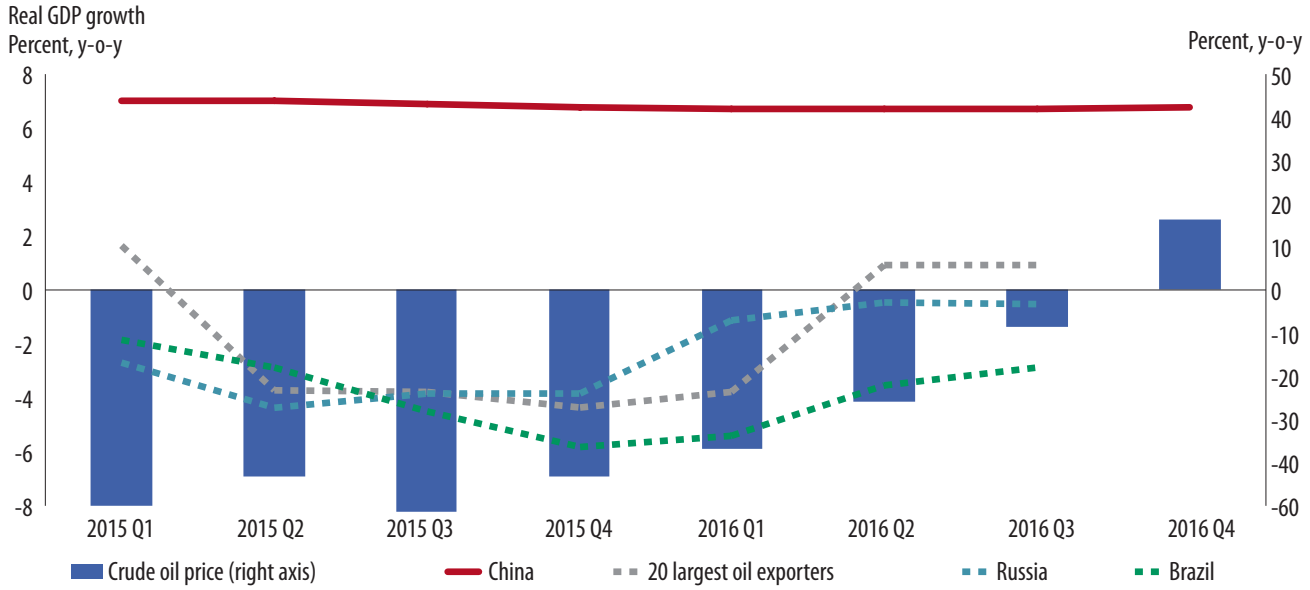
After a disappointing year, a pickup in growth rates is finally in sight. In 2016, global growth was in a post-crisis low and the first six months of the year were characterized by especially weak growth in advanced economies. At 2.3 percent on average, global growth (y-o-y) in 2016 was 0.4 percentage points

FIGURE 1: The world economy has regained some momentum.



Source: World Bank, OECD

FIGURE 2: China's growth appears resilient and oil exporters are now better positioned.

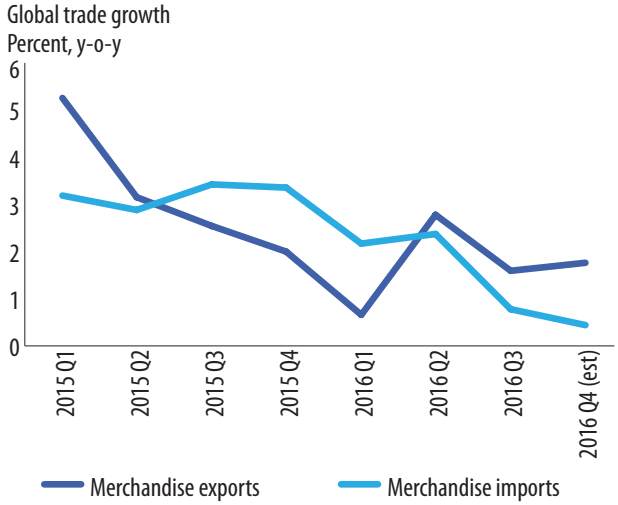


Source: World Bank, Haver Analytics/International Monetary Fund
Note: Data for Kuwait, UAE, Angola, Venezuela, Libya, Algeria & Oman is not available

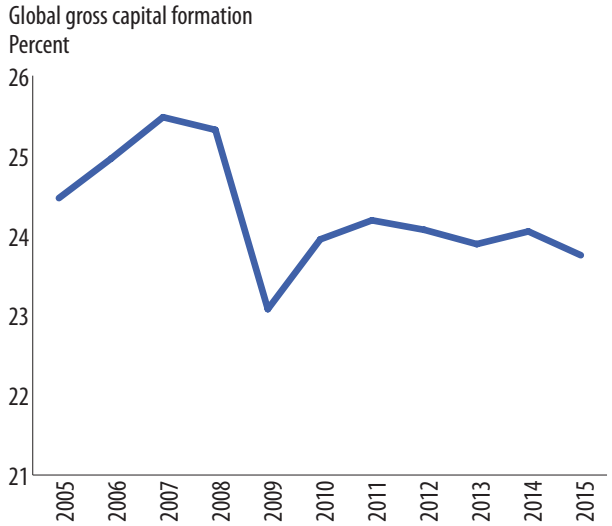
lower than in 2015. Uncertainty has been high, global trade has stalled and investment has been weak. However, in the last quarter of 2016, there are reasons for optimism. China's transition towards a growth path relying to a greater extent on domestic demand continues at a smooth pace. Many oil-exporting countries are doing better, as the price of crude oil has been rising since mid-2016; several of them, including Russia, are growing again. In Brazil the turnaround still lies ahead, but the worst may be over. Other recent developments point to the consolidation of a new global growth momentum. Commodity prices have recovered and the MSCI World - a stock market index of over one thousand five hundred stocks – has reached a record high. Economic activity in advanced economies is strengthening. In the Euro area unemployment has fallen to an eight-year low and the US experiences a broad-based upswing in manufacturing activity.

Growth is still held back by sluggish global trade and investment. After a phase of rapid expansion that ended with the global crisis, international trade growth has continuously been disappointing and 2016 was not an exception. Trade grew by less than 2 percent, which is less than global GDP growth. This partly reflects lower import demand from advanced economies, and especially lower demand of capital goods, which establishes a link between sluggish trade and sluggish investment. Since the global

FIGURE 3: Global trade and investment remain sluggish.

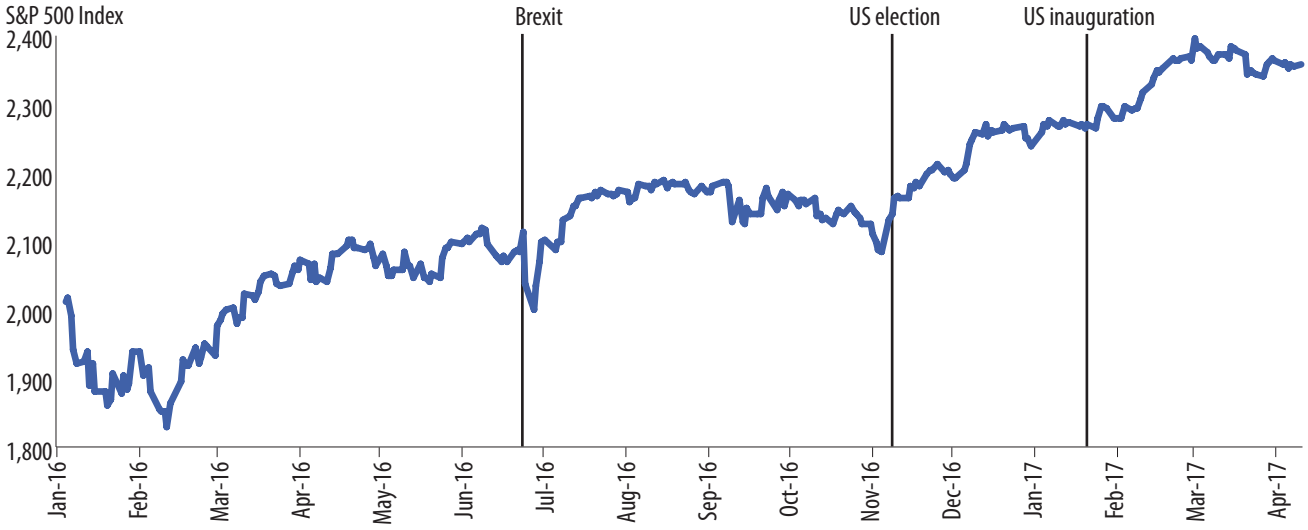


Source: World Bank WDI and staff calculations
Note: est = estimate

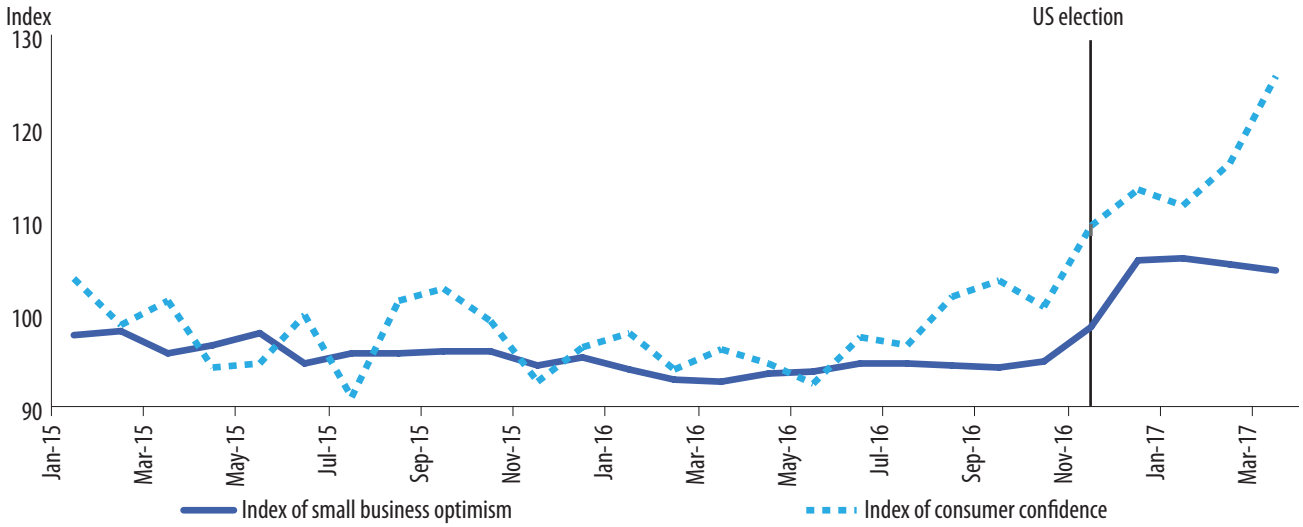


Source: World Bank WDI

FIGURE 4: There is greater economic optimism in the US.

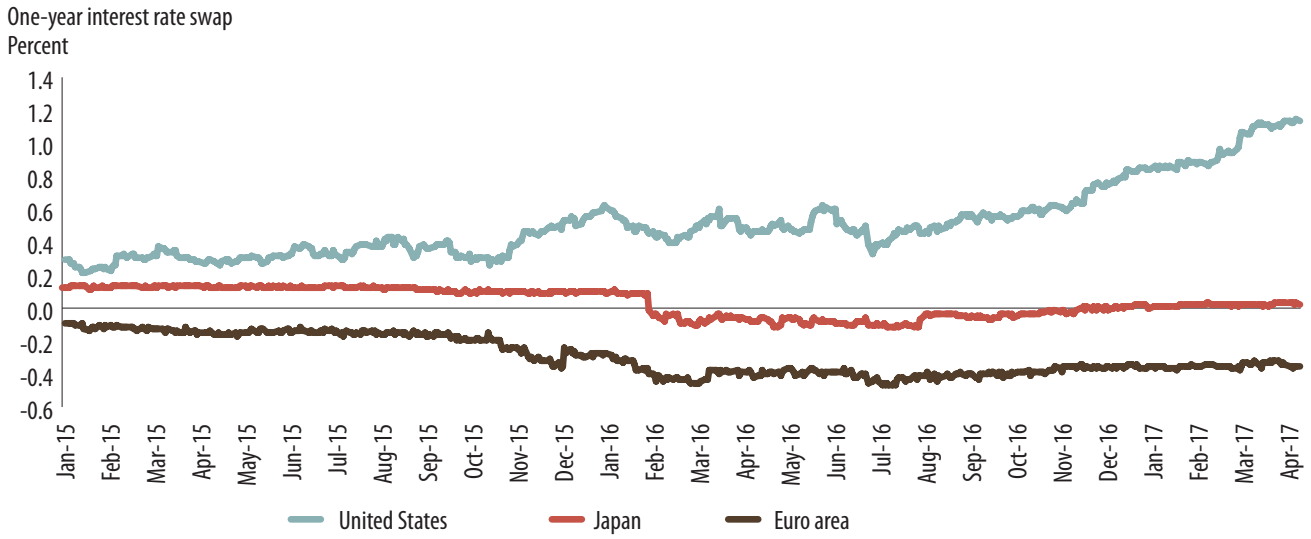


Source: Haver Analytics/New York Times



Source: National Federation of Independent Business, The Conference Board

FIGURE 5: Interest rates diverge as US monetary policy normalizes.



Source: Haver Analytics/Reuters

financial crisis, world gross capital formation is hovering around 24 percent of GDP and is not further recovering.

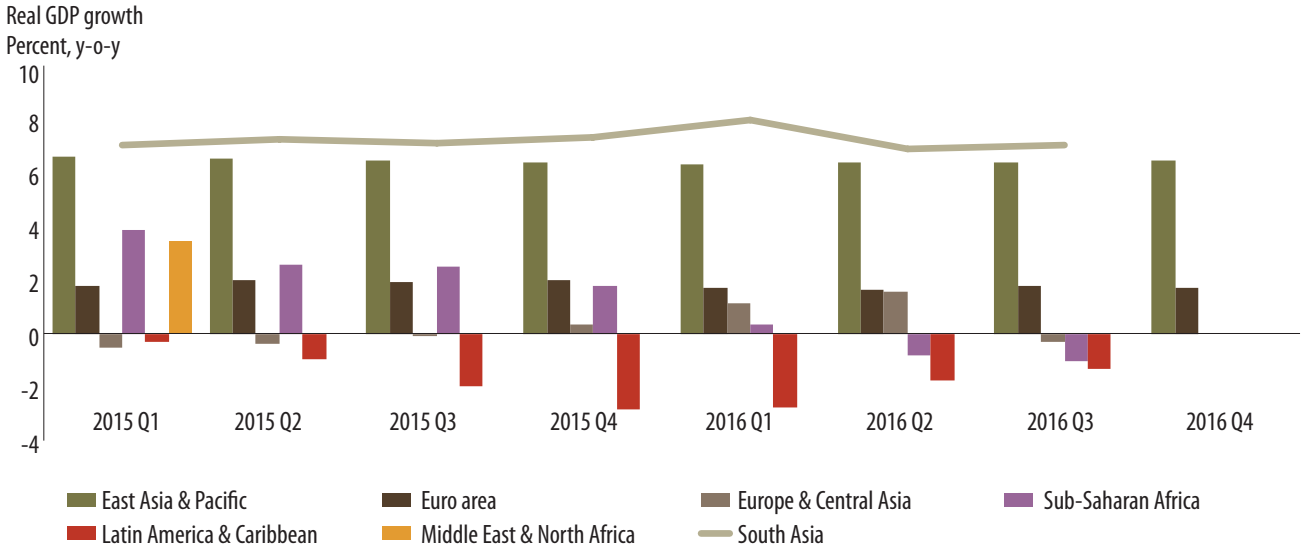
The expectation of pro-business policies has bolstered economic optimism in the US. The S&P 500, an American stock market index covering the shares of 500 large companies, has rallied since the US election. At the beginning of April it stood 10 percent higher than in early November 2016. In the 2017 JP Morgan Chase Business Leaders Outlook, over three quarters of respondents expected a positive impact of the new administration on their businesses. The top three reasons named were pro-business policies, tax reforms and reduced regulation. Optimism is not limited to financial markets and big businesses: it is also shared more broadly, as shown by rising indices of small business confidence and consumer confidence. Due to the size and international linkages of the US economy, these developments have global implications. The Federal Reserve's assessment of the economic outlook, however, remains measured. A potentially more protectionist US trade policy could affect both the US and the global economy negatively. In the 2017 JP Morgan Chase Business Leaders Outlook, among those who are expecting a negative impact of the new administration for their business, trade concerns featured most prominently.

With different paces of recovery, interest rates in advanced economies are diverging. In March, the Federal Reserve raised its benchmark rate for the third time since the financial crisis and the second time in three months. US interest rates are expected to increase further. In contrast, the Euro area and Japan still follow a dovish monetary policy. As a result, one-year interest rate swaps of advanced economies are drifting further apart. The effect of the US interest rate hike on the financing conditions in emerging markets has been muted, in particular compared to the 2013 Taper Tantrum. One reason is that the higher interest rates go hand in hand with higher inflationary expectations. A strong and unexpected rise in US bond yields or appreciation of the US dollar, could still cause financial market turbulence in emerging markets.

South Asia again outperforms all other regions

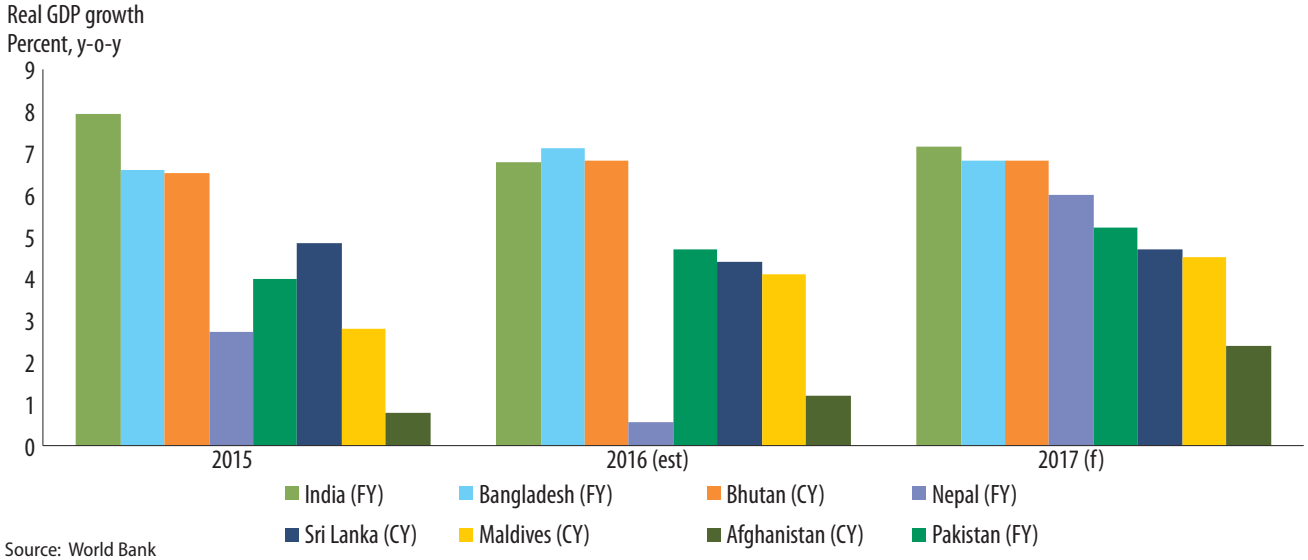
South Asia has by now consolidated its position as the global leader in economic growth. While the pick-up in growth in the first quarter of 2016 was only temporary, South Asia is still expected to have grown by an impressive 6.7 percent (y-o-y) over the year as a whole. This strong performance was despite the temporary setback caused by India's demonetization effort at the end of the year. Growth in South Asia was higher than in East Asia, where it stood at 6.3 percent. Other regions are growing either much more slowly or are even contracting.

FIGURE 6: South Asia remains the fastest-growing region in the world.



Source: World Bank, OECD

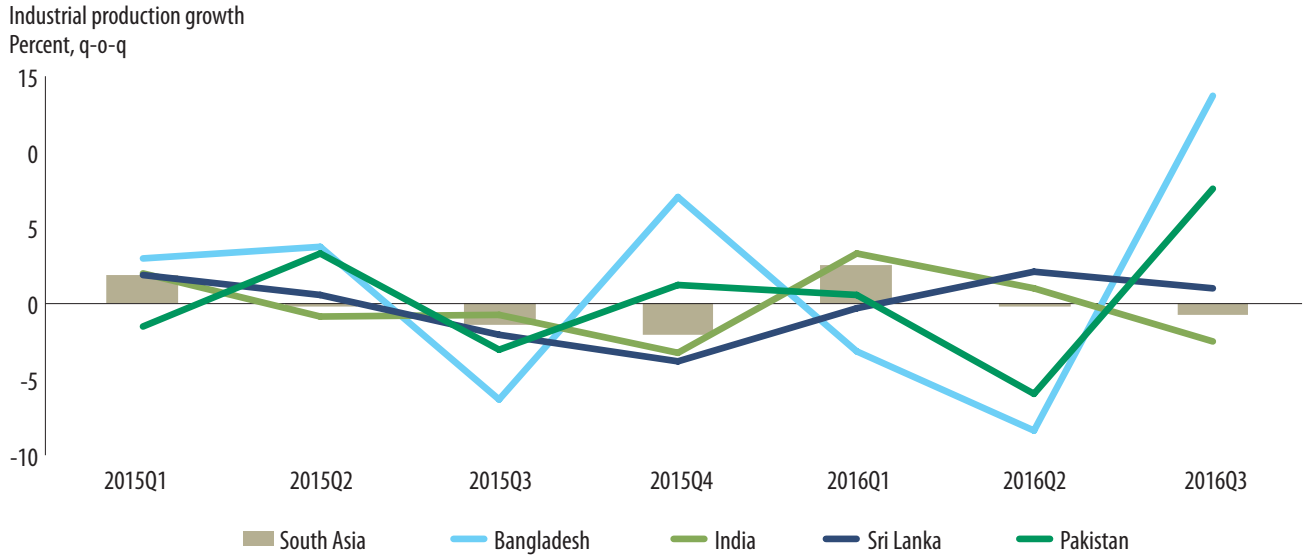
FIGURE 7: The eastern part of the region is leading, Nepal and Maldives are bouncing back.



Source: World Bank
Note: est = estimate, f = forecast

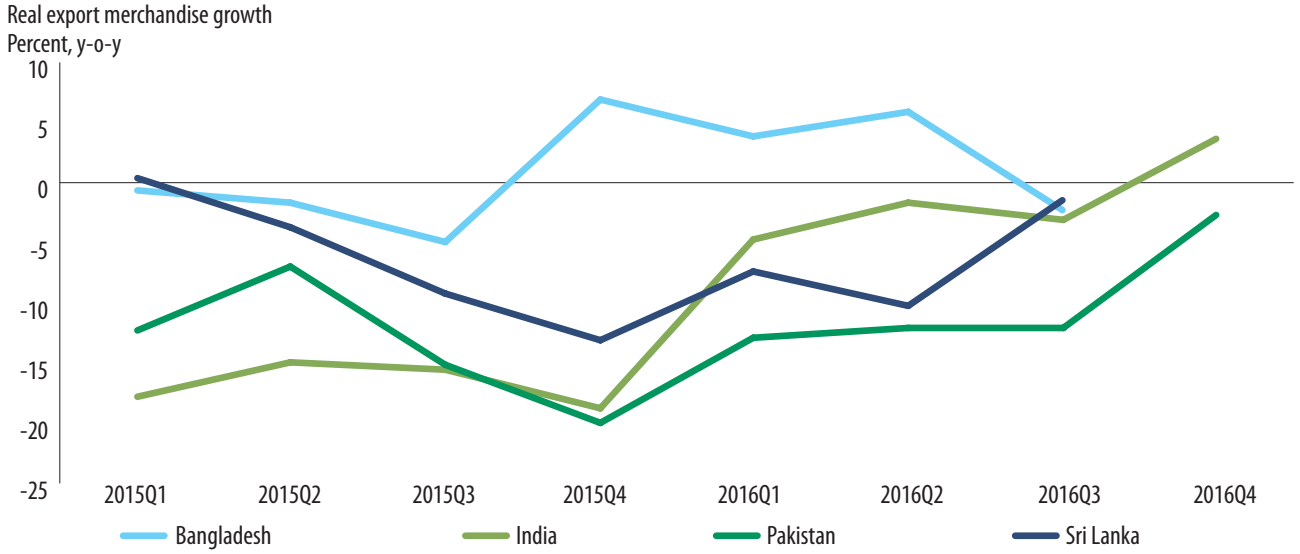
Despite sub-regional differences, most South Asian countries have shown improvements. At around 7 percent, growth has been particularly high in Bhutan, in Bangladesh, and in India. Bhutan, the fastest growing economy in South Asia, benefited from a dynamic energy sector, thanks to ongoing hydropower construction. In Bangladesh, growth has been driven mainly by private investment and exports, with industrial production recently reaching a record high. India's economy benefited from a favorable monsoon and strong urban consumption. The setback due to demonetization was noticeable but modest. After two consecutive years of very weak growth due to devastating earthquakes and a disruption in cross-border trade with India, growth in Nepal is bouncing back strongly. In Pakistan and Sri Lanka, growth has been around 5 percent. For Pakistan this implies a continuation of an upward trend. Growth there is, among other things, supported by the China Pakistan Economic Corridor and tangible improvements in security. Recent data on industrial production looks encouraging. In Sri Lanka, on the other hand, growth declined from 4.8 percent to 4.4 percent mainly due to floods and droughts. As a consequence of large investment projects growth in Maldives rebounded to 4.1 percent, and this despite a slowdown in tourism. The weakest performance was in Afghanistan, were security concerns have kept economic growth below population growth for yet another year.

FIGURE 8: Industrial production has accelerated in Bangladesh and Pakistan.



Source: World Bank

FIGURE 9: Exports have stopped their decline.

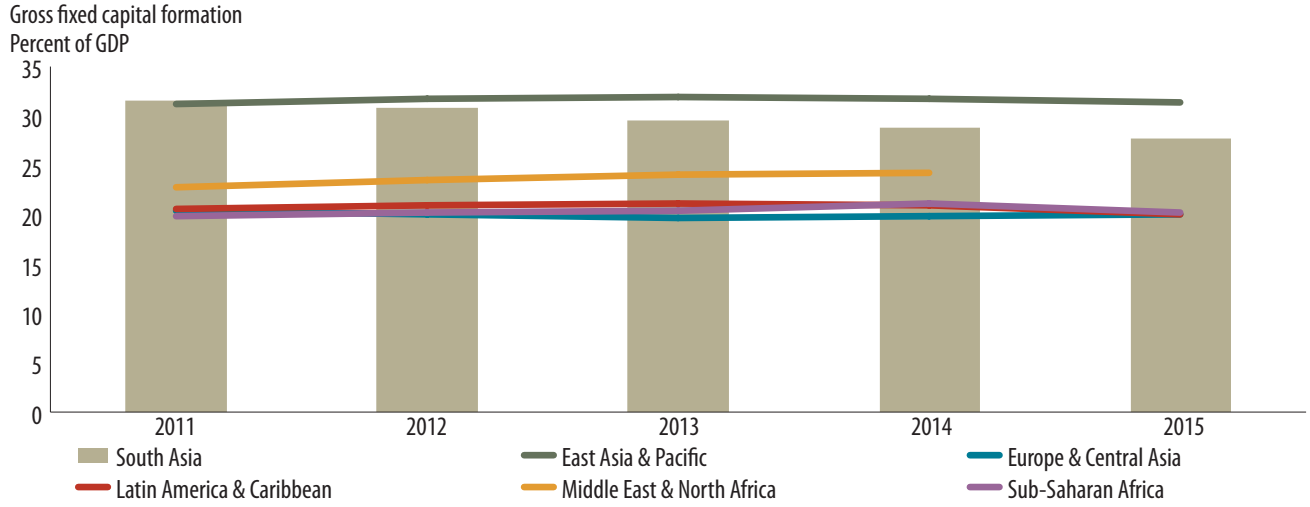


Source: World Bank DECPG and staff calculations

Growth could be even stronger if trade and investment were contributing to a greater extent. Like in the rest of the world, trade and investment growth in South Asia disappointed in 2016. For some countries in the region, export growth was mostly negative throughout the year. However, the trend has reversed lately and the most recent data is very encouraging. In Sri Lanka, exports grew strongly at the end of 2016 and in India export growth accelerated to a six-and-a-half year high in March 2017. Investment rates have been high as well, with South Asia being second only to East Asia. But as a share of GDP investment has been on a declining trend since 2011. The decline is unambiguous in India and in Sri Lanka, whereas Nepal and Bhutan are on an upward trend.

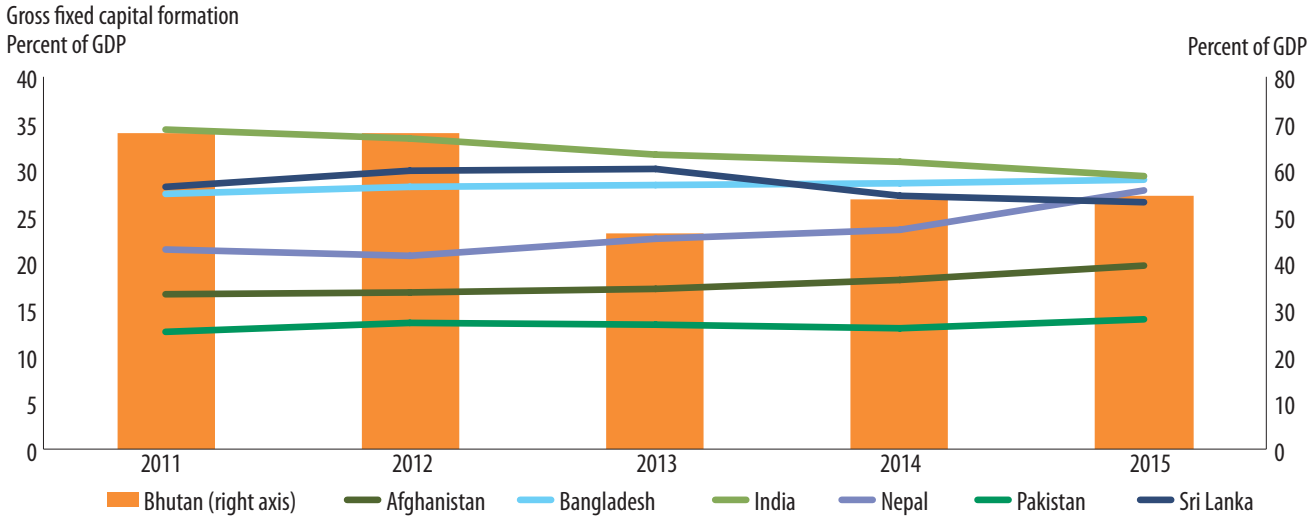
Stock markets in India and Pakistan are bullish. In a manifestation of economic optimism, share prices in India and Pakistan have been on a solid upward trend. Stocks listed in Mumbai and Karachi made large gains in 2016, with share prices in Pakistan rallying to levels never seen before. Optimism is not shared across the entire region, however. After modest gains in the first half of 2016, the Sri Lanka stock market has been on a downward trend, with the Colombo Stock Exchange index losing nearly 10 percent over the course of 2016.

FIGURE 10: Compared to other regions investment is not low, but it is decreasing.



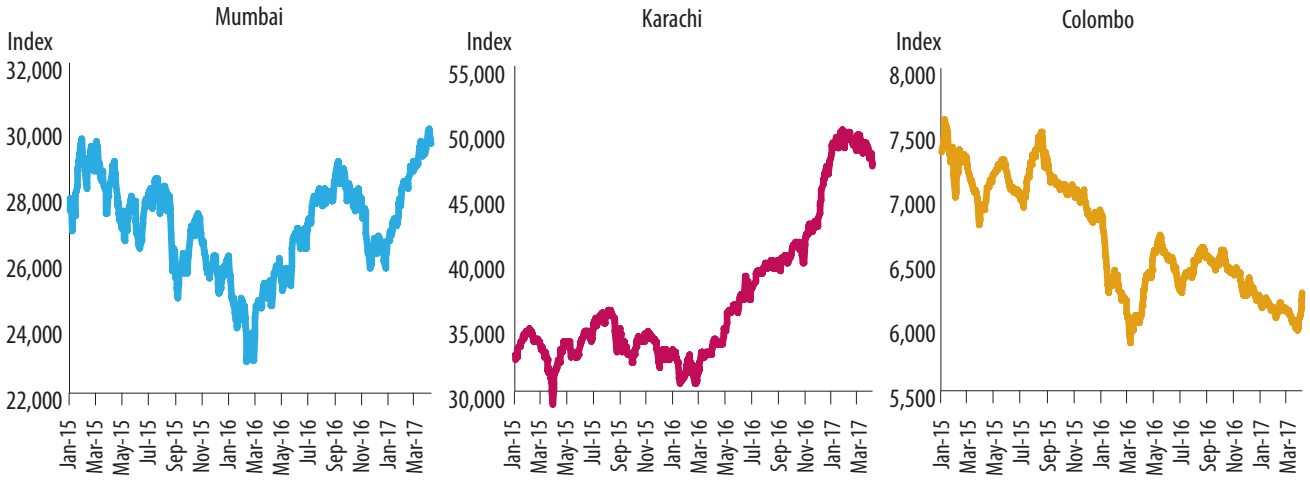
Source: World Bank WDI

FIGURE 11: Investment is declining in India and Sri Lanka but rising in the rest of South Asia.



Source: World Bank WDI

FIGURE 12: Stock market performance is strong in India and Pakistan.

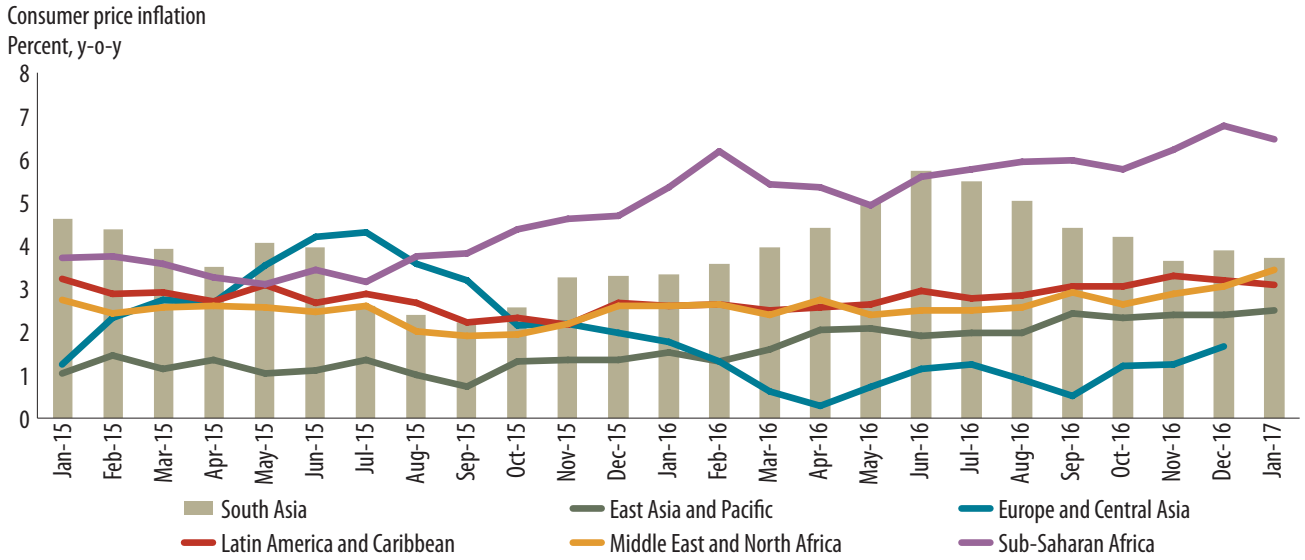


Source: Haver Analytics/Bombay Stock Exchange

Source: Haver Analytics/Wall Street Journal

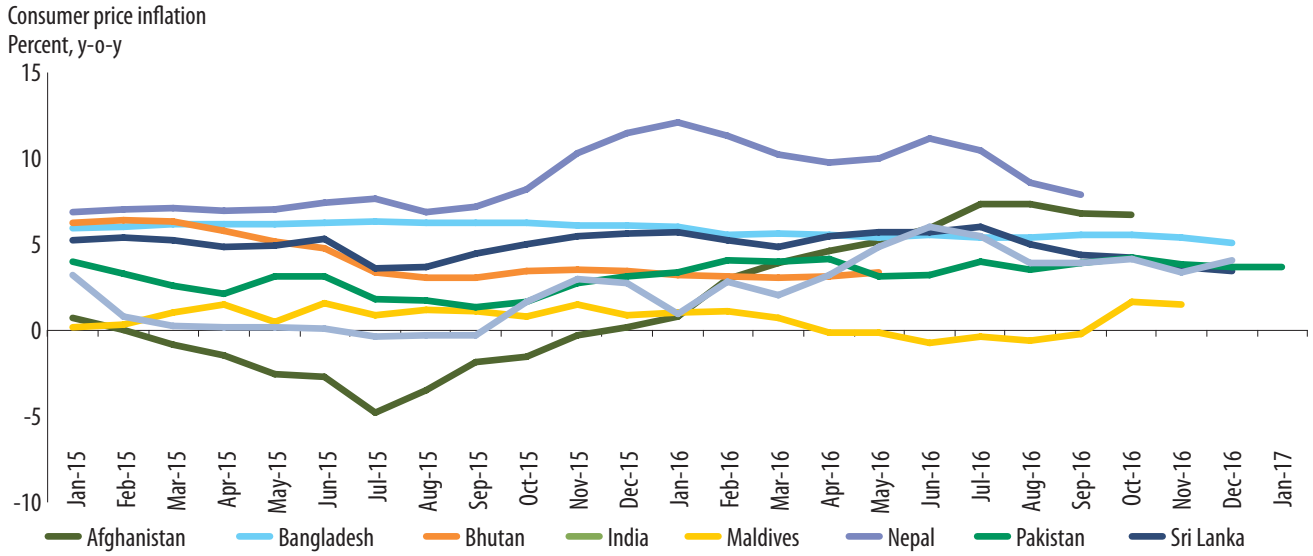
Source: Haver Analytics/Financial Times

FIGURE 13: Inflation in South Asia decelerated strongly in recent months.



Source: World Bank DECPG

FIGURE 14: Inflation slowed down across most countries in South Asia.

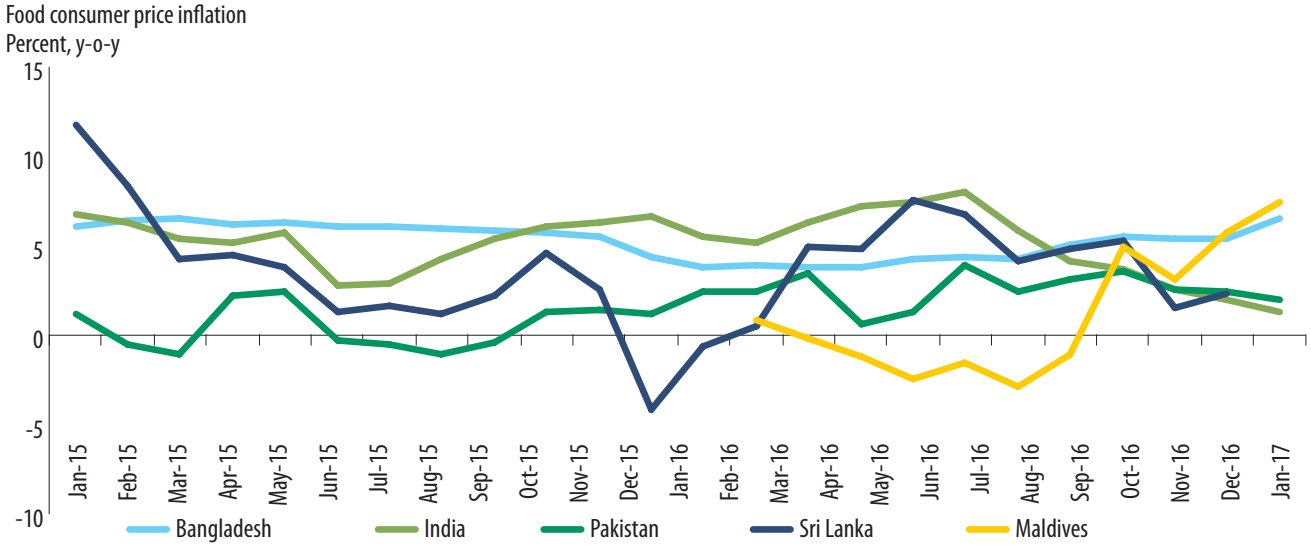


Source: World Bank

Inflation in South Asia slowed down

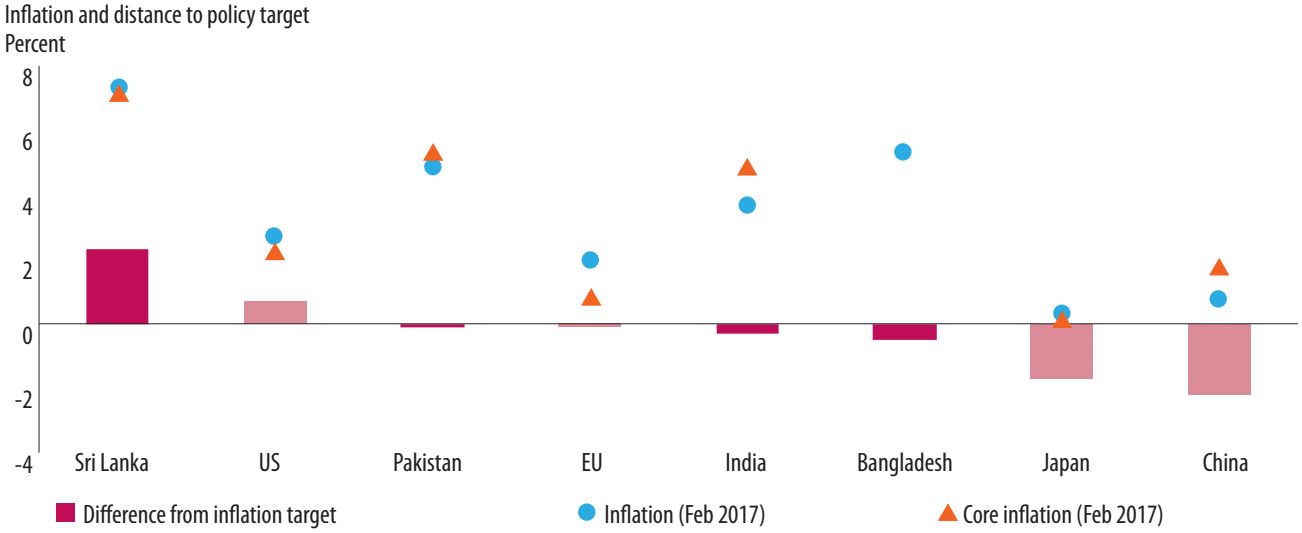
Regional consumer price inflation decelerated strongly. During the second half of 2016, inflation slowed from over 5 percent (y-o-y) in June to a little over 3 percent recently. Despite the slowdown, South Asia still has the second highest inflation rate among all regions. While inflation decelerated across most of South Asia, there is substantial heterogeneity within the region. In Nepal, inflation is back to single digits, but remains high. Pakistan managed to reign in the strong upward trend that had started in July 2015, and stabilized its inflation rate at around 7 percent. In Sri Lanka, inflation most recently picked-up and reached 6.8 percent in February. Maldives struggled with deflationary pressures during the first half of 2016, but consumer prices there are increasing again. Inflation rates in the other countries are around 4 percent. The deceleration has been mainly driven by lower commodity and lower food prices. In India, for example, food consumer price inflation decreased from 8 percent in July 2016 to below 2 percent in January 2017. Most recent observations already show a turnaround of food price inflation. Poor monsoons this year could weaken agricultural production and increase food prices further.

FIGURE 15: Food prices have been especially subdued.

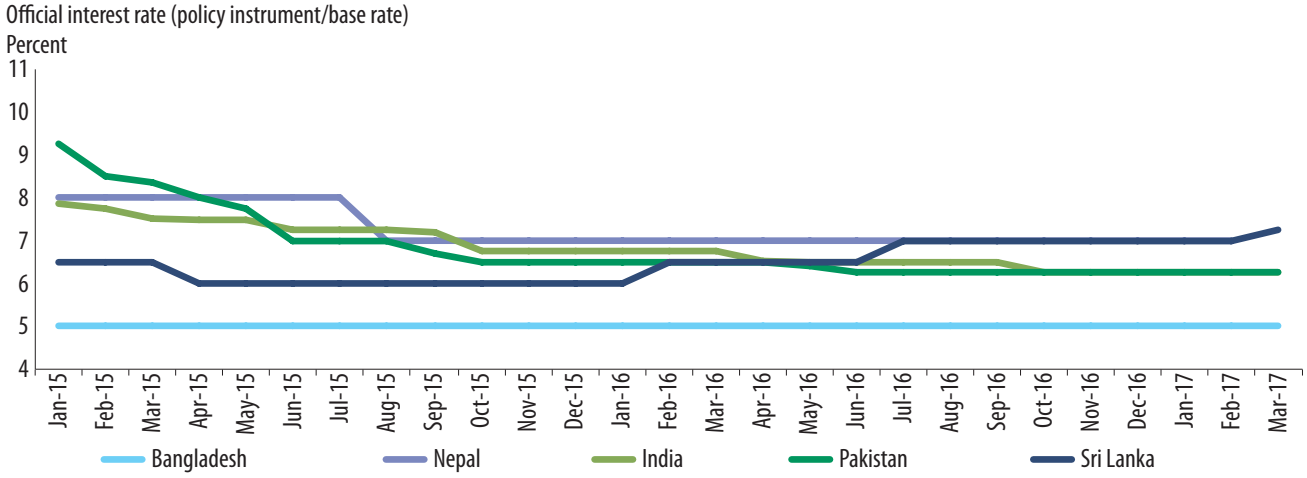


Source: Haver Analytics/National Authorities

FIGURE 16: Inflation is around target and room for monetary easing is limited.



Source: Haver Analytics/National Authorities, Eurostat, World Bank staff calculations
Note: For central banks not directly targeting inflation, the targets reflect short-term midpoints of lower and upper limit targets



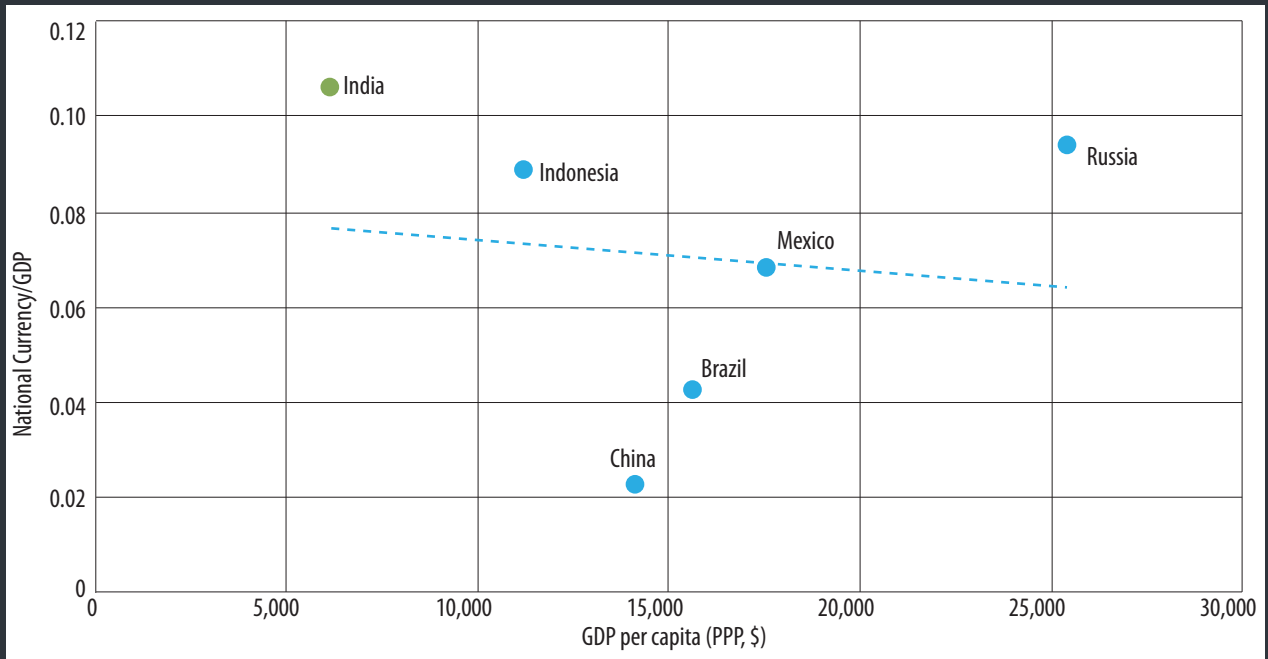
Source: Haver Analytics/National Central Banks and International Monetary Fund

Has demonetization changed the way transactions are processed in India?

At the beginning of November last year, the Indian government announced the immediate withdrawal of all 500 and 1000 Rupee bills, which represented 86 percent of the currency in circulation. These notes were gradually replaced by new 500 and 2000 Rupee bills introduced in the following weeks and months, making demonetization a massive currency exchange. The most prominent reasons brought forward for this far-reaching move were to curb black money, to eliminate counterfeit notes, and to promote the use of electronic payments. Eliminating tax evasion and corruption is typically a demanding process, involving multiple measures over time. However, demonetization could accelerate financial deepening, foster financial inclusion, and increase transparency, thereby having a positive development impact in the longer term. For this to happen, there should be a large and durable shift from cash to electronic payment methods.

There are two reasons to be hopeful about this shift actually happening. First, on the negative side, before demonetization India was relying on cash to a greater extent than other large emerging markets. And second, on the positive side, the progress made on JAM, the innovative drive to link bank accounts, mobile phone numbers and biometric identification cards, had taken the country to the cusp of a technological transformation. Mostly every adult in India has an Aadhaar card (the A in JAM) and a mobile phone (the M). However, before demonetization progress on the bank account side (Jan-Dhan Yojana, the J) was more limited. Not every household had a bank account, and many of the existing accounts were inactive. The hardship created by demonetization could have given the impetus for households to open and use bank accounts, and for IT companies to swiflty deploy digital payments technology.

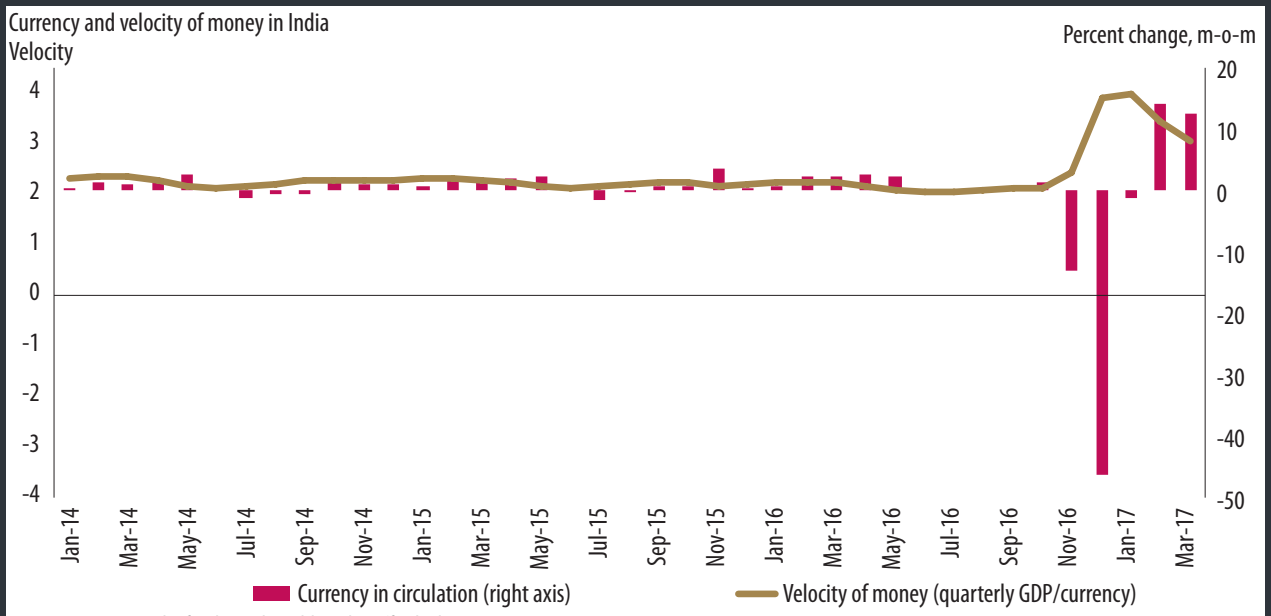
FIGURE: Before demonetization India was more cash-intensive than other large emerging markets.



Source: International Financial Statistics, Reserve Bank of India, Central Bank of Russia and World Bank staff calculations
Note: data is 2015

After declining sharply, currency in circulation has bounced back, though not to its initial level. By December 2016 currency in circulation reached again 55 percent of its pre-demonetization level and by March 2017 it stood at over 70 percent. Given that economic activity did not decline substantially, the composition of transactions must have changed in the direction of digital payments. Dividing GDP by the money stock, provides a measure of the so-called velocity of money, or how many times the same Rupee is used to buy goods and services over one year or over one quarter as shown in the figure. India's velocity of money was stable at about 2.2 before demonetization. Since then it jumped to nearly 4 and by March 2017 it was still above 3. This is roughly where India could be expected to be, given its GDP per capita.

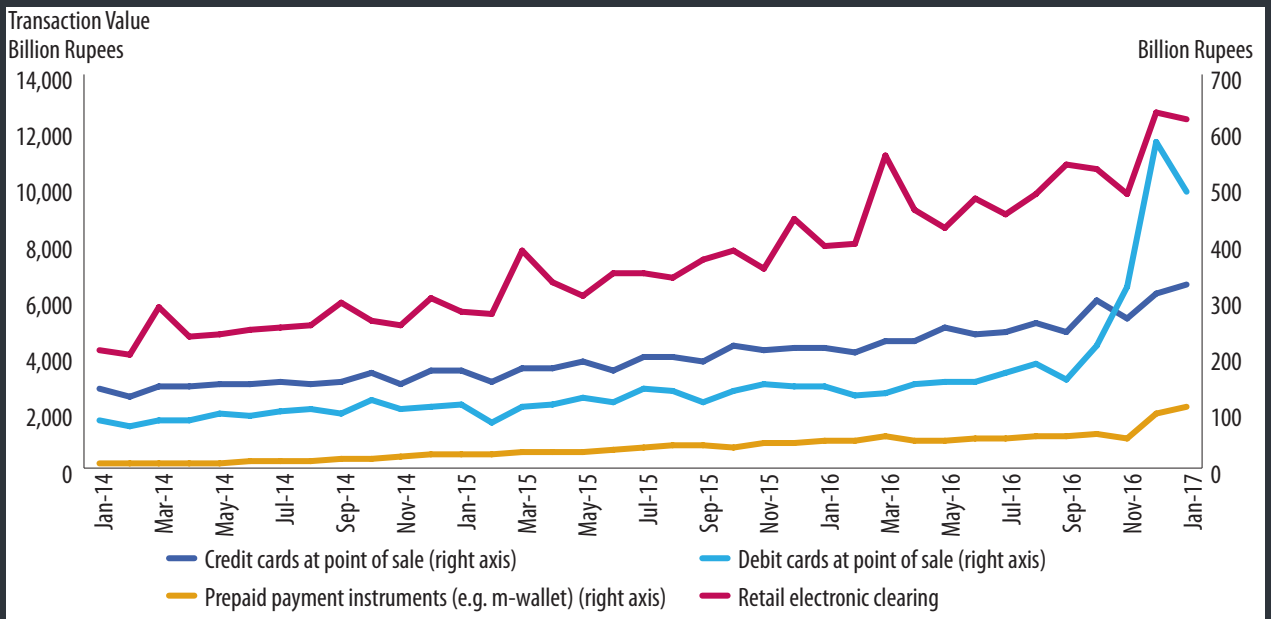
FIGURE: The velocity of money increased after demonetization but is declining again.



Source: Reserve Bank of India and World Bank staff calculations

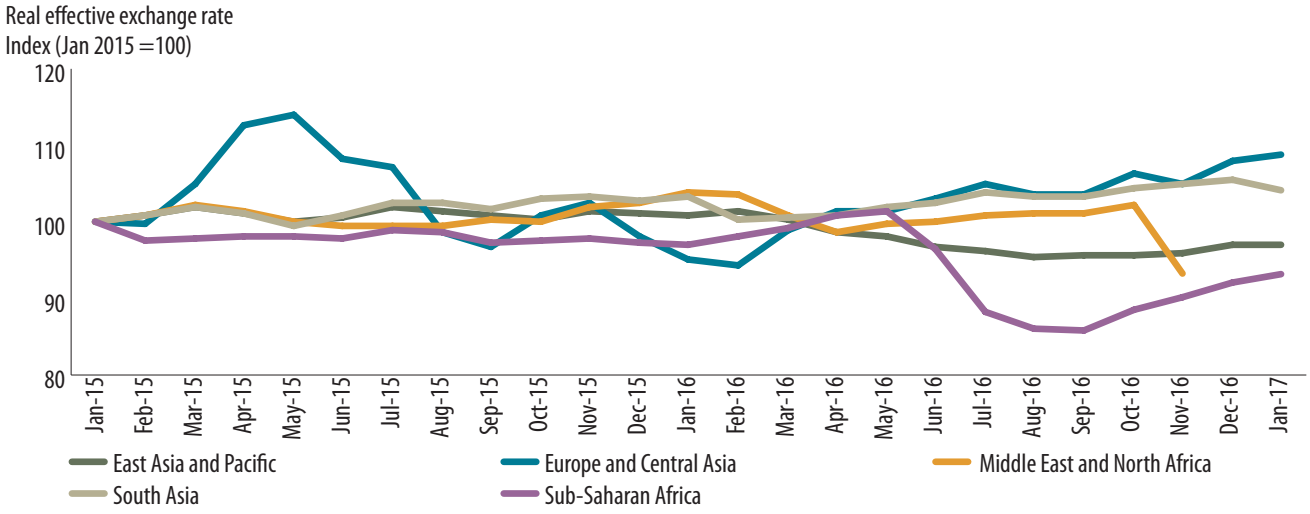
Changes in the use of specific digital payment tools over the last few months suggest that a permanent change might have taken place. Reliance on small-value digital payments, such as mobile wallets and debit and credit cards, increased strongly after demonetization. While around 7800 billion Rupees of cash were initially withdrawn from circulation, retail electronic clearing increased from 10,600 billion Rupees in October 2016 to above 12,400 billion Rupees in January 2017. Use of debit and credit cards at points of sale increased from 520 billion to 820 billion Rupees. The total value of transactions relying on prepaid instruments, including mobile wallets, doubled between November 2016 and January 2017. The coming months will tell whether these changes are here to stay.

FIGURE: Reliance on electronic payments accelerated after demonetization.



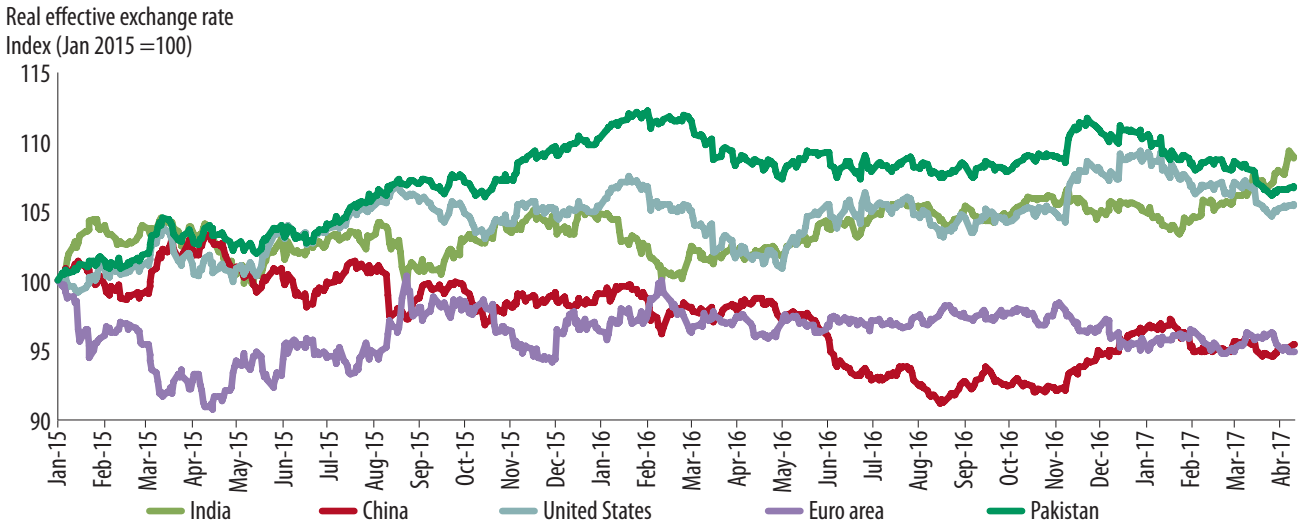
Source: Reserve Bank of India

FIGURE 17: South Asia has appreciated relative to other regions.



Source: World Bank

FIGURE 18: Competitiveness has fallen, in particular relative to China.



Source: Haver Analytics/JP Morgan

Despite lower inflation, further monetary easing is constrained. Over the course of 2016 and the beginning of 2017, official interest rates have moved relatively little in South Asia. An exception is Sri Lanka, where the interest rate was hiked three times, crawling up from 6 percent in 2015 to 7.25 percent at present. This moved helped restrain monetary and credit expansion and should help contain inflationary expectations. Conversely, in India and Pakistan interest rates have been lowered from 6.8 and 6.5 percent respectively to 6.3 percent. But overall inflation is now around target in most countries and the room for monetary easing is limited. Together with the recent reversal in food prices, increasing interest rates in the US and the experience of high inflation rates until not long ago have prompted a cautious monetary policy stance across the region.

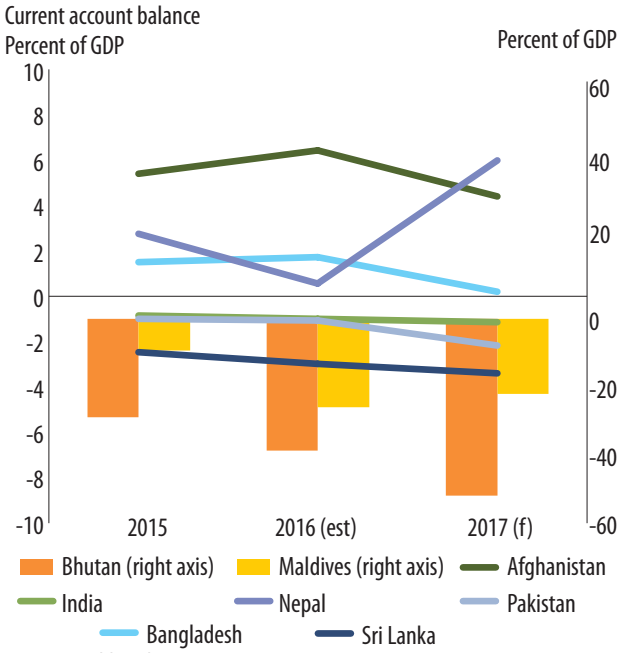
Real exchange rate appreciation may harm international competitiveness. Unlike other regions, South Asia has seen its real effective exchange rate appreciate over the course of 2016 and early 2017. Appreciation makes exports from the region less competitive in international markets. In particular, the Chinese Yuan has depreciated vis-à-vis the India and Pakistan Rupees as well as against the Bangladesh Taka. On a more positive note, the US dollar has also strengthened and the US is the most important export market for most South Asian products. With the continuing normalization of US interest rates, the US dollar may even to strengthen further. As a result, higher US demand for South Asian exports could counter the effects of real exchange rate appreciation in the region.

Current and capital accounts are for the most part in order

Current accounts remain mostly balanced. South Asian current accounts were already relatively stable in 2016, and they are increasingly balancing out this year. Bangladesh is running a surplus, but it is almost negligible. Afghanistan has somewhat closed the gap in its current account, which is expected to further consolidate this year. The current account balance will widen slightly in Pakistan, and strongly in Nepal. Maldives and Bhutan are the two long-standing outliers in South Asia, characterized by a very large and even widening current account deficit. In both cases, this large deficit is associated with large investment projects relative to the size of the country.

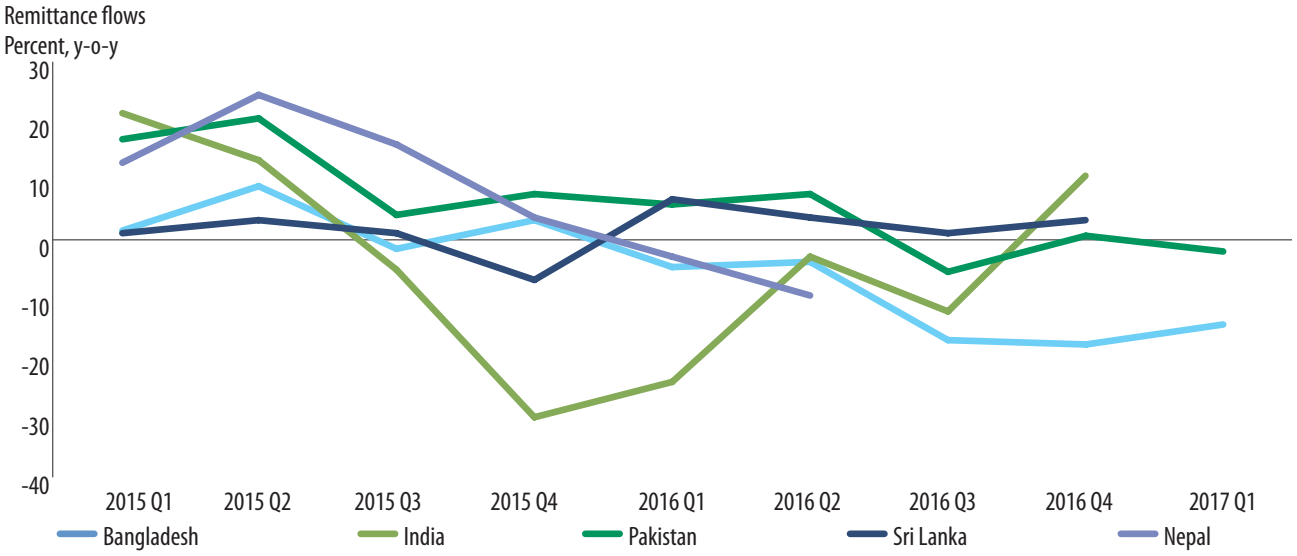
Remittances flows which had significantly slowed in recent years are beginning to rebound. Gulf countries, which are the largest recipients of South Asian migrant workers, spent most of 2015 and the first half of 2016 reeling with low crude oil prices. The fiscal constraints they faced dampened the demand for migrant labor, leading to declining remittance flows in the region. Lower remittance levels affected private consumption growth and challenged current accounts in several countries in the region. By the end of last year, remittances flows had broadly stabilized, but at relatively low levels. Based on the latest data available, remittances are still declining in Bangladesh and Nepal, while they seem to have found a floor in Pakistan and Sri Lanka. In India, where remittances are a small part of capital inflows, remittances bottomed out in late 2016. However, in absolute terms remittance inflows to South Asia are still far below their pre-oil slump level.

FIGURE 18: Except in Bhutan and Maldives, current account balances are positive or moderately negative



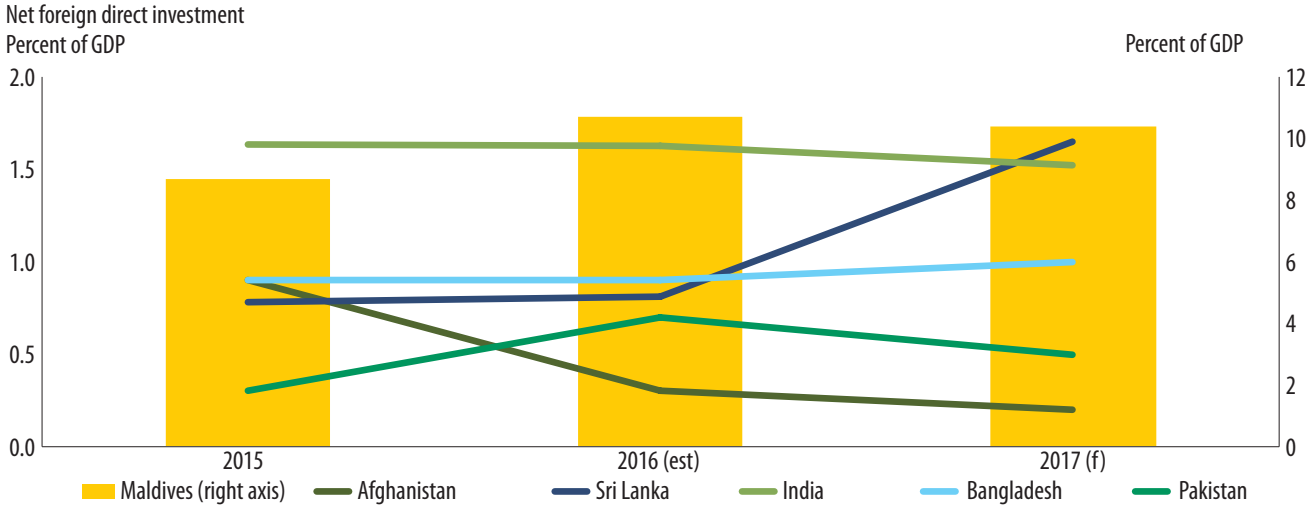
Source: World Bank
Note: est = estimate, f = forecast

FIGURE 20: Remittances are still decreasing in Bangladesh and Nepal, but holding well elsewhere.



Source: Haver Analytics/National Authorities

FIGURE 21: FDI inflows are stable but not stellar.

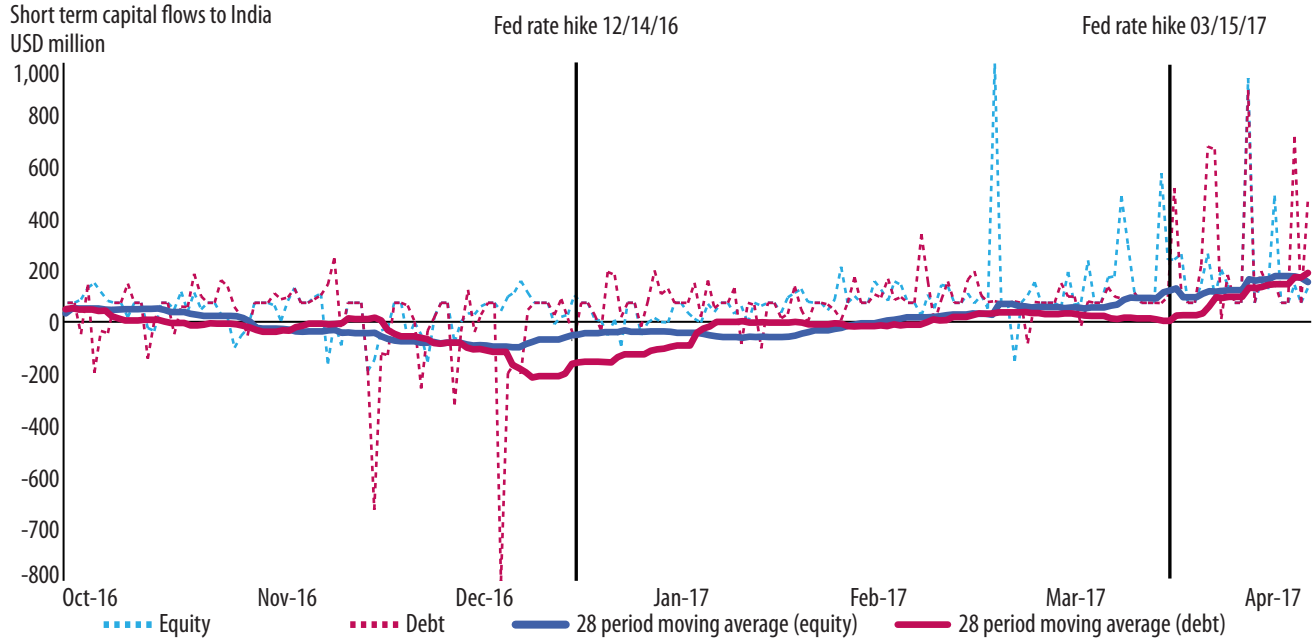


Source: World Bank
Note: est = estimate, f = forecast

Inflows of Foreign Direct Investment (FDI) remain broadly stable. Except for Sri Lanka, where inward FDI is expected to experience a sizeable increase this year, South Asia has not witnessed major changes in long-term capital flows in recent times. FDI inflows increased last year in Pakistan, but they are reverting to low levels this year. In India they remain strong and in Maldives they are particularly large – relative to the size of the economy. Shorter-term capital movements have also been resilient. Portfolio inflows are increasing in India, where they were not affected by the hike of US interest rates in March. To the contrary, in April equity and debt inflows were in fact very strong.

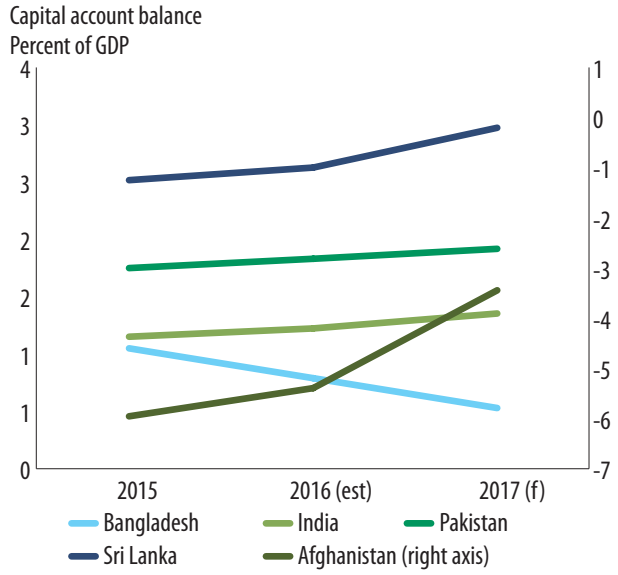
Capital account balances remain positive in most cases and international reserve levels have mostly increased. Last year, capital account balances were nearly stable in almost all countries in the region, and improved in Afghanistan. This year the balance is foreseen to increase in Sri Lanka and further strengthen in Afghanistan, while it is projected to decline in Bangladesh. Meanwhile, international reserves remain at relatively comfortable levels across the region. In

FIGURE 22: Short-term capital flows to India increased despite US interest rate hikes.



Source: Institute of International Finance and World Bank staff calculations

FIGURE 23: Capital account balances remain positive in most cases.



Source: World Bank
Note: est = estimate, f = forecast

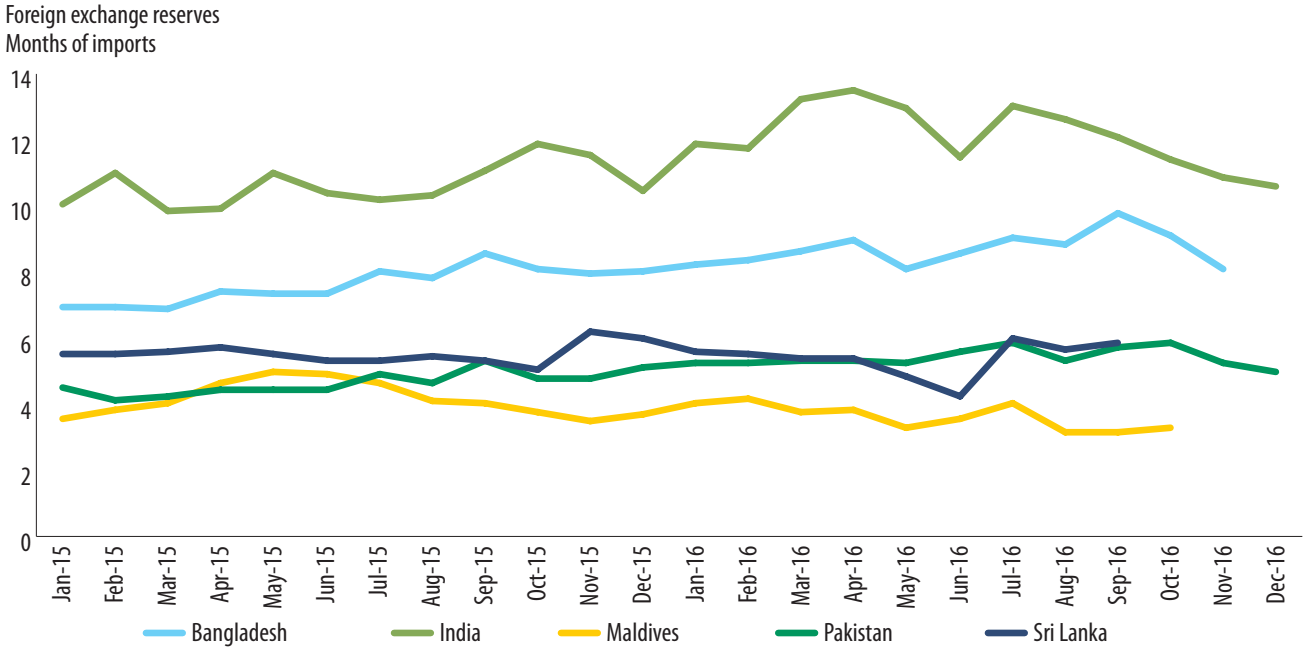
particular, Bangladesh and India have built solid cushions, representing 8 and 12 months of import cover respectively. On the other hand, Pakistan and Sri Lanka, could somewhat increase their reserve levels to reduce risks. As usual, the smallest buffers are in Maldives.

Fiscal balances and debt levels remain a concern

Fiscal consolidation remains work in progress for most of the region. Increasing government revenue is a challenging task around the world, but it seems particularly daunting in many South Asian countries. Except in the smaller countries, government revenue is low relative to GDP. Public spending is more in line with what could be expected at the region's development level, so the result is quite sizeable budget deficits. Low revenue generation should not come as a surprise in a conflict-affected country like Afghanistan, but it is a concern in fast-growing and relatively wealthier countries in South Asia. Fiscal deficits decreased modestly in Sri Lanka and Pakistan, two countries under pressure to consolidate their public finances. In India, despite steady consolidation at the central level, the overall budget deficit has remained stubbornly stable due to widening fiscal deficits at the state level. In all other countries deficits have increased. And Bhutan is expected to witness a skyrocketing deficit largely due to an increase in its capital expenditures.

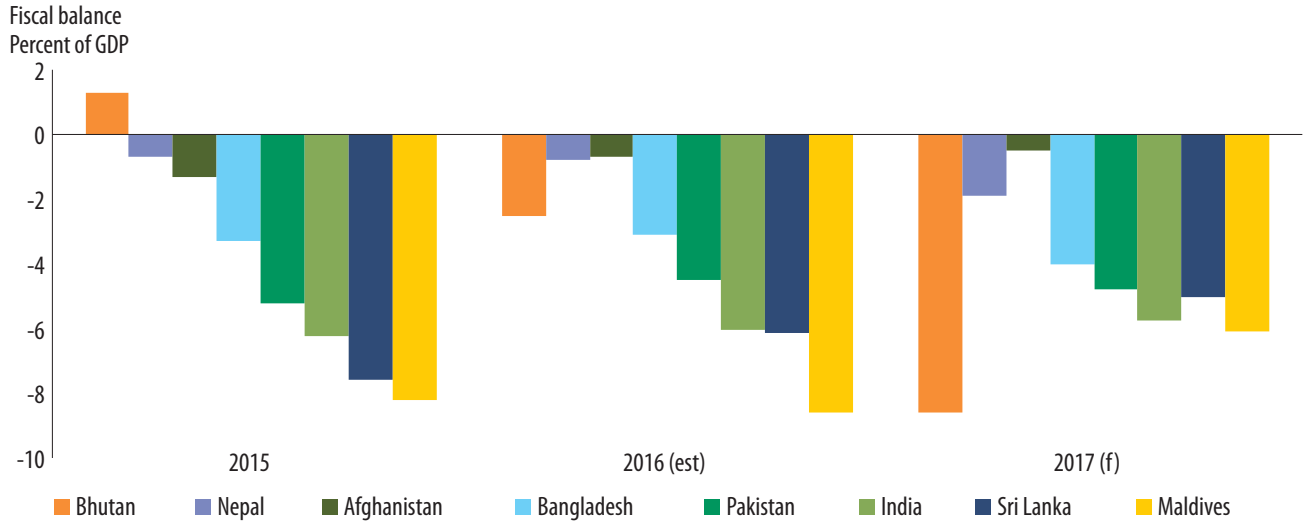
South Asia's public debt is high, and it continues to rise. South Asia's debt-to-GDP ratio is among the highest in the world, second only to that of the Middle East and North Africa region. For the region as a whole, public debt will likely surpass 60 percent of GDP this

FIGURE 24: International reserves are at comfortable levels across most of the region.



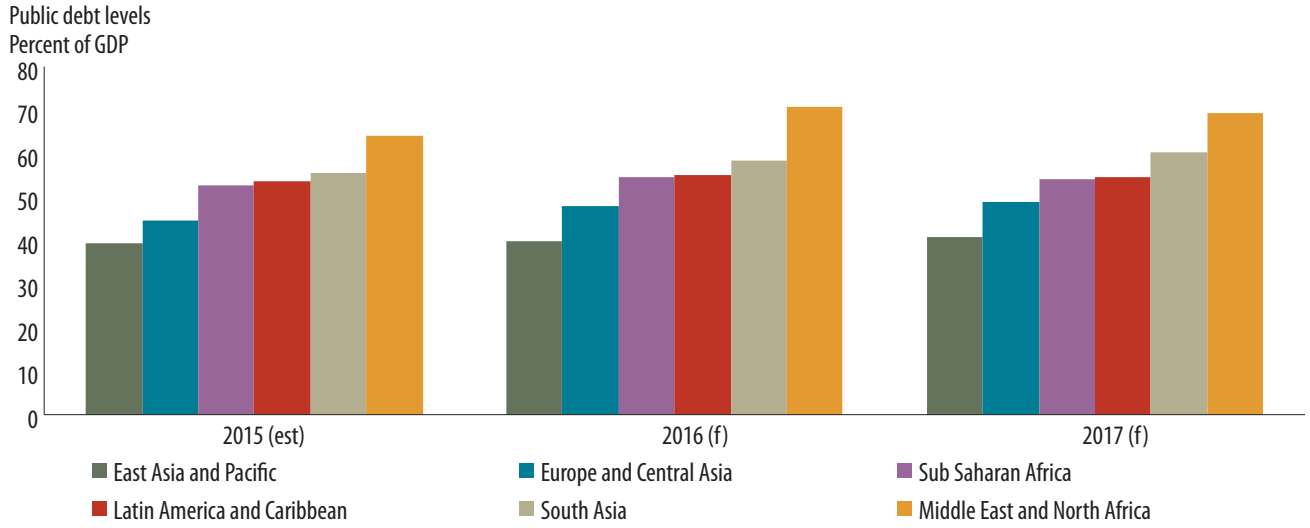
Source: World Bank

FIGURE 25: Fiscal deficits remain sizeable in Sri Lanka, Maldives and India.



Source: World Bank
Note: est = estimate, f = forecast

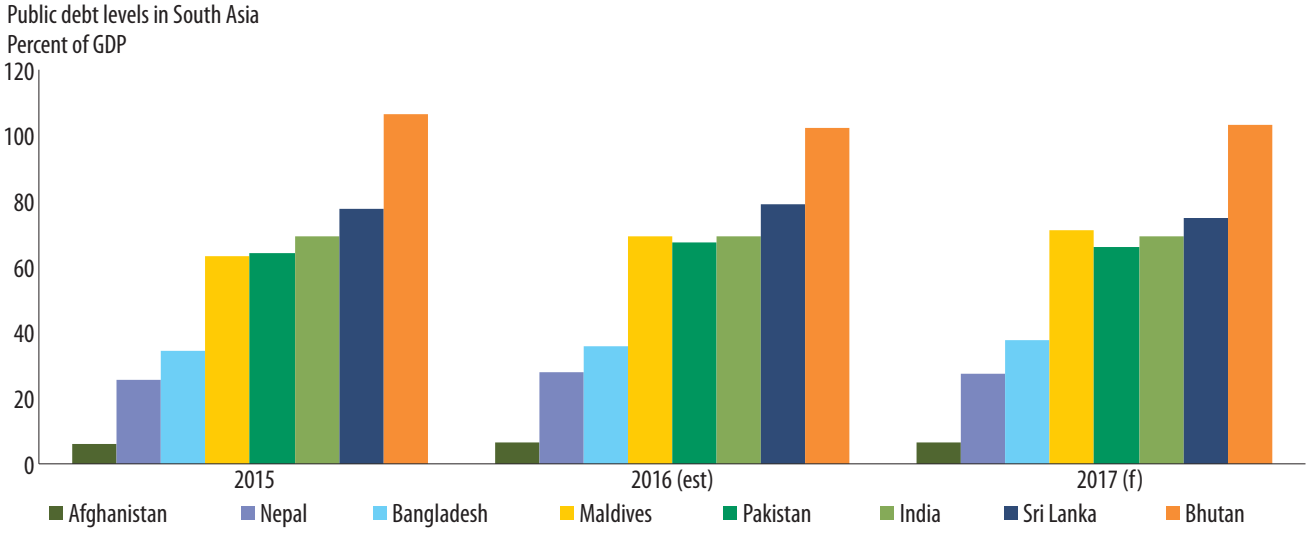
FIGURE 26: South Asia's public debt is the second highest across regions.



Source: International Monetary Fund World Economic Outlook and World Bank staff calculations
Note: est = estimate, f = forecast

year. But debt levels vary strongly within South Asia, and countries can broadly be grouped in three categories. The first category includes Bhutan and Maldives, which both have high and increasing debt levels. Bhutan's debt is mainly originating in commercially viable hydro power projects and is well financed. On the other hand, the returns on the recent increases in Maldives' public expenditure are less certain, which makes the country more vulnerable to inherently volatile tourist revenue. The second category includes Sri Lanka, India, and Pakistan, with debt to GDP ratios between 65 and 75 percent. These countries are committed to fiscal consolidation and expect declining debt-to-GDP ratios in the coming years. The third category comprises Nepal and Bangladesh, two countries with stable public debt, at around one third of GDP. While debt levels seem broadly sustainable, preserving a low risk of debt distress will require continued fiscal consolidation.

FIGURE 27: Debt levels are stable in most countries, but increasing in Bhutan and Maldives.



Source: World Bank
Note: est = estimate, f = forecast

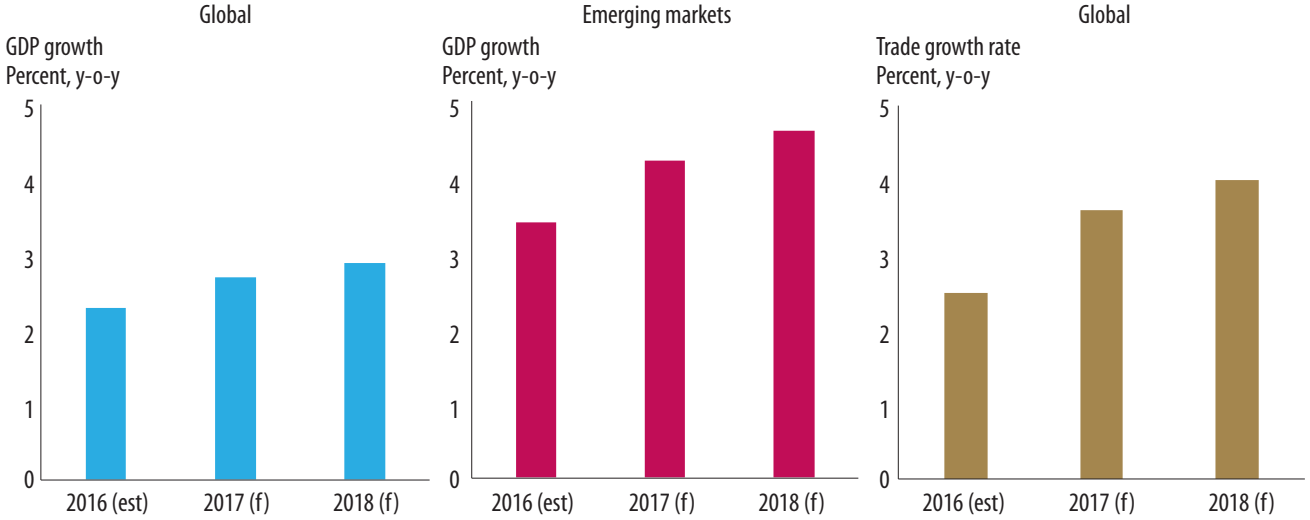
South Asia economic outlook

South Asia's performance will maintain momentum, with the gap between its growth rate and that of East Asia slightly widening over time. Regional growth is expected to surpass 7 percent from 2018 onwards. Robust domestic demand, an uptick in exports, and steady FDI inflows underlie this positive outlook. But with financial sector risks remaining, creating financing opportunities for private investment remains a challenge.

Global growth is expected to accelerate from 2.3 percent in 2016 to 2.9 percent in 2018. This regained momentum will be driven by higher growth in both advanced economies and emerging markets. In the latter group of countries, growth is expected to rise from 3.4 percent last year to 4.6 percent in 2018. This encouraging outlook depends crucially on favorable developments in world trade. The global trade growth is forecast to increase from 2.5 percent last year to 3.6 percent this year and to 4.0 percent in 2018. Higher international trade barriers would make such strong growth in trade less likely, making the threat of protectionism a key downside risk to the overall growth outlook.

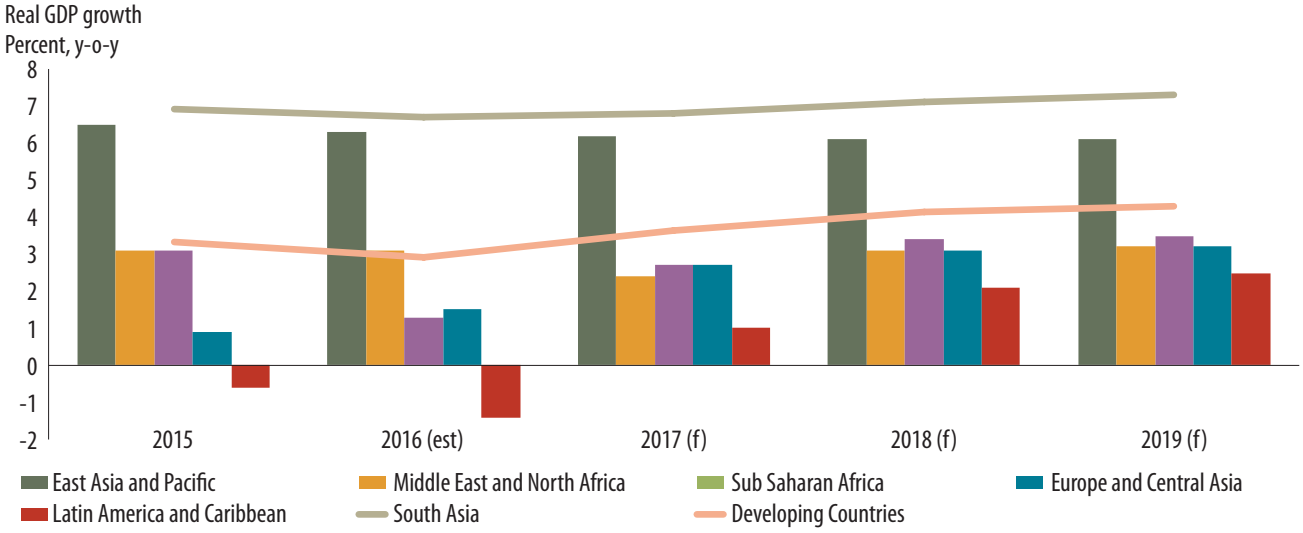
After a minor decline last year, growth in South Asia is accelerating. Growth in the region is expected to step up over the coming years, reaching 6.8 percent in

FIGURE 28: Global growth will accelerate.



Source: World Bank
Note: est = estimate, f = forecast

FIGURE 29: South Asia will consolidate its leadership of global growth.



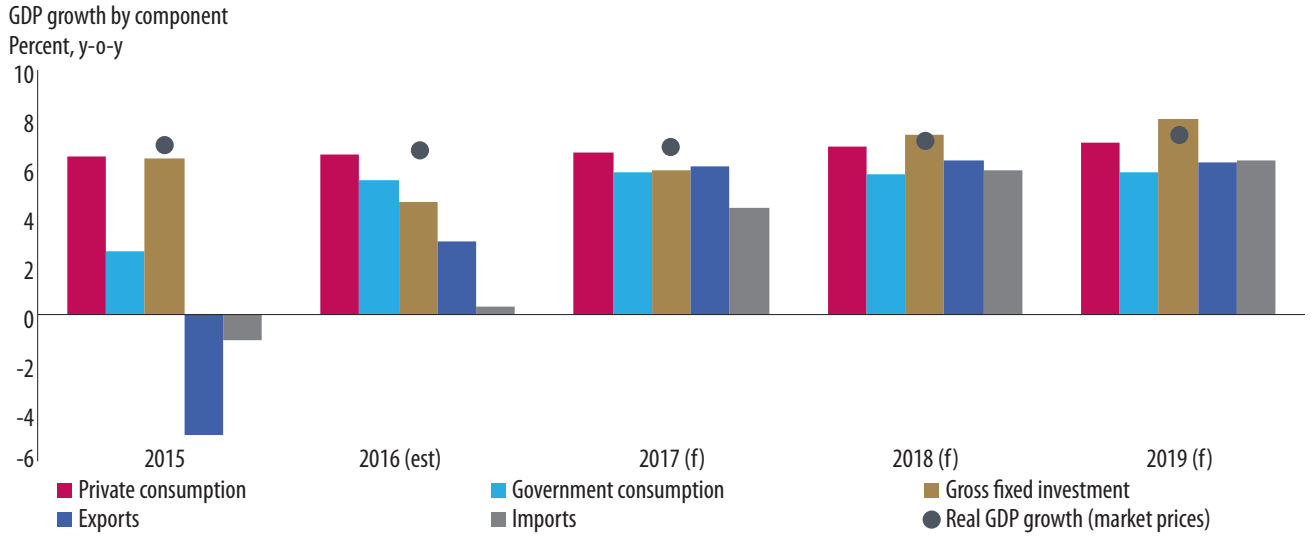
Source: World Bank
Note: est = estimate, f = forecast

2017, 7.1 percent in 2018 and 7.3 percent in 2019. While this is a very encouraging outlook, it implies slightly lower growth than predicted before. In the near future, disruptions from demonetization in India are still expected to leave a temporary mark. Regarding the longer-term, the persistent weakness in investment rates has led to a slight downward revision of the region's potential output. Regardless, with growth in East Asia expected to remain relatively stable, at slightly above 6 percent, the gap between the two regions will widen. South Asia is thus expected to expand its leadership of global growth.

In the coming years, growth in South Asia will be supported by higher exports and stronger investment growth. Private and government consumption are expected to remain broadly stable and to continue making a robust contribution to regional growth. Salary hikes for civil servants in Bangladesh and India, and larger government spending in infrastructure could even enhance the role of government consumption in the medium term. But there is also an expected acceleration of private investment and exports. By 2018, investment is anticipated to become the major driver of growth and the contribution of exports is projected to double.

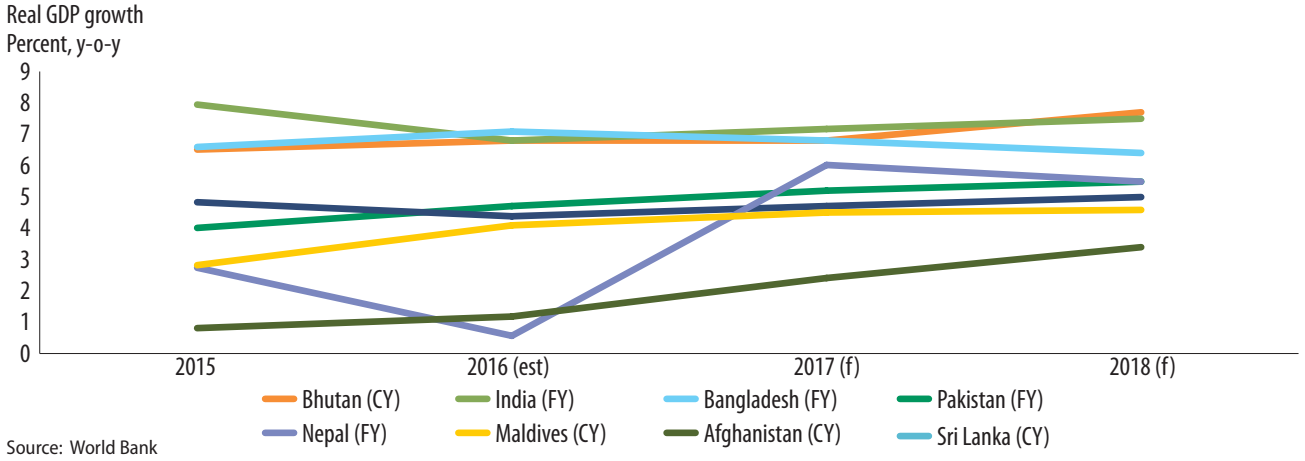
While growth rates vary across countries, the acceleration of growth should be experienced across

FIGURE 30: South Asia will increasingly be driven by exports and investment.



Source: World Bank
Note: est = estimate, f = forecast

FIGURE 31: Growth is expected to accelerate across the region.



Source: World Bank
Note: CY = calendar year, FY = financial year, est = estimate, f = forecast

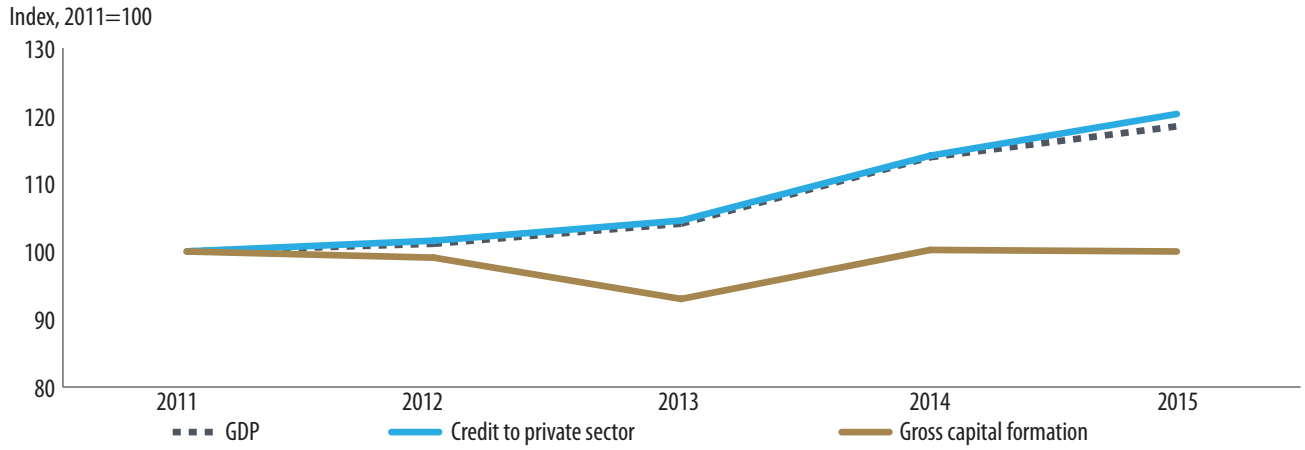
most of the region. Both Bhutan and India are foreseen to grow at rates exceeding 7 percent within the coming years. In Bhutan, the upturn in investment is expected to continue and growth in agriculture will accelerate. In India, medium-term growth will be underpinned by a recovery in private investment supported by an improvement in the investment climate. Pakistan's medium-term growth prospects have improved in recent years. And assuming that the security situation will not deteriorate further, growth in Afghanistan could reach over 3 percent in 2018. After a slowdown last year, Sri Lanka is now benefiting from its efforts to improve its fiscal sustainability and to reform its economy. It is projected to grow by 4.7 percent this year and by marginally over 5.0 percent in the medium term. After a very strong recovery, growth in Nepal is expected to moderate again. At about 4 to 5 percent, it would be close to its potential. Based on an expansion of the

TABLE 1: Growth is expected to accelerate across most of the region

Real GDP growth	2015	2016 (est)	2017 (f)	2018 (f)
Afghanistan (CY)	0.8	1.2	2.4	3.4
Bangladesh (FY)	6.6	7.1	6.8	6.4
Bhutan (CY)	6.5	6.8	6.8	7.7
India (FY)	7.9	6.8	7.2	7.5
Maldives (CY)	2.8	4.1	4.5	4.6
Nepal (FY)	2.7	0.6	6.0	5.5
Pakistan (FY, at factor cost)	4.0	4.7	5.2	5.5
Sri Lanka (CY)	4.8	4.4	4.7	5.0

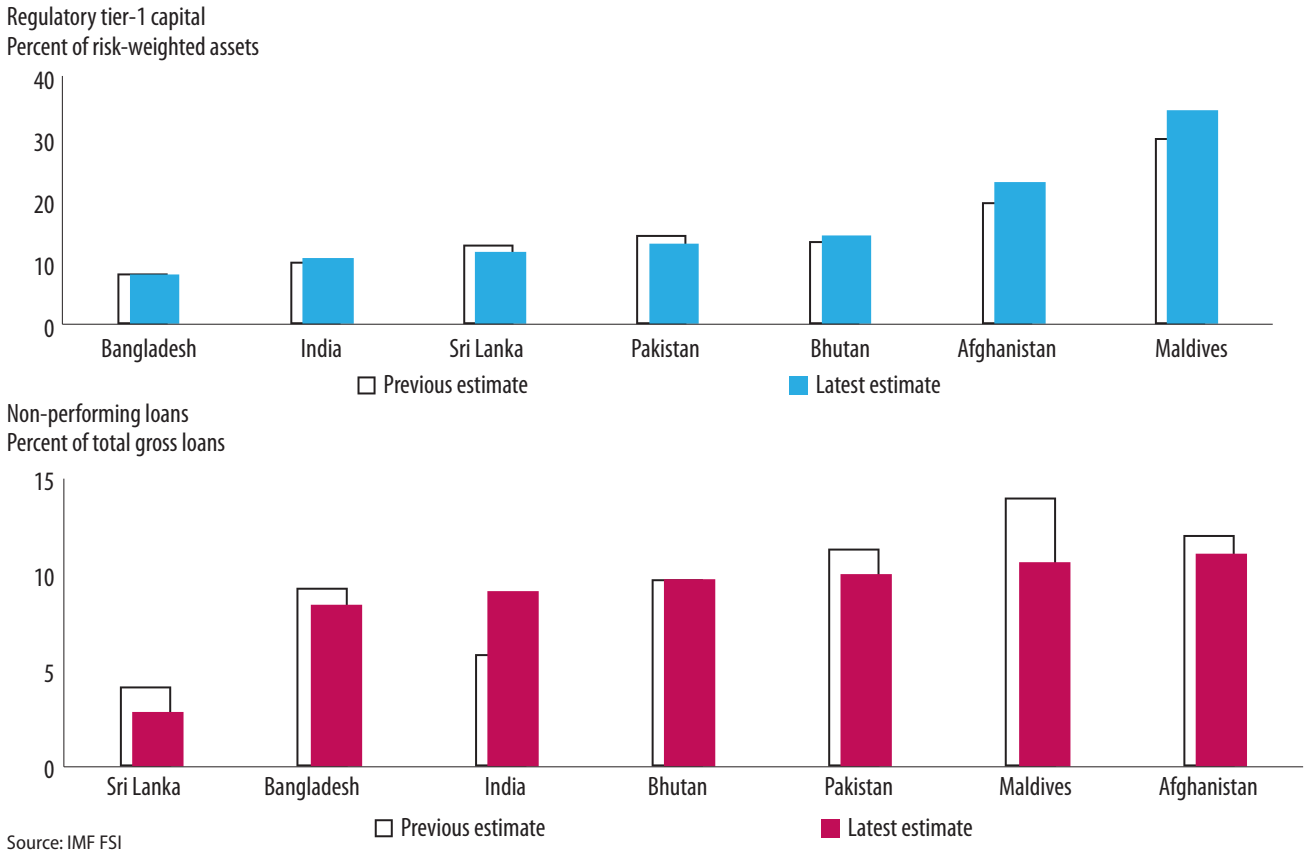
Source: World Bank
Note: CY = calendar year, FY = financial year, est = estimate, f = forecast

FIGURE 32: Despite credit expansion, investment remains morose.



Source: World Bank WDI and staff calculations

FIGURE 33: Financial sector risks remain.



Source: IMF FSI

number of resorts and large FDI inflows, Maldives is expected to sustain a growth rate above 4 percent that will gradually accelerate.

The financing of investment will remain a major challenge. The projected positive developments in South Asia build on a strong contribution of investment, typically a major source of productivity gains. With public debt levels already high, public investment will not suffice. But private investment has recently disappointed in the region. One reason is that the financial sector remains vulnerable, thus constraining the funding of new projects. To support higher private investment levels, South Asian countries will have to attract more FDI and clean-up their financial systems. The latter will require the restructuring of bad corporate debt and non-performing Private-Public-Partnerships. The current over-leveraging of corporate balance sheets adds to the concerns.

TABLE 2: Robust domestic demand, an uptick in exports, and strong investment underlay gradual acceleration of growth.

South Asia regional forecast summary (Apr 2017)							Percentage point difference from Jan 2017 projections			
	2014	2015	2016e	2017f	2018f	2019f	2015	2016	2017	2018
Real GDP growth (market prices)	6.7	6.9	6.7	6.8	7.1	7.3	0.0	0.1	-0.1	-0.3
GDP per capita (U.S. $)	5.3	5.6	5.4	5.5	5.8	6.0	0.0	0.1	0.0	-0.2
GDP (PPP $)	6.7	6.9	6.7	6.8	7.1	7.3	0.0	0.1	-0.1	-0.3
Private consumption	6.2	6.5	6.6	6.6	6.9	7.1	0.0	0.1	0.2	-0.1
Government consumption	8.9	2.6	5.5	5.8	5.8	5.8	0.0	0.4	-1.5	-1.4
Gross fixed investment	2.7	6.3	4.6	5.9	7.3	8.0	0.0	0.1	-1.9	-1.5
Exports	5.4	-4.9	3.0	6.0	6.3	6.2	-0.1	0.0	0.8	0.4
Imports	1.1	-1.0	0.4	4.4	5.9	6.3	0.1	0.6	-1.2	-0.7

Source: World Bank DECPG
Note: e = estimate, f = forecast

Globalization backlash

Pressures against international trade are mounting. The negotiation of mega-regional trade agreements stalled, the number of protectionist measures has increased, and existing agreements may be reconsidered. South Asia was already less integrated in global merchandise trade than other regions. In light of current pressures, a legitimate question is whether it should focus on exports as a driver of economic growth and job creation. However, the prospects for the region are better than it seems. The stalled mega-regional trade agreements, which did not include any South Asian country, were expected to reduce South Asia's competitiveness. Simulations on the impact of hypothetical new trade barriers applied across the board suggest that the harm for the region would be limited. And in a scenario where hypothetical new trade barriers would be applied selectively, South Asia could actually benefit from trade diversion. The region also stands to gain from the observed growth recovery in advanced economies, because they are the main markets for its exports. The current globalization backlash should thus not dissuade South Asian countries from having a stronger outward orientation. But the gains for the region would be larger if its exports were more diversified and its supply response were more elastic.

Global trade is under threat

Anti-trade moves are on the rise. The number of trade restrictions has been slowly increasing across the world, reaching last year a post-crisis high. Emerging markets and developing economies have engaged in a broad set of restrictive measures including import tariffs and export taxes. And advanced economies have enacted numerous trade defense measures. Recent political developments suggest that for many people in advanced economies globalization has gone too far. The vote for Brexit in the UK, and the election of Donald Trump as US President, have been interpreted as signaling a further shift against the international trade architecture built over the last few decades.

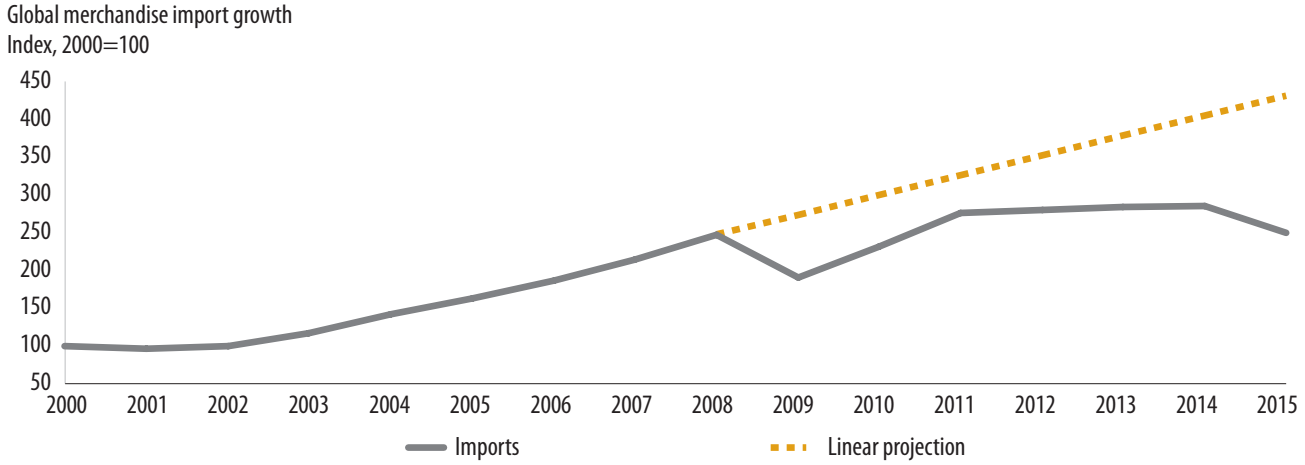
The future of trade policies is uncertain. Until not so long ago the World Trade Organization was a key player in negotiating global reductions in trade barriers. The last series of negotiations, the so-called Doha Round, aimed for a major reform of the international trading system through even lower barriers and upgraded standards. As no agreement could be reached, efforts shifted to the negotiation of mega-regional trade agreements with a broad geographic and economic coverage. The Trans-Pacific Partnership (TPP) originally included twelve countries which together account for roughly 40 percent of global GDP. The Transatlantic Trade and Investment Partnership (TTIP) was supposed to bring the US and the EU closer together. Because of their scope, these mega-regional trade agreements were expected to take global integration to a higher level. But with the recently announced US withdrawal from TPP and strong reservations against TTIP both in the US and the EU, negotiations are effectively stalled. More recently, US President Trump signed two executive orders aimed at tackling possible trade abuses, raising the prospects of trade barriers against imports from countries with large trade surpluses. In light of these developments, there is concern that international trade will be increasingly restricted. Much will depend on how the US trade policy agenda evolves.

In reality the hyper-globalization phase was already over even before this backlash. Global trade expanded much faster than global GDP over the last few decades, even doubling in just a few years, from 2000 to 2008. Lower transport costs, greater integration of production processes in global value chains, and large gains in productivity and logistics in China, underlie this surge in global integration. But the relationship between global trade growth and global GDP growth is weakening. International trade plummeted during the global financial crisis, and since then it is growing much more slowly than before.

Should South Asia worry?

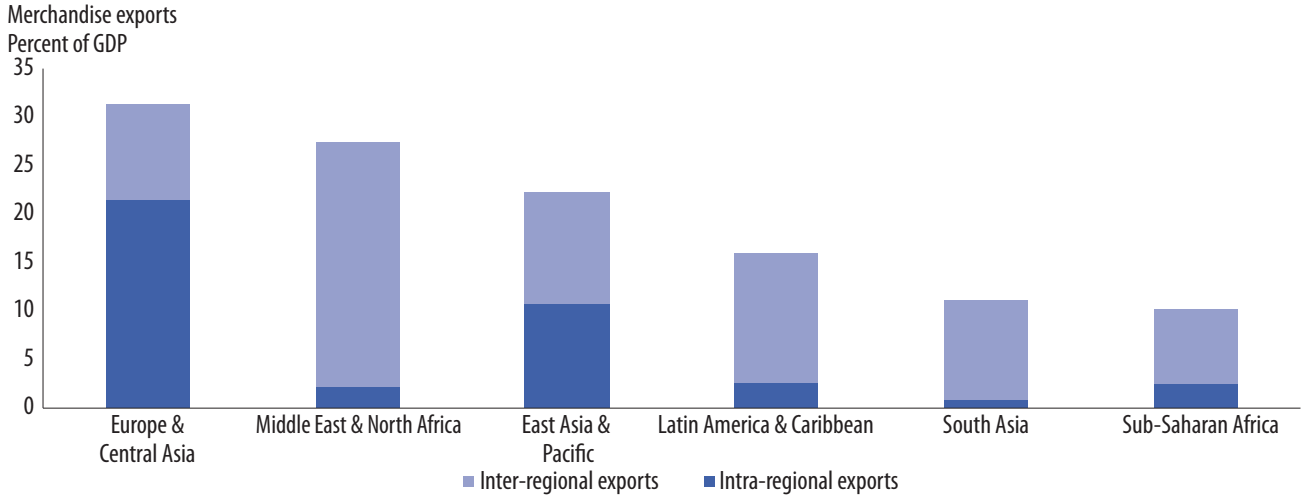
Globalization has been good for development and trade has been crucial to poverty reduction. The expansion of international trade has boosted demand for labor-intensive products and labor-intensive tasks sourced from developing countries. With labor being the main or even the only asset of the poor, this additional demand has created job opportunities and raised incomes, helping lift large numbers of people out of poverty in just a few decades. This is a key reason

FIGURE 34: The hyper-globalization phase was over even before this backlash.



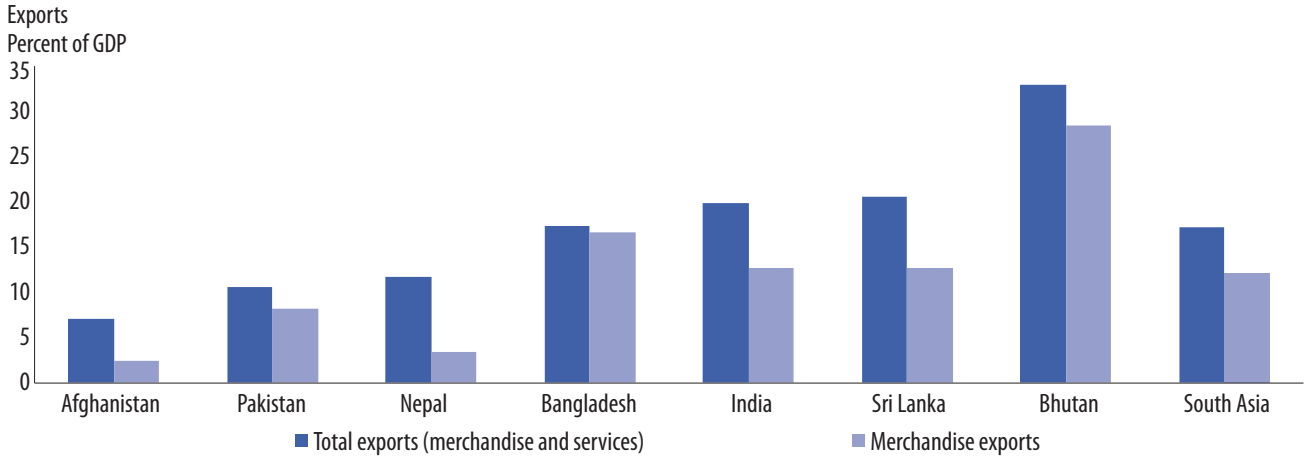
Source: World Bank WDI and staff calculations
Note: The linear projection is based on the average growth from 2003 to 2008

FIGURE 35: South Asia was not highly integrated in global markets to begin with.



Source: World Bank World Integrated Trade Solution and staff calculations

FIGURE 36: Trade is low across nearly all countries in South Asia.



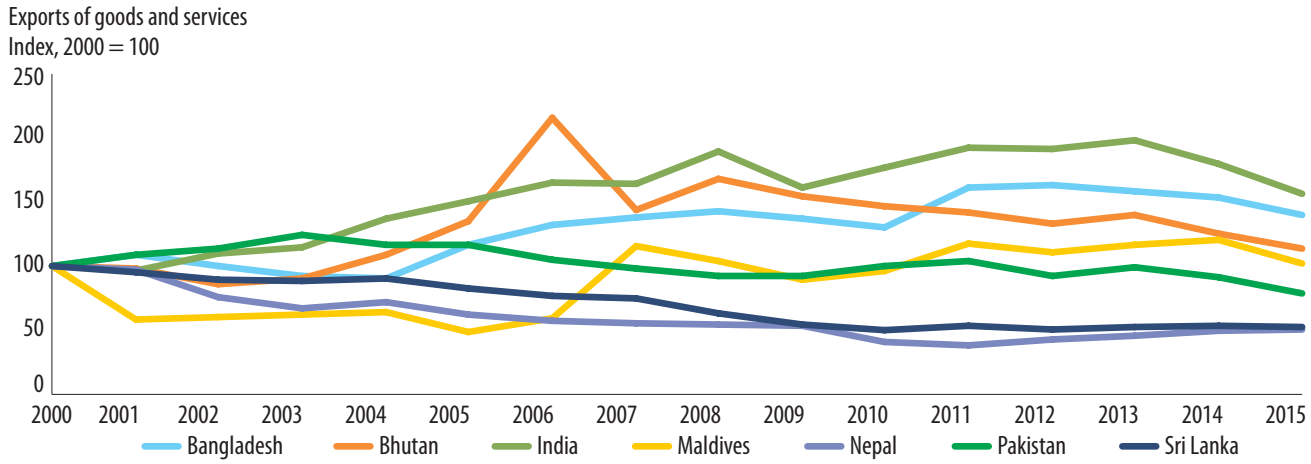
Source: World Bank WDI

why the prospect of rising protectionism is a matter for concern. Protectionism can take multiple forms, involving a combination of tariff and non-tariff measures. Increasing trade barriers across the board unambiguously reduces international trade. But if barriers are increased unevenly across countries, there can be trade diversion in addition to trade destruction.

South Asia is not highly integrated into global trade. Its exports account for only around 10 percent of its GDP, which is less than in all other regions barring Sub-Saharan Africa. For many countries in East Asia, exports have been an important driver of economic growth, accounting for over 20 percent of GDP. And in Europe and Central Asia the ratio even exceeds 30 percent of GDP. Nearly all South Asian exports go out of the region, with only a very small fraction traded among neighboring countries. But while trade is low across the region, there is also some heterogeneity across countries. Merchandise exports vary between less than 5 percent of GDP in Nepal to around 15 percent in Bangladesh. Exports of services are significant in Nepal, India, and Sri Lanka. India has increased its service exports fast and is now the 7th largest service exporter in the world. Regardless, in recent years the growth of the region has been increasingly inward-oriented, as shown by the fact that trade has decreased as a share of GDP.

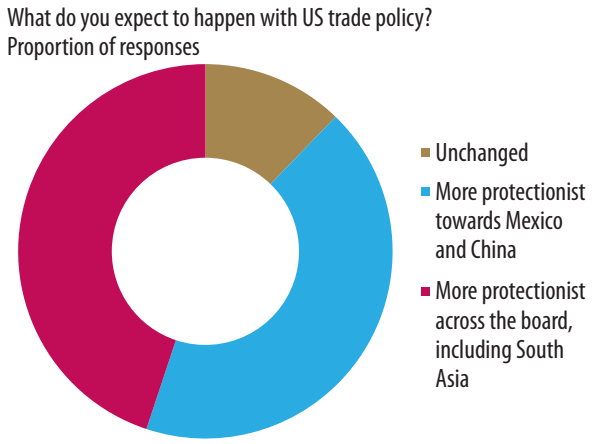
Researchers and practitioners in the region expect more protectionism in the US. The globalization backlash is clearly in the minds of experts from the South Asia Economic Policy Network. Only 12 percent of those who responded to a survey conducted for this report expect the US trade policy to remain unchanged. The rest is almost equally divided, with 43 percent expecting more protectionism towards China and Mexico and the remaining 45 percent expecting

FIGURE 37: Economic growth was already becoming inward-oriented.



Source: World Bank WDI and staff calculations

FIGURE 38: Researchers and practitioners expect more protectionism.



Source: South Asia Economic Policy Network

more protectionism across the board, including towards South Asia. Hence an overwhelming majority anticipates more protectionism, in one form or the other. This broad consensus calls for rigorous analysis aimed at understanding how mounting barriers to trade would affect the region.

The implications of the globalization backlash for South Asia are not straightforward. Given the prospect of rising protectionism, it could be argued that South Asia should not even try to rely on exports as a driver of growth. If the region found it difficult to export already in the time of hyper-globalization, how challenging would it be now? This export pessimism is often reinforced by concerns about so-called premature deindustrialization. The share of manufacturing in total GDP typically peaks at some point in a country's structural transformation, as it transitions from agrarian economy to advanced society. But the level of the peak is becoming lower over time, undermining industrialization hopes among late-comers. It is thus legitimate to ask whether South Asia should follow on the steps of East Asia and aim for export-driven growth.

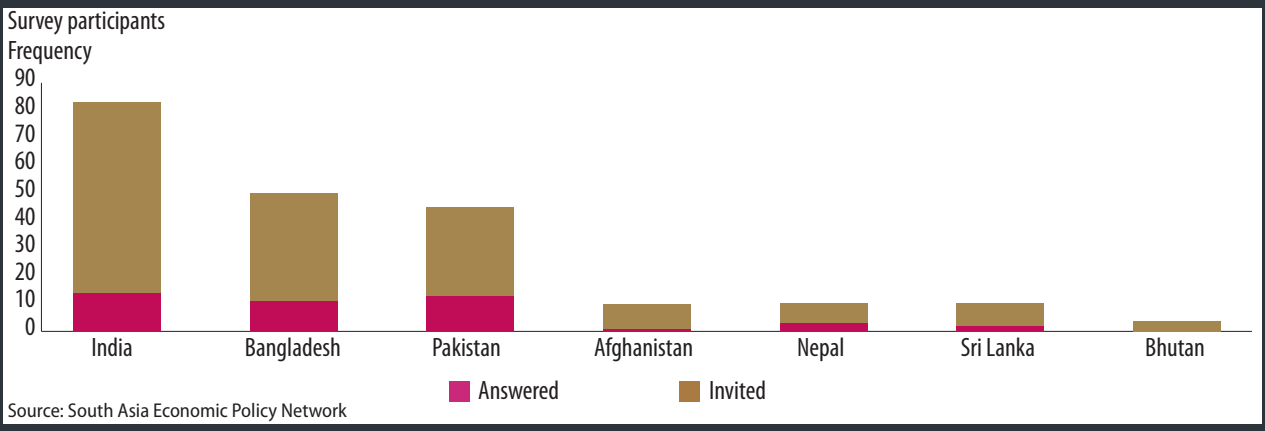
Numerical simulations provide a clearer perspective on South Asia's trade prospects than theoretical speculation. Four methodological approaches are used in what follows. First, an analytical review of research on TPP and TTIP allows quantifying the possible impact of these mega-regional trade agreements failing to materialize. Two other approaches are used to illustrate the consequences of hypothetical trade policy scenarios. These scenarios are not predictions about commercial policy in advanced economies, which this report does not make. They are only meant to inform a concerned region. One of the scenarios (trade destruction) involves a relatively small hike in US tariffs across the board; the other (trade diversion), a larger hike in tariffs against China and Mexico only. Under the assumption of approximately linear effects, these scenarios can be combined, or multiplied, to explore the possible consequences of more dramatic protectionist moves. The second methodological approach in this report employs a computable general equilibrium (CGE) model to understand the impact of these scenarios. CGE models reproduce the structure of the economy as a whole as realistically as possible, taking into account market interactions between households and firms, as well as technical linkages between sectors. The third approach adds granularity to this analysis by using a microeconometric trade model comprising thousands of products. While this approach incorporates less economic structure than a CGE model, it takes into account the relationship

The South Asia Economic Policy Network

There is remarkable analytical capacity in South Asian countries. The South Asia Economic Policy Network, launched by the office of the regional Chief Economist at the World Bank earlier this year, represents an attempt to engage more strongly with thinkers and doers across the region. The aim is to be more proactive in nurturing the exchange of ideas and to learn more systematically from colleagues and counterparts in the region. For now the Network focuses broadly on macroeconomics. It includes more than 210 researchers and practitioners who are all based in the region. Many of them are academics at renowned universities, others are researchers at central banks and think tanks, and some are affiliated with policy-making units. The network has a wide regional coverage and includes researchers from seven countries, based on peer recognition. A little over 10 percent of its members are women.

For this report, a short survey was conducted among Network member. The objective was to understand how they see economic developments unfolding in the coming months, what they would expect to happen in their countries in various trade policy scenarios, and which are in their view the most important policy priorities at this juncture. The response rate exceeded 20 percent, with 50 filled-in questionnaires received from six countries. The views of the Network are summarized throughout the *In Focus* section of this report.

FIGURE: We asked over 200 economists from seven countries about their views.



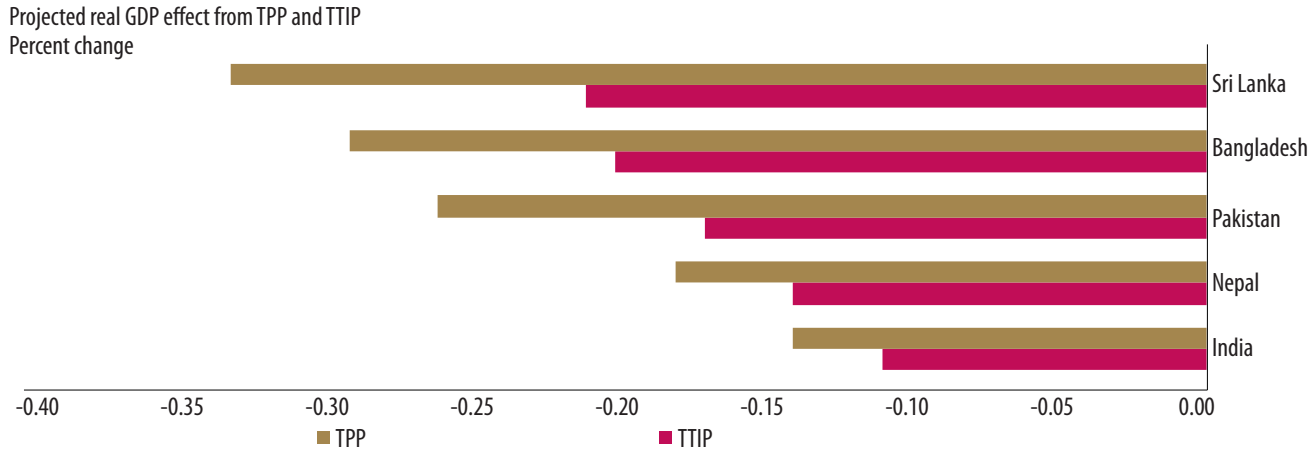
Source: South Asia Economic Policy Network

between the price of a product and the quantity demanded of it by international buyers on a product-by-product basis. Finally, the fourth approach is based on time-series analysis of aggregate indicators. In this case the methodology captures the dynamic relationship between key indicators such as GDP growth in advanced economies and in South Asia. All four approaches involve simplifying hypotheses that could be questioned. But the combination of the four gives some reassurance about the robustness of the findings. Further insights come from systematically comparing the results of these approaches with the views and predictions of experts from the region.

Gains from trade diversion

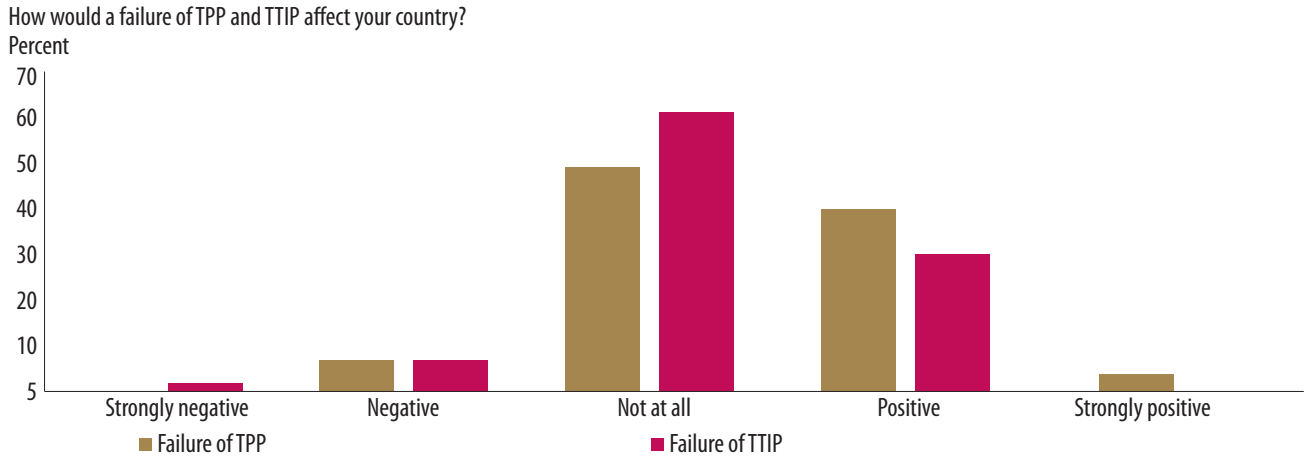
TPP and TTIP were expected to have a small negative impact on the region. Research about the effects of the two mega-regional trade agreements concluded that both would have had adverse repercussions on the region. Some aspects of such agreements, for example in the realm of regulation, tend to be non-discriminatory in nature and benefit both member and non-member countries. However, by giving their members tariff-free access to each other's markets, agreements like TPP and TTIP were expected to lead to trade diversion. The estimated impact of TPP on South Asia was larger, but the impact of TTIP was comparable in magnitude. The completion of these agreements would have caused large losses to exports of textiles and clothing from Nepal and Bangladesh. From TPP alone, exports of textiles and clothing from Vietnam – a major competitor for South Asian countries – would have increased by about 40 percent, mostly due to the

FIGURE 39: TPP was expected to have a negative impact on the region.



Sources: Faruqui, Ara and Acma (2015); Rahman and Ara (2015); Al Amin (2015); Narayanan and Sachin (2016)

FIGURE 44: Researchers and practitioners in the region are upbeat on TTP and TTIP.



Source: South Asia Economic Policy Network

implied zero-tariff access to the US market. If TPP and TTIP do not go through, the predicted negative impacts on South Asia would not materialize. A narrow majority of the regional economists does not expect any effect from a TPP and TTIP failure. But nearly half of them believes that this is good news for South Asia, with the assessment of a TPP failure being only slightly more positive than that of a TTIP failure.

South Asia would gain from higher US protection against China and Mexico. The trade diversion scenario considered here involves an increase of US tariffs for imports from China and Mexico by 10 percentage points. Such a hike would increase the price of China and Mexico products in the US market, relative to the price of similar products sourced from other countries. Based on the CGE approach, exports to the US from China and Mexico would decline by 35 percent and 25 percent respectively. South Asian countries would be able to scale up their exports to the US as a result. The expected magnitude of this trade diversion varies across South Asian countries, but it ranges between 10 and 15 percent. In the model used for this analysis, domestic production is assumed to make efficient use of all resources available and the balance of trade is supposed to be in equilibrium. Consequently resources are mainly reallocated across activities, with total exports and overall domestic production increasing modestly.

With a more elastic supply response, total exports would increase more. South Asian countries are still developing and not yet employing all their resources efficiently. If larger exports to the US did not come at the expense of exports to other destinations, or sales to the domestic market, the overall impact of the trade diversion scenario would be more significant. In Bangladesh, for instance, a 15 percent increase in exports to the US would translate into a 3 percent increase in overall exports, and not into less than 1

The expected effects of TPP and TTIP on South Asia

A significant body of research involving South Asian experts was devoted to simulating the impacts of TPP and TTIP on the countries in the region. All of these studies rely on the standard technique for estimating the macroeconomic implications of tariff changes, namely the comparative multi-regional computational general equilibrium model (CGE) of the Global Trade Analysis Project (GTAP).

The effects of TPP on GDP and welfare in India were expected to be negative, but small (Narayanan and Sachin, 2016). GDP would have decreased due to lower consumption and lower investment. Welfare would have decreased too mainly due to higher import prices and reduced efficiency in the allocation of resources. India would have imported and exported less and the overall trade balance would have improved slightly. At a more disaggregated level, the trade balance would have improved considerably for services and manufacturing but strongly worsened for textiles and processed food (Narayanan and Sachin, 2016). As a result of TPP and TTIP, the Gini coefficient in India would have risen and the poverty headcount would have increased, but again the effects would have been rather small (Ganesh-Kumar and Chatterjee, 2016).

Bangladesh would have also been negatively affected by TPP and TTIP (Faruqui, Ara and Acma, 2015). Above all, it is the local production of textiles and clothing that would havev been harmed. Vietnam would have been the biggest winner from TPP, with the production of textiles and clothing surging by about 40 percent and GDP rising by over 4.5 percent. One of the reasons for the importance of the effects on textiles and apparels are the high US tariffs in this sector, which would not have applied to TPP members. GDP and welfare would have declined in Nepal, Pakistan, and Sri Lanka as well (Al Amin, 2015; Rahman and Ara, 2015).

The model employed in all these analyses is documented in detail in Hertel (1997) and the database in Aguiar, Narayanan, and McDougall (2016). An overview of this line of research is provided by Gilbert, Furusawa, and Scollay (2016) who synthesize the impact for all countries from over 30 studies and provide an excellent simulation of their own.

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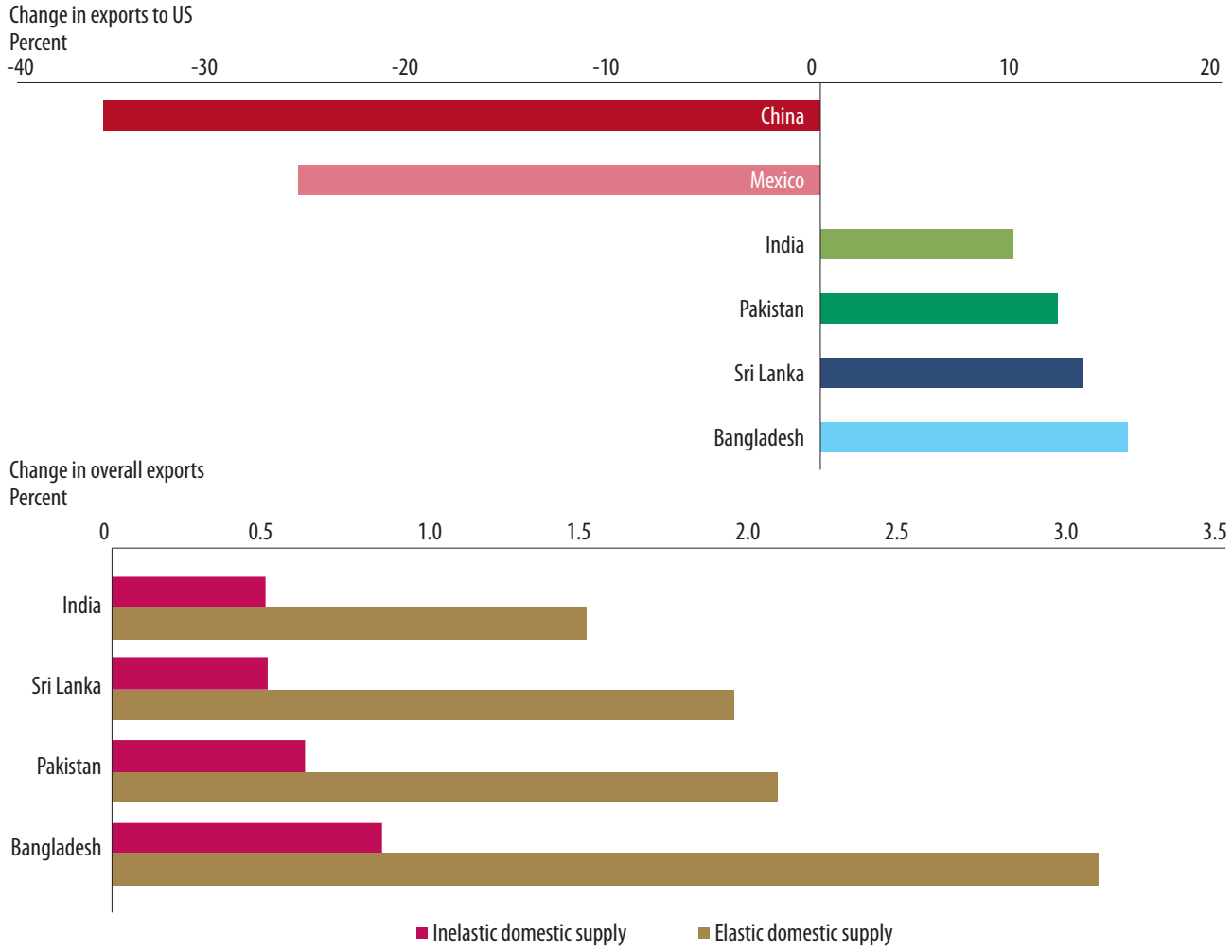
Rahman, M. M., & Ara, L. A. (2015). "TPP, TTIP and RCEP: Implications for South Asian Economies". *South Asia Economic Journal*, 16(1), 27-45.

percent as would be expected with an inelastic supply response.

Higher US protection across the board would have a negative but small effect on South Asia. The scenario considered here is an increase of US tariffs on imports from all countries in the world by 5 percentage points. In this trade destruction scenario, exports from China and Mexico to the US would decline more sharply than exports from South Asia. But both regions would suffer. By how much depends again on how elastic or inelastic domestic supply is. In the worst case, exports from South Asian countries to the US would decline by 4 to 5 percent. But even in the worst case, total exports would fall by less than 1 percent.

The negative impact is even more muted when estimated product by product. The model used for analyses above has a rich economic structure and incorporates complex economic relationships. However, it requires an aggregation of different product categories into broader groups to be tractable. Using a microeconometric trade model instead, one can estimate the effect of a 5 percentage point US tariff increase based on very detailed relationships between the prices of different products and the quantities demanded by international buyers. This approach

FIGURE 40: The region would gain from higher US protectionism against China and Mexico.



Source: World Bank
Note: Results based on LINKAGE model over 2025 horizon. This is a dynamic, multi-region, multi-sector and multi-factor computable general equilibrium model.

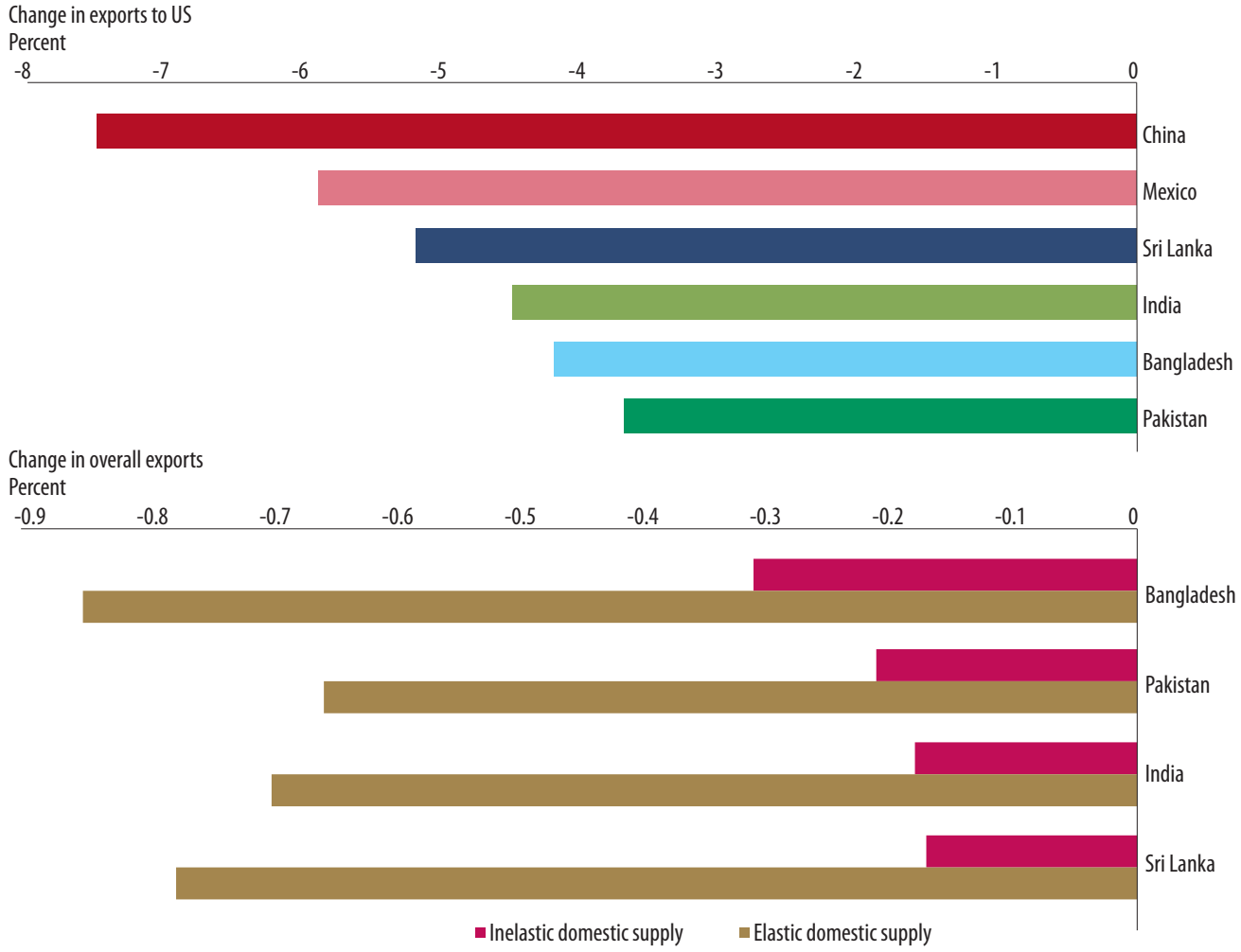
abstracts from any other effect than the price change, but it adds granularity and refines the analysis in important respect. Taking the detailed product breakdown of South Asian exports into account suggests a smaller vulnerability of the region to a rise in protectionism.

In the trade diversion scenario, textiles, auto parts, appliances and food products gain. The sectoral breakdown of the predicted export gains is very different across countries. Nearly two-thirds of the gains in Bangladesh are in textiles, but the fraction falls to one-tenth in India's case. In India and Sri Lanka, auto parts, machinery and electrical products would account for a substantial fraction of the additional exports. In Nepal and Afghanistan stone and glass products would account for a greater share. This diversity shows that different countries in South Asia are competing with China and Mexico in different sectors.

In the trade destruction scenario, textiles in many countries are more strongly affected. The sectoral breakdown of export losses in case of US protectionism across the board is not very different from the breakdown of the gains. It stands out, however, that the share of textiles in the change in exports is even more important. Textiles is by far the most affected sector in Bangladesh, Nepal, and Pakistan. India would experience a meaningful decline in chemical exports and in Sri Lanka and Afghanistan vegetable products would be the most harmed sector.

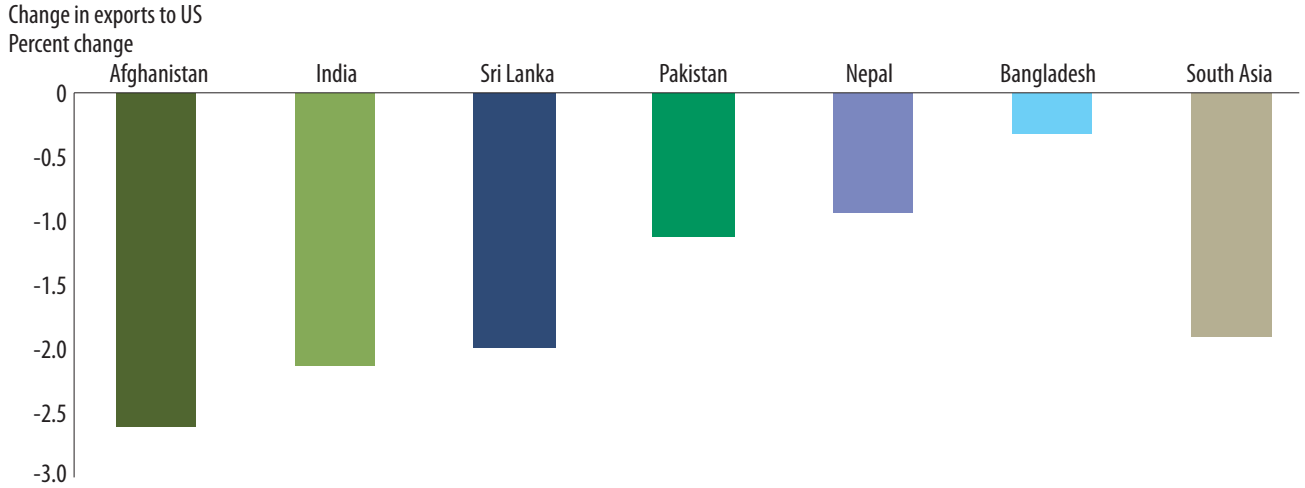
Researchers and practitioners in the region are understandably concerned. Regional experts share almost unanimously negative views on the consequences of higher US trade barriers against all countries. They are somewhat more divided on the effects of higher trade barriers directed at China and Mexico. The consequences for South Asia are seen as positive

FIGURE 41: US protection across the board would have a negative, but modest effect on South Asia.



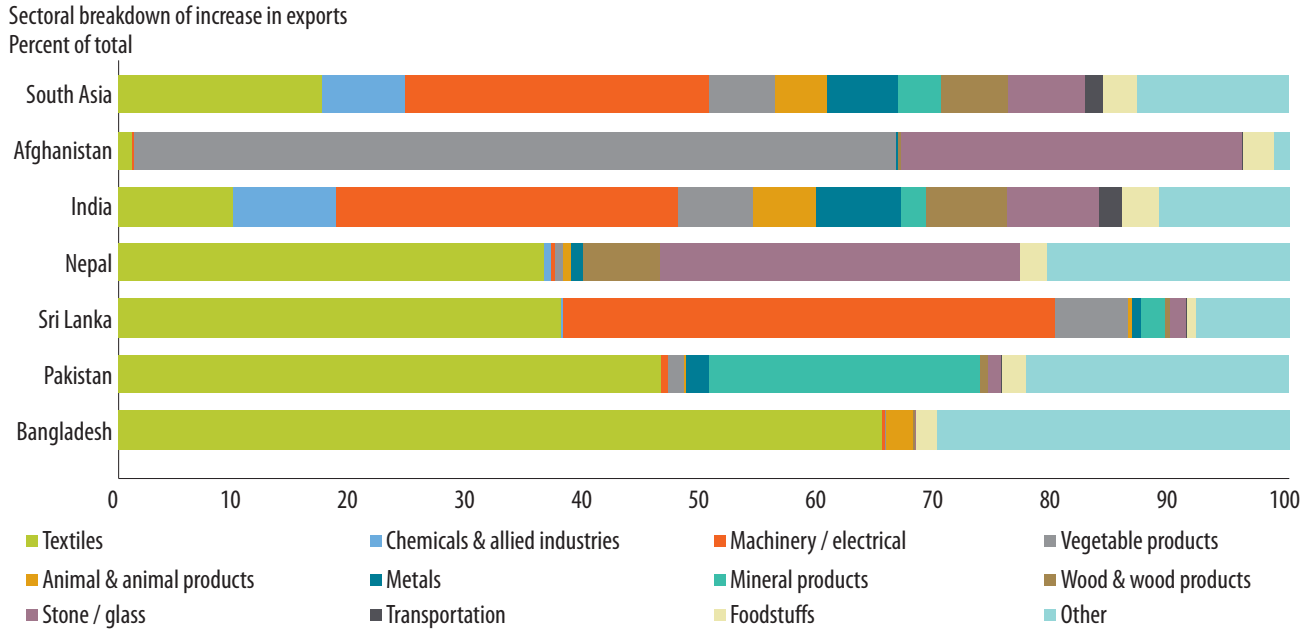
Source: World Bank
Note: Results based on LINKAGE model over 2025 horizon. This is a dynamic, multi-region, multi-sector and multi-factor computable general equilibrium model.

FIGURE 42: Negative impacts are more muted when estimating product by product.



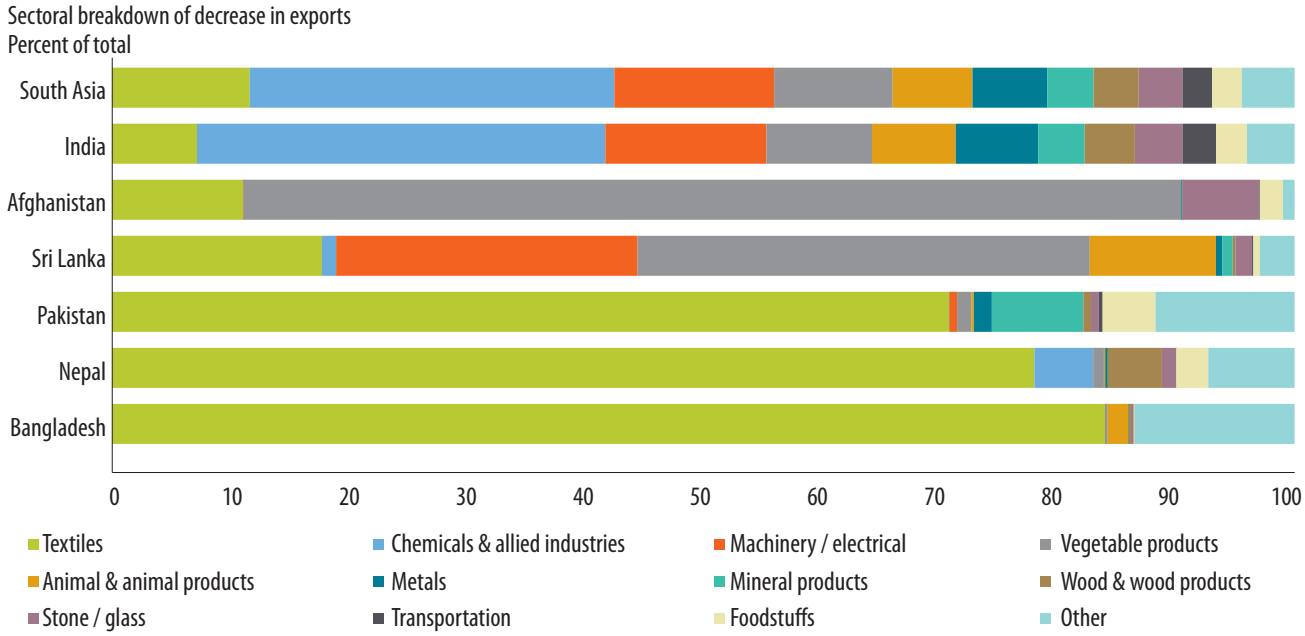
Source: World Bank
Note: Results based on Kee and Nicita (2017)

FIGURE 43: Textiles, auto parts, appliances and food gain in the trade diversion scenario.



Source: World Bank
Note: Results based on Kee and Nicita (2017)

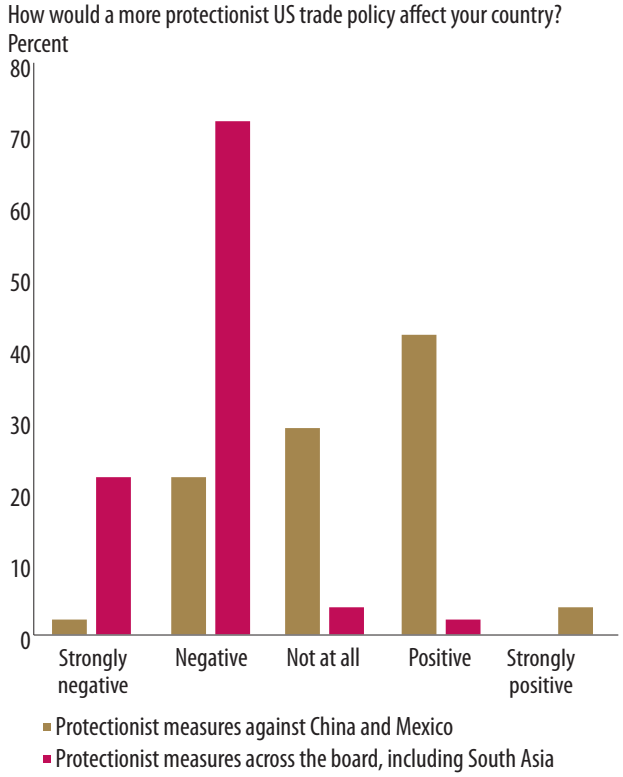
FIGURE 44: Textiles, chemicals and vegetable products lose in the trade destruction scenario.



Source: World Bank
Note: Results based on Kee and Nicita (2017)

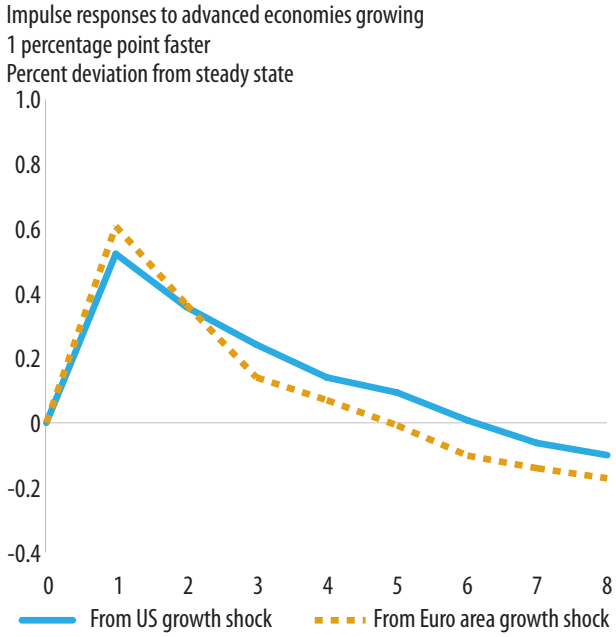
or strongly positive by 47 percent, and 29 percent expect no change at all. But 24 percent still anticipate negative or strongly negative effects. This assessment is more pessimistic than the numerical simulations for the trade diversion scenario would lead to expect. One possible reason for this divergence may be different expectations about the strength of the measures. Another could be the expectation that any form of protectionism will affect the overall business environment, and international trade with it.

FIGURE 45: Researchers and practitioners are split regarding gains from trade diversion.



Source: South Asia Economic Policy Network

FIGURE 46: South Asia is highly responsive to growth in advanced economies.



Source: World Bank
Note: Response is the unweighted average of the responses in Bangladesh, India, Pakistan, and Sri Lanka. The starting point of the estimations varies due to data availability and goes until 2016Q4. Estimated model is based on Almansour. A., Aslam. A., Bluedorn. J., and Duttagupta. R. (2015). "How vulnerable are emerging markets to external shocks?". Journal of Policy Modeling, 37(3), 460-483.

Gains from faster global growth

Demand for exports from South Asia is affected by trade policies but also by economic growth. From this perspective, the regain in dynamism observed in advanced economies is good news for the region. There is no country to which Bangladesh, India, Pakistan, and Sri Lanka export more to than the US. And for Nepal the US is the second most important export destination after India. Other important export destinations of the countries in the region include the United Kingdom and Euro area countries. Advanced economies seem to be recovering from the depths of the global crisis and the US could see even faster growth due to widespread business confidence and a possible fiscal stimulus. These developments could well offset the possible losses stemming from higher trade barriers.

Dynamic analysis reveals a strong transmission of dynamism from advanced countries to South Asia. Faster growth in advanced economies results in a higher demand for imports and therefore spills over to other countries. For one percentage point of additional GDP growth in either the US or the Euro area, growth in South Asian countries increases on impact by around 0.5 percent points in the following quarter. But the positive spillover lasts for a little over one year and accumulates to more than one percentage point. This does not imply that growth in South Asia increases more than in the US or the Euro area since the additional growth

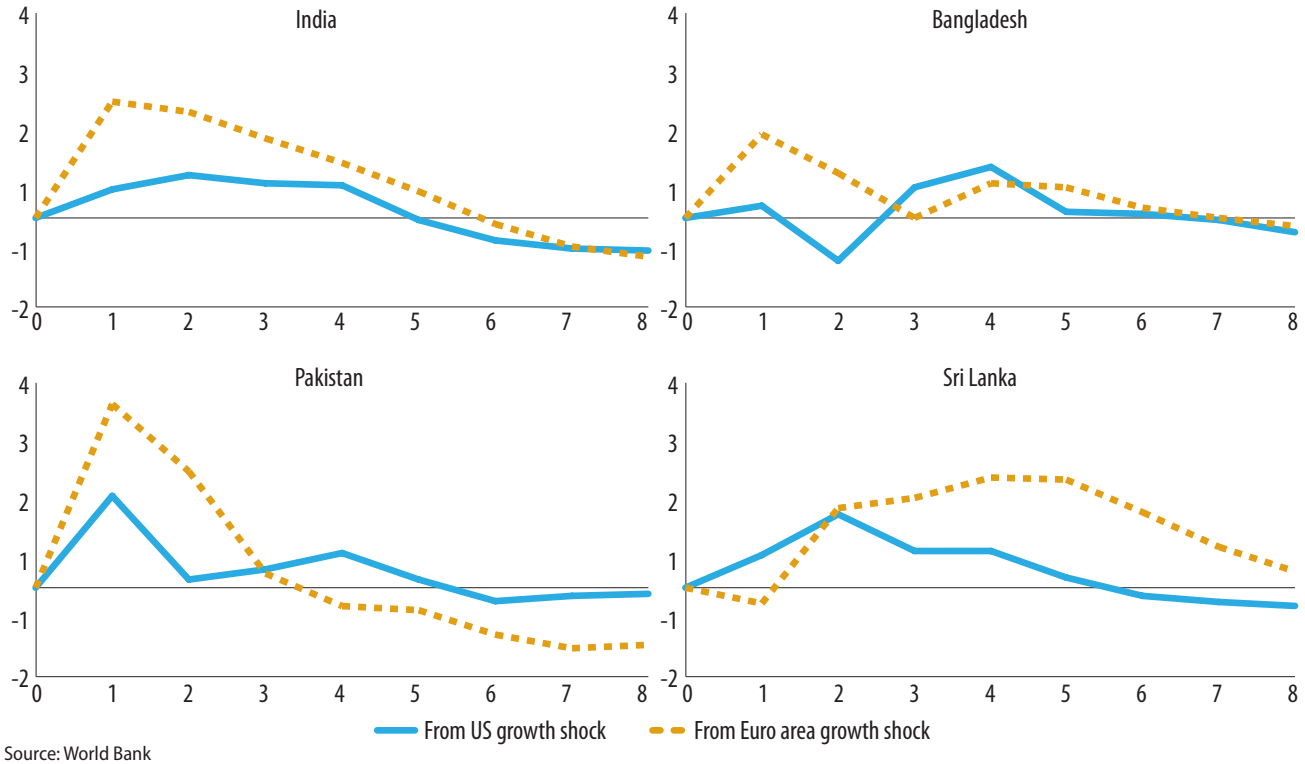
TABLE 3: Advanced economies are the largest export destination for South Asia.

	Bangladesh	India	Nepal	Pakistan	Sri Lanka
1	Unites States	Unites States	India	Unites States	Unites States
2	Germany	United Arab Emirates	Unites States	China	United Kingdom
3	United Kingdom	Hong Kong, China	Germany	Afghani-stan	India
4	France	China	United Kingdom	United Kingdom	Germany
5	Spain	United Kingdom	Turkey	Germany	Italy

Source: World Bank

FIGURE 47: Effects of faster growth in advanced economies are similar across South Asia.

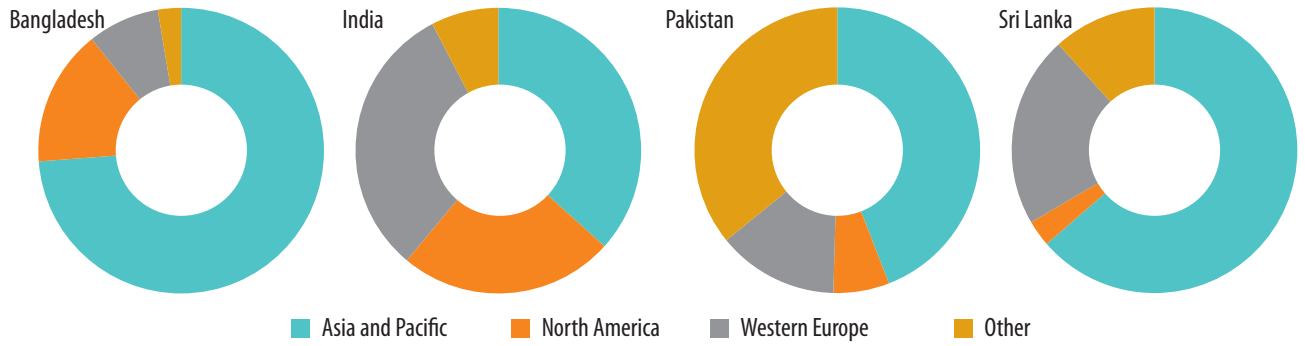
Impulse responses to advanced economies growing 1 percentage point faster
Percent deviation from steady state



Source: World Bank
Note: Estimation based on a simple GDP VAR with two lags

FIGURE 48: FDI to South Asia should not suffer much from protectionism.

Greenfield Foreign Direct Investment by origin

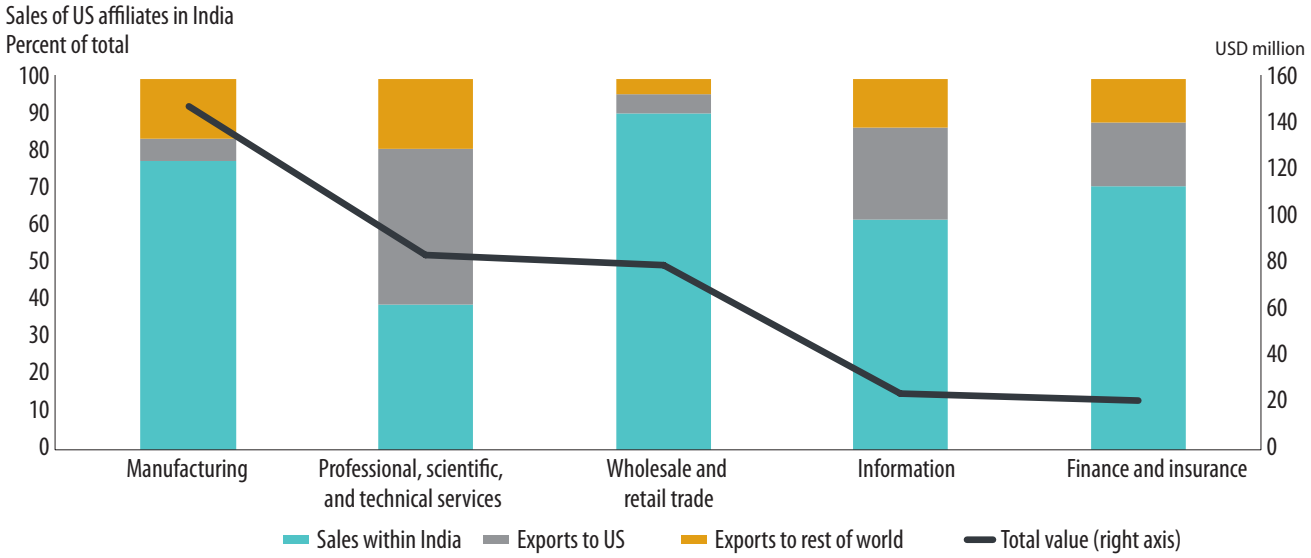


Source: fDi Intelligence and staff calculations

there continues over time as well. The responses to higher growth in the US and the Euro area are similar across South Asian countries. Researchers and practitioners in the region share this optimism, with nearly all of them anticipating faster growth in their countries as a result of faster growth in the US or the Euro area.

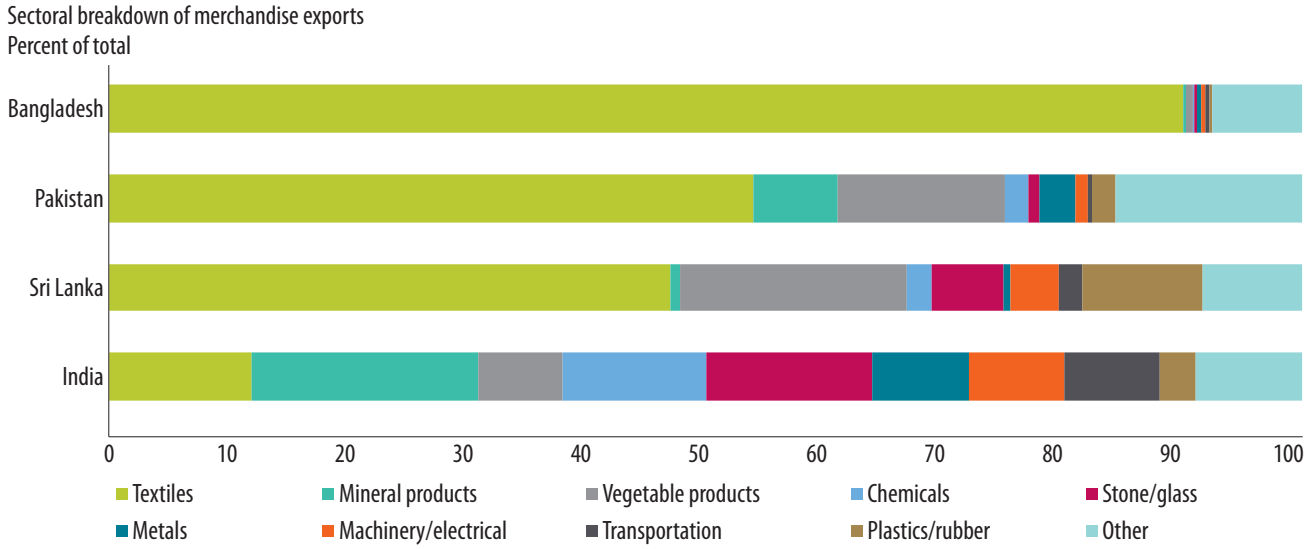
An indirect mechanisms through which protectionism could affect South Asia, namely FDI inflows, will be muted as well. There would be reasons for concern if US companies were by far the largest investors in the region, and if their investments were focused on exporting to the US market. Restricted access to the US market due to new US protectionist measures would reduce the incentives for US firms to invest in South Asia, and weaken the region's economic growth. In principle its consequences could be substantial. However, the rest of Asia is a more important source of FDI to the region than the US. And FDI in South Asia does not seem to be driven by US market access. Even in India, where FDI from the US is more significant, US affiliates sell most of their products

FIGURE 49: Even in India, FDI is not driven by access to the US market.



Source: U.S. Bureau of Economic Analysis

FIGURE 55: Except for India, South Asian exports are not highly diversified.



Source: The Atlas of Economic Complexity, CID, Harvard University

within the country. The US market seems to matter only for professional, scientific, and technical services. New US restrictions on labor mobility from South Asia, for example through reforms to the H1-B visa program, could even have a positive impact on FDI to India. If labor is hindered in moving in one direction, capital has an incentive to move in the opposite direction. New restrictions on service exports or outsourcing, on the other hand, could act as counteracting forces.

Seize the opportunity

Numerical simulations suggest that South Asia would not have much to lose from a rise in protectionism. For now, the only relatively clear development is the stalling of negotiations towards TTP and TTIP, which is found to be favorable to the region. Countries in South Asia would also stand to gain in a trade diversion scenario, and would not lose much in a trade destruction scenario, provided that the rise in trade barriers is not too steep. Faster growth in advanced economies, as is currently expected, would most probably offset the negative effects. In light of these results,

Estimating the gains from export diversification

The gains from export diversification can be assessed using the same microeconometric trade model that allowed to simulate the effects of higher tariffs on products from South Asia. This model yields precise estimates of how much US imports from different countries for about 6,000 products change when the prices of those products change. These reaction functions, called price elasticities, can be used to simulate the impact of a hike in US tariffs on all products imported from China and Mexico by 10 percentage points. A crucial question is then: as US imports from these two countries fall, who else supplies the affected products? A simple way to answer this question is to assume that total US imports of those products remain unchanged, and only the composition of suppliers is affected.

In the absence of further export diversification, the increase in South Asian exports at the product level can be estimated through a three-step procedure. First, the share of US imports originating in each country in the world is computed for every individual product. Second, the share of US imports from South Asia is rescaled as a fraction of US imports from countries other than China and Mexico, again at the product level. And third this fraction is multiplied by the change in exports from China and Mexico. The implicit assumption is the decline in US imports from China and Mexico is distributed among other countries in proportion to their original shares of US imports for that particular product. But this procedure means that there are no gains on products that South Asia did not originally export to the US.

The original shares of US imports from South Asia can be tweaked to simulate the consequences of export diversification. To illustrate the point, imagine a situation in which there are only three products traded internationally, called A, B and C. Suppose that South Asian countries originally account for 0, 2, and 4 percent of US imports of products A, B and C respectively. The simulation called "some diversification" assumes that the original shares of US imports from South Asia are the same across all products. In the example, that amounts to replacing 0, 2 and 4 percent by 2, 2 and 2 percent (with 2 being the average of 0, 2 and 4). The simulation called "strong diversification" assumes that the original shares are the average of only the strictly positive shares, which in the example considered would yield 3, 3 and 3 percent (with 3 being the average of 2 and 4).

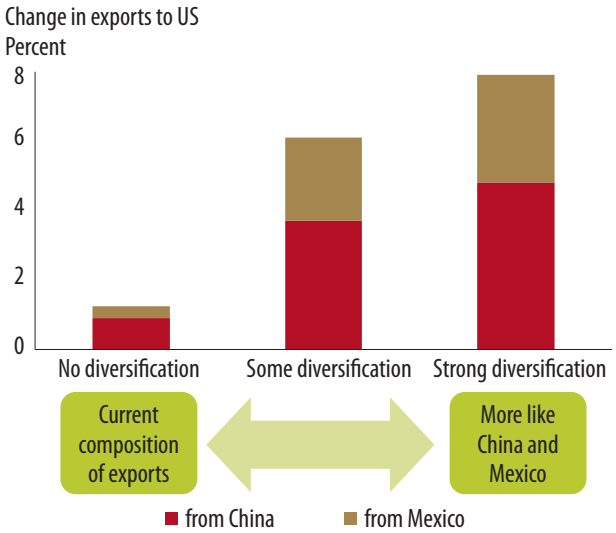
Note: The analysis is based on Kee, H.L. and Nicita, A. (2017) "Trade fraud, trade discrepancies and non-tariff measures". World Bank Manuscript

the case for South Asia to focus on export-oriented growth remains strong. Globalization has been good for development and crucial for poverty reduction. Further integration in global markets would boost the demand for labor-intensive products and labor-intensive tasks from South Asia, thus helping spur job creation.

A more proactive stance would amplify the potential gains for the region. Except for India, exports from South Asia to the US are not highly diversified. In Bangladesh, over 90 percent of sales abroad are in textiles and within textiles they are strongly concentrated in cotton products. Both in Pakistan and Sri Lanka, textiles account for around half of the exports with other important exports being vegetable products. Only India's exports spread across many different product categories, with textiles accounting for only a little over 10 percent and only mineral products accounting for more than 20 percent.

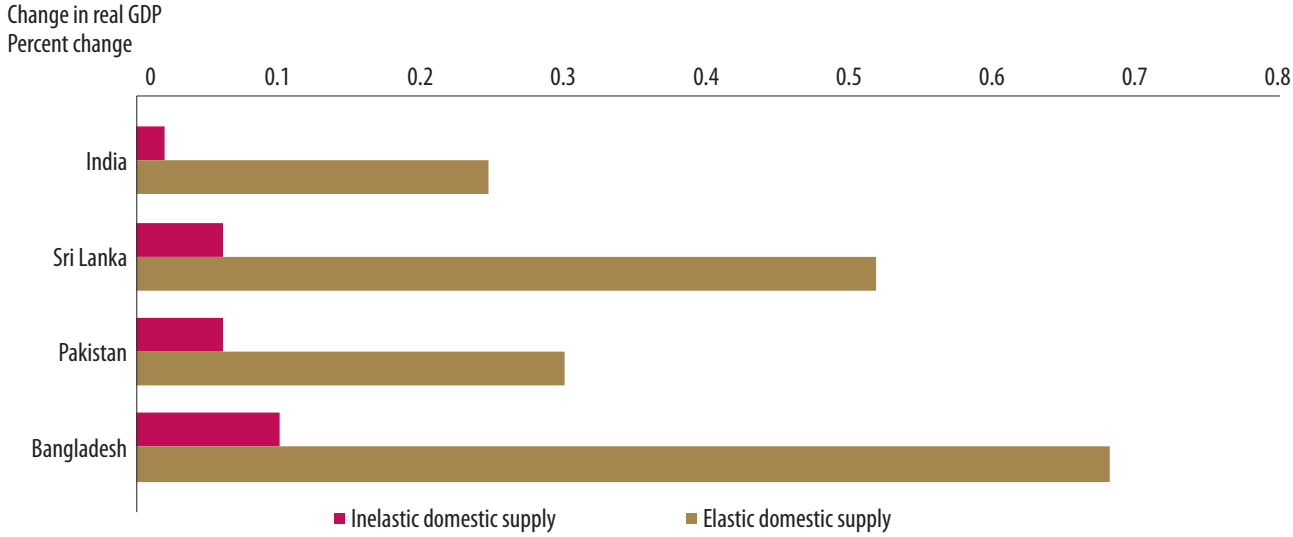
The gains from trade diversion and from the recovery in advanced economies would be greater if South Asian exports were more diversified. Currently South Asia is not exporting many of the products that China and Mexico are selling in the US market. In the trade diversion scenario if South Asia only expands its market share in products it is already exporting, its overall gains are rather small. If South Asia is able to start exporting new products, on the other hand, the gains are far greater. In other words, the gains from trade diversion would be maximized if the composition of exports to the

FIGURE 51: Gains from trade diversion would be larger if exports were more diversified.



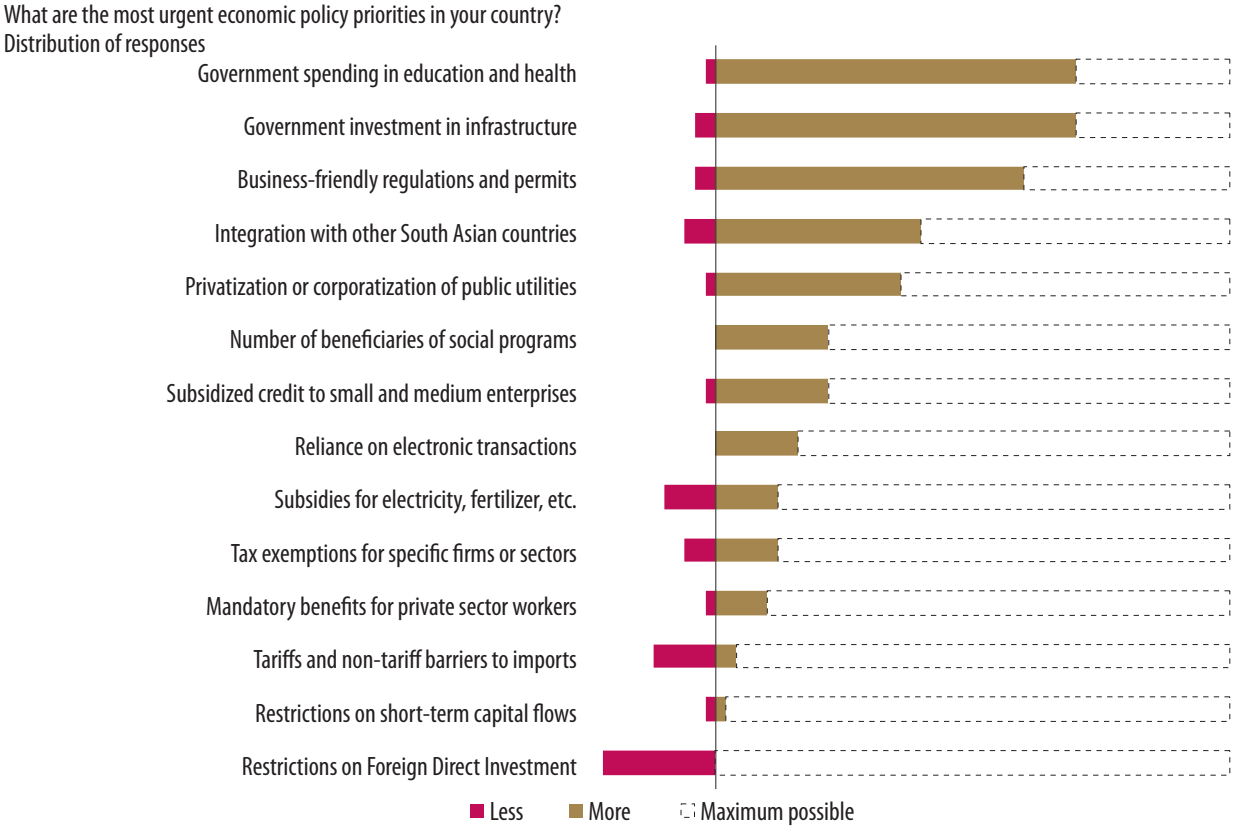
Source: World Bank
Note: Results based on Kee and Nicita (2017)

FIGURE 52: With an elastic supply response the impact on GDP growth could be sizeable.



Source: World Bank
Note: Results based on LINKAGE model over 2025 horizon. This is a dynamic, multi-region, multi-sector and multi-factor computable general equilibrium model.

FIGURE 53: Researchers and practitioners in the region favor a strong growth agenda.



Source: South Asia Economic Policy Network

US from South Asia resembled more the composition of exports from China and Mexico. And while trade diversion in the scenario above results from US protectionism, greater diversification of exports would also help South Asia benefit more from the recovery in advanced economies and from the increase in labor costs in China.

The gains for South Asia would also be greater if its supply response was more elastic. There was a sizeable difference in the overall change in exports depending on how South Asian economies reacted to the increase in exports to the US. If this increase was to come mainly from declines in exports to other countries

and in domestic sales, then the impact on GDP growth would be modest. If, on the other hand, the increase in exports to the US was in addition to exports to other countries, and in addition to domestic sales, then the expansion in GDP would be more sizeable.

Economic policies can support both export diversification and a stronger supply response. The relatively strong concentration of exports in South Asia is to some extent the result of deliberate policy decisions. For example, in some cases the tax and tariff structure discriminates against manmade fibers and instead privileges cotton as the main input for the textile industry. This is despite global consumption of manmade and synthetic fibers being much larger than that of cotton. Such artificial constraints to integrating into global value chains limit the gains that the region could expect.

There is a consensus in favor of a strong growth agenda among experts from the region. Almost all Network respondents to the survey favor a stronger accumulation of human and physical capital, through increased government spending in education, health and infrastructure. Needless to say, financing these expenditures would be challenging in light of already high fiscal deficits and high public debt levels in some countries. Experts from the region are also highly supportive of more business-friendly regulations and permits. This suggests an agreement that the private sector will have to play in important role in strengthening economic performance. Interestingly, stronger integration with other South Asian countries also features prominently, and this is clearly a way to expand markets, similar in spirit to greater global integration.

South Asia country briefs

In alphabetical order

Afghanistan

Bangladesh

Bhutan

India

Maldives

Nepal

Pakistan

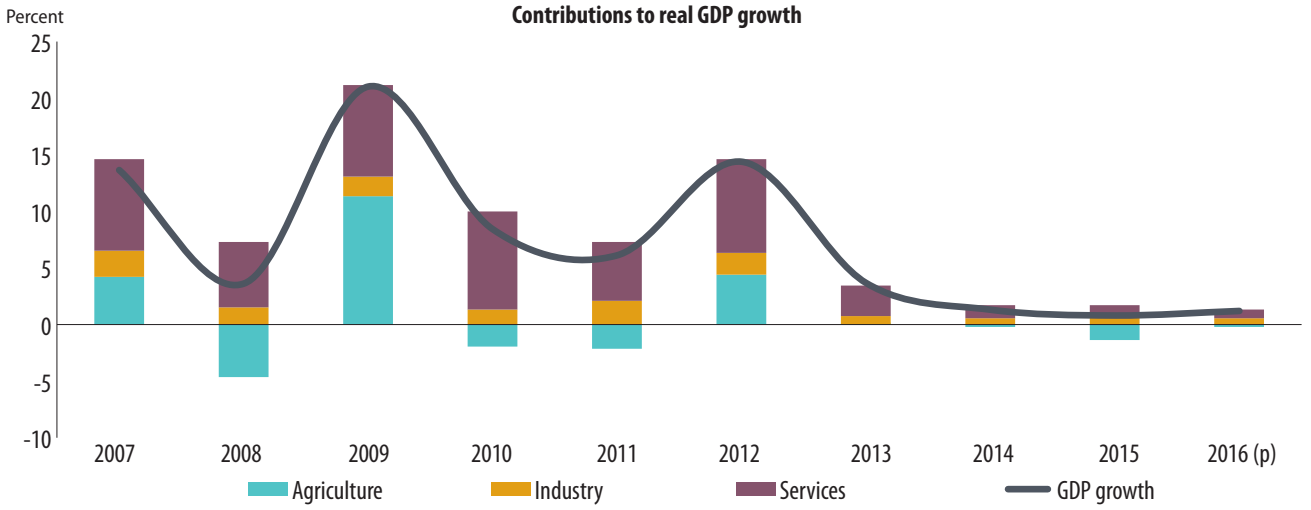
Sri Lanka

Afghanistan

Economic recovery in Afghanistan has been slow, as insecurity continues to curtail private investment and consumer demand in the economy. While revenue mobilization has intensified, risks to fiscal stability over the medium-term remain pronounced as substantial donor grants are required to meet the country's basic development needs. Increasing number of returnees and internally displaced persons, due to growing violence, have escalated the humanitarian challenges for the country.

	2016
Population, million	33.4
GDP, current US$ billion	19.4
GDP per capita, current US$	581

Sources: World Bank WDI



Sources: Central Statistics Organization and World Bank staff projections
Note: p = projection

Recent developments

Violence continues to affect the security of livelihoods and economic activity in the country. Civilian casualties increased by around 3 percent in 2016, reaching unprecedented levels. Business sentiment remains suppressed, with the number of new firm registrations being about the same level as in the previous year. Other proxy indicators, such as vehicle registration, do not indicate a strong pick-up in economic activity in the first three quarters of 2016. Agriculture sector's performance has been mixed; cereals production recorded a decline of nearly 5 percent while fruit production has been higher.

Real GDP growth is thus projected to have only marginally increased from 0.8 percent in 2015 to 1.2 percent in 2016. With a population growth of nearly 3 percent, such level of economic growth implies a decline in per capita income.

Inflation increased from -1.5 percent in 2015 to 4.4 percent in 2016, driven by lagged effects of currency depreciation. As most consumer goods in Afghanistan are imported, global prices and exchange rate movements tend to heavily drive domestic prices.

2016 also saw a worsening of the humanitarian situation in the country. Afghans represent the world's largest and most protracted refugee population, with an estimated 3.5 million people currently living abroad as refugees. Afghanistan is now facing a sharp increase in displacement due to the escalation of internal conflict, and a new wave of often involuntary refugee returns. Currently, an estimated 1.2 million people are internally

displaced and in need of humanitarian assistance, and in 2016 alone, around 600,000 Afghans returned from Pakistan and Iran. An estimated 1.1 million and 3 million Afghans remaining in Pakistan and Iran, respectively, could potentially be repatriated in 2017 if regional relations deteriorate.

Despite potential positive economic impacts in the medium-run, the return of refugees is not expected to have a significant stimulating effect on domestic demand in the short-term. Most returnees in the rural areas engage in subsistence activities, and settlers in urban or peri-urban areas are often low income earners who will depend on assistance and public service delivery. Further, given high import content of expenditures on food in Afghanistan, any increase in household consumption might be partially offset by increasing imports. Thus the net effect on real GDP growth is expected to be minimal.

On the fiscal side, revenue collection has significantly improved in the past two years after the abrupt decline in revenues in 2014. Domestic revenues increased by nearly 15 percent in 2016, which exceeded the revenue target by around 5 percent. Both tax and non-tax revenues increased, while customs duties remained flat given weak imports. In proportion to GDP, however, revenue collection still remains relatively low at 10.7 percent.

With an increase in exports and slower growth for imports (due to weaker domestic demand), the trade deficit is estimated to have improved slightly from -36.7 percent of GDP in 2015 to -35.0 percent in 2016. The large trade deficit continues to be financed by foreign aid, with the current account balance estimated at around 4 percent of GDP in 2016.

Gross international reserves increased from US$ 6.7 billion in December 2015 to $7.2 billion in December 2016.

Outlook

Growth is expected to increase to 2.4 percent in 2017 and to reach 3.1 percent by 2019, predicated on political stability and an absence of a further deterioration in the security environment. With agriculture production expected at around the historical average in 2017, food prices are expected to remain moderate and CPI inflation is forecast to reach 5.5 percent. The current account is projected to be in a surplus of about 4 percent of GDP in 2017.

Domestic revenues are projected to slightly increase to 11.0 percent of GDP in 2017, up from 10.7 percent last year. While public spending is also projected to increase by a proportionate amount as a ratio to GDP, a balanced fiscal budget is expected in 2017 if donor grants come in as planned.

Risks and challenges

Fiscal challenges remain pronounced. Development spending needs and security costs are expected to increase over the medium term, yet resources are likely to remain tight. A strategic allocation and efficient use of resources over the medium-term will be critical.

Fiscal outcomes are highly sensitive to the modality of aid. While around $3.7 billion per year in development assistance was pledged by the donors for the next four years, any delay or shortfall in the disbursement of pledged amounts will put Afghanistan in a difficult fiscal position. Further, if less than 50 percent of the donor grants are channeled through the budget by 2020, Afghanistan will not be able to fully meet its development spending needs. Currently, only 35 percent of donor grants are delivered on-budget.

The scale of large influx of refugee returns and internally displaced persons poses stark challenges to host communities already living under difficult economic conditions, amid a deteriorating security situation, with scarce human and physical capital and a demographic imbalance where job creation lags far behind the growth of the working age population. The Government and the humanitarian and development community face numerous challenges in addressing the problem of protracted internal displacement and the recent surge in returnees. Despite many initiatives to provide support and services to displaced populations, the direct fiscal implications on government budget are expected to be minimal as most of the humanitarian programs are managed off-budget, and are mostly directly financed and coordinated by the donor community and humanitarian agencies. Nevertheless, there may be some indirect costs on the budget due to increased healthcare and education services.

In the long-term, sustained economic growth in Afghanistan requires a structural transformation of the economy. New sources of growth are needed to increase government revenues (currently at less than 40 percent of total on-budget expenditures) and to generate the foreign exchange required to finance

Afghanistan's large import bill. Increased human capital investment and improved agriculture productivity could provide significant economic growth and increase employment opportunities. The development of the extractives sector could offer an important opportunity for revenue generation and foreign exchange earnings to compensate for a possible decline in aid in the future.

TABLE: Afghanistan macro outlook indicators (annual percent change unless indicated otherwise)

	2014	2015	2016 (est)	2017 (f)	2018 (f)	2019 (f)
Real GDP growth, at constant market prices	1.3	0.8	1.2	2.4	3.4	3.1
Private Consumption	3.4	2.5	1.2	1.5	1.8	2
Government Consumption	3.2	3	6.4	9.3	6.5	4.9
Gross Fixed Capital Investment	-4.3	1.5	1	1.5	2.8	2.6
Exports, Goods and Services	-19.7	-2.5	5	7	8	8
Imports, Goods and Services	-4.2	5	5	8	5	5
Real GDP growth, at constant factor prices	1.8	0.8	1.2	2.4	3.4	3.1
Agriculture	-0.1	-5.7	-0.5	2.5	2	1.5
Industry	2.4	4.1	2	2.2	3	3
Services	2.2	1.6	1.4	2.5	4.1	3.6
Inflation (Consumer Price Index)	4.6	-1.5	4.4	5.5	5	5
Current Account Balance (percent of GDP)	8	5.4	6.4	4.4	1	-1.1
Financial and Capital Account (percent of GDP)	0.6	-6.1	-5.6	-3.9	-0.5	1.6
Net Foreign Direct Investment (percent of GDP)	0.6	0.9	0.3	0.2	0.2	0.2
Fiscal Balance (percent of GDP)	-1.8	-1.3	-0.7	-0.5	0.2	-0.4
Debt (percent of GDP)	6.5	6.2	6.5	6.4	6.2	6
Primary Balance (percent of GDP)	-1.7	-1.2	-0.7	-0.5	0.3	-0.4

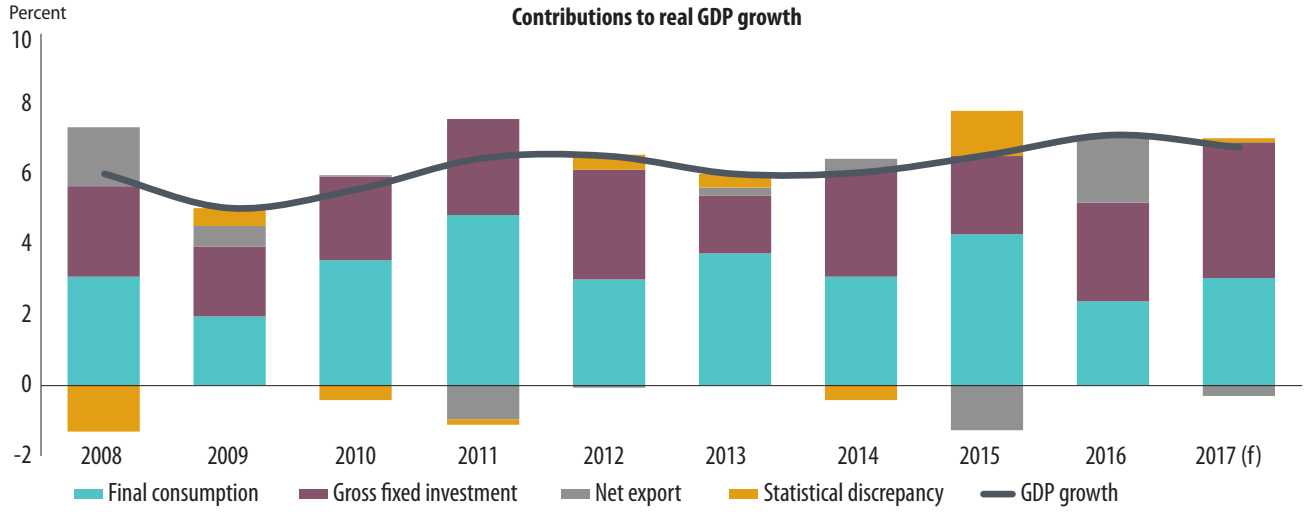
Sources: World Bank, Macroeconomics and Fiscal Management Global Practice
Notes: est = estimate, f = forecast

Bangladesh

The economy is weathering global uncertainties relatively well. The garment industry continues to anchor the external sector. Growth in FY16 remained resilient, aided by strengthening investment and a recovery of exports. Inflation decelerated and the budget deficit narrowed, while the current account remained in surplus, despite a fall in remittances. Infrastructure gaps and inadequate energy supply, combined with the high cost of doing business, remain the main obstacles to the realization of Bangladesh's growth potential.

	2016
Population, million	162.9
GDP, current US$ billion	221.4
GDP per capita, current US$	1,359

Sources: World Bank WDI.



Source: Bangladesh Bureau of Statistics (BBS) and World Bank staff estimates
Note: f=forecast

Recent developments

GDP growth increased to 7.1 percent in FY16 from 6.6 percent in FY15 (official estimates), driven by private investment and net exports. However, data on high frequency indicators point to only marginal improvements in private investment. Exports bounced back due to a resurgence in Ready Made Garments and other manufacturing activities. A 7.1 percent decline in real imports reinforced the contribution of rising exports to net export growth. Remittances through formal channels declined 2.5 percent in FY16, thus slowing private consumption growth. Agricultural growth decelerated to 2.8 percent , as the expansion in staple crops and horticulture moderated. Industrial growth increased to 11.1 percent from 9.7 percent in FY15. The export oriented garments industry and manufacturing for the domestic market performed well. Services growth was also stronger at 6.3 percent , reflecting higher spending in public administration, education, and health services.

Inflation slowed to 5.9 percent in FY16 from 6.4 percent in FY15, and further to 5.2 percent (y-o-y) in January 2017. A confluence of domestic output growth, accommodative monetary policy and moderation in global commodity prices contained inflation. Non-food inflation decelerated steadily since June 2016, reflecting weakening demand due to a large decline in remittances and the effect of the public sector wage increases tapering off. Food inflation accelerated in recent months, driven by rice price increases, the latter caused by a higher tariff on rice imports and production losses due to floods.

Macroeconomic balances remained prudent. The 13.8 percent broad money growth was short of the 14.3 percent nominal GDP growth in FY16. Low levels of expenditure outturns relative to revenues resulted in a significantly lower budget deficit of 3.1 percent of GDP, compared with the 5 percent target. Financing relied heavily on domestic non-bank sources, constituting 2.2 percent of GDP. The planned expansionary fiscal stance turned out to be less expansionary than expected. Overall, the balance of payments remained comfortable, with a surplus of $5.0 billion in FY16, compared with $4.4 billion in FY15. Foreign exchange reserves exceeded $32 billion at the end of February, 2017, equivalent to over 8 months of imports. The real effective exchange rate appreciated 6.5 percent in the 12 months ending December 2016.

Outlook

GDP is projected to grow by 6.8 percent in FY17, with agriculture growth accelerating to 4.1 percent as farmers respond to sustained relative price increases of rice, vegetable and livestock products in the last half of 2016. Weaker domestic demand from a large decline in remittances and a base effect of high growth last year may edge down the rate of industrial growth to 8.9 percent . Services are projected to grow at a steady 6 percent , benefitting from political stability, a rise in agricultural growth, and increases in public sector benefit payments. The upturn in private investment is projected to continue in FY17, helped by political stability and a reduction in trade logistics costs due to the completion of two key road projects. Strong performance of high-frequency indicators so far give confidence that the economy is on course to maintaining robust growth.

Macroeconomic stability is expected to be maintained, notwithstanding a moderate increase in inflation. The global commodity outlook suggests emergence of pressures from higher import prices. Output is projected to continue above potential, rising from 0.4 to 0.7 percentage points above potential, thus exerting upward pressure on core inflation and sustaining relatively high inflationary expectations. The monetary policy statement for the second half of FY17 is committed to stabilizing inflation, while supporting output and employment growth by accommodating the projected FY17 nominal GDP growth. The current account surplus is projected to shrink with lower export growth and declining remittances, without impairing stability in the foreign exchange market given the cushion in reserves. The FY17 budget aims to raise revenue through the implementation of the new VAT law and improved revenue administration. Current spending will grow with an increase in public sector benefits and larger subsidies directed mainly to agriculture and social welfare. Capital spending is slated to rise as well. The deficit is projected around 4 percent of GDP with 60 percent financed by domestic borrowing.

Risks and challenges

Domestic risks include further deterioration in financial sector stability, slippages in implementing fiscal reforms, and elevated political tensions in the run up to elections in 2019. External risks remain, despite Bangladesh's still limited global integration. They include heightened policy uncertainty in the United States and Euro Area (Bangladesh's largest export markets and the most important source of remittance inflows after the GCC), and a jump in energy prices. High levels of non-performing bank loans make banks vulnerable to financial stress. The business environment continues to be weak, with Bangladesh ranking 176th out of 190 countries in *Doing Business* and 107th out of 140 in the Global Competitiveness Index 2016, one of the lowest in South Asia.

Continued fiscal and financial sector strengthening will help to maintain fiscal space and investor confidence. Improved public financial management and better revenue collection through streamlining direct and indirect taxes, expanding the tax base and improving the efficiency of tax collection would anchor expectations of fiscal sustainability. Reforming SOEs could lessen strains on the budget. Needed banking reforms include strengthening supervision to encourage competitive behavior and ensuring capital adequacy.

Structural reforms to raise potential growth and increase productivity are a priority. This can be accomplished by expanding investments in human capital, increasing female labor force participation, and raising productivity through increased global value chain integration. Reducing infrastructure gaps and improving the business climate would allow new productive sectors to develop and generate jobs.

TABLE: Bangladesh macro outlook indicators (annual percent change unless indicated otherwise)

	2014	2015	2016	2017 (f)	2018 (f)	2019 (f)
Real GDP growth, at constant market prices	6.1	6.6	7.1	6.8	6.4	6.7
Private Consumption	4.0	5.8	3.0	4.0	5.0	5.6
Government Consumption	7.9	8.8	8.4	10.2	9.6	8.9
Gross Fixed Capital Investment	9.9	7.1	8.9	12.0	11.1	11.0
Exports, Goods and Services	3.2	-2.8	2.2	5.0	6.0	6.5
Imports, Goods and Services	1.2	3.2	-7.1	6.0	10.5	11.5
Real GDP growth, at constant factor prices	6.1	6.5	7.2	6.7	6.6	6.7
Agriculture	4.4	3.3	2.8	4.1	2.5	3.3
Industry	8.2	9.7	11.1	8.9	8.3	8.9
Services	5.6	5.8	6.3	6.1	6.8	6.3
Inflation (Consumer Price Index)	7.3	6.4	5.9	5.6	6.3	6.3
Current Account Balance (percent of GDP)	0.8	1.5	1.7	0.2	-0.3	-0.6
Financial and Capital Account (percent of GDP)	1.9	1.2	0.9	0.6	0.5	0.2
Net Foreign Direct Investment (percent of GDP)	0.8	0.9	0.9	1.0	0.8	0.8
Fiscal Balance (percent of GDP)	-3.5	-3.3	-3.1	-4.0	-3.5	-3.7
Debt (percent of GDP)	33.9	34.6	35.8	37.8	38.9	40.0
Primary Balance (percent of GDP)	-1.5	-1.5	-1.4	-2.2	-1.6	-1.7

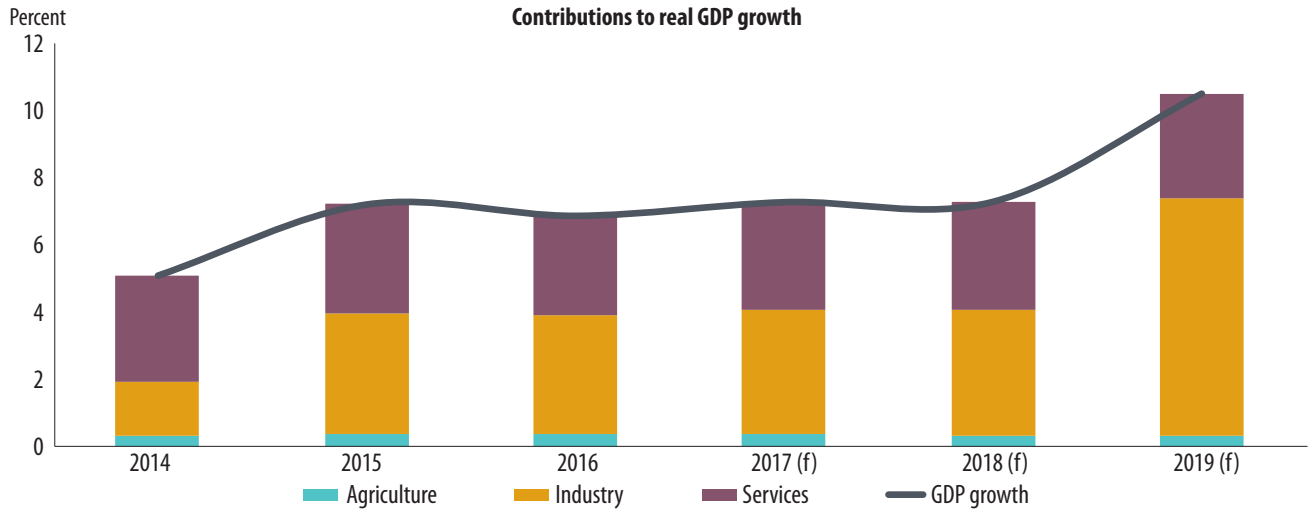
Sources: World Bank, Macroeconomics and Fiscal Management Global Practice
Notes: f = forecast

Bhutan

Bhutan maintained a solid growth in 2016. Investments in hydropower remained strong with supportive fiscal and monetary policies. However, risks are emerging including possible delays in hydropower constructions and growth deceleration in India. The massive scale of the hydropower projects is expected to generate large macroeconomic imbalances in the short term. With continued stable growth, poverty is expected to be reduced in a steady manner.

	2016
Population, million	0.8
GDP, current US$ billion	2.2
GDP per capita, current US$	2,891

Sources: World Bank WDI



Sources: National Statistics Bureau and World Bank forecasts
Note: f = forecast

Recent developments

GDP growth is estimated at 6.8 percent in 2016 following a solid growth performance of 6.5 percent in 2015. The main growth driver is the energy sector, particularly with the ongoing hydropower constructions. Good agriculture harvest and the service sector also supported growth. On the demand side, government consumption and gross fixed investment led the strong growth in 2016. Consumer price inflation of 3.2 percent was the lowest since 2003, driven by stable food and non-alcoholic beverages. The ngultrum exchange rate (pegged to Indian rupee) depreciated by 1 percent against the US dollar in the first 3 months of 2017. The current account deficit is estimated to reach 39 percent of GDP in 2016, mainly due to the increase in imports related to hydropower projects. However, the increase in international reserves by about 20 percent between December 2015 and November 2016 suggests that the capital and financial account surplus – mainly concessional loans from India covered the current account deficit. Other than hydropower exports, Bhutan's export base is very limited. The Constitution requires the domestic revenue to fully cover the recurrent expenditure. However, the fiscal policy has become expansionary to support the implementation of the 11th Five-Year Plan. The fiscal balance is projected to deteriorate from 1.3 percent of GDP in 2015 to -2.5 percent of GDP in 2016. The deficit is largely due to the increase in capital expenditure. Tax revenues in nominal terms have increasing, but not to the same extent as GDP. The latest debt sustainability analysis conducted in 2016 concluded that the risk of external debt distress remains moderate, as vmuch of the external debt is due to hydropower project loans from India.

Outlook

The economy is expected to grow steadily in 2017 and 2018 before accelerating in 2019 with the commissioning of two new hydropower projects. Agriculture and tourism are expected to grow at a stable rate, with continued investment/initiatives in these sectors. The Government has recently revised the Economic Development Policy for private sector development and accelerated the formulation of the next five-year plan which will commence in 2018 to address key developmental issue such as youth unemployment. Consumer price inflation is expected to be steady following a similar trend as India, as the currency is pegged to the Indian Rupee. Efforts to boost domestic revenue mobilization are underway, including the introduction of the goods and services tax in the medium term and the tax rationalization measures. Further, in order to ensure debt sustainability, the government has introduced a debt policy which provides debt thresholds outside the hydropower sector, as well as financing of the hydropower sector. While ongoing hydropower constructions will support growth, the delays in the completion of hydropower constructions will put pressure in the current account as exports of electricity will take more time to materialize.

Risks and challenges

Development of ongoing hydropower construction offers both opportunities and challenges. Further delays in construction will negatively affect growth and macroeconomic stability. Also, when commissioned, revenues from the hydropower sector could lead to overheating of the domestic economy. Any adverse weather pattern may negatively affect the economy through reduced electricity generation of existing hydropower plants. While risk of debt distress is categorized as moderate, a more rapid accumulation of the debt would still need to be cautioned. In that vein, large easing of the fiscal stance should be avoided and the tax reform aimed at improving tax collection and limiting exemptions should be concluded. The close economic linkages with India offer both opportunities and vulnerabilities.

TABLE: Bhutan macro outlook indicators (annual percent change unless indicated otherwise)

	2014	2015	2016 (est)	2017 (f)	2018 (f)	2019 (f)
Real GDP growth, at constant market prices	5.7	6.5	6.8	6.8	7.7	10.5
Private Consumption	18	7.2	7	7	7	10
Government Consumption	24	10.8	13.2	10.8	9.3	9.3
Gross Capital Investment	38.3	12.9	23	27.6	23	12.4
Exports, Goods and Services	-6	-5	0.1	1	2	5
Imports, Goods and Services	-3.5	10.1	20	25	20	10
Real GDP growth, at constant factor market prices	5.5	7.5	7.1	7.5	7.5	10.7
Agriculture	2.4	3	3	3	3	3
Industry	3.1	8.1	8	8.3	8.3	15
Services	8.2	8.3	7.5	8	8	8
Inflation (Consumer Price Index)	8.3	4.5	3.2	4	4	4
Current Account Balance (percent of GDP)	-24.6	-29.1	-38.8	-51.8	-61	-60.7
Fiscal balance (percent of GDP)	2.7	1.3	-2.5	-8.6	-5.6	-3.4
Debt (percent of GDP)	96.4	106.5	102.1	103.2	97.7	95
Primary Balance (percent of GDP)	4.4	1.6	-1.4	-8.5	-7.1	-3.9

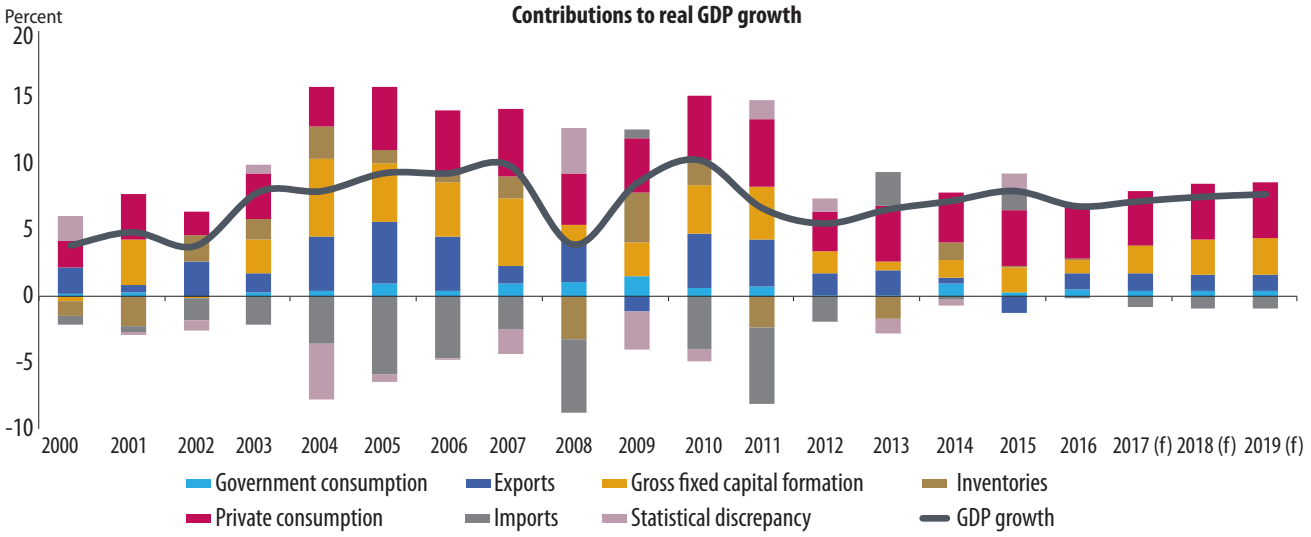
Sources: World Bank, Macroeconomics and Fiscal Management Global Practice
Notes: est = estimate, f = forecast

India

India's economic momentum suffered a modest setback due to demonetization, while the poor and vulnerable likely witnessed a larger negative shock. The economy is expected to recover and growth will gradually accelerate to 7.7 percent by FY19/20. Re-balancing of growth drivers towards investment will support the sustainability of GDP and household income growth, albeit with heightened uncertainty.

	2016
Population, million	1325.3
GDP, current US$ billion	2448.4
GDP per capita, current US$	1,847

Sources: World Bank WDI



Sources: Central Statistical Organization and World Bank
Note: f = forecast

Recent developments

Favorable monsoons provided tailwinds to India's domestically-driven expansion. GDP expanded by 7.9 percent in FY15/16[1], the fastest pace in 5 years, supported by investment and urban consumption. Normal monsoons in FY16/17 boosted agriculture and rural consumption, while urban consumption remained robust. Despite renewed weakness in private investment and limited lift from external demand, India was poised to continue growing robustly until 'demonetization' dented growth, albeit modestly.[2] Demonetization caused an immediate cash crunch, and activity in cash reliant sectors was affected. GDP growth slowed to 7.0 percent y/y during Q3 FY16/17, from 7.3 percent during H1 FY16/17. Such a modest slowdown can be explained by: (i) coping mechanisms (e.g. informal credit); (ii) higher rural wages; and (iii) higher reported sales to legitimize holdings of old currency, which exacerbated measured growth.

The central Government met its commitment to fiscal consolidation, but state finances are murkier. The central Government expects to meet its fiscal deficit target of 3.5 percent of GDP in FY16/17 as tax collections remained robust. The fiscal stance of the General Government is less clear. Reporting by states, which have been undertaking a growing share of expenditures, is less reliable and deficits may have risen.

1 FY15/16 refers to the year ended March 31, 2016.
2 Because the policy entailed immediate demonetization of INR500 and INR1000 notes, it became widely known as "demonetization," but it's best described as currency exchange, since new INR500 and INR2000 notes were introduced soon after.

External accounts remain robust. Exports contracted for five consecutive quarters, but turned positive in the second half of FY16/17, supported largely by higher prices and improvements in the global trade and contributing to containing the current account deficit. Capital inflows accelerated, reflecting in part reforms in FDI policies and in part global appetite for Indian equities. Consequently, foreign reserves rose to $360bn, or 9 months of imports.

Outlook

Economic activity is expected to accelerate in FY17/18. GDP growth is expected to slow to 6.8 percent in FY16/17 due to a combination of weak investments and the impact of demonetization, and to recover in FY17/18, when GDP is expected to grow by 7.2 percent. Growth is projected to increase gradually to 7.7 percent by FY19/20, underpinned by a recovery in private investments, which are expected to be crowded-in by the recent increase in public capex and an improvement in the investment climate.

India's fiscal, inflation and external conditions are expected to remain stable. The center will continue to consolidate modestly in FY17/18, while retaining the push towards infrastructure spending. Inflation will stabilize, supported by favorable weather and structural reforms. Normal monsoons have so far offset increases in petroleum prices. The Government amended the RBI act to reflect an inflation target of 4 (+/-2) percent and establish a monetary policy committee (MPC), boosting the credibility of the central bank. The exchange rate has appreciated, partly reflecting expectations of a narrowing inflation gap between India and the US and limited external vulnerabilities as the current account deficit is expected to remain below 2 percent of GDP and fully financed by FDI inflows.

Risks and challenges

There are significant risks to India's favorable growth outlook. Continued uncertainties in the global environment, including rising global protectionism and a sharp slowdown in the Chinese economy, could further delay a meaningful recovery of external demand. Second, there is great uncertainty about the extent to which demonetization caused small, informal firms to exit and shed jobs. Third, private investment continues to face several impediments in the form of corporate debt overhang, stress in the financial sector, excess capacity and regulatory and policy challenges. Subdued private investment would put downside pressures on India's potential growth. Finally, further rapid increases in oil and other commodity prices could lead to a negative terms-of-trade shock. On the other hand, timely and smooth implementation of the GST could prove to a significant upside risk to economic activity in FY17/18.

TABLE: India macro outlook indicators (annual percent change unless indicated otherwise)

	2014	2015	2016 (est)	2017 (f)	2018 (f)	2019 (f)
Real GDP growth, at constant market prices	7.2	7.9	6.8	7.2	7.5	7.7
Private Consumption	6.8	7.3	7.2	7.3	7.4	7.5
Government Consumption	9.4	2.9	4.7	4.4	4.2	4.3
Gross Fixed Capital Investment	4.1	6.1	3.3	6.8	8.8	8.9
Exports, Goods and Services	1.7	-5.4	6.1	6.3	6.0	6.1
Imports, Goods and Services	0.8	-5.9	0.7	3.7	4.8	4.8
Real GDP growth, at constant factor prices	6.9	7.8	6.8	7.2	7.5	7.7
Agriculture	-0.3	0.8	4.9	2.1	2.3	2.3
Industry	6.9	8.2	5.8	7.1	7.6	8.0
Services	9.5	9.8	8.1	8.7	8.8	8.8
Inflation (Consumer Price Index)	6.0	5.0	5.2	4.9	4.9	4.9
Current Account Balance (percent of GDP)	-1.3	-0.8	-1.0	-1.2	-1.3	-1.5
Financial and Capital Account (percent of GDP)	2.0	1.3	1.4	1.5	1.6	1.8
Net Foreign Direct Investment (percent of GDP)	1.5	1.6	1.6	1.5	1.4	1.3
Fiscal Balance (percent of GDP)	-7.2	-6.2	-6.1	-5.7	-5.5	-5.4
Debt (percent of GDP)	68.6	69.5	69.2	69.2	68.2	66.7
Primary Balance (percent of GDP)	-2.3	-1.5	-1.4	-1.2	-1.1	-1.2

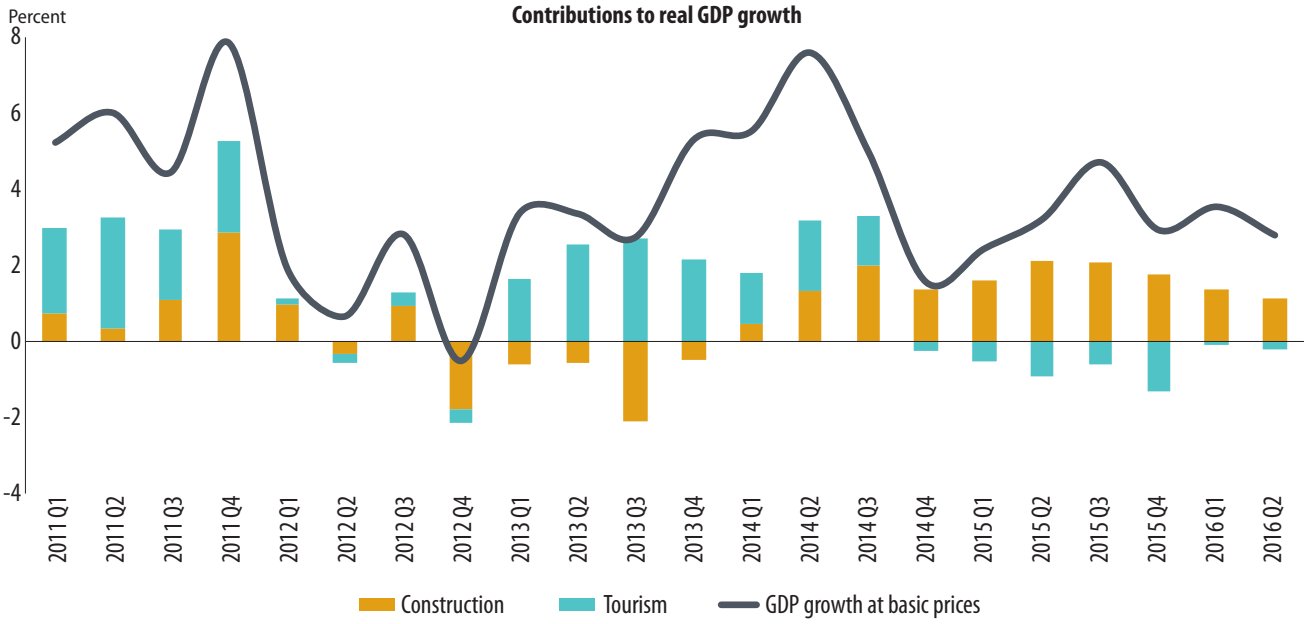
Sources: World Bank, Macroeconomics and Fiscal Management Global Practice
Notes: est = estimate, f = forecast

Maldives

The Government started a number of large infrastructure projects to allow the population to move from small, vulnerable islands to Greater Malé, one of the reasons why construction has overtaken tourism as the main driver of growth. To make space for these investments, the government is implementing a reduction in current expenditure. In the medium term, construction is expected to remain the main driver of growth with large current account deficits financed by investment and infrastructure loans.

	2016
Population, million	0.4
GDP, current US$ billion	3.6
GDP per capita, current US$	8,620

Sources: World Bank WDI



Sources: Ministry of Finance and Treasury, and World Bank staff calculations

Recent developments

Overall GDP growth rebounded to an estimated 4.1 percent in 2016, compared to 2.8 percent in 2015.[3] Construction for housing and large investment projects has taken over as the main driver of growth since late 2014, while tourism has been slowing down due to an economic slowdown in key countries.

Inflation fell further to 0.5 percent in 2016 thanks to continued low global food and fuel prices and a stable exchange rate, as most products are imported.

The fiscal deficit in 2016 has widened slightly to an estimated 8.6 percent of GDP. Revenue and grants are estimated to have declined slightly to 32.2 percent of GDP. The expenditure side reflects a significant policy shift of around 4 percent of GDP away from recurrent expenditure, by abolishing electricity subsidies effectively, to capital expenditure into primarily population centers around Greater Malé and into the expansion of the main airport. Public debt grew from 63.4 to an estimated 69.5 percent of GDP. Thanks to concessional external debt and domestic debt issued at low, fixed

3 World Bank staff estimates. Official final estimates GDP have not yet been released.

rates, and relatively high revenue collection, the cost of debt service is low at 17 percent of revenue. In a sign of increased transparency, the Ministry of Finance and Treasury started to publish monthly fiscal outcomes on its website.

A long-running court case between the airport SOE and an Indian engineering company was settled for USD 271 million in November 2016, partly through selling a bond to the central bank, which used a USD 100 million 6-month currency swap with the Reserve Bank of India to replenish reserves. The current account deficit has widened sharply from 9.5 percent in 2015 to 25.7 percent of GDP in 2016, on the back of reduced tourist services income, further declines in fish exports and increased imports of construction materials, and the one-off impact of the settlement on the current account, while commodity imports fell thanks to low global prices. FDI inflows were not sufficient to cover the current account deficit unlike previous years. Gross official reserves fell to USD 467 million at end-2016, although usable reserves[4] were only USD 200 million (1.2 months of imports). The exchange rate to the USD remains at 15.4, the low end of the currency band.

Outlook

Maldives is expected to continue to expand the number of resorts, attracting substantial FDI inflows of around 9-10 percent of GDP a year. Construction is also likely to remain a key growth driver, while the tourism sector growth is likely to remain below previous growth rates, reflecting lower growth expectations in key countries, despite an expected recovery in Russia.

As food subsidies are being gradually phased out in 2017, inflation is expected to spike due to the direct impact and knock-on effect on other food items. The Government has put in place a targeted cash transfer program to protect vulnerable households from the impact, even if take-up of the cash transfer has been limited so far.

The Government has projected a budget deficit for 2017 of 1 percent of GDP. While acknowledging the effort to phase out food subsidies, it may be difficult to meet the deficit target unless new revenue measures and further expenditure savings are realized, and the World Bank projects a fiscal deficit of 6.1 percent of GDP instead, which would still be the lowest deficit since 2007. Efficiency gains in the universal health system could make the budget more flexible and subsidies reduction make it less exposed to global commodity price shocks. However, the level of public debt is expected to remain elevated as long as the investment boom continues.

The current account deficit is likely to remain around 20 percent of GDP, financed by FDI, external loans, an expected Eurobond issuance and one-off income sources. Usable reserves are expected to remain low, as the currency swap and other foreign loans will be due for repayment.

Risks and challenges

It is important that Maldives preserves its tax base and efficient tax system, as it prepares to develop Special Economic Zones offering tax concessions. On the expenditure side, the World Bank encourages the Government to continue to seek efficiency improvements in the health system, while updating and strengthening its targeted social protection system to avoid a return of food and electricity subsidies once commodity prices rise again. Improved project selection, planning and budgeting for construction, maintenance and operations could increase the value-for-money for public investment. A Sovereign Development Fund set up to receive the newly introduced Airport Development Charge and dividends from the airport SOE will ring-fence funds to repay the loans to finance the airport expansion.

The level of reserves at the central bank is structurally low, but large economic actors are typically able to supply dollars to the market to keep the parallel market premium low.

While construction and resort tourism are expected to drive growth in the medium term, these sectors do not create sufficient jobs for Maldivians. The consolidation of population from vulnerable islands and atolls to larger islands in Greater Malé, while also reducing pressure on Malé is a country priority. If successful, it may eventually allow for new forms of economic activity in line with the aspirations of Maldivian youth and provide employment, improve the quality of public services such as health and education, and make the country more resilient to climate change.

4 After netting out short-term foreign currency liabilities to the banking sector.

TABLE: Maldives macro outlook indicators (annual percent change unless indicated otherwise)

	2014	2015	2016 (est)	2017 (f)	2018 (f)	2019 (f)
Real GDP growth, at constant market prices	6	2.8	4.1	4.5	4.6	4.6
Private Consumption	..	..	..	..	..	..
Government Consumption	..	..	..	..	..	..
Gross Fixed Capital Investment	..	..	..	..	..	..
Exports, Goods and Services	..	..	..	..	..	..
Imports, Goods and Services	..	..	..	..	..	..
Real GDP growth, at constant factor prices	6	2.8	4.1	4.5	4.6	4.6
Agriculture	0.2	-0.5	1.9	2.3	2.5	2.4
Industry	12.9	18.3	6.6	6.7	6.8	6.9
Services	4.6	1.6	3.3	3.8	4	3.9
Inflation (Consumer Price Index)	2.1	1	0.5	2.4	2.8	3
Current Account Balance (percent of GDP)	-3.8	-9.5	-25.7	-21.9	-21	-19.4
Net Foreign Direct Investment (percent of GDP)	10.8	8.7	10.7	10.4	9.9	9.4
Fiscal Balance (percent of GDP)	-8.2	-8.2	-8.6	-6.1	..	..
Debt (percent of GDP)	65.9	63.4	69.5	71.2	..	..
Primary Balance (percent of GDP)	-4.6	-5.6	-5.6	-2.7	..	..

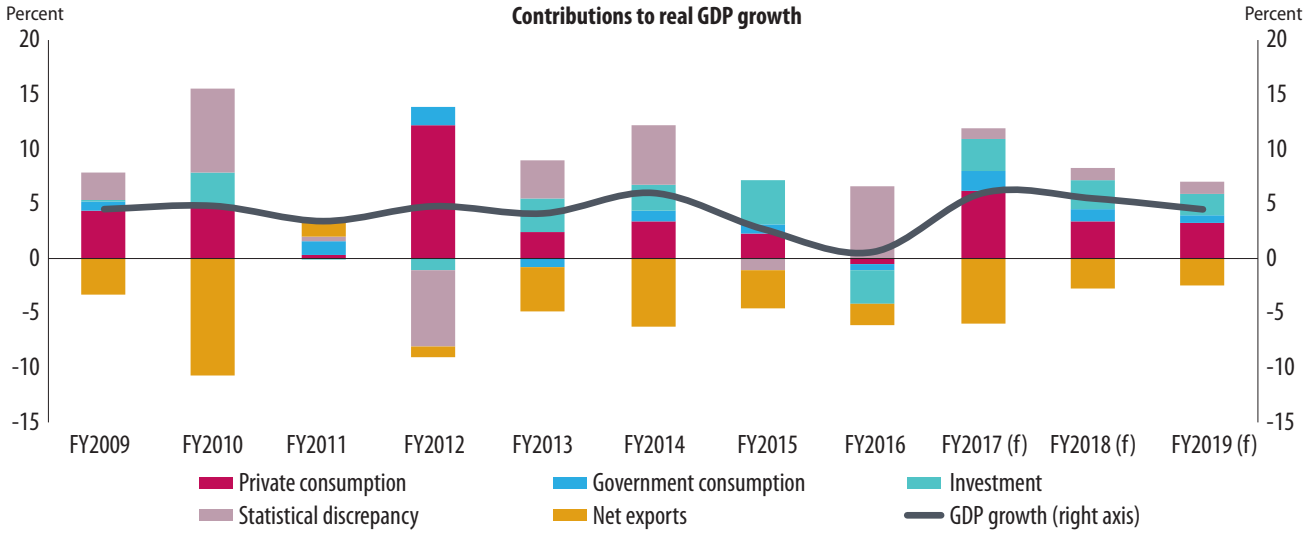
Sources: World Bank, Macroeconomics and Fiscal Management Global Practice.
Notes: est = estimate, f = forecast

Nepal

A broad-based recovery is on-going in FY2017 as activity is rebounding, inflation is moderating, government revenue and spending is picking up and remittances are growing, albeit more slowly than ever before. Growth is expected to remain strong thereafter, but to moderate in line with the potential. However, slow recovery of exports, potential tightening of credit, continued decline in departures of migrant workers going abroad and a fluid political environment will continue to pose challenges in the forecast period.

	2016
Population, million	28.9
GDP, current US$ billion	21.2
GDP per capita, current US$	736

Sources: World Bank WDI



Sources: Central Statistics Organization and World Bank staff projections
Note: f = forecast

Recent developments

Real GDP growth, which had already fallen to 2.7 percent in FY2015 on account of the devastating earthquake, was dragged further down to a 14-year low of 0.6 percent in FY2016 on account of complete disruption in cross-border trade with India. However, economic activity is rebounding strongly following two challenging years.

On the back of one of the best monsoons in recent years, the rice production is estimated to have reached a record high at 5.5 million tons, up from 4.3 million tons a year ago, boosting agricultural output. Post-earthquake reconstruction activities are picking up after a slow start. All eligible houses—about half a million—have received the first of three tranches of the housing grant. Second tranche of the housing grant is expected to start in the second half of FY2017. Nearly 100 MW of hydropower projects which were delayed by the earthquakes and trade disruptions have come on-stream. There has been a revival of transport and full normalization of wholesale and retail trade. Tourism is also recovering as arrivals have reached pre-crisis level during the September-December tourist season.

High inflation in the past two years induced by disruptions has moderated sharply to 3.2 percent (y/y) in the first half of the FY2017. Normalization of imports and a favorable external environment, particularly the moderating inflation in India as a result of demonetization, are the primary reasons for a deceleration of inflation. Food prices have also declined.

The new government has initiated a series of reforms in electricity and health, with the most visible impact in the electricity sector with the elimination of power cuts in several major cities across Nepal. Efforts to reduce the financial/technical losses of the electricity utility, NEA, are also showing results.

Government revenue and spending have also performed well. Revenue has exceeded the six months' target and spending, including on capital goods, has also significantly picked up compared to previous years and is on par with revenue. Nevertheless, overly ambitious expenditure envisioned in the budget has not materialized leaving previously accumulated government deposits (10 percent of GDP) intact.

Credit has grown rapidly over the past year and has reached 30 percent (y/y) while deposits growth slowed marginally to 18 percent (y/y). However, banks are running up against prudential limits on lending. Additionally, government's large cash balances have had the effect of a monetary tightening at a time when the banks are trying to increase their capital base to meet the increased regulatory requirements for paid up capital.

Imports which had rebounded fast following the end of trade disruptions have reached a record high. Exports despite some recovery are yet to reach their pre-disruption levels whose recovery is also affected by continued appreciation of real effective exchange rate. As a result, trade deficit has continued to increase. While the remittances continue to grow, although at a slower pace, they are still high enough to offset the trade deficit.

Outlook

Growth is expected to rebound strongly and reach 6 percent in FY2017 on the back of increased agriculture output, increased availability of electricity, and greater investment as the earthquake reconstruction gathers speed. However, it is expected to moderate thereafter in line with the country's potential. The inflation gap with India has reduced to pre-disruption levels indicating reduced supply-side constraints and it is expected to pick up somewhat as the effect of demonetization tapers off in India. Nonetheless, inflation is expected to be below the central bank's target of 7.5 percent for entire FY2017.

Fiscal deficit is expected to widen during the forecast period, however, given the large cash balance on hand, financing is not expected to be a problem. Government's spending will grow substantially in FY2017 owing to increase in earthquake related cash assistance and proposed election related spending as well as measures introduced to increase civil servants' compensations, pensions and social protection. FY2017 budget called for an expenditure increase of more than 10 percent of GDP which is unlikely to materialize as in the previous years. Realizing this, the government's mid-year budget has already lowered the spending targets. Meanwhile, the current account surplus is expected to narrow and turn into a deficit as import growth is expected to persist coupled with the slower growth in remittances.

Risks and challenges

Domestic risks predominate and are on the downside. The political environment remains fluid as the term of the current government—which was sworn in during July 2016 as part of the power-sharing agreement among the coalition partners—is coming to an end. In addition, a series of elections (local, provincial, federal) needs to be held by early 2018, as stipulated by the new constitution, with a date for local elections announced for May 2017.

Banks are running up against regulatory limits for lending which risks a sudden stop in new credit. Banks are allowed to lend up to 80 percent of their local currency deposits and core capital and are running up against this limit. As a result, the central bank announced regulatory measures to ease the constraints and has also warned six banks that have breached the lending limit. Increased vulnerability in the financial sector could pose a challenge in the remainder of the forecast period.

The external environment is likely to be less favorable as well. Continued underperformance of the exports despite the end of disruptions remains a persisting challenge. Remittances account for 30 percent of GDP with the majority of migrants going to oil-exporting Gulf Co-operation Countries (GCC). Significant spending cuts, including on capital spending, announced in the GCC countries and persistent contraction in departures of migrants have contributed to lower growth of remittances and risk a possible sharper slowdown during the forecast period.

TABLE: Nepal macro outlook indicators (annual percent change unless indicated otherwise)

	2013/14	2014/15	2015/16 (est)	2016/17 (f)	2017/18 (f)	2018/19 (f)
Real GDP growth, at constant market prices	6.0	2.7	0.6	6.0	5.5	4.5
Private Consumption	4.1	2.9	-0.6	7.7	4.2	4.0
Government Consumption	10.0	7.4	-7.1	16.5	9.5	5.7
Gross Fixed Capital Investment	11.4	19.6	-11.5	13.9	11.3	8.0
Exports, Goods and Services	18.8	6.8	-2.8	3.8	12.0	10.0
Imports, Goods and Services	20.9	9.6	3.3	12.8	8.0	7.0
Real GDP growth, at constant factor prices	5.7	2.3	0.8	6.0	5.5	4.5
Agriculture	4.5	0.8	1.3	4.8	3.5	3.0
Industry	7.1	1.5	-6.3	5.0	4.7	3.5
Services	6.1	3.7	2.7	7.2	7.1	5.8
Inflation (Consumer Price Index)	9.1	7.2	9.9	5.2	6.0	7.0
Current Account Balance (percent of GDP)	4.6	5.1	6.2	1.0	-0.7	-1.3
Fiscal Balance (percent of GDP)	0.6	-0.7	-0.8	-1.9	-2.2	-2.2
Debt (percent of GDP)	28.3	25.6	27.9	27.3	26.9	26.7
Primary Balance (percent of GDP)	1.3	-0.2	-0.4	-1.4	-1.7	-1.7

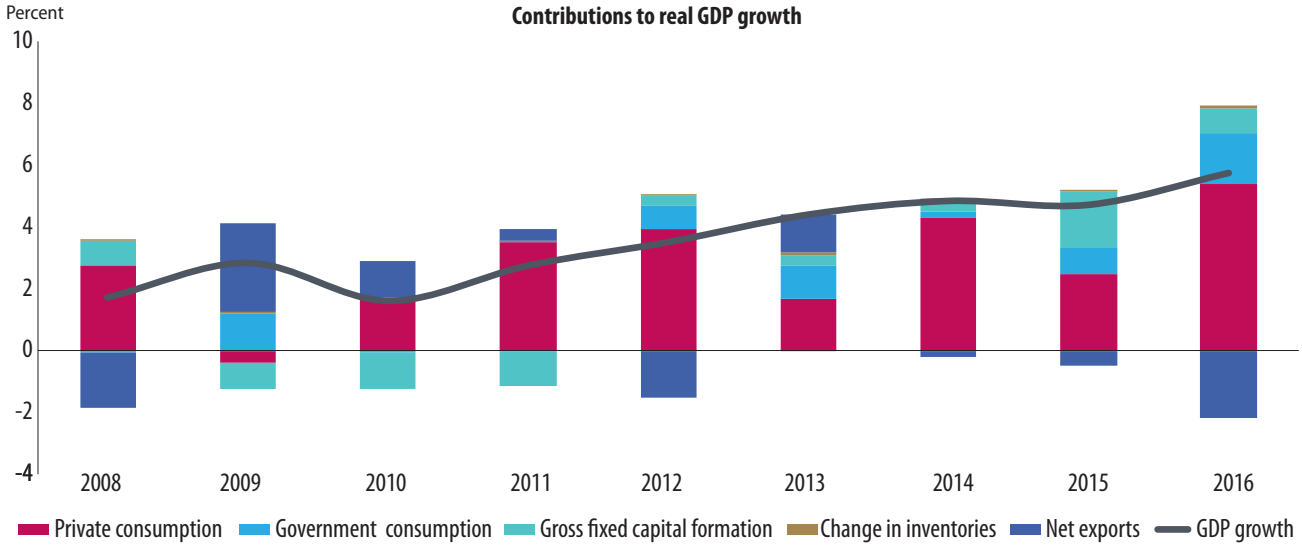
Sources: World Bank, Macroeconomics and Fiscal Management Global Practice
Notes: est = estimate, f = forecast

Pakistan

Pakistan's growth prospects continue to improve and inflation remains contained. However, weak fiscal performance and pressures in external account pose a challenge. Efforts to reverse the current imbalances and continued implementation of structural reforms will be needed for sustaining and accelerating growth and improving welfare.

	2016
Population, million	192.8
GDP, current US$ billion	284.0
GDP per capita, current US$	1473

Sources: World Bank WDI



Sources: Pakistan Economic Survey and World Bank staff estimates

Recent developments

Macroeconomic conditions continued to improve during FY2016 and economic growth accelerated to 4.7 percent. After a weak performance in FY2016, the agriculture sector picked up during the first half of FY2017 due to better cotton, sugarcane, and maize crops. Large Scale Manufacturing (LSM) growth (Y-o-Y) remained at 3.9 percent during the first half of FY2017, supported by growth in automobiles, construction, food & beverages, pharmaceuticals, and fertilizer. The China Pakistan Economic Corridor (CPEC) projects have supported construction activity, which is expected to stimulate industrial sector growth in the second half of FY2017. Headline inflation remained moderate during Jul-Feb FY2017 at 3.9 percent.

The external account improved during FY2016 and reserves rose to US$18.1 billion by end of FY2016, equivalent to 4.1 months of prospective imports. Country risk improved and Standard and Poor's raised its rating to B in October 2016. Pakistan was also able to issue US$1.0 billion Sukuk at relatively low rates in October 2016. It was upgraded to 'emerging market' status in the MSCI Index. Notwithstanding these positive developments, exports have been on a declining path since FY2015. Exports contracted by 2.0 percent during Jul-Feb FY2017. Imports grew at 11.2 percent during the first eight months of FY2017. The trade deficit, therefore, widened by 26.9 percent (Y-o-Y) during Jul-Feb FY2017. Remittances decreased by 2.5 percent during Jul-Feb FY2017 due to declining public investment in GCC economies. Therefore, the current account is experiencing some pressure. Pakistan received FDI of US$1.2 billion from July 2016 until February 2017. The Rupee remained stable against the US dollar in Jul-Feb 2017 as market expectations were kept in check due to a comfortable official reserves position.

The consolidated fiscal deficit (including grants) declined from 5.2 percent of GDP in FY2015 to 4.5 percent in FY2016—the lowest in nine years. Weaker revenue collection and strong growth in the expenditures has led to a widening of the deficit to 2.4 percent in the first half of FY2017, 0.7 percentage points higher than the same period of last year. Debt to GDP ratio stands high at 62.8 percent at the end of Q2-FY2017.

Outlook

The economy is projected to grow by 5.2 percent in FY2017. On the demand side, the near-term growth outlook will primarily be supported by public and private consumption. Investment to GDP ratio will improve marginally due to CPEC and other public investment.

On the supply side, impetus to growth is projected to come from services and the industrial sector. The services sector is expected to grow by 5.6 percent and the industrial sector is expected to grow by 6.1 percent in FY2017. After a weak performance in FY2016, the agriculture sector is expected to grow at 3.4 percent in FY2017.

The current account deficit is expected to widen from 1.2 percent of GDP in FY2016 to 2.2 percent in FY2017 and 2.4 percent by FY2019. The key contributor to this will be a widening of the trade deficit due to moderate growth in exports (due to weakening of exports competitiveness and global demand) and higher growth in imports due increased economic activity. FDI flows will strengthen due to the accelerated implementation of CPEC projects. Official foreign exchange reserves are projected to decline to 3.2 months of imports by FY2019 due to larger current account deficit, and higher debt repayments (due to IMF repayments) in FY2018.

The fiscal deficit is projected to be 4.8 percent in FY2017, 0.3 percentage point higher than the FY2016 deficit. This widening is primarily driven by slower increase in government tax revenues (both federal and provincial) coupled with decline in non-tax revenues.

Inflation has already bottomed out. Projected increases in economic activity and an expected gradual increase in energy prices will push up domestic prices. Inflation is projected to increase from 2.9 percent in FY2016 to 5.0 percent in FY2017 and 7.0 percent in FY2019.

Risks and challenges

There are significant downside risks to the projected outlook. The upcoming national election in 2018 may affect reform momentum and macroeconomic policy orientation. Slower progress in much-needed structural reforms could weaken growth prospects.A stable PKR/US$ nominal exchange rate has resulted in appreciation of Real Effective Exchange Rate (REER). Furthermore, lingering uncertainty about the course of US economic policy and the possibility of a protracted global economic weakness, especially in the Euro area due to Brexit, could negatively affect exports. Pakistan is also vulnerable to any significant decline in remittance flows, particularly from oil-rich countries (around two thirds of all remittances), if oil prices remain depressed. But low oil prices will also improve the current account deficit and create an environment conducive for a reduction in energy subsidies.

TABLE: Pakistan macro outlook indicators (annual percent change unless indicated otherwise)

	2014	2015	2016 (est)	2017 (f)	2018 (f)	2019 (f)
Real GDP growth, at constant market prices	4.7	4.7	5.7	5.2	5.5	5.8
Private Consumption	5.6	3.2	7.0	4.4	4.3	4.7
Government Consumption	1.5	8.1	15.1	11.5	11.3	11.2
Gross Fixed Capital Investment	2.5	14.1	5.7	8.2	8.3	8.5
Exports, Goods and Services	-1.5	-6.3	-4.8	0.2	4.4	4.5
Imports, Goods and Services	0.3	-1.6	12.4	5.2	5.5	5.5
Real GDP growth, at constant factor prices	4.1	4.0	4.7	5.2	5.5	5.8
Agriculture	2.5	2.5	-0.2	3.4	2.9	3.3
Industry	4.5	4.8	6.8	6.1	7.0	7.7
Services	4.5	4.3	5.7	5.6	5.8	6.0
Inflation (Consumer Price Index)	8.6	4.5	2.9	5.0	6.0	7.0
Current Account Balance (percent of GDP)	-1.3	-1.0	-1.1	-2.2	-2.4	-2.4
Financial and Capital Account (percent of GDP)	3.0	2.0	2.1	2.2	2.4	2.4
Net Foreign Direct Investment (percent of GDP)	0.6	0.3	0.7	0.5	1.1	1.1
Fiscal Balance (percent of GDP)	-4.7	-5.2	-4.5	-4.8	-5.1	-4.9
Debt (percent of GDP)	64.4	64.1	67.4	66.1	64.6	62.6
Primary Balance (percent of GDP)	-0.2	-0.5	-0.2	-0.1	-1.0	-1.4

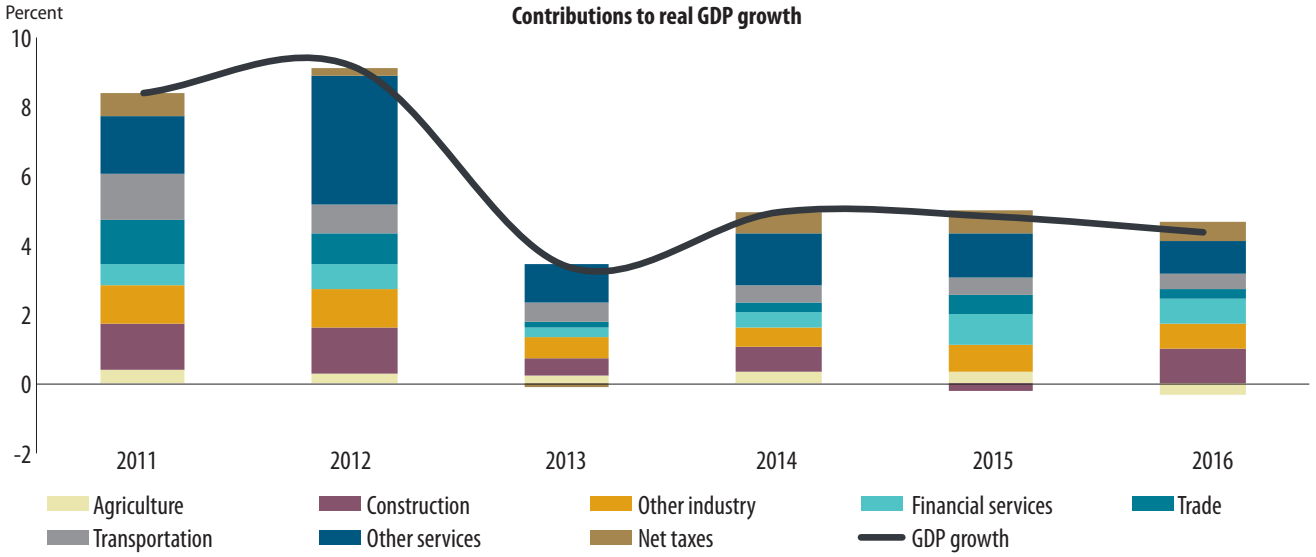
Sources: World Bank.
Notes: est= estimate, f = forecast

Sri Lanka

Recent policy measures supporting fiscal consolidation and monetary tightening contributed to an improved outlook, against the backdrop of the IMF program. Despite a high budget deficit and public debt, signs of improvements in public finance were seen in 2016; however, external buffers remained weak on account of subdued export performance, low FDI and capital outflows. It is critical to expedite structural reforms to promote competitiveness and governance, and continue on fiscal consolidation in order to ensure sustained growth and development.

	2016
Population, million	21.1
GDP, current US$ billion	80.6
GDP per capita, current US$	3,824

Sources: World Bank WDI



Sources: Department of Census and Statistics, Sri Lanka

Recent developments

Despite formidable challenges, Sri Lanka's macroeconomic performance remained broadly satisfactory in 2016 thanks to key policy measures taken during the year. The changes to the VAT Act and improved revenue administration helped strengthen the revenue-led fiscal consolidation, while monetary policy was tightened to dampen high monetary growth and support external sector stability. These measures provided a platform to lower the fiscal deficit, stabilize the public debt-to-GDP ratio and support external stability in 2017 and beyond. Nevertheless, weak external liquidity remains a key challenge amid capital outflows and low FDI inflows.

The IMF-supported program continued to anchor macroeconomic stability and structural reforms while strengthening external resiliency. In November 2016, the first review of the Extended Fund Facility (about USD 1.5 billion) was completed, allowing the disbursement of the second tranche. The program calls for fiscal consolidation; transition to flexible inflation targeting; and reforms in public financial management, state enterprises and trade and competitiveness. During the year, budget support through a Development Policy Financing operation by the World Bank and Japan International Cooperation Agency reinforced policy reforms to improve private sector competitiveness, transparency, public sector management, and fiscal sustainability.

Real GDP growth in 2016 slowed to 4.4 percent, reflecting the impact of floods and droughts, despite significant contributions from construction, trade, financial

and other services. Although the VAT rate was increased, annual average inflation measured by the Colombo Consumer Price Index remained benign, 4.5 percent in year-on-year terms as of December 2016, due to low international commodity prices and domestic price controls on staples. Core inflation, which excludes fresh food and energy, closed the year at 5.8 percent, reflecting demand-side pressures and high monetary growth.

The fiscal deficit for 2016 is anticipated to decline to 6.1 percent of GDP from 7.6 percent in 2015, due both to increased revenue collection, less capital expenditure, and control of current expenditure. The benefit of low oil prices appears to have been offset by greater imports of food and petroleum due to the drought, while broadly stable remittances and increasing tourism receipts continue provide a cushion. Nevertheless, low FDI, sizeable external debt service and capital outflows have all exerted pressure on the currency, while foreign reserves, at around 2.9 months of imports, were below comfortable levels.

Outlook

Recent policy reforms including monetary tightening and revenue-led fiscal consolidation have improved the outlook. Continuation of the IMF program will add to the confidence and support fiscal sustainability while structural reforms supported by the World Bank are expected to yield benefits in the medium term.

The economy is projected to grow by 4.7 percent in 2017 and marginally exceed 5.0 percent growth in the medium term, driven by private consumption and investment. The impact of past currency depreciation and the rise in the VAT rate will increase inflation in 2017 despite downward pressure from low international commodity prices. The external sector is poised to benefit from the reinstatement of GSP+ preferential access to European Union and rapidly growing tourism, although the drought could adversely impact exports and increase petroleum imports. External buffers are projected to improve, with emphasis placed on purchasing foreign exchange, maintaining a more market-determined exchange rate, using monetary policy and the sale of selected government assets. The fiscal deficit is projected to fall to 5.0 percent of GDP for 2017 due to the implementation of revenue measures.

Risks and challenges

The immediate challenge is to improve the external liquidity position and prepare for active liability management. Given the significantly large external obligations falling due, especially starting in 2019, potential actions include buying back and re-issuing longer-dated bonds.

Structural challenges include further progress on revenue-led fiscal consolidation; and narrowing the persistent current account deficit. The latter is linked to structural competitiveness issues, as indicated by a low level of exports and a stale export basket. The country's transition towards upper middle income status is expected to lead to more commercial borrowing terms, leading to increased fiscal pressures. Finally, given low national savings rates, more FDI is needed in the manufacturing and export sectors to sustain a high growth path.

Key risks include a growth slowdown, which would lead to fast rising public debt; and delays in key reforms in a challenging political environment. While global policy uncertainty could weigh on the external sector performance, the direct impact of a slowdown in China and the Brexit would be limited. Continued economic woes in the Middle East and the EU could adversely affect exports and remittances. Tightening global financial conditions could elevate capital outflows and make borrowing more expensive.

It is important that fiscal policy is used to promote competitiveness and reduce poverty while pursuing the path of revenue-led fiscal consolidation. The country has already embarked on bold steps to increase fiscal space, taken measures to reduce fiscal risks from SOEs and make the country more export-oriented. Additional fiscal space could help minimize the impact of the reforms on vulnerable citizens through reforms, targeted social protection programs and pro-poor investments. Ongoing efforts to reform the targeting system used by the flagship Samurdhi Social Protection program will help in this regard. Fiscal buffers could also help counter the impact of frequent natural disasters. Structural changes to public expenditure are needed to focus on investment in human and productivity-enhancing physical capital to return to a higher growth trajectory and maintain its strong recent record of poverty reduction while preparing to take care of an aging society.

TABLE: Sri Lanka macro outlook indicators (annual percent change unless indicated otherwise)

	2014	2015	2016 (est)	2017 (f)	2018 (f)	2019 (f)
Real GDP growth, at constant market prices	5.0	4.8	4.4	4.7	5.0	5.1
Private Consumption	5.7	6.5	4.5	4.8	5.1	5.2
Government Consumption	6.1	10.3	4.9	0.2	0.3	0.7
Gross Fixed Capital Investment	-3.2	1.0	7.2	8.0	6.9	6.8
Exports, Goods and Services	4.3	4.7	5.1	4.7	4.4	4.4
Imports, Goods and Services	9.6	10.6	5.9	5.3	4.1	5.0
Real GDP growth, at constant factor prices	5.0	4.8	4.4	4.7	5.0	5.1
Agriculture	4.6	4.8	-4.2	2.0	3.0	3.0
Industry	4.7	2.1	6.7	5.5	5.5	5.5
Services	4.8	5.7	4.2	4.2	5.0	5.1
Inflation (Consumer Price Index)	3.3	0.9	4.0	5.2	5.2	5.2
Current Account Balance (percent of GDP)	-2.5	-2.5	-3.0	-3.4	-3.5	-3.7
Financial and Capital Account (percent of GDP)	2.0	2.9	3.0	3.4	3.5	3.7
Net Foreign Direct Investment (percent of GDP)	1.0	0.8	0.8	1.7	1.9	1.8
Fiscal Balance (percent of GDP)	-5.7	-7.6	-6.1	-5.0	-4.5	-4.1
Debt (percent of GDP)	71.3	77.6	79.1	74.7	73.4	71.9
Primary Balance (percent of GDP)	-1.5	-2.9	-0.9	0.4	1.1	1.4

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice
Notes: est = estimate, f = forecast

South Asia at a glance

			AFG (1)	BGD (6)	BTN (10)	IND (14)	MDV (19)	NPL (23)	PAK (27)	LKA (33)	SAR (39)
BALANCE of PAYMENTS	Real GDP Growth	2014	1.3	6.1	5.7	7.2	6.0	6.0	4.1	5.0	..
		2015	0.8	6.6	6.5	7.9	2.8	2.7	4.0	4.8	6.9
		2016 (est)	1.2	7.1	6.8	6.8	4.1	0.6	4.7	4.4	6.7
		2017 (f)	2.4	6.8	6.8	7.2	4.5	6.0	5.2	4.7	6.8
		2016 Q2	..	..	..	7.0	..	..	..	2.7	6.9
		2016 Q3	..	..	..	7.1	..	..	..	4.1	7.0
	Inflation (Consumer Price Index, CY)	2014	4.6	7.3	8.3	6.0	2.1	9.1	8.6	3.3	7.7
		2015	-1.5	6.4	4.5	5.0	1.0	7.2	4.5	0.9	6.8
		2016 (est)	4.4	5.9	3.2	5.2	0.5	9.9	2.9	4.0	3.5
		2017 (f)	5.5	5.6	4.0	4.9	2.4	5.2	5.0	5.2	4.3
		2016 Nov	..	5.4	..	3.7	1.5	..	3.8	3.3	3.7
		2016 Dec	..	5.1	..	3.4	..	..	3.7	4.1	3.9
	REER (CY)	2013	100.8	84.1	98.2	94.4	98.6	98.5	102.2	95.1	95.2
		2014	97.7	97.0	99.4	96.1	98.2	99.0	104.2	96.8	96.9
		2015	97.6	103.2	99.3	103.8	106.6	101.9	112.1	97.0	104.6
		2016	..	..	..	105.0	..	..	113.8	..	105.9
		2016 Dec	..	..	..	107.6	..	..	116.1	..	108.5
		2017 Jan	..	..	..	106.4	..	..	115.9	..	107.3
	Current Account Balance (% of GDP)	2014	8.0	0.8	-24.6	-1.3	-3.8	4.6	-1.3	-2.5	-2.5
		2015	5.4	1.5	-29.1	-0.8	-9.5	5.1	-1.0	-2.5	-3.9
		2016 (est)	6.4	1.7	-38.8	-1.0	-25.7	6.2	-1.1	-3.0	-6.9
		2017 (f)	4.4	0.2	-51.8	-1.2	-21.9	1.0	-2.2	-3.4	-9.4
	Trade Balance (% of GDP)	2012	-36.1	-5.4	-21.1	-11.0	-50.1	-25.8	-6.9	-13.8	-10.8
		2013	-34.5	-4.2	-21.1	-8.7	-49.1	-28.6	-7.0	-10.2	-8.8
		2014	-30.5	-4.3	-20.1	-7.1	-53.6	-33.1	-7.3	-10.4	-7.4
		2015	-33.3	-3.0	-20.3	-6.5	-48.2	-26.9	-6.1	-10.2	-6.8
	Import Growth (%, y-o-y)	2014	-4.2	1.2	-3.5	0.8	..	20.9	0.3	9.6	1.1
		2015	5.0	3.2	10.1	-5.9	..	9.6	-1.6	10.6	-1.0
		2016 (est)	5.0	-7.1	20.0	0.7	..	3.3	12.4	5.9	0.4
		2017 (f)	8.0	6.0	25.0	3.7	..	12.8	5.2	5.3	4.4
	Export Growth (%, y-o-y)	2014	-19.7	3.2	-6.0	1.7	..	18.8	-1.5	4.3	5.4
		2015	-2.5	-2.8	-5.0	-5.4	..	6.8	-6.3	4.7	-4.9
		2016 (est)	5.0	2.2	0.1	6.1	..	-2.8	-4.8	5.1	3.0
		2017 (f)	7.0	5.0	1.0	6.3	..	3.8	0.2	4.7	6.0

			AFG (1)	BGD (6)	BTN (10)	IND (14)	MDV (19)	NPL (23)	PAK (27)	LKA (33)	SAR (39)
BALANCE of PAYMENTS	Foreign Reserves, months of import cover (CY)	2013	9.1	5.5	9.3	8.1	2.6	8.6	2.0	5.8	7.5
		2014	10.3	6.5	11.9	9.1	3.9	8.4	3.8	5.8	8.5
		2015	9.7	8.0	9.6	10.4	3.7	12.5	5.1	6.0	9.8
		2016 (est)	..	8.1	..	10.6	3.3	..	5.0	5.9	9.8
		2016 Jul	..	8.1	..	10.9	..	..	5.2	..	10.0
		2016 Aug	..	..	..	10.6	..	..	5.0	..	9.8
	Remittances (US$ million) (CY)	2012	252	14,120	18	68,821	3	4,793	14,007	6,000	108,013
		2013	314	13,867	12	69,970	3	5,589	14,629	6,422	110,806
		2014	268	14,988	14	70,389	3	5,889	17,244	7,036	115,831
		2015	301	15,388	20	68,910	4	6,730	19,306	7,000	117,658
		2016 Q3	..	22,953	..	8,930	..	..	4,760	1,860	..
		2016 Q4	..	23,984	..	..	..	..	4,599	..	..
GOVERNMENT FINANCES	Fiscal Balance (% of GDP)	2014	-1.8	-3.5	2.7	-7.2	-8.2	0.6	-4.7	-5.7	-6.6
		2015	-1.3	-3.3	1.3	-6.2	-8.2	-0.7	-5.2	-7.6	-6.4
		2016 (est)	-0.7	-3.1	-2.5	-6.1	-8.6	-0.8	-4.5	-6.1	-6.1
		2017 (f)	-0.5	-4.0	-8.6	-5.7	-6.1	-1.9	-4.8	-5.0	-6.0
	Public Debt (% of GDP)	2014	6.5	33.9	96.4	68.6	65.9	28.3	64.4	71.3	54.4
		2015	6.2	34.6	106.5	69.5	63.4	25.6	64.1	77.6	55.6
		2016 (est)	6.5	35.8	102.1	69.2	69.5	27.9	67.4	79.1	58.4
		2017 (f)	6.4	37.8	103.2	69.2	71.2	27.3	66.1	74.7	60.4
CONSUMPTION and INVESTMENT	Private Consumption Growth (%, y-o-y)	2013	3.4	4.0	18.0	6.8	..	4.1	5.6	5.7	6.2
		2014	2.5	5.8	7.2	7.3	..	2.9	3.2	6.5	6.5
		2015	1.2	3.0	7.0	7.2	..	-0.6	7.0	4.5	6.6
		2016 (est)	1.5	4.0	7.0	7.3	..	7.7	4.4	4.8	6.6
	Gross Fixed Capital Investment Growth (%, y-o-y)	2013	-4.3	9.9	38.3	4.1	..	11.4	2.5	-3.2	2.7
		2014	1.5	7.1	12.9	6.1	..	19.6	14.1	1.0	6.3
		2015	1.0	8.9	23.0	3.3	..	-11.5	5.7	7.2	4.6
		2016 (est)	1.5	12.0	27.6	6.8	..	13.9	8.2	8.0	5.9
	Net Foreign Direct Investment (% of GDP)	2014	0.6	0.8	0.4	1.5	10.8	0.2	0.6	1.0	1.6
		2015	0.9	0.9	1.6	1.6	8.7	0.2	0.3	0.8	1.8
		2016 (est)	0.3	0.9	..	1.6	10.7	..	0.7	0.8	..
		2017 (f)	0.2	1.0	..	1.5	10.4	..	0.5	1.7	..
	Portfolio Investment (US$ million)	2012	43	1	..	-29,285	-53	..	-117	-2,126	..
		2013	52	-127	..	-6,858	53	..	-27	-2,068	..
		2014	52	-968	..	-37,740	17	..	-3,836	-2,065	..
		2015	85	-300	..	-9,487	5	..	-909	-689	..

Notes

est	Estimate
f	Forecast
CY	Series for Calendar Year
FY	Series for Fiscal Year
Sources	World Bank MFM, World Bank DECPG, World Bank WDI, IMF WEO, Haver Analytics, and national authorities
Real GDP Growth	Real GDP growth rates (percent change, y-o-y) at Market Prices, measured in Constant 2010 US$
Inflation (Consumer Price Index)	Period average percent change in CPI inflation
REER (CY)	Period average percent change in Real Effective Exchange Rate
Current Account Balance (% of GDP)	Does not include grants unless otherwise stated
Trade Balance (% of GDP)	Net balance of gross trade in goods and non-factor services (GNFS) (% of GDP)
Import Growth (%, y-o-y)	Annual (respective) fiscal year percent change of goods and non-factor services (GNFS) imports
Export Growth (%, y-o-y)	Annual (respective) fiscal year percent change of goods and non-factor services (GNFS) exports
Foreign Reserves, months of import cover (CY)	Gross reserves to number of months of import coverage, EOP
Remittances (US$ million) (CY)	Personal remittances ncluding personal transfers and compensation of employees in Current US$
Fiscal Balance (% of GDP)	Does not include grants unless otherwise stated
Public Debt (% of GDP)	Gross public debt stock including domestic and foreign liabilities, End of Period
Private Consumption Growth (%, y-o-y)	Annual (respective) fiscal year percent change in gross consumption expenditure
Gross Fixed Capital Investment Growth (%, y-o-y)	Annual (respective) fiscal year percent change in gross fixed capital expenditure
Net Foreign Direct Investment (% of GDP)	Net balance of Foreign Direct Investment assets and liabilities as as ratio to GDP
Portfolio Investment (US$ million)	Net balance of Foreign Portfolio Investment assets and liabilities in Current US$

Afghanistan

1	Real GDP Growth figures for calendar year
2	REER (CY): World Bank DECPG
3	Foreign Reserves, months of import cover (CY): World Bank WDI
4	Current Account Balance (% of GDP): Including donor grants
5	Fiscal Balance: Includes donor grants

Bangladesh

6	Fiscal Year runs from Jul-1 to Jun-30; for exmaple: for 2016 observations 2015-2016 values are used
7	Inflation (Consumer Price Index) monthly data is End-of-Period values
8	REER (CY): World Bank DECPG
9	Remittances (US$ million) (CY): Haver Analytics (National Sources)

Bhutan

10	Fiscal Year runs from Jul-1 to Jun-30; for exmaple: for 2016 observations 2015-2016 values are used
11	REER (CY): World Bank DECPG
12	Foreign Reserves, months of import cover (CY): World Bank WDI
13	Net Foreign Direct Investment (% of GDP): World Bank WDI

India

14	Fiscal Year runs from Apr-1 to Mar-31; for exmaple: for 2016 observations 2015-2016 values are used
15	Quarterly Real GDP Growth (y-o-y): World Bank DECPG
16	Monthly Inflation (Consumer Price Index) uses nominal, seasonally adjusted data from World Bank DECPG
17	REER (CY): World Bank DECPG
18	Quarterly Remittances (US$ million) (CY): Haver Analytics (National Sources)

Maldives

19	Real GDP Growth figures for calendar year
20	Monthly Inflation (Consumer Price Index) uses nominal, seasonally adjusted data from World Bank DECPG
21	REER (CY): World Bank DECPG
22	Foreign Reserves, months of import cover (CY): World Bank WDI

Nepal

23	Fiscal Year runs from Jul-16 to Jul-15; for exmaple: for 2017 observations 2016-2017 values are used
24	REER (CY): World Bank DECPG
25	Foreign Reserves, months of import cover (CY): World Bank WDI
26	Net Foreign Direct Investment (% of GDP): World Bank WDI

	Pakistan
27	Fiscal Year runs from Jul-1 to Jun-30; for exmaple: for 2017 observations 2016-2017 values are used
28	Real GDP growth reported at factor cost
29	Monthly Inflation (Consumer Price Index) uses nominal, seasonally adjusted data from World Bank DECPG
30	REER (CY): World Bank DECPG
31	Foreign Reserves, months of import cover (CY): World Bank DECPG
32	Remittances (US$ million) (CY): Haver Analytics (National Sources)
	Sri Lanka
33	Real GDP Growth figures for calendar year
34	Quarterly Real GDP Growth (y-o-y): World Bank DECPG
35	Monthly Inflation (Consumer Price Index) uses nominal, seasonally adjusted data from World Bank DECPG
36	REER (CY): World Bank DECPG
37	Foreign Reserves, months of import cover (CY): World Bank DECPG
38	Remittances (US$ million) (CY): Haver Analytics (National Sources)
	SAR
39	Real GDP Growth figures for calendar year: World Bank Global Economic Prospects, April 2017
40	Quarterly Real GDP Growth: World Bank DECPG
41	Inflation data is seasonally adjusted median weighted CPI percent change, y-o-y
42	Current Account Balance (% of GDP): WB Staff calculations
43	REER (CY): World Bank DECPG
44	Import Growth (%, y-o-y): World Bank DECPG
45	Export Growth (%, y-o-y): World Bank DECPG
46	Foreign Reserves, months of import cover (CY): World Bank DECPG
47	Fiscal Balance (% of GDP): WB staff Calculations based on IMF WEO data
48	Public Debt (% to GDP): WB staff Calculations based on IMF WEO data
49	Private Consumption Growth (%, y-o-y): World Bank DECPG
50	Gross Fixed Capital Investment Growth (%, y-o-y): World Bank DECPG
51	Net Foreign Direct Investment (% of GDP): World Bank staff calculations based on World Bank WDI data


JUKI

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