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

## I. Recent Economic Developments
- a. Growth shows signs of stabilization significantly below pre-crisis levels ........................................... 9
- b. Core inflation has eased, but headline inflation remains high due to food prices ................................... 11
- c. The policy stance remains accommodative, but some countries recover fiscal space ....................... 12
- d. Current account deficits have been widening, but remittance flows held up well .............................. 14
- e. Capital inflows are increasingly dependent on volatile portfolio investments .................................... 17

## II. Outlook and Policy .......................................................................................................................... 21
- a. The region remains vulnerable in light of continuing near-term uncertainty ..................................... 22
- b. Uncertainty on policy orientations is bound to affect investment ...................................................... 23

## III. Focus: The Investment Climate as the Key to Regain Momentum ................................................. 27
- a. Much of the economic slowdown can be traced back to slow investment .................................... 27
- b. FDI has expanded in most countries, but goes mainly into the services sector .............................. 28
- c. FDI inflows bear the potential to boost overall investment and growth ........................................ 30

## IV. South Asia Country Briefs ............................................................................................................. 35

### Afghanistan ........................................................................................................................................ 36
- Recent Economic Developments ............................................................................................................. 36
- Outlook and Policy ................................................................................................................................. 37

### Bangladesh ......................................................................................................................................... 38
- Recent Economic Developments ............................................................................................................. 38
- Outlook and Policy ................................................................................................................................. 39
<table>
<thead>
<tr>
<th>Country</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bhutan</td>
<td>41</td>
</tr>
<tr>
<td>India</td>
<td>42</td>
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<tr>
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</tr>
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<td>Pakistan</td>
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<td>Sri Lanka</td>
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V. South Asia at a Glance

Notes: (Table South Asia at a glance)
Recent Economic Developments

To regain the strong growth it had before the global crisis, South Asia will have to manage a combination of persistent external economic headwinds and increasing regional macroeconomic and structural vulnerabilities. Macroeconomic policies to tackle the adverse effects of the global downturn have left the South Asian countries with weaker fiscal and monetary options to stimulate growth today. Against this background, countries will need to confront the economic slowdown and a still-tumultuous external environment with continuing action to boost productivity and investment. The options are well known to the region’s policy-makers and progress has been made, but keeping ahead of the global curve will require a deepening of commitment to growth.

A. Growth shows signs of stabilization significantly below pre-crisis levels

South Asian economies managed the turbulence of the financial and economic crisis reasonably well; however, post-crisis real GDP growth rates have moderated and remain well below pre-crisis rates. Partly, this reflects a return to more sustainable levels of growth, but current rates leave the region below its potential. Overall, regional growth slowed from 7.2 percent in calendar year (CY) 2011 to 4.7 percent in CY2012, mainly driven by India’s slowdown (Figure 1). Due to its size and regional importance, India’s economy continues to significantly affect other countries, particularly Nepal.1 India accounts for about 80 percent of South Asia’s GDP; its real GDP growth (at market prices) is projected at 4.7 percent for FY2012/13, down from an actual 6.3 percent in FY2011/12. Most recently, during Q3 of FY 2012/13 real GDP growth at factor cost slipped to a 15-quarter low of 4.5 percent (year-over-year), compared to 5.3 percent in the previous quarter. Pakistan, the region’s second largest economy with about 8 percent of regional GDP, faces a stagnant environment where factor-cost GDP growth is estimated at 3.5 percent in FY2012/13, with a negative outlook, down from an actual 3.7 percent in FY2011/12.

With the exception of Afghanistan, economic growth across other South Asian countries—Bangladesh, Bhutan, Maldives, Nepal, and Sri Lanka—has been moderating or stagnating. In Bangladesh, with export and investment growth slowing, GDP growth is likely to fall to around 6 percent in FY2013/14, down from 6.3 percent in FY2012/13. Over the same period, Bhutan saw its growth rate decline from almost 9 percent to 7.6 percent. For Nepal, public spending dropped sharply, 1 Growth spillover effects may occur through such direct linkages as trade and financial flows as well as such indirect linkages as total factor productivity (TFP) or business confidence “India’s Growth Spillovers to SA,” a recent IMF WP (12/56) by Ding and Masha, conducts panel regressions with country fixed effects and, controlling for standard drivers of growth, estimates that real GDP growth in India is significantly affecting SAR growth rates over the post-reform period of 1995-2007. A 1 percentage point increase in India’s growth rate implies a 0.37-0.77 percentage point increase in the regional growth rate.
Agricultural performance was meager, and India’s economy slowed significantly. As a result, growth of a subdued 3 percent is expected in FY2012/13, down from 4.6 percent in FY2011/12. The crisis depressed Maldives’ tourism sector, contributing to a decline in real GDP growth from 7 percent in 2011 to 3.4 percent in 2012. Sri Lanka, facing prudent macro-economic policies and dampened demand in main export markets, will see estimated growth of 6.4 percent in 2012, compared to 8.3 percent in 2011. In Afghanistan, the regional outlier, real GDP growth for 2012 is estimated at 11.8 percent, up from 7.3 percent in 2011.

A significant drop in the region’s exports and fixed investment are primarily responsible for South Asia’s growth moderation. Private consumption remained stable, helped by resilient remittance flows, and is expected to only pick up slowly due to effects of persistent inflation, fiscal consolidation and slow recovery in disposable income. Fiscal constraints have led to decreasing public consumption and investment. Export growth has plummeted from 16.5 percent in 2011 to 4.5 percent in 2012, and is forecast to stay weak due to slow and uncertain recoveries in Europe and the US. Fixed investment growth has dropped to a low of 2.6 percent in 2012, less than half of its 2011 rate and down from 12.3 percent in 2010 (Figure 2).
After recovering in CY2009-10, regional industrial production has been trending downwards and remains sluggish, particularly in India, Pakistan, and Sri Lanka. The slowdown has been caused by a mix of weak external demand and structural supply-side constraints in domestic economies (Figure 3). Most recently, India saw its mining sector activity slow down and its IIP (Index of Industrial Production for core sectors) registered a contraction of 2.5 percent for February 2013, down from 3.1 percent in January, with five of the eight sectors — coal, crude oil, natural gas, fertilizers and electricity seeing declines in output and none of the sectors expanding faster than a year ago. Overall IP expanded 0.6 percent y-o-y in February, 2013, down from 2.4 percent in January.

B. Core inflation has eased, but headline inflation remains high due to food prices

Headline inflation has recently moderated across SAR countries; however, it remains at relatively high rates, with recent signs of an upswing mainly due to food prices. Most recent data indicate a CPI increase in India from 8.8 percent (year-over-year) in February 2012 to 10.9 percent in February 2013 with a slight decline to 10.4 percent in March 2013, however Wholesale Price Index (WPI) inflation surprised positively in March 2013 with 5.95 percent, down from February’s 6.8 percent. Sri Lanka’s headline inflation (year-over-year) was 9.8 percent in February 2013, and Nepal’s was 9.5 percent. Bhutan’s inflation rose to 13.5 percent in the second quarter of FY2012/13.

Core inflation fell across several countries, including Bangladesh, India, and Pakistan, while food and fuel price inflation continues as the main impetus driving South Asian headline inflation (Figure 4). Recently, lower food prices—mostly due to favorable weather and international market conditions—helped push down headline inflation in Pakistan (though equally driven by core nonfood prices), Maldives, and Afghanistan. In India, year-over-year core inflation was 3.8 percent in February 2013, but prices increased 10.7 percent for food and 10.5 percent for fuel. In January 2013, Sri Lanka’s year-over-year food inflation was 12.9 percent, well above the nonfood inflation of 7.2 percent. Unfavorable harvests and balance of payments developments in Bhutan pushed food-price inflation to 18.4 percent for the second quarter of FY2012/13, compared with nonfood inflation of 10.7 percent.

Notable exceptions to this regional trend are Bangladesh and Nepal, where non-food prices have recently driven headline inflation. In Bangladesh, the rise in annual headline inflation from 8.8 percent in FY2011/12 to 10.6 percent in FY2012/13 was actually driven by non-food price inflation, most likely through upward adjustments of administered energy prices as well as expansionary macroeconomic policy. However, lower food price inflation during 2012

![FIGURE 3: Industrial production across main South Asian economies remains sluggish (monthly; y-o-y; percent)](source: IMF IFS, Central Bank of Sri Lanka)
has helped reduce overall inflation to 8.2 percent in February 2013. In Nepal, higher headline inflation—from 4.2 percent in May 2012 to 11.8 percent in December to 9.6 percent in February 2013—comes from increasing commodity prices, the depreciation of the Nepali rupee, and structural supply-side constraints.

C. The policy stance remains accommodative, but some countries recover fiscal space

With the exceptions of Sri Lanka and India, real interest rates remain negative for major South Asian economies, suggesting that monetary policy’s overall stance has been broadly accommodative (Figure 5). Negative real interest rates (RIR) signal an easy monetary policy stance for many South Asian countries, suggesting the need
for central banks to tighten policy to restore positive real interest rates return. India’s positive RIR and softening core inflation have led the Reserve Bank of India to recently ease monetary policy slightly by reducing its repo rate by 25 basis points in January and March 2013, down to 7.5 percent. However, rates remain relatively high by historical standards.

Today, most countries in South Asia are constrained in the fiscal policy space they have to buffer potential external shocks, leaving them much more vulnerable to adverse events. With the exception of Bangladesh, space for fiscal and monetary stimulus is more limited now than it was in the aftermath of the global crisis (Figure 6). In addition, those countries in difficult economic and political situations face severe difficulties in starting to rebuild their buffers. Fiscal deficit constitutes a major concern in Pakistan, where revenue shortfalls coupled with an electricity subsidy overrun have lifted the projected consolidated FY2012/13 budget deficit above 7 percent of GDP, well above the targeted 4.7 percent (Figure 7). By contrast, India’s situation has shown some improvement. Using the World Bank definition, which discounts one-time divestments from revenues, the FY2012/13 central government deficit came in at 5.4 percent of GDP, 0.6 percent of GDP lower than the previous year and significantly below the peak deficit of 6.8 percent in FY2009/10. Maldives had the region’s largest deficit in FY2011/12—and the largest projected deficit in FY2012/13.

Some countries have executed prudent fiscal management to rebuild buffers. Bangladesh achieved a budget deficit below the target of 5 percent of GDP (excluding grants); to better its financing, the country is using more concessional resources and less domestic bank financing. The external position is stable, and international reserves reached a record

![FIGURE 6: South Asia Region’s (SAR) fiscal space remains limited (percent of GDP)](image)

Source: World Bank Staff Calculations

![FIGURE 7: Recent trends suggest many South Asian countries have started to rebuild buffers (fiscal deficit to GDP (percent))](image)

Source: World Bank and IMF
USD 13.6 billion in March 2013. Nepal’s fiscal position remains comfortable. As tax collections remain high, total revenues and grants are expected to exceed expenditure by 3.6 percentage points of GDP, with the Government a net lender.

Debt-to-GDP ratios have remained fairly stable across the region (Figure 8). Slowing growth stalled India’s debt ratio reductions, begun in FY2002/03. In the current fiscal year, the country debt load is projected at 67.9 percent, remaining close to the FY2011/12 level of 67.6 percent. Standing at 58 percent of GDP at the end of December 2012, Pakistan’s debt ratio maintains an upward trajectory, and it is projected to reach 64.5 percent for FY2012/13. While both Bhutan and Maldives may have higher debt levels, Bhutan is capable of managing its debt and Maldives risks problems with debt sustainability in the medium term. Bhutan’s high debt is tied to commercially viable hydropower projects, and Indian energy demand is set to remain high. Maldives external debt obligations, including the public and private sectors, probably reached 86 percent of GDP in 2012, and they are projected to rise to 115 percent by 2015, a difficult development in light of the country’s increasing balance of payments pressures.

South Asian countries’ current account deficits, particularly the larger than expected increase in India, imply the growing need for ongoing capital inflows (Figure 9). India’s current account deficit has widened to 6.7 percent of GDP for Q3/FY2012/13, up from 4.4 percent for Q3/FY2011/12, signaling weakening external demand as well as domestic supply-side constraints. While India remains capable of financing its current account deficit, Bangladesh, Maldives, and Pakistan may find themselves in more difficult situations, struggling to prevent their economies from shrinking and managing a smooth adjustment of their currencies.

D. Current account deficits have been widening, but remittance flows held up well

South Asia’s trade balance remains negative, with both export and import growth significantly slowing across countries. Recovery is expected to be slow due to continued demand weakness in the Euro Area, the region’s most important export market. India’s record current account deficit widening was mainly fueled by its growing trade deficit, with merchandise trade deficit increasing from 10 percent to 11 percent of GDP. During January and February 2013, however, merchandise exports started to pick up, reducing the year-over-year export decline from 7 percent in April through December to 5 percent April through February. Meanwhile,
growth in merchandise imports slowed to 1 percent, down from 33 percent for the same period a year earlier (Figure 10). Overall import growth remains positive, but the boost received through gold imports has weakened with gold imports growing by 5.6 percent between April and December 2012, down by 9 percent (in USD terms) when compared to the same period last year. Pakistan saw its trade deficit improve only marginally, driven by import contraction due to overall slowdown in productive activity. In Maldives, import growth drove most of the current account deficit widening during 2012, while import slowdowns helped improve the trade balances in Sri Lanka and Bangladesh. Sri Lanka’s share of exports to GDP continues to decline. Afghanistan’s large trade deficit of 43 percent of GDP
remains a major issue as exports continue to decline in spite of currency depreciation, suggesting major capacity constraints. Nepal’s trade deficit continues to grow by 1 percentage point per year, with constrained export performance and growing imports six times the value of export earnings. Lastly, Bhutan’s export performance remains volatile due to weather induced weaker electricity exports in 2012. Overall, while the eurozone may remain subject to weak demand for time to come, the US recovery may help boost South Asian exports in the middle term.

The overall real effective exchange rate depreciation across South Asia reflects weak economic fundamentals. For Bangladesh and Sri Lanka, flexible nominal exchange rates (depreciation/devaluation) clearly have been helping offset relatively high inflation rates vis-à-vis main trading partners, moderating the negative impact on competitiveness (Figure 11). In India, the real effective exchange rate remained fairly constant, suggesting a fairly stable economy that remained sufficiently capitalized. In Pakistan, the central bank has kept nominal exchange rates fairly stable despite the country’s weak fundamentals,
accepting the costs of diminished international reserves and decreasing competitiveness in exchange for near term interest rate stability. Ultimately, the Maldives’ announced depreciation of 2011 reflects the catching up of nominal exchange rates with fundamentals.

Remittances have proven fairly resilient, helping to sustain consumption and mitigate trade balance effects (Figure 12). For 2012, South Asia’s remittances are estimated at USD 109 billion, up from USD 97 billion in 2011. India experienced robust inflows, increasing to 1.7 percent of GDP during Q1-Q3 FY2012/13, up from 1.6 percent a year ago. Pakistan benefitted from strong remittance growth of 10.4 percent between July 2012 and January 2013, helping the country avoid a complete balance of payments collapse—for now. In Nepal, estimated remittances reached 23 percent of GDP for FY2011/12, enough to cover the economy’s net deficit. However, this may not be sustainable. Compared to the previous fiscal year, Bangladesh had a solid 17.3 percent growth in remittance inflows during the first eight months of FY2012/13. Sri Lanka relied on remittances—up 16 percent to 10 percent of GDP—as a cushion for its widening current account deficit.

E. Capital inflows are increasingly dependent on volatile portfolio investments

South Asia’s fixed investment declined in 2012, while total private net inflows are estimated to remain at 2011 levels, driven by more volatile net portfolio flows. Overall, net FDI inflows totaled an estimated USD 29.7 billion in CY2012, down from USD 35.7 billion in 2011 and USD 50.8 billion in 2008 (Figure 13). The sharpest FDI decline was in Pakistan, which fell to one-third its FY2010/11 level. The decline reflected market concerns about security, structural energy constraints, and weak growth prospects and contributed to a significantly weakened external position. In India, FDI has been bouncing back after a slump of USD 9.4 billion in FY 2009/10 to a projected USD 20 billion for FY 2012/13, although it declined 26 percent (year-over-year) during Q1-Q3 of FY2012/13, a likely result of weaker business sentiment and policy uncertainty. Regional net portfolio investment inflows have proven volatile in recent years, with a collapse of almost USD 5 billion in 2011 followed by some returning momentum at USD 11.5 billion in 2012. With FDI dropping and IMF debt repayments underway, subdued portfolio investment in Pakistan could not help alleviate the overall balance of payments stress. India, falling in line with other emerging market economies, could increase its net year-over-year portfolio investment inflows from USD 0.8 billion to USD 5.6 billion in the first half of FY2012/13.
International gross reserves fell below levels of two months of import coverage in Pakistan as well as the Maldives, partly reflecting the two countries’ difficult external situations. During the first eight months of FY2012/13, Pakistan’s net international reserves fell to 1.8 months, down from 2.6 months in the previous fiscal year (Figure 14). This reduction was mainly driven by a sudden stop in FDI inflows. Aggravated by high fiscal deficits and recent debt settlements, also the Maldives saw their gross official international reserves deteriorate below two months of import coverage in February 2013, exacerbating Maldives’ vulnerable situation in the face of weak tourism and potential commodity price hikes.
Overall, South Asia is set to continue to grow, although on a more modest pace and with significant downside risk. Regional GDP growth is expected to pick up to 5.5 percent in 2013 and eventually 6.3 percent in 2014. Ultimately, external and regional factors will determine the region's growth trajectory and the extent the region takes full advantage of the demographic dividend. On the one hand, prudent near-term macroeconomic management will help to reduce countries’ vulnerabilities in an uncertain global environment. On the other hand, with a view toward achieving increased and sustainable medium-term growth rates, South Asian countries will have to address structural and regulatory constraints that stand as impediments to an efficient and attractive investment and business climate. How countries cope with these issues will be critical not only for managing near-term current account or fiscal deficits but also for tackling the region's long-term challenges of infrastructure, energy pricing, poverty reduction, and shared prosperity in South Asia and beyond.

**TABLE 1**: Forecasts for South Asia show significant regional slowdown but suggest bottoming out (GDP at market prices; annual percentage change)

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<th>2013</th>
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<td>Private Consumption</td>
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<td>Government Consumption</td>
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<td>Gross Fixed Investment</td>
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<td>Statistical Discrepancy (% of GDP)</td>
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<td>Current account balance (% of GDP)</td>
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<td>-3.1</td>
<td>-4.5</td>
<td>-3.7</td>
<td>-3.1</td>
<td>-2.7</td>
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Source: World Bank Staff Calculations; Note: Includes India, Pakistan, Bangladesh, Sri Lanka and Nepal

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1 Demographic dividend broadly refers to favorable demographic developments including high dependency ratios due to a relatively large young, working share of the population, and related favorable savings and investment rates as well as scale effects in educational attainment.
A. The region remains vulnerable in light of continuing near-term uncertainty

With ongoing uncertainty prevailing in the Euro Zone and the US economies, the probability of external shocks continues to be a risk at a time when South Asian economies have gradually become more exposed to the external environment. Despite some improvements in the global economic outlook in recent months, many countries’ current account balances have deteriorated and put pressure on the financing side of the balance of payments. Inflation remains high in all SAR countries, posing a severe monetary policy constraint. All countries in South Asia remain dependent on imports and thus vulnerable to international commodity price movements. Some countries have decreased their reserves significantly—in the case of Pakistan and Maldives, to critical levels. While improving, fiscal deficits remain a vulnerability in India, Pakistan, Sri Lanka, and above all Maldives, and relatively high debt levels will be costly to sustain for many countries, most notably Bhutan, India, Maldives, and Sri Lanka (Table 2).

Inefficient revenue collection and expenditures on (energy) subsidies need to be addressed because they remain important driving forces of fiscal deficits across countries. In Pakistan, only 38 percent of budgeted revenue had been collected at the end of the first half of FY2012/13, suggesting an imminent shortfall. Meanwhile, power sector subsidies have reached 80 percent of their budgeted cap, making it almost certain they’ll exceed the budgeted 0.8 percent of GDP. Sri Lanka’s fiscal system exhibits significant structural weaknesses, with total revenues slipping to 13.5 percent of GDP and tax revenue down to 11.5 percent of GDP—both the lowest levels ever recorded. At the same time, expenditures rose by 10%

### TABLE 2: Most countries in South Asia are vulnerable to external shocks

<table>
<thead>
<tr>
<th>Country</th>
<th>EX to GDP</th>
<th>Commodity IM/total IM</th>
<th>CAB to GDP</th>
<th>Remittances (share of GDP)</th>
<th>Reserves (months of IM)</th>
<th>Primary Fiscal Balance</th>
<th>Debt</th>
<th>Fiscal Deficit to GDP</th>
<th>Mandatory Expenditure as a percent of Total Expenditure</th>
<th>Inflation</th>
<th>Real Interest Rate</th>
<th>Exchange Rate Flexibility</th>
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Source: World Bank Staff Calculations
Threshold descriptions of vulnerability by indicator in sequence (green=low/yellow=intermediate/red=high). Exports to GDP (<25%/25-50%/50%); Commodity imports/total imports (<20%/20-30%/30%); Current Account Balance to GDP (<0%/-0.5%/-1%); Remittances as a share of GDP (>2%/>4%/>8%); Reserve Coverage in months of imports (>1y/>6m/>1y); Primary Fiscal Balance (>1.5%/-1.5%/-3%); Debt Burden (<25%/25-60%/60%); Fiscal Deficit to GDP (<5%/-5%/-12%); Mandatory Expenditure as a % of Total Expenditure (<50%/50-70%/70%); Inflation (<3.5%/3.5-7%/>7%); RIR (>1.5%/0-1.5%/0%); ER Flexibility (float/managed float/peg); Int. reserves to GDP (>15%/10-15%/10%).
percent nominally and reached 20.3 percent of GDP, mainly driven by debt service, subsidies, and transfer payments. India faces lower than expected revenues from corporate and excise taxes as well as customs duties (down 0.2 percent of GDP) and non-tax revenue (down 0.3 percent), leaving the overall shortfall at 0.5 percent of GDP. While expenditures remained below target, fiscal consolidation continues to lag recommendations by India’s Finance Commission. In Bangladesh, tax revenues failed to meet the July 2012 to January 2013 target, contributing to a shortfall in the overall revenue target for FY2002/13, the first since FY2008/09. Expenditures remain broadly on track, and the Government’s moderate consolidation path is within reach. Similarly, Maldives’ revenue collection fell well below budget levels due to reduced customs duties and shortfalls in nontax revenues, while expenditures on subsidies and transfers to State Owned Enterprises also boosted the overall fiscal deficit. Also Afghanistan missed its 2012 revenue target by a margin of 3.9%, mainly due lower customs revenues.

B. Uncertainty on policy orientations is bound to affect investment

To tackle the challenges of reestablishing resilience against potential external shocks, sustaining a stable macroeconomic environment and assuring a stimulating investment climate will require determined action by South Asia’s policy makers. Investors, both domestic and foreign, as well as savers (depositors) will look towards ongoing improvements regarding inflation, fiscal deficits and debt, consumption, export growth, as well as underlying policies pertaining to interest and tax rates, regulation across real and financial sectors, and the broader political economy with great and continued interest.

Current and upcoming political transitions will pose challenges to reform momentum in several South Asian countries. Afghanistan’s transition, presidential elections in April 2014, and security concerns caused by the departure of NATO troops will create challenges for the Government. In particular, reduced international aid flows will increase pressures to create a stable and vibrant domestic business environment. Maldives has effectively entered a state of political flux, with presidential elections scheduled for September 2013 and Majlis elections for the second quarter of 2014. Both elections are expected to be keenly contested. Pakistan achieved a milestone in March 2013, when an elected government completed its five-year term peacefully, paving the way for democratic transition through a caretaker government currently preparing for general elections scheduled for May 11, 2013. However, security concerns have been mounting and remain a concern. In Bangladesh, increasingly fragile political conditions may affect the investment climate, while Nepal shows signs of improvement.
Market sentiment reflects perceptions of continuing uncertainty and vulnerability. Consensus forecasts show that market expectations were deteriorating at the beginning of 2013, reflecting new information regarding India’s economic performance and a significantly more modest growth outlook than at the end of CY2012 (Figure 15). While these forecasts give insight into current market sentiments and perceptions, they may foreshadow future attractiveness for investment and broader business activity.

Most of South Asia’s recent economic slowdown has been associated with significant decline in exports and a pronounced slowdown in the investment rate, while near term growth is expected to be mainly investment driven. With trade and consumption expected to remain modest growth drivers in the short and middle run, investment activity will be key in allowing the region to regain momentum. Following India’s recent reforms and increasing openness to international investment, the region hopes to benefit from increasing fixed investment growth in the middle to long run, while continued fiscal consolidation and efforts to reduce subsidy burdens will help countries including Bangladesh, India and Sri Lanka to further rebuild fiscal buffers. With a view to the longer term, the region will have to continue its attempts to tackle structural supply side challenges, most notably relating to energy and infrastructure gaps.
Focus: The Investment Climate as the Key to Regain Momentum

A. Much of the economic slowdown can be traced back to slow investment

For South Asian countries, private investment will increasingly become important for financing current account deficits and fueling economic growth. Over the next 20 years, more than 1 million new workers will be entering the South Asian labor market each month, offering an opportunity to reap a substantial demographic dividend. To absorb these workers into productive jobs and ultimately to reduce poverty and boost shared prosperity, South Asia will need to provide an investment climate conducive to sustaining broad-based growth and job creation. With fiscal deficit and debt levels constraining public budgets in the medium term, countries will need to stimulate and attract private investment to compensate for weaknesses in public-sector investment.

Total regional fixed investment growth has dropped to 2.6 percent in 2012, down from a high of 16.7 percent in 2010 (Figure 16). Broadly, investment rates have stagnated, for example in Bangladesh at relatively low and in India at comparably higher levels, or significantly dropped such as in the case of Pakistan. In Pakistan, total investment during FY 2011/12 reached a historic low of 12.5 percent of GDP, y-o-y, mainly driven by a stark fall in FDI inflows, while India is projected to register investment at 30.6 percent of GDP for FY 2012/13, only down 0.1 percent of GDP from its FY 2011/12 rate. Bangladesh’s investment rate stagnated at 25.4 percent of GDP in FY 2012/13 as compared to 25.2 percent in the previous fiscal year, while Sri Lanka’s investment rate slightly increased to an estimated 30.6 percent of GDP in 2012, up from 29.9 percent in 2011. To regain momentum, however, a sufficiently high investment rate able to accelerate and sustain growth will be important. Experience of successful developing countries in Asia in recent decades reveals that the historically high economic growth recorded by

![FIGURE 16: SAR total fixed investment growth slowed down, in line with lower net private inflows](source: World Bank)
these economies is essentially the result of increased levels of investment in relation to GDP. Capital deepening and related efficiency gains, including labor productivity helps driving growth while lack of improvement in macroeconomic, political and governance indicators has contributed to stagnation in private investment in relation to GDP.

Increasing domestic private sector investment is important, but no country has moved into middle- or upper-income status without the benefit of substantial foreign-capital inflows (Frankel, 2010). Foreign-capital inflows—both direct and portfolio (i.e., equity and debt)—expand the potential sources of capital, raising productivity and boosting growth. However, studies find that foreign direct investment (FDI) has a potentially larger role due to its greater stability (Levchenko and Mauro, 2007) and its larger impact on transfers of knowledge and technology.\(^3\) Domestic and foreign investors respond to the same incentives and economic fundamentals that make an attractive investment climate.

**B. FDI has expanded in most countries, but goes mainly into the services sector**

South Asia has experienced rising inflows of FDI and portfolio investment, falling in line with the global trend of increased shares of FDI flowing into developing countries. While both FDI and portfolio investment flows move with the global business cycle, the relative stability of FDI becomes particularly relevant during “sudden stops,” or interruptions in capital flows. Capital flows skewed toward non-FDI types, such as bank lending and portfolio investments, may lead to increased volatility and vulnerability to economic shocks. This pattern certainly played out in South Asia during the global financial crisis that began in 2008 (Figure 17).

India attracts 85 percent of total South Asian FDI inflows; however, the relative economic importance of FDI as a share of GDP and related pass through effects stemming from the global crisis appear as more evenly distributed across countries in the region. In relative terms, the Maldives was the most affected by the global crisis because it relies heavily on tourist activity from the US and Europe. It saw a 64 percent drop in inward FDI as a share of GDP during 2008–11 (Figure 17). Looking at absolute levels, both India and Pakistan had significant FDI declines after the crisis. India experienced a 30 percent FDI slide between 2008 and 2010. Annual FDI to the Pakistani economy fell by 60 percent during the same period and continued to fall in 2011. Foreign investors, particularly from Europe and the US, suffered losses at home, leaving them less capital to invest abroad. The fall was compounded by Pakistan's weakening macroeconomic environment, security issues, and political uncertainty. Unlike Pakistan, India's absolute inward FDI flows rebounded in 2011. The country's FDI saw additional but more modest growth in 2012.

Most recently, some countries including Bangladesh and Pakistan have experienced significant decline in FDI performance. Bangladesh’s rate of FDI inflows registers USD 995 million received during FY 2012/13 down from USD 1.13 billion in 2011, a rate perceived as particularly low when compared to the regional USD 39 billion in FDI attracted in 2011. More strikingly, in Pakistan net FDI inflows have fallen by over USD 1.1 billion, or 70 percent below the fiscal 2011 level, mostly due to increasing security concerns and Balance of Payment distress.

Experiencing annual average real GDP growth rates of 6.7 percent for a decade has made South Asia the world’s third largest region in terms of GDP, while its FDI inflows as a share of GDP are the lowest of all developing regions, averaging just 1.5 percent between 2000 and 2011. Unlike other regions, South Asian FDI inflows have never fully caught up with GDP growth rates. Although the gap had been narrowing, it regressed somewhat after the global crisis.

FDI flows into South Asia are heavily skewed toward the services sector, with manufacturing and agriculture FDI as a share of GDP lagging almost all other regions (Figure 20). Led by India, South Asia is one

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**FIGURE 17:** FDI and portfolio investment flows into South Asia have been increasing, particularly during the mid 2000s.

![Graph showing FDI and portfolio investment flows into South Asia from 1990 to 2012.](source: UNCTAD statistics and World Bank Staff Calculations)

**FIGURE 18:** The importance of FDI inflows (as percent of GDP) across South Asian countries varies.

![Graph showing FDI inflows as percent of GDP across South Asian countries from 2000 to 2012.](source: World Bank (2013))

**FIGURE 19:** When compared to other regions, South Asia’s growth significantly outpaces FDI inflows.

![Graph showing real GDP growth rate versus FDI inflows as percent of GDP.](source: WDI and World Bank Staff Calculations)
of the largest international hubs for the service industry, particularly Business Process Outsourcing (BPO). When it comes to FDI inflows, the services sector accounted for around USD 10 trillion in 2009, or 72 percent of total inward FDI. At 1.77 percent of GDP, however, overall inward FDI as a share of GDP remains modest—the lowest among six regions and well below the developing country average of more than 3 percent.

C. FDI inflows bear the potential to boost overall investment and growth

South Asia lags other developing regions when it comes to the performance of its main drivers of FDI growth. A recent World Bank study identifies the key forces for attracting FDI to SAR countries: investment policy openness, natural resource endowments, trade liberalization growth, changes in control of corruption, corporate tax changes, and the initial inward FDI stock as a share of GDP. While South Asia’s initial stock of inward FDI as a share of GDP was lowest across all developing regions, it actually helped inward FDI growth relatively more than for the average developing country. With regard to all other key driving forces for South Asian FDI, the regional performance in terms of effects of policies on FDI growth over the last decade lags the average developing country, more precisely South Asia featured the lowest reduction in corporate tax rates as a share of profits (and actual increases outside India), and hence a net negative effect on its FDI growth, as well as the largest decline in investment policy openness, the lowest level of natural resources per capita, and largest deterioration in political stability (particularly for South Asia outside India), again mostly with a negative impact on inward FDI growth with the exception of a light positive effect from trade liberalization (Figure 21).

However, country performances vary substantially. India, which accounts for 85 percent of regional FDI inflows, stands out with strong improvements to investment policy and trade liberalization, which have played a positive role in enhancing growth in FDI as a share of GDP (FDI/GDP). In other characteristics that influence FDI, such as control of corruption and corporate tax changes, India is quite similar to the rest of South Asia. For Pakistan, reductions in corporate tax rates have been a large positive in enhancing FDI/GDP growth compared to other developing countries and the rest of South Asia, while control of corruption and improvements

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4 World Bank (2013) "Getting the most from FDI in South Asia" (Gould, Tan and Sadeghi).

The estimation results are based on a world panel (79 countries over the period 2000-2010) as well as subsample estimations for 33 developing countries. The econometric technique can be described as a reduced form cross-section regression of growth of inward FDI between 2000-10 on a comprehensive set of explanatory variables including regional and oil fixed effects. Endogeneity is addressed implicitly by deriving explanatory variables over the first 5 years only (2000-05), thereby attempting to match the model formulation with the actual process and time structure of investment decisions.
in investment policy growth have been relatively large negatives. Overall levels of FDI/GDP are relatively small in Bhutan and Nepal, suggesting a large potential for future FDI/GDP growth in countries with high natural resource endowments due to unexploited hydropower potential. Nonetheless, the deterioration in investment policies has been a relatively large deterrent to FDI/GDP growth in Nepal. For Maldives, the current large stock of FDI/GDP suggests that potential for future FDI/GDP growth is modest. Control of corruption is a significant hurdle to the in FDI/GDP growth for most countries in the region, with the exception of Bhutan, where improvements have been a positive contributor to foreign investment. However, Bhutan has implemented some temporary trade control measures to manage the rupee shortage, somewhat offsetting the positive impact of the gains through controlling corruption. Overall, the results suggest South Asia has the potential, through policy changes, to take important steps toward becoming a much greater FDI magnet.

**Pakistan and Maldives stand out in terms of their low savings rates, with Maldives actually dis-saving in 2012, while India recently experienced a decline in its savings rate vis-à-vis a high and constant investment rate.** India’s savings rate came down to 29 percent of GDP for 2012 from a 37 percent high in 2009, which implies greater reliance on foreign investment inflows for sustaining the fairly stable domestic investment rate of slightly above 30 percent (of which almost 24 percent are private). However, due to its favorable demographic transition, India’s savings rate can be expected to stay strong and hence be considered as a strong investment driver in the middle term. Pakistan, on the other hand, features a much lower investment rate at around 13 percent of GDP for 2012, which can be explained by a mix of dropping foreign investment (mainly FDI) due to security and macroeconomic stability concerns and low domestic savings. The latter is mainly due to low rates of return on deposits as well as a strong bias towards consumption.

**South Asia does well in other dimensions relevant for growth and FDI and may continue to build on those.** The region has been stronger than others in human capital expansion; it has the largest reduction in energy losses (despite weak improvements in India); financial sector development growth is second only to the Europe and Central Asia regions; and infrastructure growth has been second only to Sub-Saharan Africa. For India, trade liberalization (as measured by reduced effective rates of tariff protection) and investment policy openness have been particularly strong between 2000–10, while the rest of South Asia has shown only modest improvements or deterioration. However, except for overall trade liberalization and investment policy openness in India, the analysis indicates these factors are not significant determinants of FDI/GDP in South Asia, but they may be important contributors to growth.
This may partly explain the region’s relatively strong GDP growth over the past decade, a period of relatively weak growth in FDI inflows.

Significant scope exists for increasing South Asian FDI flows and their positive economic effects by addressing structural and policy constraints and fostering regional integration and intra-regional investment flows. Two factors are at work—high overall regulatory restrictions on FDI and specific restrictions placed on doing business with other countries in the region. Also limiting FDI flows are overall trade restrictiveness and weak institutions to protect foreign investors and facilitate investment. India contributes 70 percent of intra-regional FDI; however, total within-region FDI represents just 3.7 percent of all South Asian inward FDI (Table 3). India is the region’s largest market and a potential investment magnet for the other South Asian countries; however, bilateral restrictions remain despite considerable improvement in the country’s overall FDI policies.

While ongoing efforts are moving in the right direction, a variety of policy challenges remain. Liberalizing policy constraints in both trade and foreign investment, keeping corporate tax rates competitive and low, and improving governance and transparency could help to substantially improve FDI flows.
South Asia Country Briefs

In alphabetical order:

- Afghanistan
- Bangladesh
- Bhutan
- India
- Maldives
- Nepal
- Pakistan
- Sri Lanka
Afghanistan

While domestic developments helped to increase growth, Afghanistan's external position remains weak. Following a strong performance in 2012, economic growth is expected to slow down as a result of a weather induced moderation in agricultural performance and uncertainties stemming from transition which constitute a significant downside risk.

Recent Economic Developments

One year into the transition process, Afghanistan's economy still gives an impression of strength. The positive aspects include an exceptional wheat harvest, favorable developments in the mining and services sectors, and increased real GDP growth, to 11.8 percent from 7.3 percent. Inflation has halved, and continuing high levels of aid have helped to further bolster international reserves. However, the transition is characterized by a loss of business confidence, reflected in lower private sector investment and a depreciating exchange rate. This compounds the already sluggish recovery of the banking sector from the Kabul Bank crisis which hit the country in 2010. Trends in public finance deserve attention: more on-budget aid will pose challenges to execution through the relatively weak country systems. Growth of domestic revenues is slowing due to worrisome developments in customs revenue collection.

Exports, estimated at USD 2.6 billion, declined by 5 percent in 2012, in spite of a weakening currency. In contrast, total imports increased by approximately 5 percent, to USD 11.2 billion in 2012, leading to a higher nominal trade deficit, of USD 8.5 billion in 2012. The Afghan export base has relatively few tradable products and these are heavily concentrated in a few markets. Dry fruits, which account for around one-third of official exports, declined by 21 percent. Carpet exports, another major export item, nearly halved to USD 23 million in 2012. The lack of export response to the depreciation of the afghani illustrates Afghanistan's limited export capacity.

Afghanistan's external position in 2012 remains weak. The huge trade deficit of 43 percent of GDP was offset by large transfers—mainly foreign aid inflows—in the current account. Remittance inflows, believed to be large, are mostly informal and not captured by the balance of payments statistics. Foreign direct investment remained stagnant at around 2 percent of GDP. As result, the overall balance of payments in 2012 remained in surplus which contributed to a further accumulation of international reserves. Gross international reserves reached a record high of USD 7.1 billion in December 2012 but had declined to USD 6.5 billion by March 2013.

Budget execution improved in real terms in 2012. While the government executed only half of the development budget in 2012, as in fiscal 2011, nominally it disbursed almost as much in the nine months (USD 1 billion) as it did over the full 12 months of the previous year (USD 1.1 billion).

Domestic revenues increased by 13.1 percent in 2012 but fell short of targets. Revenues reached Afs 81.7 billion (equivalent to USD 1.6 billion), or 8 percent of GDP, but missed the target agreed with the IMF by 3.9 percent, mainly because of a
lower revenue performance at customs. Customs revenues account for approximately one-fourth of total revenues and have been steadily increasing. But last year these declined by 9.6 percent in spite of higher import volumes—due in part to deteriorating governance at customs.

The mining sector, meanwhile, showed dynamic developments in 2012. Historically small, the share of mining in aggregate output increased from 0.6 percent of GDP in 2010 to an estimated 1.8 percent in 2012, due largely to the start of oil production at the Amu Darya fields. The oil fields are currently producing around 1,950 barrels per day and are expected to reach more than 4,000 barrels per day by end-2013.

Trends in microfinance remain a concern. The sector has been going through a deep consolidation phase since 2008, resulting in slower growth of the loan portfolio, a decline in the number of active borrowers, and the exit of several institutions from the sector.

The afghani depreciated by nearly 9 percent against the US dollar in 2012, falling to Afs 50.9/USD 1.00 from an average Afs 46.9/USD 1.00 in 2011, probably due to increased uncertainty over security and the business environment. This was reflected in increased demand for foreign exchange at the Central Bank auctions. However, the afghani remained stable against the euro, at Afs 65.4 on average in 2012 and appreciated by around 1 percent against the Pakistani rupee.

Outlook and Policy

Economic Growth is expected to slow in 2013. Political and security uncertainties are expected to limit private-sector growth in the coming years. Increased public spending, however, will continue to fuel demand for services and construction through 2013. Mining should contribute more noticeably to growth with the increasing oil production at Amu Darya (the expected contribution to the government budget through royalties and taxes is projected to be around USD 250 million annually for the next 25 years). On the agricultural front, however, only moderate rainfalls are forecast for this season, which would reduce the year’s harvest to a more normal output and slow GDP growth to 3.1 percent in 2013.

The transition process exposes Afghanistan to a number of serious risks, such as rising financing for public service provision. Security considerations aside, promoting sources of inclusive economic growth, especially agriculture, and strengthening domestic revenue mobilization will be important to mitigate some of these risks.
Bangladesh

Overall prudent macro management and a favorable downward trend in inflation helped sustain growth. While remittances are expected to remain strong and together with a decline in imports will help maintain Bangladesh’s positive external position, slow progress on structural reforms and rising political fragility pose threats to future investment.

Recent Economic Developments

GDP growth in fiscal 2013 is likely to fall to around 6 percent, from 6.3 percent in fiscal 2012. Weak exports and investments resulting from the impact of the euro-area crisis, domestic supply constraints, and intensified strikes and unrest were principal reasons for the slowdown. However, strong remittance and robust service sector performance are expected to help keep growth in healthy territory. An increasingly fragile political situation, however, does not bode well for revival of the investment needed to accelerate growth.

A broad-based declining inflation trend appears to be gaining ground. Average (twelve-monthly-moving) inflation has declined steadily over the past ten months, from a peak of nearly 11 percent in February 2012 to 8.2 percent in February 2013, reflecting declines in both food and non-food inflation. Favorable international commodity prices, a stable exchange rate and monetary tightening helped to lower inflation.

The overall external balance continued to remain positive with a record increase in reserves to over USD 13.8 billion (equivalent to 4.4 months of imports) by end-February 2013. The rapid increase in reserves reflects both the economy’s strengths in attracting remittance and external assistance, and weaknesses in the form of depressed domestic demand growth leading to a decline in imports.

Financial development is riding a bumpy road. Bangladesh slipped one notch in the Financial Development Index, and is now ranked 57th out of 62 economies. Stability of the banking sector deteriorated as a result of corporate governance failures, non-bank institutions are not doing any better, and the confidence deficit in the capital market persists.

Prudent monetary and fiscal management contributed to sustained growth and macroeconomic stability. Monetary policy has gained credibility by adhering to the monetary program target for the first half of fiscal 2013, but the shift towards an expansionary stance for the second half, albeit modest, may be premature. Fiscal policy is on track to maintain prudent levels of overall deficit and improve the composition of deficit financing towards lower monetization and domestic bank financing, with a rise in the share of concessional external finance.

Progress on structural reforms has been slow. The government has undertaken a reform program supported by the International Monetary Fund’s ECF. Structural measures in the program aim to modernize the tax regime, bolster fiscal controls, strengthen financial sector oversight, and improve the trade and investment climate. Policy undertakings have been broadly in line with program commitments of the ECF, but a number of structural benchmarks were not met, because of either delays in completion or the need for more time to make legislative changes or reach internal policy consensus.

Progress on the Millennium Development Goals (MDGs) has been remarkably successful, with
Bangladesh managing to bend the arc of poverty reduction to a remarkable degree and share prosperity during 2000-2010 far better than in the preceding decade. Bangladesh has already achieved three of the 28 MDG targets, and is on track with another 11, while needing to give attention to the remaining 14 (as of 2011). Poverty reduction during 2000-2010 was so dramatic that Bangladesh was listed among the 18 “highlighted” countries of the South that made greater gains than expected in the Human Development Index between 1990 and 2012, based on their previous performance. Human development also has been more inclusive than before in Bangladesh. The number of poor declined by 15 million in the first decade of the new millennium, compared with a decline of 2.3 million in the preceding decade. There have been improvements too in several dimensions of non-consumption-based welfare. Inequality has stabilized and there has been some regional convergence in consumption poverty levels in the second half of the 2000-2010 decade. Growth of labor income and declining dependency were the main indicators of poverty reduction in this period. Nevertheless, Bangladesh still has the highest rate of poverty in South Asia, when measured by continuing low real per-capita GDP.

There needs to be more depth and breadth in development for Bangladesh to sustain its stellar progress up the human development charts. Even with its outstanding achievements in reducing poverty and childhood under-nourishment at national level, achieving all of the hunger MDGs remains a daunting challenge. The country faces a rough road in addressing certain pockets of poverty that lag far behind the national averages (for example, in urban slums, the hill tracts, coastal belts, and other ecologically vulnerable areas). Enrollment in schools of the last 10 percent of hard-to-reach children, ensuring quality of education, and promoting gender equity in tertiary education are especially big challenges. The threat of climate change could also diminish hard-earned benefits from years of growth and development.

**Outlook and Policy**

The outlook depends largely on how successfully Bangladesh seizes its opportunities and manages the associated risks. Export product and market diversification as well as diversification of the main migrant labor destination countries would provide the wherewithal for accelerating economic growth. Experience from other countries suggests that export diversification is associated with generally strong economic performance. Current instability in the Middle East and North Africa may have negative consequences for Bangladeshis living and working in...
those regions, and hamper their ability to earn and remit money home.

**Recovery in the euro area and the United States will be especially important to Bangladesh’s economic prospects.** Global growth is projected to increase during 2013, but the near-term outlook for the euro area has been revised downward. Activity is now expected to contract by 0.2 percent instead of expand by that figure in 2013. Risks of prolonged stagnation in the euro area as a whole will rise if the momentum for reform is not maintained. Growth in the United States is forecast to average 2 percent in 2013, rising above trend in the second half of the year. The projections are predicated on the assumption that the fiscal sequester from March 1, 2013 will have a relatively small adverse impact on GDP growth.

**There is a downside balance of risks in the near term.** The readymade garments (RMG) industry is suffering from a severe image crisis in the international markets because of concerns about labor safety arising from fire incidents in two garment factories. These prompted the US and EU to rethink the Generalized System of Preference facilities provided to Bangladesh. Sustainability of the recovery in remittance growth is subject to downside risks because of the uncertainties relating to manpower export prospects. An immediate hindrance to the acceleration of growth is the unprecedented political complexity that Bangladesh appears to have entered.

**Should these risks materialize, policy adjustments will have to be primarily through exchange rate and fiscal channels.** At the same time, monetary policy will have to remain sufficiently restrained to contain inflation and maintain reserves. In the near term, a further escalation of political tensions and deterioration in the financial condition of state-owned commercial banks pose the largest risk that may affect growth prospects and public finances.

**In the longer term, the central question is, where will Bangladesh’s good jobs come from?** More than half of the population depends on agriculture, but that proportion will have to shrink if per-capita incomes in agriculture are to rise substantially. Industry is creating jobs, but too many are low-productivity, low-income, offering little protection, and no benefits. Services jobs are relatively high productivity, but employment growth in services has been slow in recent years. Bangladesh’s challenge is to create the conditions for faster growth of productive jobs outside of agriculture, especially in organized manufacture and services, while at the same time improving agricultural productivity. The reward for meeting that challenge is decades of strong, inclusive growth.

**Domestic employment generation in the medium term is likely at best to barely absorb new entrants to the domestic labor market.** At current employment elasticity of growth (0.4) and under the baseline growth scenario, Bangladesh can expect to generate about 1.3 to 1.6 million jobs per year. Its domestic labor force is projected to grow by 1.3 million per year. This will hardly make a dent in the stock of unemployed until growth picks up to 6.5 percent-plus after fiscal 2014. Even that will not be enough to bring the unemployment rate down to single digits. Job creation on a significant scale would require a lot more than business as usual.

**TABLE 4: Bangladesh Labor Market Projections**

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<td>Unemployment rate (%)</td>
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<td>13.21</td>
<td>12.87</td>
<td>12.29</td>
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*Note: Total unemployed persons by economic category are a combination of unemployed population aged 15 years and over, and unemployment equivalent of underemployed & unpaid family workers working less than 15 hours/week. Source: Calculated from Labor Force Survey, Bangladesh Bureau of Statistics, IMF.*
Bhutan

Lingering effects of Bhutan’s overheated economy continue to challenge macroeconomic management. Poverty reduction and governance show significant signs of improvement. The outlook on growth remains cautiously optimistic, with large hydro power projects in the pipeline, but also conditional on a proactive solution of the Rupee shortage and a stabilization of the financial sector.

Recent Economic Developments

The overheating of the Bhutanese economy has ended with slowing private credit growth and moderation of near-term growth, but its aftermath continues to linger in the continued appetite for rupee resources and vulnerabilities in the financial sector. Though private-sector credit growth slowed considerably during 2012, the use of short-term rupee borrowings continued to climb, reaching Nu 17 billion by end-January 2013, an addition of Nu 6 billion since June 2012. Inflation retreated but is still high, at around 10 percent, as the wedge with India’s inflation persists. Prices of non-traded services are rising.

The financial sector, though fundamentally sound with capital adequacy ratios above the thresholds, has become vulnerable with liquidity shortages and deterioration in bank portfolio quality.

Export revenues from electricity sales (about one-third of total merchandise exports) were again lackluster through the peak July-October season. Export revenues have fluctuated with a slight downward drift reflecting the vagaries of hydrological flows, as no new projects have come on line since 2006. Tourism has turned into an important source of export revenue. The period January through November 2012 shows a surge of 17 percent in tourist arrivals and 32 percent in revenue receipts, to USD 60 million.

Poverty reduction and governance are two beacons of positive achievement for Bhutan. The Bhutan Living Standards Survey 2012 shows the percentage of people living below the poverty line fell to 12 percent, from 23.3 percent in 2007, thus exceeding the 10th Five-Year Plan target of 15 percent by 2013.

The pace of poverty reduction in Bhutan is one of the highest in the world. Similarly, with its new Anti-Corruption Law, Bhutan has emerged as South Asia’s most powerful anti-corruption authority, serving as a model for the region and beyond.

Outlook and Policy

GDP growth is projected to moderate to 7.6 percent in fiscal 2013 and remain subdued until new hydro-power projects come on stream in fiscal 2018. Though the aim of adding 10,000 MW of electricity generation potential by 2020 is feasible, the growth path may be more gradual than earlier envisaged, due in part to funding constraints and a desire to avoid another bout of overheating.

The government has taken steps to avoid repeating a rupee shortage—engaging in short-term borrowing and imposing controls on lending for new houses and the import of cars. New lines of credit with the government of India for another Indian Rs.3 billion and rupee-swap facility for USD 100 million are some of the new measures. While these short-term measures may reassure the public, they could become counter-productive unless the public sector and households can be persuaded to raise savings levels.
India

India’s continued slowdown is broad-based across sectors. Vulnerabilities, mainly due to a wide current account deficit and high inflation reducing macro buffers and increasing reliance on investment, persist. Slower growth and tighter fiscal space may affect India’s progress towards universal health coverage.

Recent Economic Developments

The slowdown in growth that began last year continued in fiscal 2013. The growth of real GDP at factor cost fell to 4.5 percent (y-o-y) during the third quarter of fiscal 2013, the worst outturn in 16 quarters. For the entire fiscal year, the growth rate of real GDP is expected to fall to 5.0 percent, the slowest pace in a decade. The slowdown has been broad-based, affecting all major sectors of economic activity. The slump in the first half of the fiscal year was particularly pronounced in private consumption and especially investment, which contracted by nearly 3 percent over the first two quarters of fiscal 2013, however, growth in final consumption expenditure and gross fixed capital formation picked up in Q3 FY2013, suggesting that the slowdown in demand may be bottoming out. Although persistent weakness in the global environment contributed to the slowdown in growth, the adverse contagion effects from the Eurozone debt crisis explain only a small part of the overall deceleration.

Continued weakness in the industrial sector dragged down growth in services, the original harbinger of India’s economic progress. Growth in the industrial sector started weakening during fiscal 2012 as mining activity stalled and manufacturing output decelerated. These weaknesses continued in fiscal 2013, bringing down the average industrial growth to 3.3 percent from an average of 9.2 percent during the preceding two years. This slowdown in services was most pronounced in the third quarter of fiscal 2013 as the services sector was adversely affected by the industrial slowdown through forward and backward demand linkages, bringing down its projected rate of growth an 11-year low of 6.6 percent in fiscal 2013.

Macroeconomic vulnerabilities have increased. A record current account deficit, stubbornly high inflation, and a halt to the declining trend in the debt-to-GDP ratio highlight the growing macro vulnerabilities and limit the policy room available to the authorities. The Reserve Bank of India (RBI) has had to strike a difficult balance between monetary stimulus and price restraint. Policy action to reduce fuel subsidies and the recently presented fiscal 2014 Union Budget reaffirmed the authorities’ commitment to fiscal consolidation.

The current account gap worsened due to a widening trade deficit. The current account deficit increased to a record 5.4 percent of GDP in the first half of fiscal 2013, compared to 4.1 percent in the corresponding period last year. The merchandise trade deficit widened to 11 percent of GDP, from 10 percent the previous year, the central cause of the deterioration in the current account balance. The worsening in the current account balance occurred despite a robust inflow of remittance, which increased to 1.7 percent of GDP during Q1-Q3 FY2013, from 1.6 percent last year.

The trade balance has showed signs recently of improvement. Merchandise export growth (in US dollars) turned positive during the first two months of 2013, slowing the decline in exports from 7 percent (y-o-y) to 5 percent (y-o-y) in April-December.
The decline in exports can be attributed primarily to a fall in demand from Asian economies and for goods such as engineering and petroleum products. Growth in merchandise imports also slowed, to 1 percent (y-o-y) during April-February, from 33 percent last year. Import growth remains positive, however, even though gold imports declined relative to last year, primarily because of inelastic oil imports which grew at 13 percent y-o-y during April-December 2012. As a result, the trade deficit, which touched an all-time high of USD 22 billion in October (44 percent y-o-y growth), fell to USD 15 billion by February (the same level as in February 2012).

With output growth slowing, headline inflation fell to its lowest level in over three years. It prompted the RBI to lower the policy repo rate by 25 bps twice (in January and March) to 7.50 percent, after having held it constant for the previous seven meetings. Wholesale headline inflation averaged 7.4 percent during April-February, down from 9.1 percent in the same period last year. However, after December, headline retail inflation increased to more than 10 percent (y-o-y). Food inflation remained high, widening the wedge between wholesale and retail inflation. Food wholesale inflation averaged 9.3 percent y-o-y during April-February in fiscal 2013, significantly above 7.2 percent y-o-y during the same period last year, due to a surge in vegetable prices. Some suppressed fuel inflation surfaced—rising to 10.5 percent (y-o-y) in February, from 7.1 percent in the month before—after the government allowed phased deregulation of diesel prices.

Revenues underperformed as the pace of economic activity slowed. Although gross tax revenue improved to 10.4 percent of GDP from 9.9 percent a year ago, the increase was 0.2 percent of GDP less than the budgeted amount. Total revenue and grants reached 8.7 percent of GDP, 0.3 percent of GDP higher than last year but 0.5 percent of GDP below the budgeted amount.

The pace of fiscal consolidation by the central government continues to lag behind the targets set by the 13th Finance Commission (FC). The central government has pledged its commitment to bringing down the deficit to 3.0 percent of GDP by fiscal 2017, but at this deadline looks likely to slip. The states, on the other hand, have largely achieved the FCs’ targets, except for a brief deviation after the global financial crisis, by acting on state-specific fiscal legislation passed in fiscal 2005. According to FC targets, the states’ aggregate fiscal deficit-to-GDP ratio should decline to 2.5 percent in this fiscal year.

The improvement in the central government’s debt-to-GDP ratio over the last several years appears to have lost momentum. In fiscal 2012, the central government’s internal liabilities rose for the first time in seven years, reaching 48.1 percent of GDP. It is expected to remain at about the same level in the current fiscal year.

**Outlook and Policy**

Economic growth will likely slow further in 2013 but rebound somewhat through fiscal 2014 and beyond, although downside risks remain high. The slowing momentum of growth may have bottomed out in the third quarter of fiscal 2013, but even a substantial pickup in the last quarter is unlikely to lift the rate of real GDP much beyond 5.0 percent. However, a minor increase in the trend-cycle component of GDP in the third quarter, an upturn in industrial production in February, and some modest improvements in investment and exports give reason for optimism that economic activity may have turned the corner. With these factors, and a gradual improvement in the global environment, growth is expected to climb to 6.1 percent in fiscal 2014.

Downside risks remain high, however. Macro buffers are largely depleted and the authorities’ ability to
respond to negative external shocks is likely to be much more limited than during the 2007-2009 global crisis. The current account deficit is increasingly financed by more volatile portfolio flows. While two main rating agencies maintain a negative outlook on India’s sovereign debt, with specific concerns on the slowdown in economic growth, a third agency has recently reaffirmed a stable outlook based on robust savings and private sector dynamism. Continued progress on the domestic reform agenda to encourage investment and unlock supply constraints while adhering to fiscal consolidation—especially important in the context of upcoming state and general elections—is critical to supporting growth and lowering macro vulnerabilities.

India’s growth drivers will increasingly have to come from domestic sources. The authorities’ commitment to fiscal discipline may give the Reserve Bank of India more room for accommodative monetary policy, while a series of investor-friendly measures announced in the fiscal 2014 budget will provide additional incentives for increased investment.

Inflationary pressures are expected to moderate. Despite the surprise uptick in wholesale price inflation in February and the pressure from food prices keeping consumer inflation persistently high, inflationary momentum is expected to wane over the coming months. The RBI has remained staunch on inflation and is unlikely to lower rates prematurely or be very aggressive with rate cuts. The stabilization of the rupee following a bout of depreciation in the first half of calendar 2012 is also likely to limit inflationary pressures. Good rainfall in the spring and another solid wheat harvest should help alleviate some push factors on food prices, although recent steps to curtail fuel subsidies are likely to contribute to higher impetus from fuel prices in the short term.

Fiscal deficits are likely to decline as the authorities have renewed their commitment to fiscal consolidation. Following notable fiscal slippages in previous years, the authorities delivered on their commitment to keep the fiscal 2013 central government deficit within the revised target of 5.3 percent of GDP. Even if divestment revenues in fiscal 2014 fall short of expectation, the authorities are likely to be able to meet the deficit target of 4.8 percent of GDP with expenditure compression and a recovery in tax revenues as economic activity picks up. With states’ fiscal performance roughly on target with the adjustment path recommended by the FC, the general government deficit is likely to remain below 8 percent of GDP in fiscal 2014 and fall to around 7.2 percent of GDP in fiscal 2015.

Debt ratios look likely to resume their decline but at a slower rate than before. This year, the central government’s debt-to-GDP is expected to remain around 48 percent of GDP, just 0.1 percent of GDP lower than last year, and decline gradually over the next few years. Even if real interest rates rise, a recovery in growth and continued commitment to fiscal discipline are expected to offset any potential adverse effects on debt sustainability and contribute to a slowing decline in central government’s debt to 47 percent of GDP by fiscal 2015.

Slower growth and narrowing fiscal space could affect India’s progress towards universal health coverage. Based on recent trends in the roll-out of a new wave of government-sponsored health insurance schemes (GSHIS) launched since 2007, the share of Indian population covered by some form of health insurance could rise from 25 percent in 2010 to 50 percent by 2015. In particular, the coverage of GSHIS could increase to more than 500 million persons by 2015. While the schemes are a crucial component of building human capital and fill an important niche for an otherwise under-served population, the additional expenditures required to finance the initiatives could amount to between 0.4 and 1.0 percent of GDP in 2015. The central government looks likely to be able to finance its share of the incremental expenditure towards broadening access to government-sponsored health insurance. However, divergence in growth performance at the state level and lower income flexibilities of public health expenditure at the state level, imply that a number of states may need to substantially reallocate fiscal resources to finance the expansion of government-sponsored health insurance.

In the global context, India’s growth could benefit from economic recovery in the high-income countries, but this would not be sufficient to return it to the record pace of the late-2000s. If high-income economies were to recover strongly—with growth of, say, 3 percent in 2014 and 2015—global import demand could be expected to rise by about 5.5 percent, which would buoy India’s exports by 4.5 percent relative to the baseline for 2014 and 2015, and real GDP growth by 0.4-0.5 percentage point in 2013 and 2014, and 0.2 percentage point the following year. If such auspicious developments were to
be joined by positive investor and consumer sentiment and an easing in financing constraints for firms globally, India’s GDP could accelerate by another 0.1 percentage points relative to the baseline.6

Despite the current slowdown in economic growth, India’s long-term prospects remain highly favourable. The country possesses the fundamentals to grow at sustained high rates over the next several decades on the strengths of its demographic transition, high savings and investment rates, rising educational attainments, and increasing agglomeration effects (urbanization and growth of secondary cities). India is entering demographic transition much later than many other developing countries, and will still be a relatively young nation 20 years from now, even as its dependency ratio declines to 49 percent in 2030 from its current 56 percent. Even as economic activity fell to a decade-low pace this year, investment rates did not decline much below 30 percent; combined with the demographic dynamics and a rising age-savings profile, India is likely to generate significant volumes of savings and investment over the coming years. In combination, these are the foundations for strong growth for decades to come.

6 These calculations are based upon the World Bank’s global macro model, developed by the Development Prospects Group, which covers some 150 economies and includes detailed trade linkages between each of these economies.
Maldives

Political instability paired with a precarious external situation constitutes the biggest threat to Maldives near term economic future. The tourism sector and the fiscal situation remain weak while debt sustainability may become a major concern.

Recent Economic Developments

The economy remains hostage to politics in Maldives, and the political situation is in flux with a series of crucial elections ahead. The Presidential elections are scheduled for early September 2013, and the Majlis (parliamentary) elections for April 2014, with local government polls thereafter. The first two elections, at least, look to be keenly contested, and the Majlis poll could result in another hung parliament.

Real GDP growth is reckoned to have reached 3.4 percent in 2012, on the back of sluggish tourism performance. Inflation has remained subdued on account of favorable global commodity prices, especially food and fuel. However, recent increases in global fuel prices are likely to stoke inflationary pressures.

The fiscal position remains precarious, with the government cash-flow position considerably weakened. In response, the government has resorted to imprudent means of managing the cash flow: (i) ad-hoc borrowings from the banking and private sectors, at high interest rates, (ii) monetizing, and (iii) running huge payment arrears, amounting to over 11 percent of GDP.

The precarious external situation presents a serious challenge to the country. The situation has been aggravated by continued high fiscal deficits as well as recent debt settlements. Current gross reserves are below two month of imports and in the face of increased monetization of the deficits, could deteriorate further.

In light of the precarious external situation, external debt sustainability has also become a major concern. Under current trajectories, total external debt obligations are projected to reach over 115 percent of GDP by 2015—a seriously vulnerable situation, given the recent slowdown in tourism, and the susceptibility of the economy to external shocks (such as commodity price hikes).

Outlook and Policy

The political tensions are likely to prevail through the lead-up to the elections—and beyond, if any of the major polls turn out inconclusive. An inconclusive or disputed outcome would likely prolong tensions and policy uncertainty.

Growth prospects for 2013 and beyond may remain weak in the face of sluggish global prospects, with the political crisis also a dampening factor. The IMF predicts only slow growth over the medium term—reaching 3.8 percent in 2013, and thereafter around 4 percent growth in 2014 and 2015. This is strongly commensurate with the expected low growth in the tourism sector, mainly in view of the falling average duration of stay.

The dire fiscal position and the government’s recourse to highly imprudent financing of the cash-flow shortfall could have far-reaching consequences. The 2013 budget addressed the issue by emphasizing consolidation of the fiscal situation—increasing taxes and cutting expenditures. But
these measures are unlikely to succeed—particularly the expenditure cuts, which lack specific policies to ensure compliance. The authorities need to take more urgent action, such as (i) better targeting of the main subsidy schemes—particularly electricity and Aasandha health insurance, and (ii) freezing capital expenditure for the foreseeable future. In the medium term, the government should also seek to rein in the biggest scourge of the public finance system: the size of the public sector and associated high costs of pay and allowances.

As long as the unsustainable fiscal deficits persist, the rufiyaa will be under pressure. The prospects of further money printing threaten the external stability and risk a sharp adjustment in the exchange rate. The biggest risk posed by a further exchange-rate adjustment is the possible impact it could have on poverty; the recent HIES shows that poverty rates remain high despite years of fast per-capital income growths. However, a move to a more flexible exchange rate system—perhaps through the widening of the existing band of the managed float, or outright currency flotation—would be futile in the face of persistently high fiscal deficits. The monetary authorities need to liaise closely with their fiscal counterparts to bring about the necessary adjustments, even though such adjustments are bound to be painful. A proper and sufficient level of adjustment, on the other hand, would likely see the resumption of the stalled IMF program, and open the door for more donor support.
Nepal

Nepal experienced a significant slowdown to the lowest levels of growth in a decade. Persistent political instability, a related shortfall in public spending, a weak investment climate and its dependence on India’s business cycle continue to shape Nepal’s economic near term outlook.

Recent Economic Developments

Political instability has governed economic performance in the current fiscal year, with growth expected to be well below expectations with public spending having slowed sharply. In the short to medium term, however, there are reasons for cautious optimism: not only has the (partial) resolution of the political stalemate opened the possibility of a more normal fiscal stance, but overall risks—linked mostly to the financial sector—have also decreased, thanks to the government’s active reforms in that area.

The growth rate for fiscal 2013 is projected to be 3.0–3.5 percent, the lowest in a decade. The initial projection of 3.8 percent growth was downgraded to account for (i) a significant shortfall in public spending, particularly on infrastructure; (ii) low levels of private investment due to structural weaknesses such as power outages, labor issues, and policy inconsistencies, and political uncertainty; (iii) strong linkages with India’s economy that is expected to slow significantly in fiscal 2013; and (iv) a disappointing monsoon that depressed agricultural production.

Despite low growth, inflation is expected to remain high and the current account to slip back into deficit. Inflation, currently at 9.5 percent, is expected to remain well above the policy target of 7.5 percent because of large remittance inflows, accommodative monetary policy, and supply-side rigidities. Both, food and non-food prices rose in the first seven months of the fiscal year (by 9.9 percent and 11.2 percent), well above the rates for the same period in fiscal 2012.

The trade deficit rose to nearly one-quarter of GDP in fiscal 2012 and remains on an upward course. Both current and reserve accounts remain positive but are dwindling as the deficit grows. It has increased by one percentage point of GDP per annum for the past five years (except in fiscal 2010, when it shot up to 26.2 percent of GDP). Nepal has a narrow range of export products, whose total value amounted to barely 5 percent of GDP. By contrast, consumption-fueled imports have been growing steadily in share of GDP, and are now six times higher in value than export earnings.

Remittance inflows are financing the trade deficit but this may not be sustainable. Remittance inflows are estimated at 23.1 percent of GDP, which is just enough to cover the net deficit of goods and services, amounting to 23 percent of GDP. The difference allowed Nepal to maintain a positive current account balance in fiscal 2012 and to accumulate reserves equivalent to 10.3 months of imports of merchandise and services, the highest yet seen.

Public expenditure dipped in the absence of a full budget (which might emerge in April). The inability of political parties to agree on either a consensus government or budget through fiscal 2013 (to date) prompted the President to limit spending to the same actual nominal expenditure of the previous fiscal year—while leaving tax rates unchanged and prohibiting domestic borrowing. Authorized expenditure for fiscal 2013 amounts to 18.3 percent of GDP, the lowest in the past five years. A mid-term budget review estimates a 1.1 percent of GDP shortfall in allocations for the year under the current budget arrangement. A budget ceiling of 22.7 percent of GDP is proposed for fiscal year 2014.

Budgetary issues aside, tax collection has improved with the use of progressive instruments. Revenue targets will be met, if not exceeded. In the first half of fiscal 2013, income, trade and VAT tax collection rates exceeded the six-month targets. Revenue collection in January was NRs.134.6 billion, 102 percent above the targeted NRs.131.9 billion.

Financial market liquidity stresses have eased from last fiscal year, but not disappeared. The overall credit-to-deposit ratio was 82.2 percent (mid-Jan) compared to 78.4 percent the year before and 76.2 percent in 2011. Aggressive lending by banking and financial institutions resulted in this mismatch with deposits growing at a rate of 4.4 percent (NRs.38 billion) compared to credit growth of 12.3 percent (NRs.76 billion).
Nepal has met the MDG target of halving the percentage of people living on less than USD 1.25 per day. The number of poor has declined dramatically since the mid-1990s. In 1996, 68 percent of the population lived under USD 1.25 per day; by 2011 this had fallen to 24.5 percent. The pace of poverty reduction accelerated sharply in the last decade, from 1.5 percentage point per year during 1996-2004, to 2.5 percentage points during 2004-2011—faster even than that of Bangladesh.

Remittance—which accelerated in the post-conflict period—also played a key role in poverty reduction. Nepal is the world’s largest recipient of foreign remittance in proportion to GDP (25 percent) among countries with populations bigger than 10 million. The proportion of households receiving remittance (internal or external) rose from 23 percent in fiscal 1996 to 32 percent in 2004, then jumped to 56 percent in fiscal 2011.

Outlook and Policy

The economy could rebound if the trend towards political stability firms. This, with the expected recovery of India’s economy and pull from the construction and services sectors could push Nepal’s growth above 5 percent, especially if the country takes full advantage of China’s granting of zero-tariff status on most Nepali products. However, much depends on the success of the upcoming elections and whether the new government will fully utilize its opportunities.

Stability is essential to hydro and construction sectors which require significant upfront investments and long-term engagement. Financial agreement has been concluded to build a 750 MW medium-size hydro scheme in 2014, while another 309 MW medium-size hydro project is expected to begin generating power in fiscal 2015.

Risks remain high, however, and the future rate of remittance inflows will be critical. The current slowdown in growth of remittance flows could put pressure on domestic borrowing to fund larger public expenditure outlays. The country remains at moderate risk of debt distress, and further pressure from the use of high interest-bearing channels could set the government on the edge of a “fiscal cliff”.

Can Nepal overcome its historic inertia to fully exploit its geographic advantage between two of the world’s most populous and fast-growing economies in order to improve its investment climate, fast-track completion of infrastructure projects, and open its abundant resources to foreign investment? The establishment of the Investment Board Nepal has begun to facilitate smoother processing of large investment projects, but Nepal’s poor implementation record suggests more challenges lie ahead.
Pakistan

Pakistan has entered a new stage of external weakness. The fiscal deficit is widening and stalled progress on structural reforms, in particular tax and energy related, pose major near term challenges. The completion of a full term by the government marked a historic milestone in the country's democratic development.

Recent Economic Developments

Pakistan's economy is slowing, moving from borderline stagflation to deflation as real GDP growth hovers around a mediocre 3.5 percent with downward bias. Inflation has sunk into single digits, although it appears likely to return to double digits by mid-year. The agricultural sector, contributing one-fifth of national GDP, is projected to grow at half of its targeted 4.2 percent. In the industrial sector, large-scale manufacturing—accounting for 52 percent of sectoral output—showed mild signs of revival in the first half of fiscal 2013, growing by less than 2 percent. The services sector, which accounts for over 53 percent of domestic output, is expected to grow at a rate close to but lower than the targeted 4.6 percent. Its growth will remain broad-based, benefitting from growth in the wholesale and retail trade, finance and insurance, and public administration sub-sectors.

The external position deteriorated significantly during the first eight months of fiscal 2013. Net international reserves fell from about 2.6 months of next year's imports to 1.8 months. This is not attributable to the current account; indeed, mild export growth, declining imports associated to the economic slowdown and strong inflows of workers' remittance have resulted in a low current account deficit projected to be around 0.8 percent of GDP. The risk lies in the precipitous decline in financial inflows—especially in FDI to about one-third of its fiscal 2011 level—and scheduled external public debt repayments that are draining reserves. Foreign aid inflows remained weak during the first half of the year and are not expected to be significant in financing the fiscal deficit.

Progress on critical structural reforms, especially in tax administration and the energy sector, has effectively stalled. The government has not increased power tariffs since May 2012 and unofficial estimates of the circular inter-agency debt are approaching Rs.600 billion. These constraints, together with difficulties encountered by the sector, such as reduced allocations of the low-cost natural gas feedstock, and delays in appointing professional boards (which discourage private sector investment in electricity generation, leading to high load-shedding levels averaging 8 hours per day) continue to undermine growth.

Power sector subsidies have continued to propel expenditures. Confounding government's expectations, power sector subsidies increased and by the end of the first half of the fiscal year, 80 percent (i.e., Rs.166 billion) of the total subsidy budget was already spent, with power sector subsidies amounting to 0.7 percent of GDP. With election politics likely to prohibit any major adjustment in power tariffs, the electricity subsidies are likely to continue or even be accelerated, and by the close of the fiscal year will likely exceed the target by around 0.8 percent of GDP.

On the positive side, provincial finances seem to be doing much better than anticipated. Provincial expenditure has risen much less than expected: only 9 percent. Hence, the provincial fiscal surplus was 0.6 percent in the first half of the fiscal year, which implies that the provinces could generate a full-year fiscal surplus of 0.8 percent of GDP.

The public debt-to-GDP ratio has maintained an upward trajectory. At end-December 2012, the public debt-to-GDP ratio stood at 58.0 percent of the projected GDP, about 0.5 percentage point higher than at end-December 2011. The rising short-term financing pattern of the government, has exposed scarce budgetary resources to enormous interest outlays. Interest on floating debt alone was 20 percent of total revenues in the first half of fiscal 2013, about 62 percent more than that paid on the same instruments in the corresponding period last year. IMF repayments dominated the external debt. The external debt of the country declined by USD 2.2 billion in the first half of fiscal 2013 mostly because of IMF repayments of about USD 1.2 billion.

The overall slowdown in economic activity is due also in part to low credit to the private sector. The
Rs.104.5 billion disbursement to the private sector during the first half of fiscal 2013 appears much lower than that of the same period in fiscal 2012 (Rs.194 billion). Credit to private sector businesses, which truly captures private sector activities, increased modestly by Rs.153.5 billion during the first half of fiscal 2013 (Table 6), the biggest expansion of the last three years. Most of this expansion came from meeting working capital needs, which stood at Rs.127.9 billion.

The balance of payments (BoP) situation remains stressed: The reason for this is the sudden halt in financial inflows, aggravated by high scheduled debt repayments. The official government inflows are barely sufficient to meet the amortization of medium- and long-term loans. Besides marginal improvement in the trade deficit and robust growth in workers’ remittances, the external current account deficit for fiscal 2013 is projected to remain at around 0.7 percent of GDP.

The trade deficit of USD 8.8 billion from July-January of fiscal 2013 is small. Although exports grew by slightly less than 1 percent in this time, the marginal improvement in the trade deficit was due to a contraction of 2.2 percent in imports. The overall slowdown in productive activity in the economy and the reduction in the prices and volumes of imports explain this result.

Inflationary pressures eased considerably over the last eight months of fiscal 2013. But risks remain. CPI inflation declined to 7.4 percent (y-o-y) in February 2013, from 11.3 percent in June 2012. Both food and non-food groups contributed to this deceleration, but the share of the non-food group was relatively higher than the food group. Food inflation declined from 10.3 percent in June 2012 to 5.3 percent in November 2012 before increasing to 7.4 percent in February 2013. The State Bank of Pakistan (SBP) reduced the policy rate by 250 bps in the first half of fiscal 2013. The Net Foreign Assets (NFA) of the banking system contracted by Rs.80 billion (negative growth of 22.3 percent y-o-y) during Jul 1-Feb 22, 2013.

Financial Sector developments: The banking system maintained profitability during 2012 with before-tax profit increasing 10 percent compared to the previous calendar year. Both return on assets (ROA) and return on equity (ROE) remained at satisfactory levels of 2.1 percent and 22.9 percent respectively, and the sector’s liquidity position improved.

Credit quality remains a risk, but shows signs of stabilizing. Non-performing loans (NPLs) remain high, at 14.5 percent of loans in December 2012, and present a medium-term risk to the sector, but have declined over the past year (15.7 percent in December 2011). The microfinance sector is one of the most progressive and innovative globally, but lags substantially in its overall outreach to demand, particularly women. The sector registered a 13.6 percent increase in active borrowers, 32.6 percent growth in gross loan portfolio, 19 percent increase in savers, and 61 percent in value of savings between December 2011 and December 2012.

Outlook and Policy

The major risk comes from the significant weakening of the external position. The main issues are the sudden stoppage of financial inflows—especially the fall in FDI to about one-third of its fiscal 2011 level—and scheduled external public debt repayments that are draining reserves.
The fiscal situation is worrisome. Pakistan is poised yet again to miss all of its budget targets by large margins. Expenditure overruns in an election year are likely to remain substantial, as power sector subsidies remain high. Revenue shortfalls are expected to be large, due partly to the long-standing structural problems with tax policy and tax administration but also to an apparent slowdown in domestic economic activity and reduced oil imports (a major source of revenue). The budget deficit could balloon to 7 percent of GDP by the end of the year—well above the budget target of 4.7 percent.

Credit quality shows signs of stabilizing but is still at risk. Non-performing loans (NPLs) remain high, at 14.5 percent of loans in December 2012, and present a medium-term risk to the sector, but have declined over the past year (15.7 percent in December 2011). Vulnerability to default risk remains but has been mitigated so far by adequate provisioning requirements and strong earnings (Net NPLs to loans are at 4.6 percent compared to 5.4 percent in December 2011). Banks are moving aggressively into new financing avenues, with some using mobile phone technology to reach to the un-banked segment of the economy.

There is a growing national consensus that the country needs to recover its external position. Talks begun in February for another IMF-supported stand-by arrangement (SBA) but stalled because of the authorities’ failure during the election campaign to agree on satisfactory revenue generation measures and properly contain expenditure for fiscal consolidation—a situation aggravated by a questionable tax amnesty scheme. How soon the SBA negotiations resume will likely depend in the near term on the caretaker or next government. Budget support from the World Bank and other donors remains dependent on not only establishing a satisfactory framework for economic stabilization and recovery, but on designing a comprehensive growth-oriented set of structural reforms in areas such as power sector reform, economic governance (business climate, and state-owned enterprises), trade diversification, job creation and the safety-net system. The approaching two-to-three-months transition period of the caretaker government could help to restore momentum in the key reforms essential for not only recovering solid macro fundamentals but fostering Pakistan’s growth agenda in the medium term.
Sri Lanka

Sri Lanka’s growth moderated, however, remains at healthy levels. To sustain growth in the future, the country will face the challenges of strengthening the revenue side of the fiscal balance as well as attracting greater foreign investment flows.

RECENT ECONOMIC DEVELOPMENTS

Economic growth moderated in 2012, signaling a tempering of the post-conflict boom. Nevertheless, GDP growth was still a healthy 6.4 percent in 2012, far above regional peers, though significantly below the 8.2 percent averaged through 2010 and 2011. The slowdown was due largely to (i) conscious macroeconomic policies aimed at managing credit growth in the face of aggravating balance of payments (BoP) issues, and (ii) dampened global economic conditions that impacted particularly the country’s main export markets.

On the production side, favorable weather conditions supported good agricultural growth overall in 2012, while the industrial and services sector growth rate respectively stagnated and moderated.

While inflation has risen from 2011, it is still manageable, in single digits. Moderating demand has put downward pressure on inflation, counteracting cost-push pressures that would have driven it higher. Year-end inflation reached 9.2 percent (y-o-y) compared to 4.9 percent in 2011, while the average for the year was 7.5 percent compared to 6.7 percent for 2011. The data for early 2013 indicate a further rise, though not beyond single digits—February’s headline inflation coming in at 9.8 percent (y-o-y).

Monetary policy has turned back towards accommodation, reversing a brief period of tightening. This was likely due to falling growth rates and the prevalence of low inflation. The central bank had raised policy interest rates in February and again in April, keeping them steady until making a small downward adjustment in December.

The external balance improved because of a reduction in imports, while continued inflows to services, income and financial accounts provided a more comfortable cushion against external risks in 2012 compared to 2011. The import bill declined by 5.8 percent in 2012 to USD 19.1 billion, largely because of the policy measures introduced early in the year, lower global commodity prices, and a weaker rupee. The trade balance improved from a deficit of 16.4 percent of GDP to 15.8 percent, while the current account deficit improved from nearly 8 percent of GDP to 6.6 percent. With these developments, the country’s basic balance improved in 2012 to a deficit of 5.2 percent of GDP from a deficit of 5.7 percent of GDP the year before.

The Sri Lankan rupee depreciated rapidly with relaxation of the forex market in early 2012 but settled to around SLRs.127/USD 1 by year’s end. By not intervening aggressively, the central bank managed to build up its foreign exchange reserves from a somewhat precarious three-and-a-half months of imports at end-2011 to a relatively better four-and-a-quarter months of imports by end-2012.
The weakening of the currency had little impact on inflation, thanks to strong support from domestic supply that helped contain price impacts, and the moderation of aggregate demand. In step with the sharp currency depreciation, the real exchange rate also depreciated sharply post-February. However, these trends reversed later in the year as positive inflation differentials built up and inflow of foreign exchange, largely through the financial accounts of the BoP, maintained the strength of the currency.

Overall fiscal policy remained stimulatory while the overall deficit narrowed only marginally to 6.4 percent of GDP in 2012, from 6.8 percent in 2011. Several structural weaknesses in the fiscal structure came into sharp focus in 2012—notably weak revenues, which reached their lowest levels in history.

Outlook and Policy

The country will need decisive policies to meet its medium-term challenges. Fiscal policy, in particular, will need to place emphasis on reforming the state-owned enterprise sector, and require a combination of hard budget constraints and broad-based reforms to stop the current hemorrhaging. The government needs also to adopt policies that attract greater foreign investment in order to buoy the country’s growth potential. The long-term decline in exports gives cause for concern; the authorities need to focus beyond traditional export markets, into more of the emerging markets.

Structural limitations threaten Sri Lanka’s ability to sustain the high level of economic growth of recent years. Firstly, the country’s current investment levels are well below the rates required to spur the 8 percent-plus growth envisaged by the government. Investment rates in Sri Lanka rose to 30.6 percent of GDP in 2012, from 30 percent in 2011. To sustain 8 percent-plus growth Sri Lanka will require investment rates of 35-40 percent of GDP. This will require increased domestic investment but also foreign investment—in particular foreign direct investment (FDI). FDI is particularly important in the Sri Lankan context because it facilitates technology transfers which support productivity and innovation. However, Sri Lanka has not shown a striking ability to attract sufficient FDI in the recent past. Sustaining economic growth will be subject to fiscal constraints and the increasing challenge of maintaining government expenditure on public investments at 6.0-6.5 percent of GDP. The problem is aggravated by a lack of effective reform in the SOE sector, with several SOEs being a considerable drain on fiscal resources. Sri Lanka’s long-term decline in exports gives reason for concern, highlighting a need to reverse the country’s increased reliance on domestic sources for growth.

The government’s medium-term revenue growth target appears ambitious, particularly in light of the poor revenue fundamentals in the country. Contemporary analysis shows that Sri Lanka has one of the highest gaps between actual and potential revenue in South Asia, with these gaps likely to worsen. Furthermore, Sri Lanka also records one of the lowest revenue buoyancies in South Asia—a ratio close to 0.61, substantially below unity. Sri Lanka’s low buoyancy seems to come from poor performance of all tax instruments. No individual tax category has buoyancy above 1.0, and buoyancy is particularly low for VAT, the single largest source of tax revenue. Against this backdrop it is important that the government gives due cognizance to the recommendations of the Presidential Tax Commission (PTC) that delivered its findings to the government in September 2010. While the 2011 budget did take cognizance of some of these recommendations, a lot more needs to be done to revamp the revenue machinery.
## South Asia at a Glance

### OUTPUT and PRICES

#### Real GDP Growth

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<td>3.7</td>
<td>-2.1</td>
<td>-6.8</td>
<td>-7.4</td>
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<td>-6.4</td>
<td>-8</td>
<td>-8.7</td>
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<tr>
<td>2011</td>
<td>-0.9</td>
<td>4.1</td>
<td>-0.7</td>
<td>-6</td>
<td>-1.3</td>
<td>-0.9</td>
<td>-8.5</td>
<td>-6.8</td>
<td>-7.6</td>
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<tr>
<td>2012</td>
<td>1.6</td>
<td>4.5</td>
<td>-1.6</td>
<td>-5.2</td>
<td>-4.2</td>
<td>-0.6</td>
<td>-7</td>
<td>-6.4</td>
<td>-9.4</td>
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<tr>
<td>2013</td>
<td>1.6</td>
<td>4.5</td>
<td>-1.3</td>
<td>-5.4</td>
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<td>3.6</td>
<td>-7</td>
<td>-5.8</td>
<td>-8.3</td>
</tr>
</tbody>
</table>
Notes: (Table South Asia at a glance)

- **Estimate**
- **Forecast**
- **Projections**

**Afghanistan**
- 1. These numbers are for fiscal year unless otherwise mentioned. For example; for 2010 numbers, 2010-2011 values are used.
- 2. Core inflation (exc. Fuel and cereal, %)
- 3. Including grants
- 4. Overall Core Balance incl. grants
- 5. WB Staff Calculations

**Bangladesh**
- 6. These numbers are for fiscal year unless otherwise mentioned. For example; for 2010 numbers, 2010-2011 values are used.
- 7. (Avg of Jan-Feb)
- 8. Current Account bal/GDP (%) is for calendar year
- 9. Remittances numbers are taken from GEP 2013 Jan report and they are calendar year numbers (USD billions)
- 10. WB Staff Calculations
- 11. Portfolio Investment Liabilities, US $ billions

**Bhutan**
- 12. These numbers are for calendar year unless otherwise mentioned.
- 13. Current Account surplus or deficit (% of GDP)
- 14. WB Staff Calculations
- 15. Net private foreign direct investment. (USD billion)

**India**
- 16. These numbers are for fiscal year unless otherwise mentioned. For example; for 2010 numbers, 2010-2011 values are used.
- 17. Wholesale Price Index
- 18. (Avg of Jan-Feb)
- 19. Remittances numbers are taken from GEP 2013 Jan report and they are calendar year numbers (USD billions)
- 20. Foreign Exchange Reserves (in months of next year’s goods and services imports)
- 21. WB Staff Calculations
- 22. Foreign Investment (US billion)
- 23. Portfolio Investment, net (US billion)

**Maldives**
- 24. These numbers are for calendar year unless otherwise mentioned.
- 25. WB Staff Calculations
- 26. WB Staff Calculations
- 27. WB Staff Calculations
- 28. Net private Foreign direct investment (USD billions)
Nepal

29 These numbers are for fiscal year unless otherwise mentioned. For example; for 2010 numbers, 2010-2011 values are used.

30 (Avg of Jan-Feb)

31 Remittances numbers are taken from GEP 2013 Jan report and they are calendar year numbers (USD billions)

32 Gross official reserves in months of GNFS (goods and nonfactor services) imports

33 WB Staff Calculations

Pakistan

34 These numbers are for fiscal year unless otherwise mentioned. For example; for 2010 numbers, 2010-2011 values are used.

35 Real GDP Growth (at factor cost)

36 (Avg of Jan-Feb)

37 Current Account Bal/GDP (%) is for calendar year

38 Remittances numbers are taken from GEP 2013 Jan report and they are calendar year numbers (USD billions)

39 SBP Gross Reserves exclude Cash Reserve Requirement, gold and foreign currency deposits of commercial banks held with SBP & in months of next year’s imports of goods and services.

40 WB Staff Calculations

41 & 42 USD billions

43 Portfolio Investment Liabilities

Sri Lanka

44 These numbers are for calendar year unless otherwise mentioned.

45 (Avg of Jan-Feb)

46 Remittances numbers are taken from GEP 2013 Jan report and they are calendar year values which is same as the fiscal year (USD billions)

47 WB Staff Calculations

48 & 49 USD billions

SAR

50 These numbers are for calendar year unless otherwise mentioned.

51 Remittances numbers are taken from GEP 2013 Jan report and they are calendar year numbers (USD billions)

52 & 53 USD billions

Sources: World Bank, IMF, CEIC, National Authorities