

South Asia Economic Focus
Spring 2016



Fading Tailwinds



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

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**South Asia Chief Economist Office
Macro and Fiscal Management Global Practice**



Table of Contents

Recent economic developments	8
The world economy remains jittery	10
South Asia's vulnerability to external stress is limited	12
Remittances show signs of weakness, export performance disappoints	15
Capital flows slowed down but reserve buffers are large	16
South Asia's growth continues to be the fastest across regions	18
Inflation has come down a long way, but has it come to stay?	21
Fiscal policy remains constrained	22
Besides budgets, financial systems remain potential weak spots	24
Outlook	27
South Asia's gradual growth acceleration continues	27
A common upward trend across countries, but different challenges	28
Political risk factors persist across South Asia	29
Which direction for fiscal policy?	30
South Asia is on a path to fiscal consolidation	32
Fiscal policy can contribute to macroeconomic stability	33
Fiscal policy matters for equity	38
Fiscal policy can help reduce emissions	42
A fiscal policy scorecard	43
South Asia country briefs	46
Afghanistan	48
Recent Developments	48
Outlook	49
Risks and Challenges	50
Bangladesh	51
Recent Developments	51
Outlook	52
Risks and Challenges	53



Bhutan	54
Recent Developments	54
Outlook	55
Risks and Challenges	56
India	57
Recent Developments	57
Outlook	58
Risks and Challenges	58
Maldives	59
Recent Developments	59
Outlook	61
Risks and Challenges	61
Nepal	62
Recent Developments	62
Outlook	63
Risks and Challenges	63
Pakistan	65
Recent Developments	65
Outlook	66
Risks and Challenges	67
Sri Lanka	68
Recent Developments	68
Outlook	69
Risks and challenges	70
South Asia at a glance	72
Notes	74



Recent economic developments

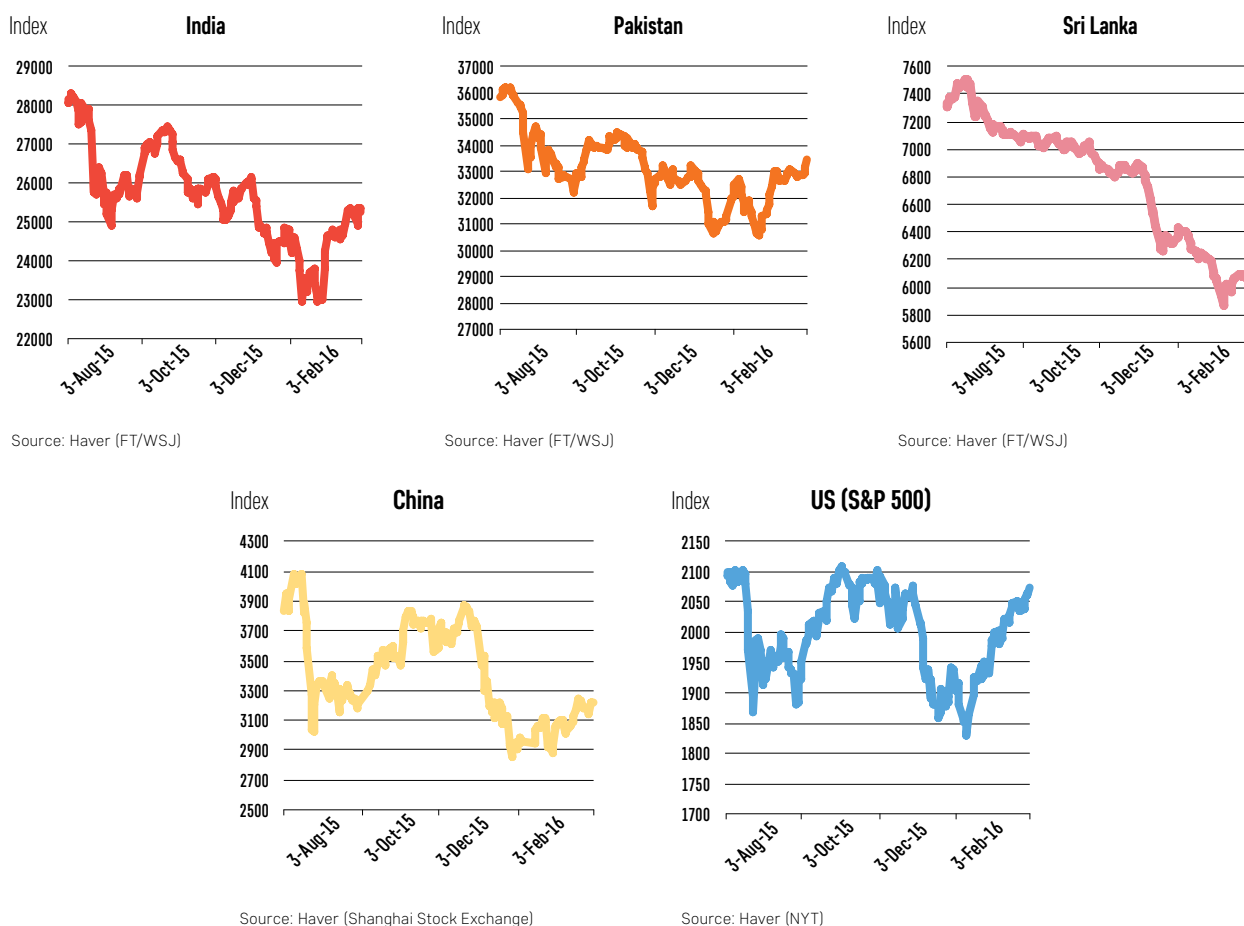




South Asia shows continued resilience in the face of turbulent international markets, maintaining its spot as the fastest-growing region in the world. Growth performance is especially solid in India, which continues to lead among large emerging market economies. However, the overall pace of growth is slower than anticipated and inflation has recently been on the rise. These are signs of fading tailwinds. Capital flows to the region have declined and remittances originating in oil exporting countries have started to weaken. Oil remains cheap but its international price is unlikely to keep falling. Most countries have built up solid buffers in terms of reserves and monetary policy space. But fiscal space for infrastructure investment remains limited, and high levels of public debt persist.



Figure 1: Regional stock markets are experiencing high volatility or outright decline



The world economy remains jittery

Stock markets experienced major losses and continue to be volatile. After some strengthening following the August 2015 slump, most markets have started 2016 with yet another pronounced fall in share prices. China began the year 2016 off on a weak note, showing signs of continued slowing and rebalancing. A rally in Emerging Market (EM) bonds, Foreign Exchange (FX) indices and equity prices through mid-March somewhat reversed the bad start. However, in light of the broader emerging market outlook, more volatility is to be expected. Chinese markets may be bottoming out, but other BRICs such as Brazil or Russia exhibit a clear downward trend that appears set to continue in the near term. In South Asia, after three years of sustained gains, stock prices in India, Pakistan and Sri Lanka have shown signs of trend reversal around 2015 and early 2016. The decline has been strongest in Sri Lanka.

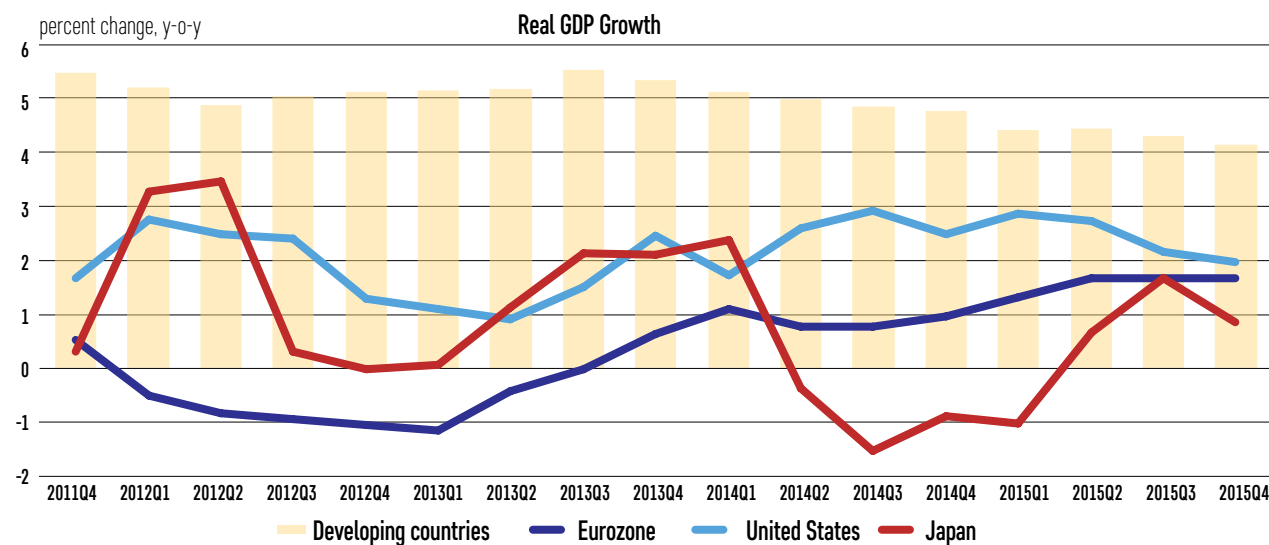
Advanced economies gradually contribute more to global growth but momentum remains weak.

Global growth slumped from 2.6 to 2.4 percent in 2015. This is short of expectations, and the updated forecast for the coming years is below the previously anticipated trajectory. Major advanced countries continue to perform below their potential. Japan grows at below 1 percent in 2015Q4, while the Euro area expanded by only 1.6 percent in 2015. The US economy continues to send mixed signals, with a relatively low 1.8 percent real GDP growth in 2015Q4 (y-o-y) but featuring robust job growth in early 2016.

There is also a striking economic deceleration in emerging market economies and developing countries. All the BRICS, with the exception of India, are facing a slowdown with potential negative spillovers among some of them, and for the global economy as a whole. China continues to rebalance its growth model, whereas Brazil and Russia face severe adjustments. These major economies also set the stage in their regions. Growth in Latin America is estimated at -0.8 percent in 2015 and forecast at -1.8 percent in 2016. Europe and Central Asia is estimated to have contracted by 0.1 percent in 2015 and is expected to

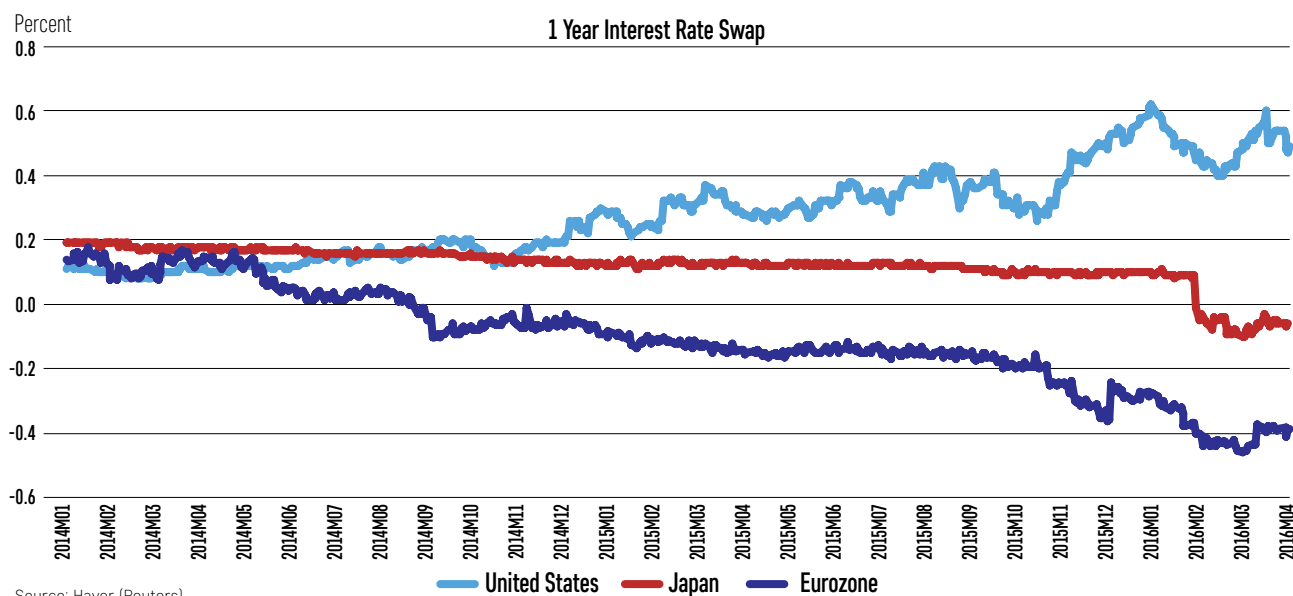


Figure 2: Growth in major advanced economies remains sluggish



Source: World Bank DECPG

Figure 3: Expectations regarding monetary policy differ across major advanced economies



Source: Haver (Reuters)

grow by only 0.8 percent in 2016. Countries including Libya, Ukraine and Venezuela are facing major crises as a result of political turmoil, conflict or unsound economic policies. One tumultuous year has ended, and maybe another one has just begun.

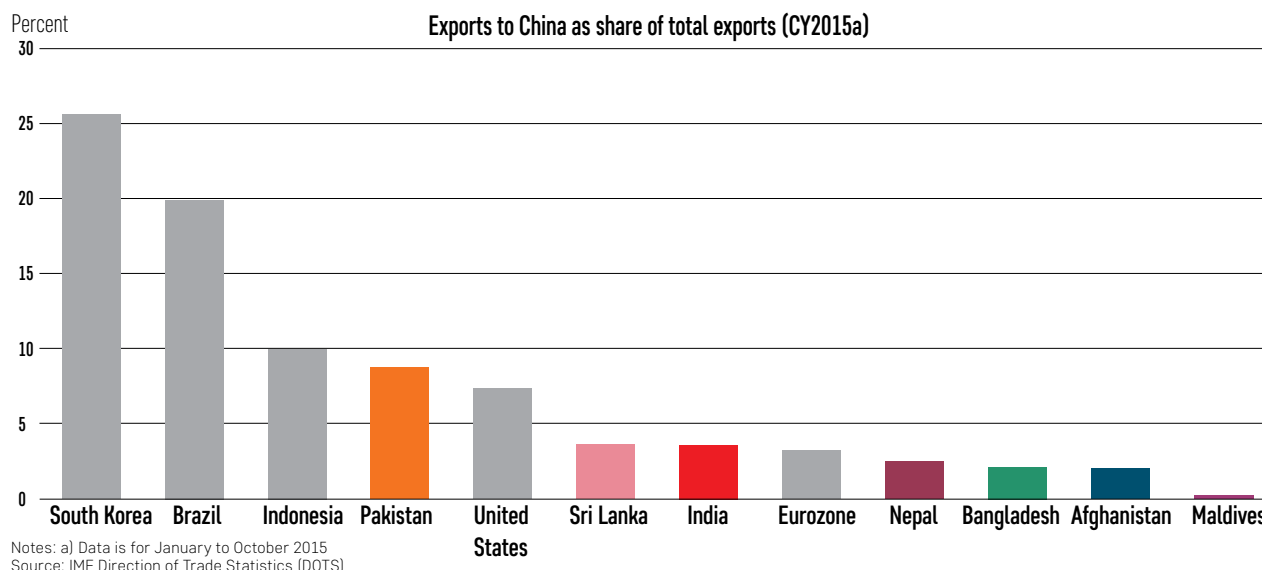
Monetary policy asymmetry among advanced economies adds to the uncertainty.

The US Federal Reserve Bank increased the federal funds rate by ¼ percentage point in December 2015. But shortly after it began to curb expectations of further tightening towards a slower and more gradual path than originally provisioned. Noting weaker US economic performance towards the end of 2015 and in early

2016, no further rate increase was decided in March. In the Eurozone and Japan, on the other hand, negative interest rates and further Quantitative Easing (QE) are setting the tone for the short and medium term. The Euro area deposit rates are now at -0.4 percent and the European Central Bank (ECB) is now providing a QE envelope of Euro 80 billion per month (up from Euro 60 billion). Japan's policy rate stands at -0.1 percent and QE continues at an annual rate of Yen 80 trillion.



Figure 4: The Chinese slowdown does not pose a direct threat to South Asia's trade balances



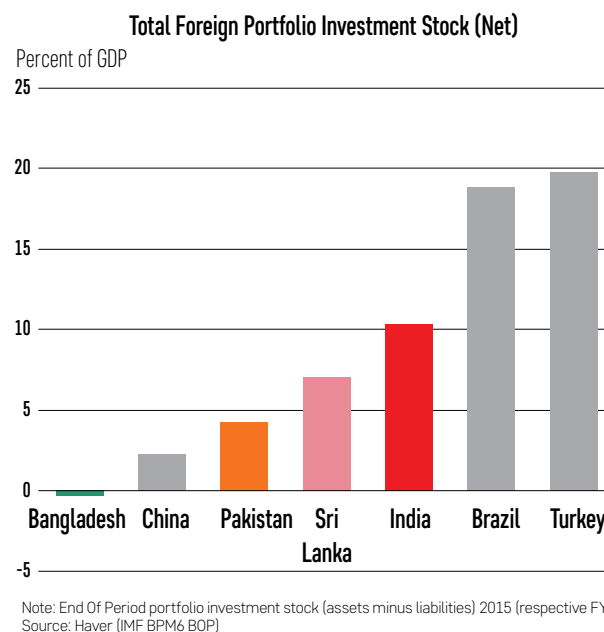
South Asia's vulnerability to external stress is limited

Trade patterns do not expose South Asia to a continued Chinese slowdown. The region is more inward-oriented than others, and its growth is less dependent on global markets. Unlike Latin America, South Asia is not directly affected by declining prices for food and metals stemming from more sluggish Chinese demand. Most countries in the region import massively from China, but flows in the opposite direction are considerably more modest. With the exception of Pakistan, the share of exports to China is low. For India the most relevant external market is the US. For Bangladesh and Sri Lanka it is the EU. If anything, performance among these two major advanced economies is improving.

Exposure to jittery international markets is also limited because capital inflows are modest. Generally, the net stock of Portfolio Investment (PI) across South Asia is limited by international standards. Only India with net PI of around 10 percent of GDP by end of FY2015 is somewhat vulnerable to international portfolio rebalancing and related volatility. Sri Lanka's exposure to international investor sentiment is more limited with a portfolio stock of around 7 percent of GDP (although its PF debt liabilities at around 13 percent of GDP – without counting assets – are significant and could entail larger exposure), while other regional economies feature only small or negligible amounts of international and more volatile Portfolio Investment.

India's potential exposure is higher but the volatility of its equity and debt flows has been limited.

Figure 5: Exposure to capital flow volatility from portfolio rebalancing is moderate



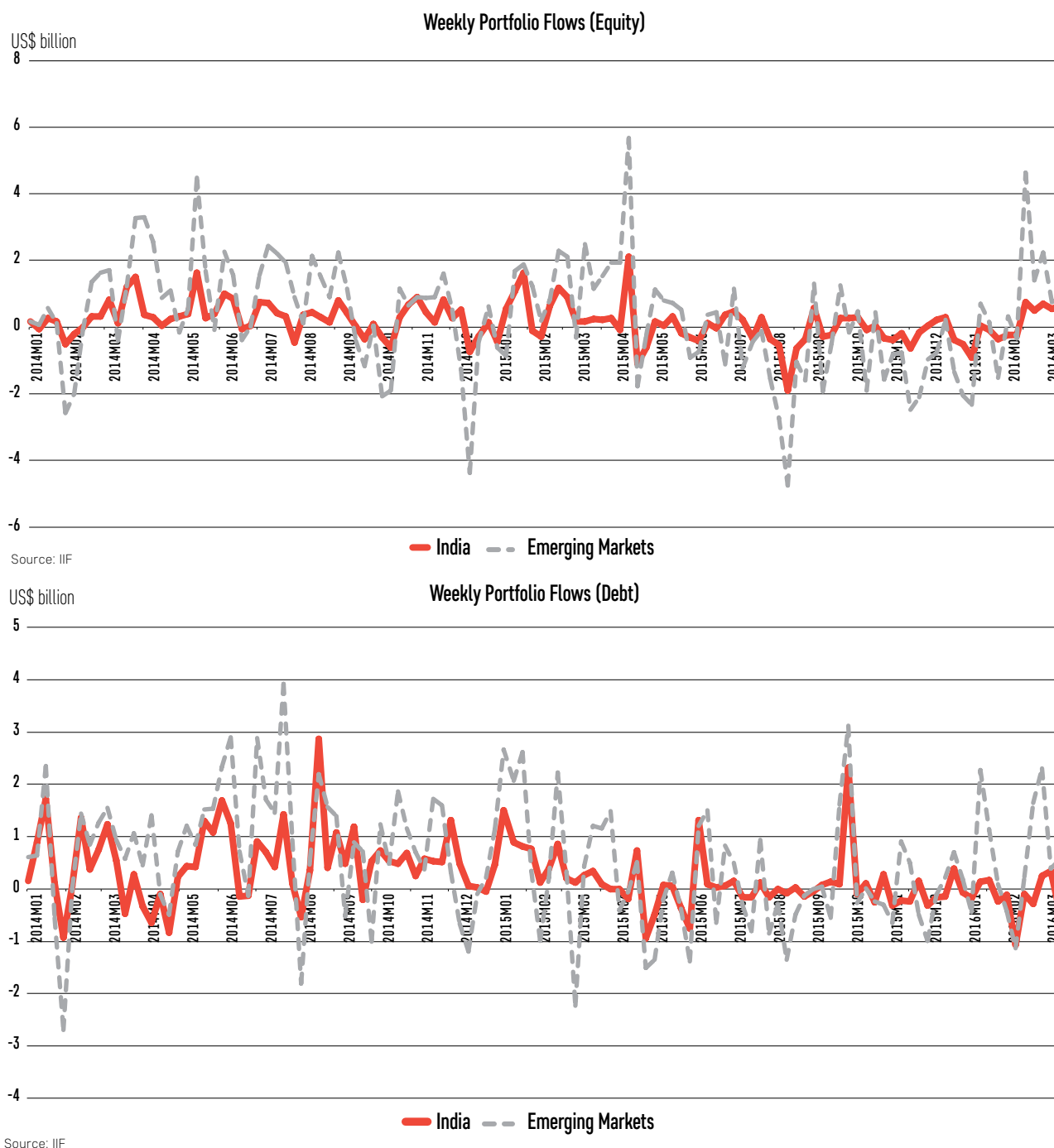
Given the size of its financial and capital markets, India can be considered relatively more exposed to jitters in global financial markets. Yet, it stands as exceptional among large emerging markets in that the volatility of its equity and debt flows is relatively lower.

India's external stability is remarkably persistent.

In 2013, in the aftermath of the announcement of a tapering in US stimulus policies, India had experienced a large depreciation of the rupee. Back then, the "tapering talk" had caught markets by surprise and triggered



Figure 6: Financial market volatility is lower in India than in other emerging markets



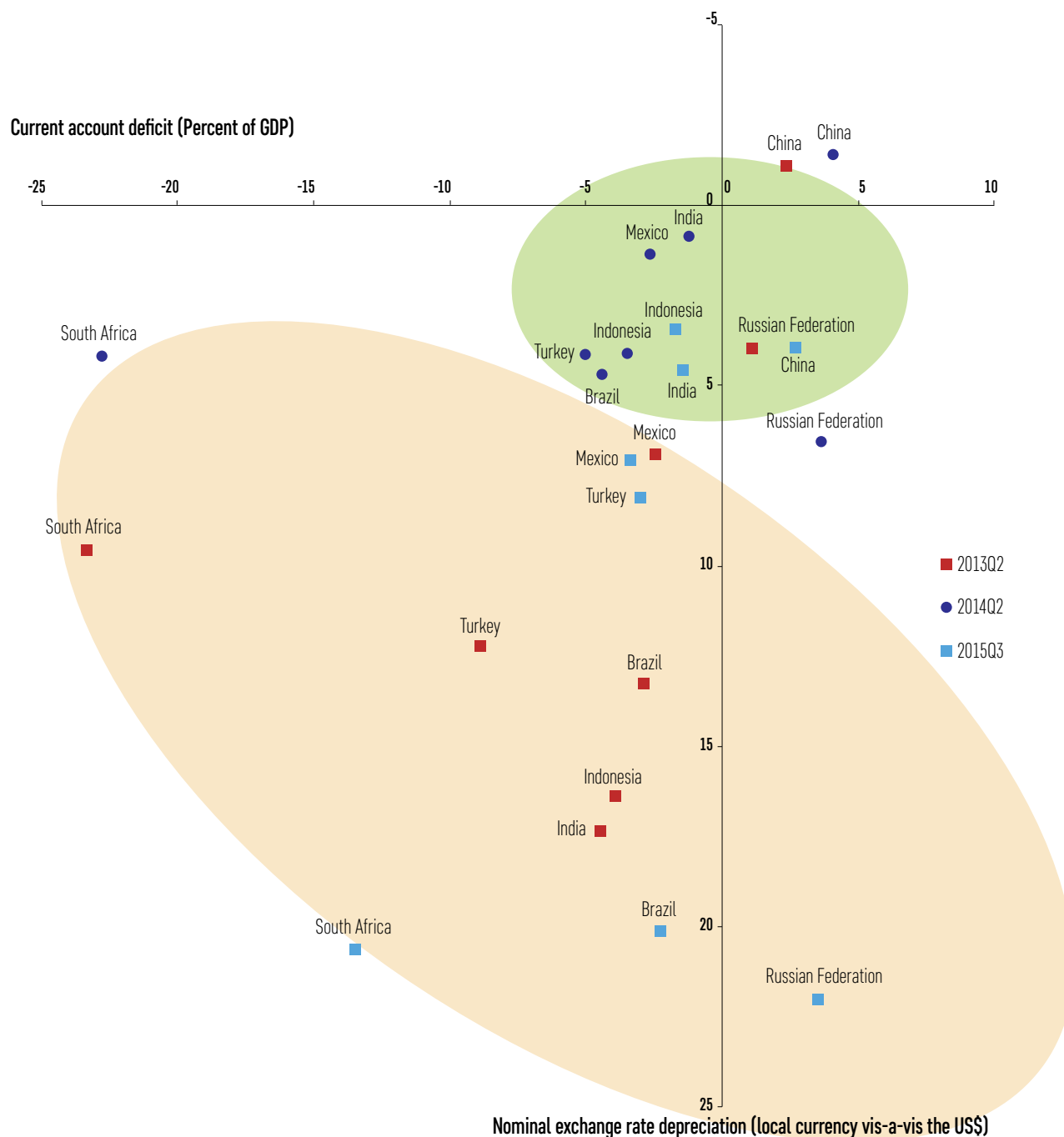
large portfolio outflows across emerging markets, in what became known as the “tapering tantrum”. But after a rapid policy response by the authorities, India has featured a consistently low current account deficit paired with relatively moderate nominal rupee depreciation. This stable external position makes India an exception among large emerging market economies. Many of them were somewhat rebounding in 2014, but proved unable to maintain stable exchange rates and current account balances in 2015. With reserve

coffers replenished and a manageable current account deficit ahead, India is relatively insulated from global turmoil entering through the exchange rate and current account channels.

Overall, current account deficits are manageable across South Asia. Estimates for 2015 suggest that South Asia’s largest economies – India and Pakistan – feature current account deficits at 1.3 and 1 per cent respectively. The deficit is even more modest in



Figure 7: Since its recovery from the 2013 taper tantrum, India maintains a solid external position



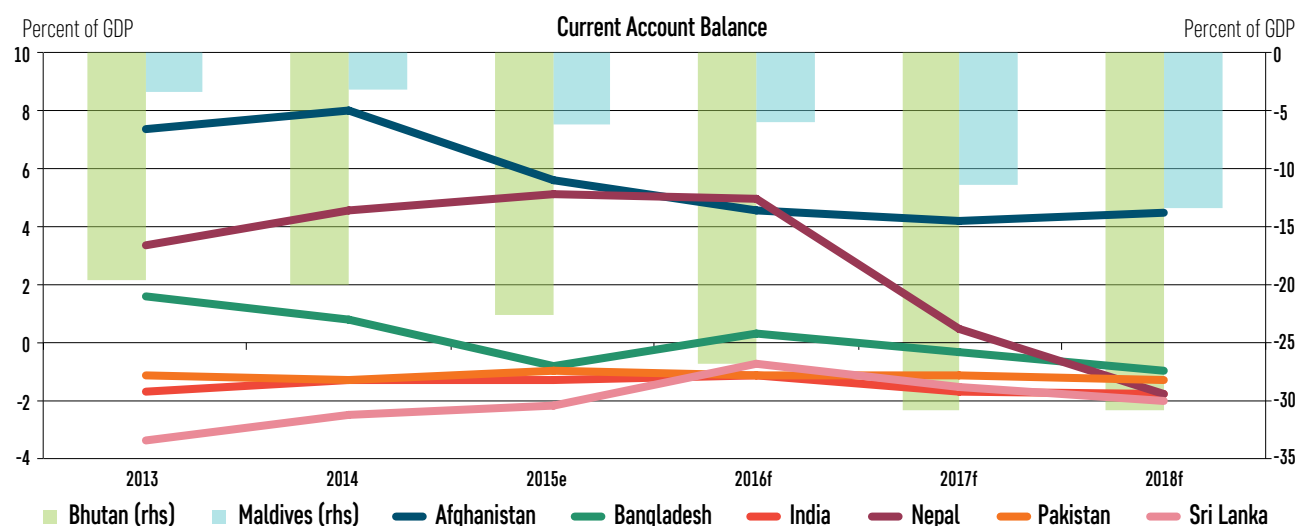
Source: World Bank DECPG, Haver (National Central Banks), World Bank staff calculations

Bangladesh, where it only reaches 0.8 percent of GDP, helped by an improving trade balance. Afghanistan and Nepal actually had a current account surplus in FY2015. However, Nepal may be headed towards a deficit over the medium term, on the back of faster import growth due to post-earthquake reconstruction. At 2.2 percent of GDP, Sri Lanka's current account deficit was above the regional average, but it is expected to narrow mainly on account of curbing recent

strong import growth. As usual, the only two countries with very large current account deficits are Bhutan and Maldives. These are mainly financed through capital inflows, associated with large investments in hydro-power and tourism resorts respectively. The inflows are highly predictable in Bhutan's case.



Figure 8: Current accounts remain broadly balanced across most of South Asia.



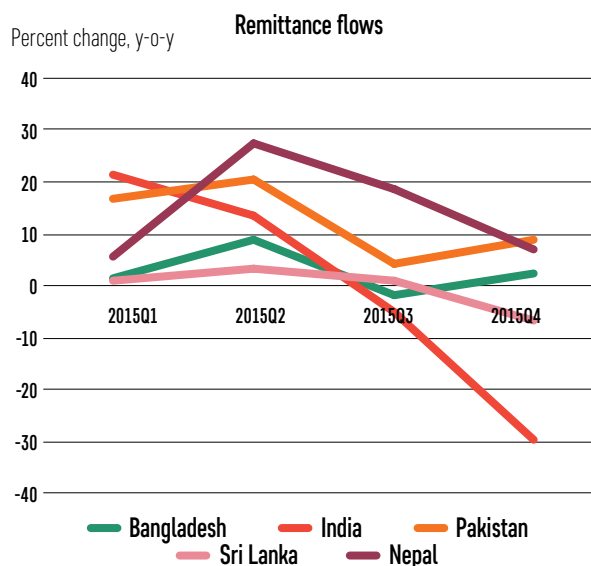
Note: Years are respective fiscal years.
Source: World Bank MFM

Remittances show signs of weakness, export performance disappoints

Remittances, the backbone of South Asian current accounts, are starting to feel the pinch from low oil prices. Large numbers of South Asians work abroad, and the money they transfer home has been an important driver of poverty reduction. Large and growing remittance inflows had also been the flip side of large trade deficits in countries like Nepal, Pakistan or Bangladesh. However, low oil prices have significantly weakened oil exporting economies such as the Gulf States, which are a traditional destination of South Asian migrants. Nepal saw remittance growth slowing down after a post-earthquake surge in mid-2015, while Bangladesh experienced flat remittances of around USD 2.1 billion in FY2016H1. In Pakistan, the growth in remittances is expected to be around 5.5 percent until FY2018, way below the 16 percent average growth of the previous five years. In Sri Lanka, remittance flows are projected to grow less than GDP.

Trade balances continue to disappoint, with the gains from lower oil import bills vanishing in some countries. Real merchandise imports fell over large parts of 2015 in Bangladesh, India, Pakistan and Sri Lanka. But declines have mainly bottomed out by now. In Sri Lanka, expansionary fiscal and monetary policy led to a surge of non-oil imports, almost offsetting the low commodity price windfall. Meanwhile, export growth has been modest or negative across most of the region. Disappointing export performance partly

Figure 9: Remittances, a major source of foreign exchange, show signs of slowing down

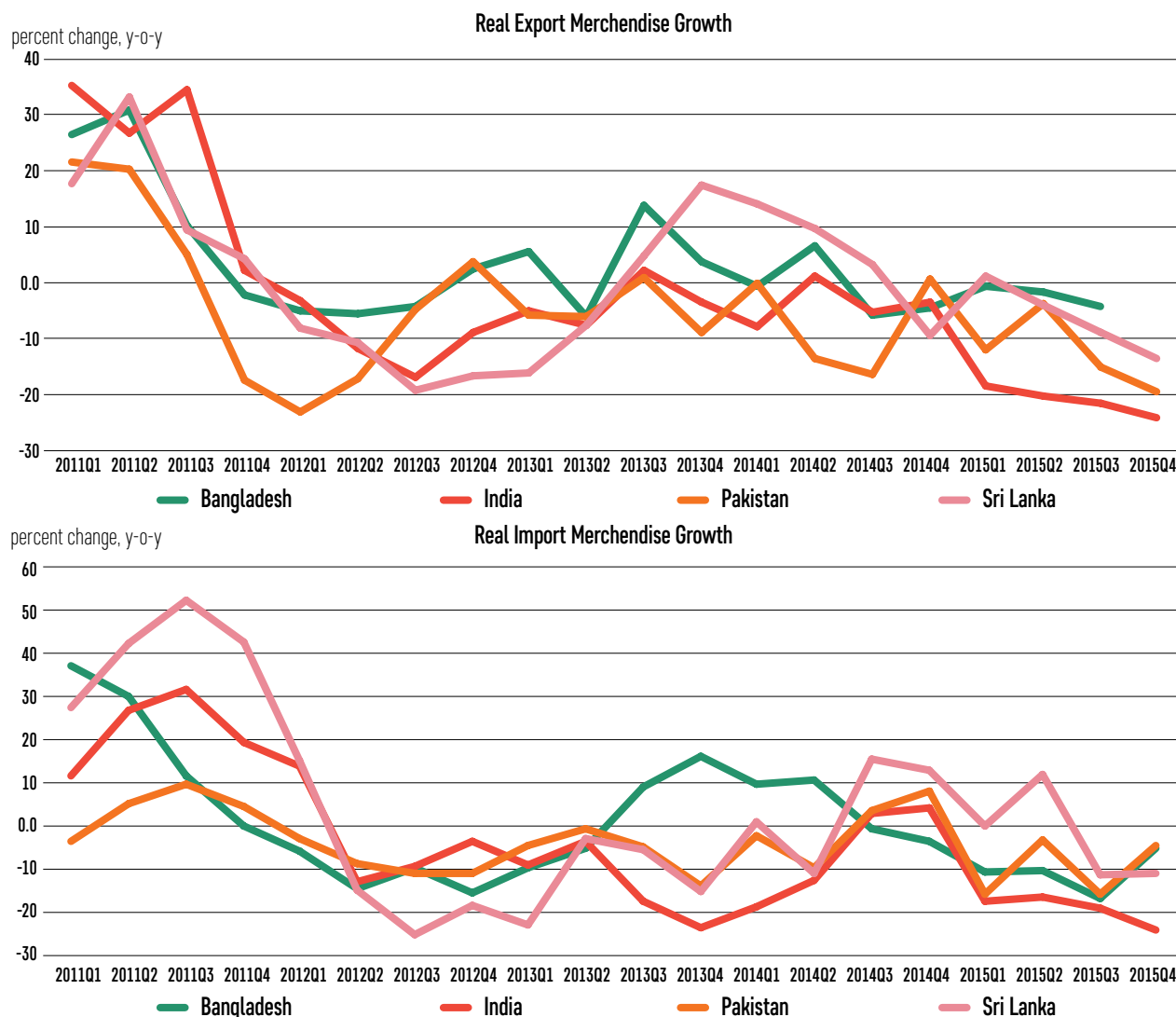


Source: Haver (National Central Banks)

reflects persistent structural weaknesses, but it is also the outcome of noncompetitive exchange rates. In India for example, exports declined by 6.5 percent y-o-y over the first three quarters of FY2016, while imports contracted by a similar 6.4 percent y-o-y between April and December 2015. For the region as a whole, exports contracted by 2.6 percent in 2015. Given the weight of exports in aggregate demand, this contraction mechanically translates into a 0.3 percent drag on GDP growth.

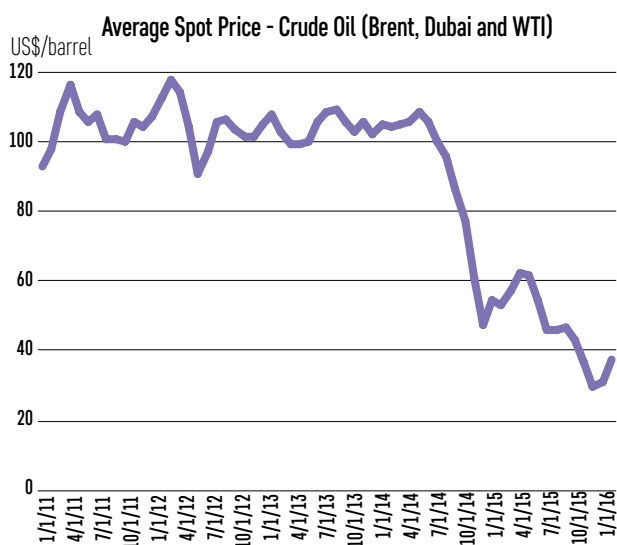


Figure 10: Export growth has been modest or negative across South Asia



Source: WB DECPG

Figure 11: International oil prices may have bottomed out



Source: World Bank, Haver

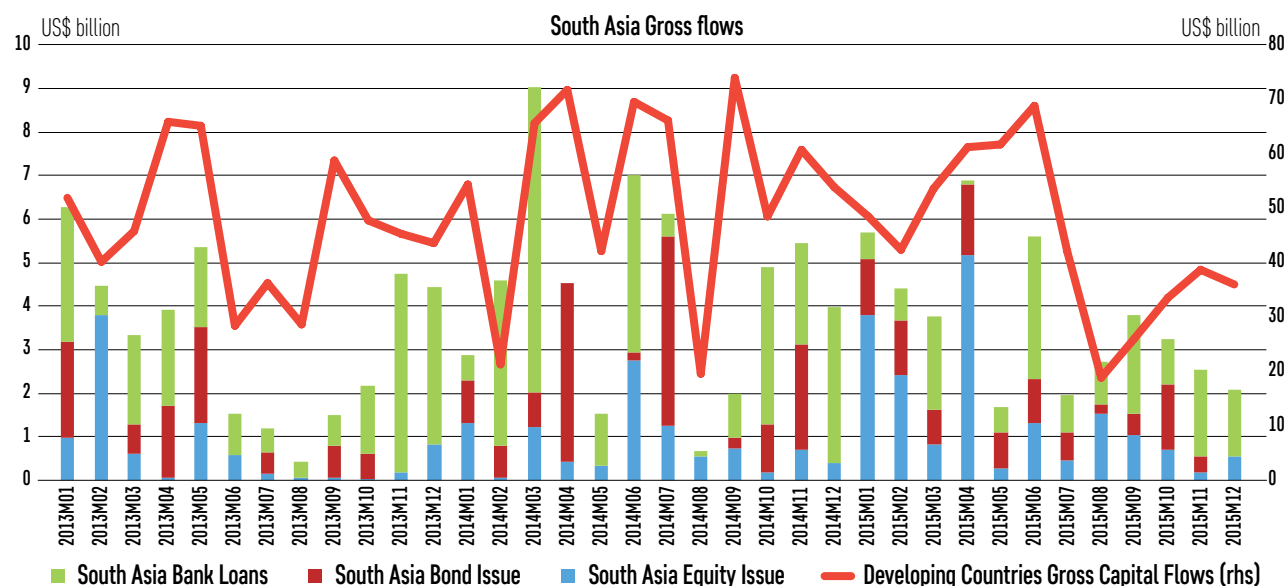
Fading tailwinds on the current account come at a time where international oil prices may have bottomed out. South Asia, a net oil importing region, has significantly benefitted from the oil price decline over 2014 and 2015. However, prices show signs of bottoming out, thereby making another boost for South Asia less likely.

Capital flows slowed down but reserve buffers are large

Capital flows to the region have been slowing recently but current account deficits remain financed. After a period of brief resurgence, capital flows to developing countries fell significantly in the summer of 2015. The downward trend could also be observed in South Asia's case. In Sri Lanka this was compounded by scheduled external debt



Figure 12: Gross capital flows show a downward trend while net FDI flows remain at low levels

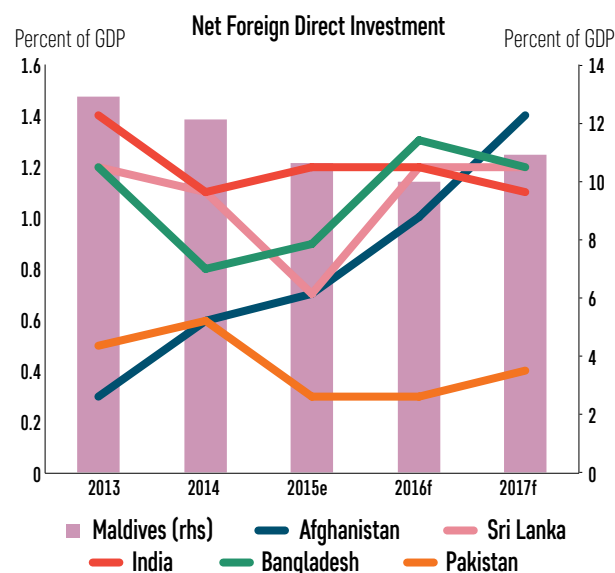


Source: World Bank DECPG

obligations and domestic policy uncertainty leading to net capital outflows. In Afghanistan, foreign aid inflows (security and civilian) have declined. Growing uncertainty around the political and security environment have triggered lower capital inflows while increased out-migration might have been associated with larger capital outflows. Pakistan also experienced a pronounced slowing in its already low net Foreign Direct Investment (FDI). However, Greenfield investments in the context of the China-Pakistan Economic Corridor could potentially reverse this trend. Bangladesh shows growing FDI flows, as does India mostly on account of being the “bright spot” among large emerging market economies. And yet, even in these cases, FDI inflows are very modest relative to GDP.

Major South Asian economies maintain adequate foreign exchange buffers.

The region as a whole saw its FX reserves slightly decline in January and February 2016, by 0.9 and 0.1 percent p/p. But this was from high starting points. In Bangladesh, gross international reserves reached USD 28 billion by end-February 2016, equivalent to 6.8 months of imports of goods and services. India had exceeded 10 months of import cover by end 2015, and Pakistan has reserves in excess of four months of imports of goods and services. Official reserves also increased in Maldives, from USD 368 million at the end of 2013 to USD 564 million at the end of 2015. However usable reserves (net of short-term foreign liabilities to the banking sector) representing only about 1.2 months of import cover.

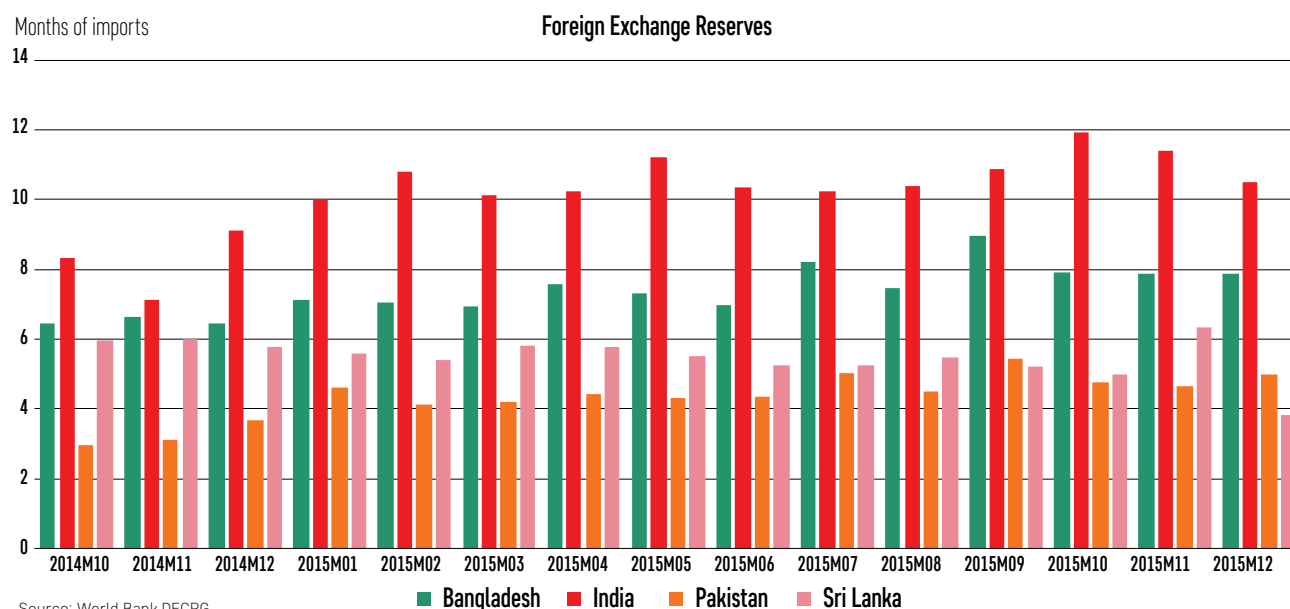


Source: World Bank MFM

Sri Lanka saw its official reserves decline. Large sales of foreign currency aimed at stabilizing the exchange rate led to a decrease in reserves from solid levels to an estimated 3.8 months of imports of goods and services by end-2015. This was in spite of higher-than-budgeted foreign borrowings and swap arrangements with the Reserve Bank of India. With over USD 4 billion of FX liabilities due in 2016, managing external balances has become one of the most immediate challenges for the country.



Figure 13: International reserves provide policy space across most of South Asia

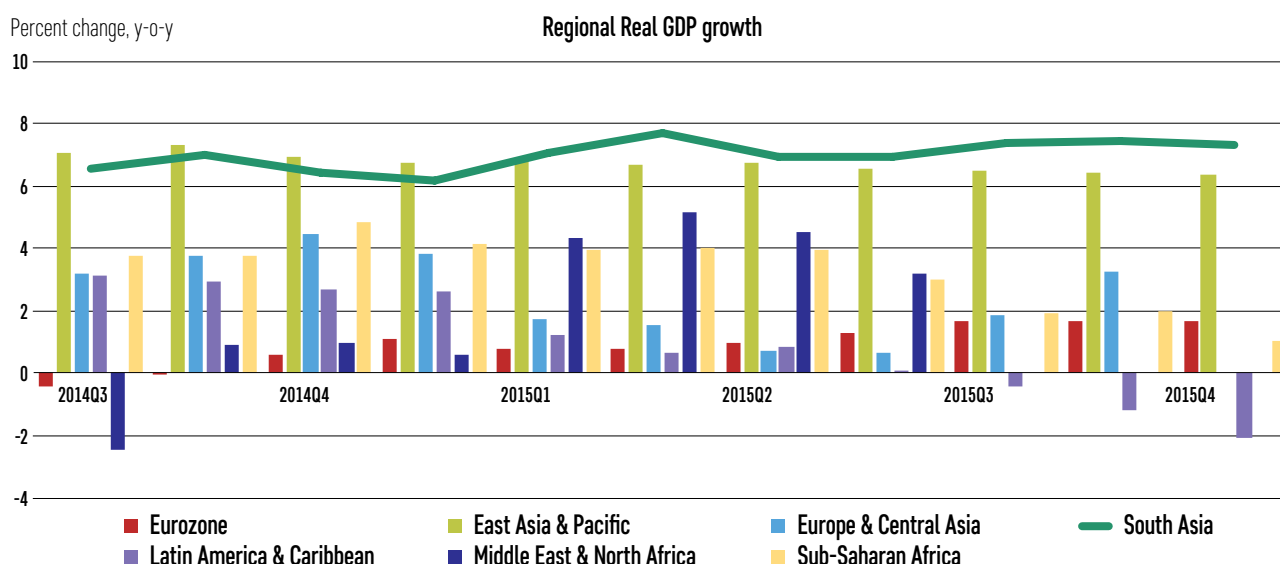


South Asia's growth continues to be the fastest across regions

South Asia completes the calendar year 2015 as the fastest growing region in the world. Real GDP growth was well above 7 percent y-o-y for 2015Q2-Q4, solidifying South Asia's top spot among developing regions. East Asia and Pacific remains a very solid second, with 6.4 percent GDP growth in 2015Q4. But this performance is on a gradually declining trend due to the ongoing rebalancing of the Chinese economy.

India, the bright spot among large emerging markets, remains the leading force for sustained regional growth. While China's growth slowdown is associated with its transition towards a more consumption-based development model, India's sustained growth is also happening on the back of strong private consumption. However, India's fixed investment also accelerated to 5.2 percent during the first 9 months of FY2016, up from an FY2013-14 average of 4.1 percent. The acceleration was driven mainly by public investment. From a sectorial perspective most growth is happening in services, although agriculture

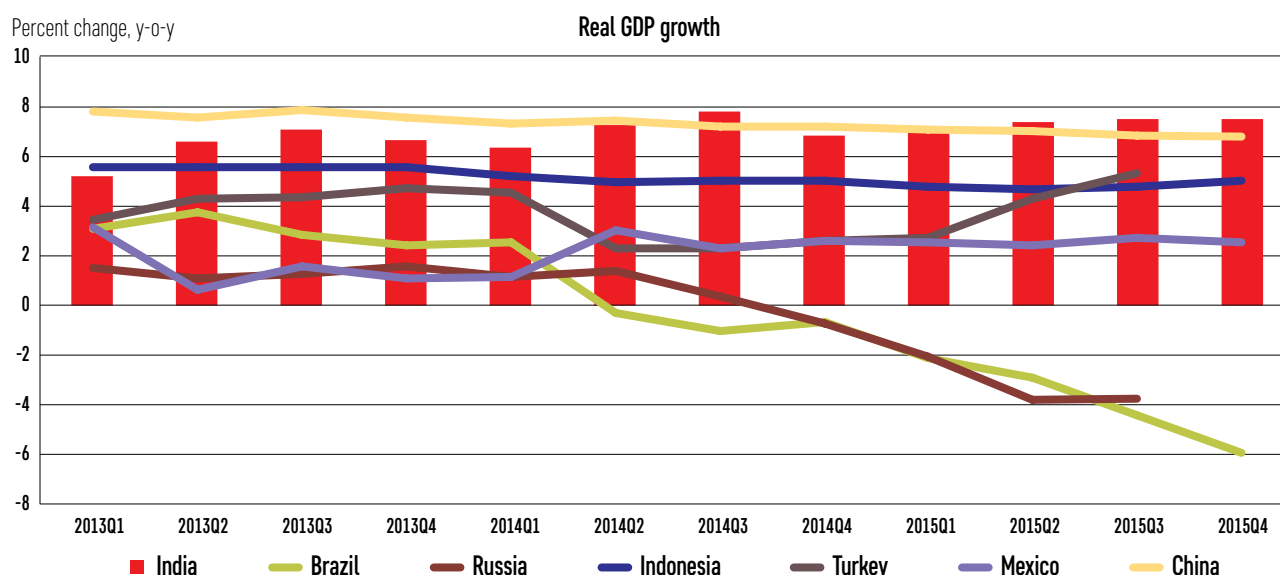
Figure 14: South Asia consolidates its position as the top regional growth performer



Source: World Bank DECPG



Figure 15: India has become the fastest-growing large economy



is expected to rebound if the year 2016 delivers a normal monsoon. Overall, India's real GDP growth for FY2015 is estimated at 7.4 percent. A continuation of this solid performance requires strong private investment, on the back of an expected push in infrastructure spending, an improved investment climate, and less leveraged corporate and financial balance sheets.

Across most of South Asia, government consumption is a key driver of growth. In Bangladesh, government consumption expenditure is projected to grow by 20 percent reflecting the implementation of a pay

increase the nearly doubles the salaries of government employees. With an estimated 16 percent change for 2015, Pakistan also relies heavily on public consumption expenditure for growth. Sri Lanka witnessed a marginal deceleration of growth in 2015 due to slowing construction activity, as the new government was reassessing the previous construction-based development model. But in spite of the slowdown, government consumption expanded by 10.3 percent, remaining a major driver of growth. Afghanistan is an outlier, as domestic demand shows little signs of pick up. Bhutan is also an outlier, as rapid growth is largely driven by

Figure 16: There is no clear trend in industrial production, except lack of momentum

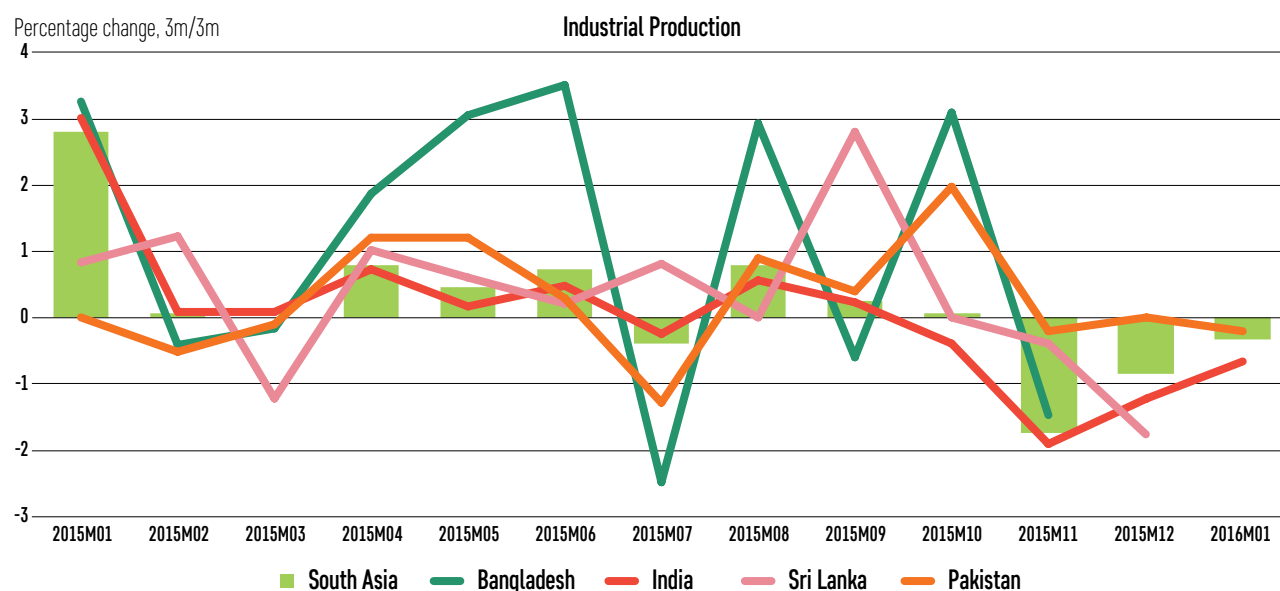
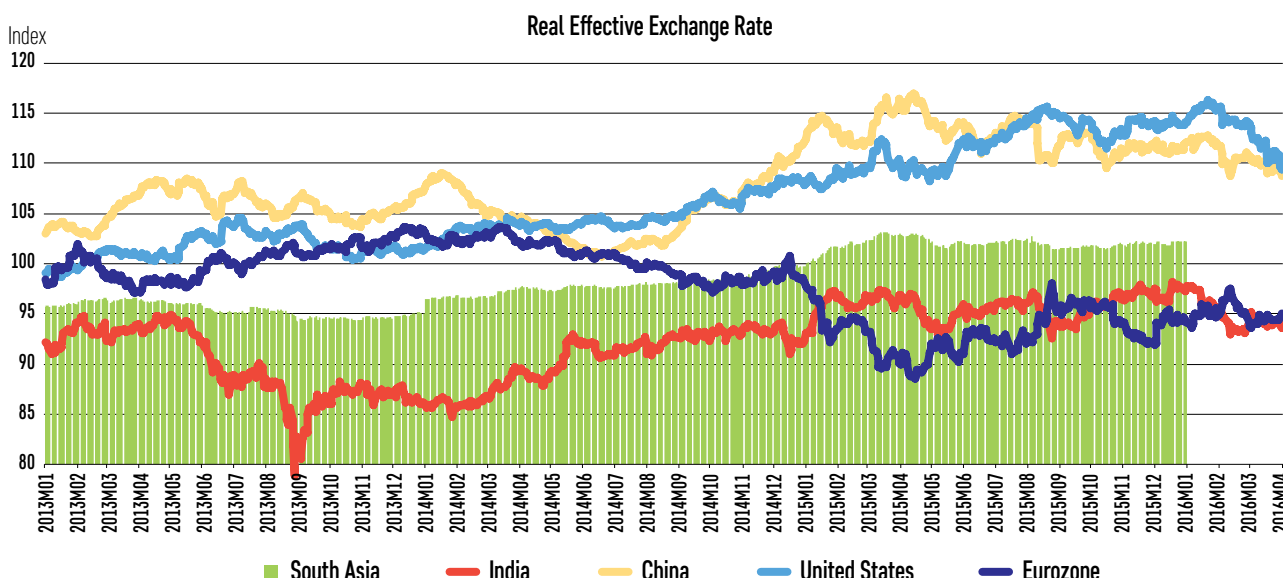


Figure 17: No major competitiveness dividends are to be expected in South Asia



Source: Haver (JP Morgan), World Bank

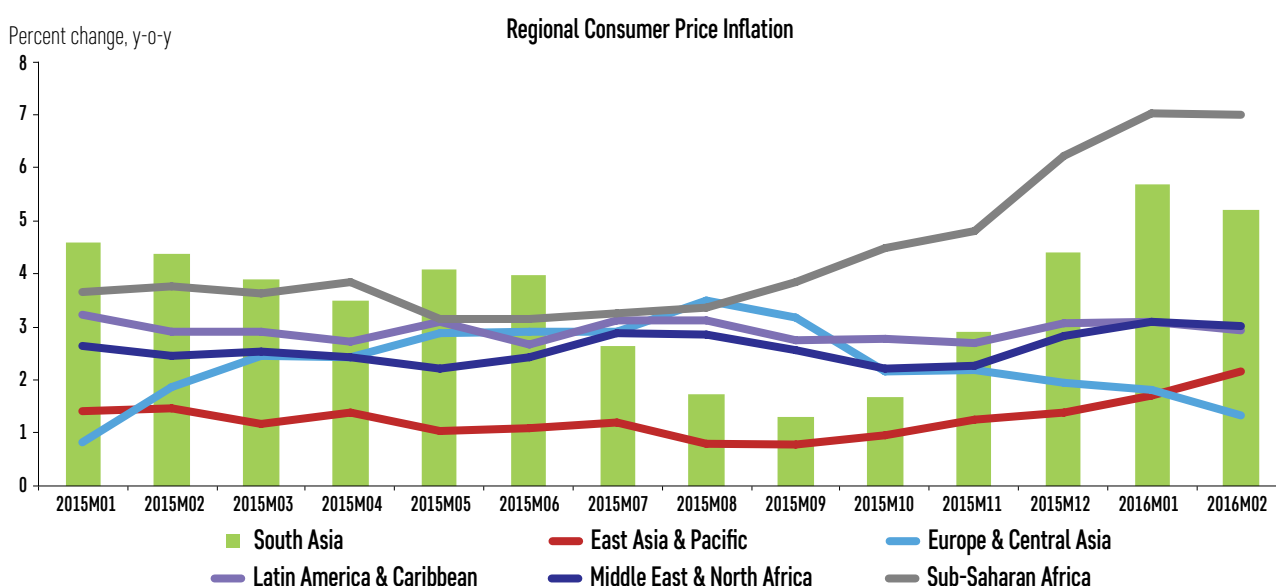
hydropower investment. But even there government consumption notes an estimated 13.6 percent growth rate for FY2014-15.

Growth in industrial production is volatile and shows little momentum. Market sentiment is often measured through Purchasing Managers' Indices (PMI), with expansion expected when the PMI is above 50. On this basis, markets remain slightly optimistic for India, while industrial production generally lacks dynamism across the rest of South Asia. An exception is Pakistan, where the outlook is slightly more positive

on the back of large-scale manufacturing and construction activities driven by CPEC infrastructure and energy projects.

South Asia's real effective exchange rate has not delivered any significant competitiveness effects in 2015. Even more so, since the US Federal Reserve Bank has signaled a more gradual approach to its rate hiking cycle and monetary policy in Europe and Japan has stayed extremely loose, emerging market currencies have posted a record gain vis-à-vis the US Dollar in March 2016.

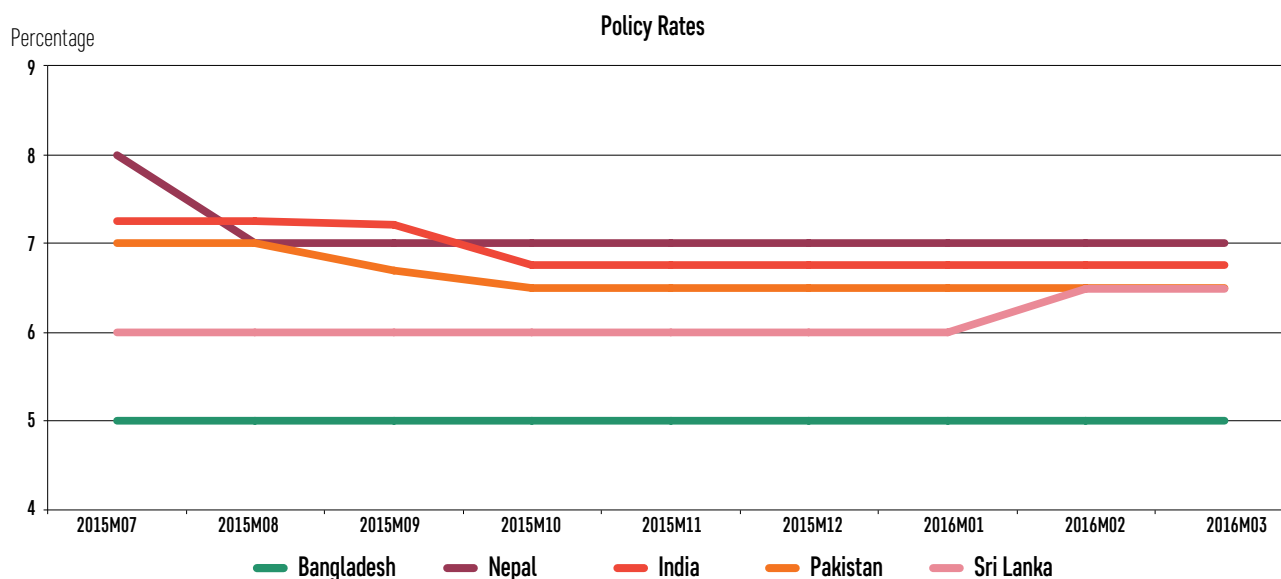
Figure 18: South Asian consumer price inflation is accelerating again



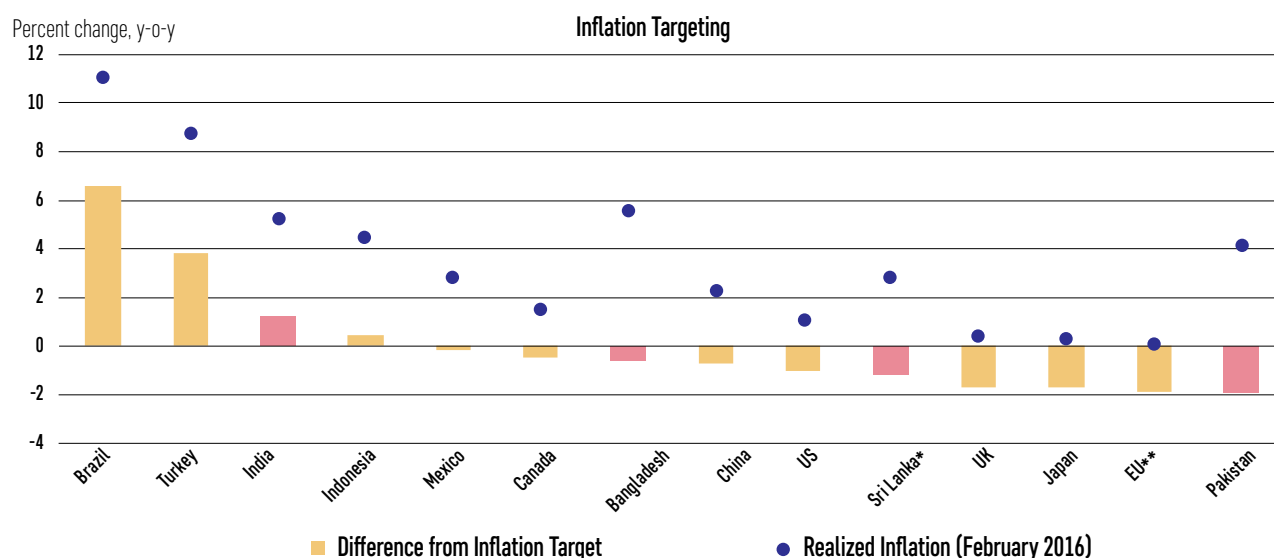
Source: World Bank DECPG



Figure 19: Interest rates are stable and further monetary policy easing is becoming less likely



Source: Haver (National Central Banks/IMF)



Notes: * latest available data is for December 2015; ** HICP (2015 = 100)
Source: World Bank DECPG, Eurostat, Haver (National Central Banks), World Bank Staff Calculations.

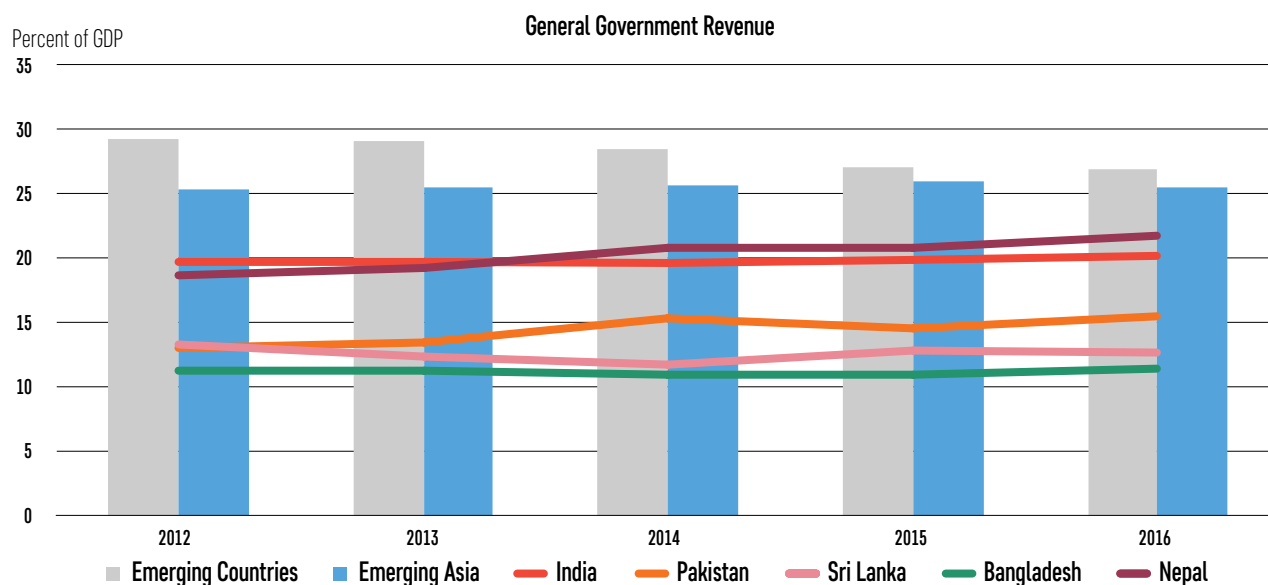
Inflation has come down a long way, but has it come to stay?

Inflation appears to have bottomed out and shows recent signs of pick up. Between mid-2014 and 15, South Asia went through an impressive and steady transition from being the region with highest consumer price inflation to being among the lowest. This move has mostly been supported by low commodity and food prices. However, since September 2015, the regional Consumer Price Index (CPI) has started to pick up again. The tendency may gain more momentum in case oil prices start increasing again and the expected strong El Niño leads to higher food prices.

After a year that saw some monetary easing, a more cautionary policy stance on inflation may follow. While monetary policy remains highly constrained in major advanced economies, South Asia broadly maintains some policy space. During a favorable year 2015, central banks in India, Pakistan, and Bangladesh have been on their way to successfully meet their policy targets. The Reserve Bank of India (RBI) took advantage of low inflation to cut interest rates further as recently as April 2016. However, the recent acceleration in headline inflation warrants careful monitoring in a region with a history of high prices. Somewhat owing to exceptional circumstances, Sri Lanka already took steps towards tightening monetary



Figure 20: Revenue generation across South Asia remains among the lowest globally



policy in late 2015, by allowing greater exchange rate flexibility and curbing growth in private credit. Policy rates were ultimately increased in February 2016, for the first time in almost four years.

Fiscal policy remains constrained

Progress in boosting government revenues is slow.

Relative to GDP, revenue generation and collection is well below emerging market or peer standards in most of the region. This should not come as a surprise in a conflict-affected country like Afghanistan, but it is also happening in fast-growing Bangladesh and in

relatively wealthier Sri Lanka. Government revenue is also relatively low in Pakistan. There is agreement that reforms geared at increasing the tax base and improving tax administration are a priority across the region. Tax collection in particular remains well below estimates or targets across most South Asian economies. On a positive note, fiscal indicators have recently improved in Afghanistan, where after a drop of 8.5 percent in 2014, revenues increased by 22 percent in 2015, amounting to 10.6 percent of GDP.

Fiscal consolidation is gradual, and much of the heavy lifting is done on the expenditure side.

Overall, South Asia displays one of the largest fiscal

Figure 21: Fiscal deficits across South Asia are decreasing only gradually, if at all

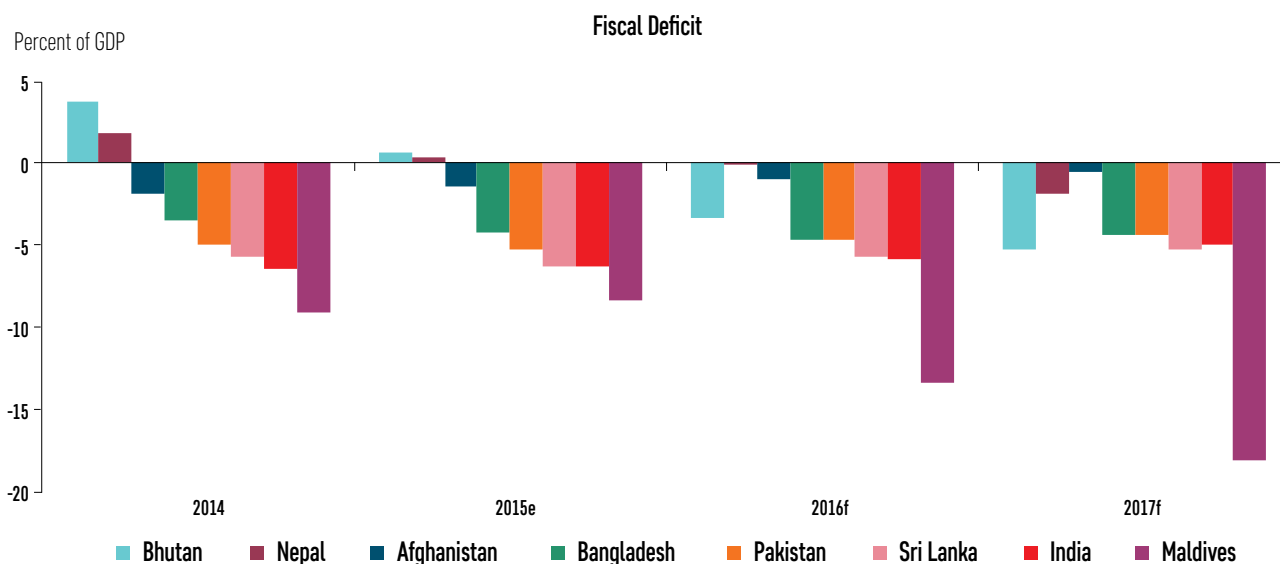
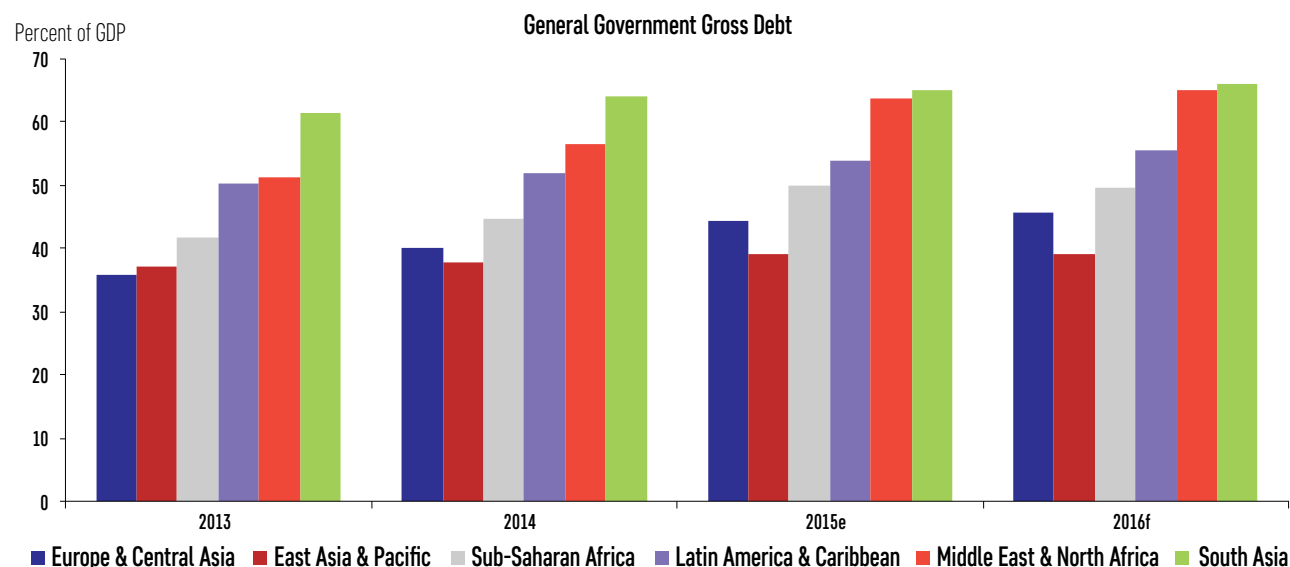
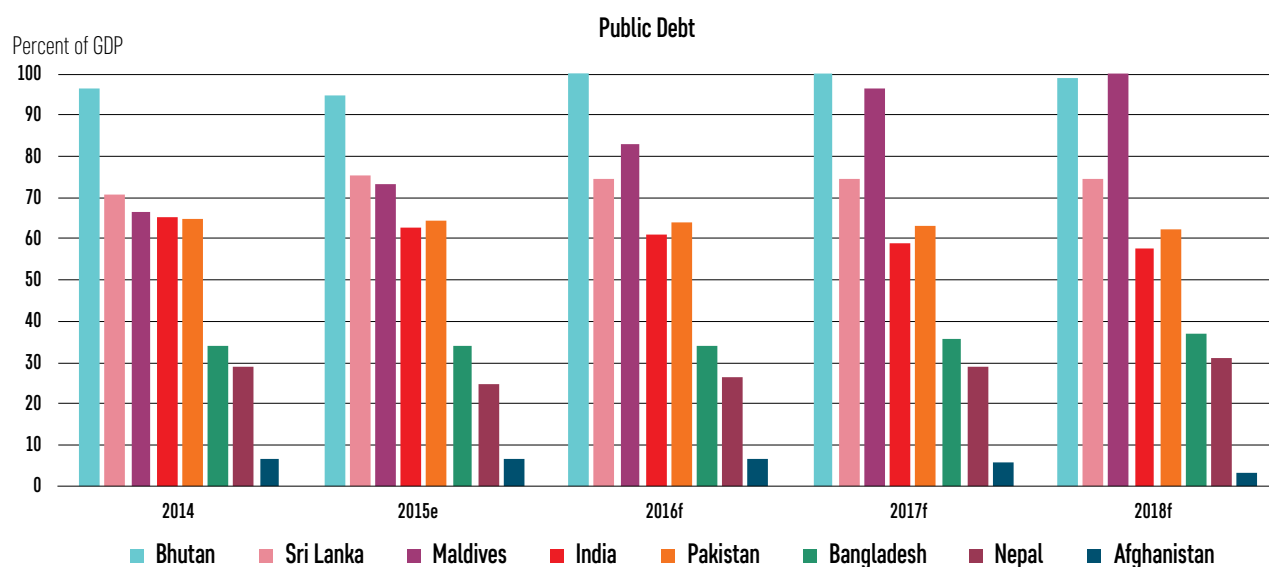


Figure 22: South Asia's debt-to-GDP ratio is set to remain the highest among developing regions.



Source: IMF WEO, World Bank Staff calculations

Figure 23: South Asia's debt-to-GDP ratio is set to remain the highest among developing regions.



Source: World Bank MFM

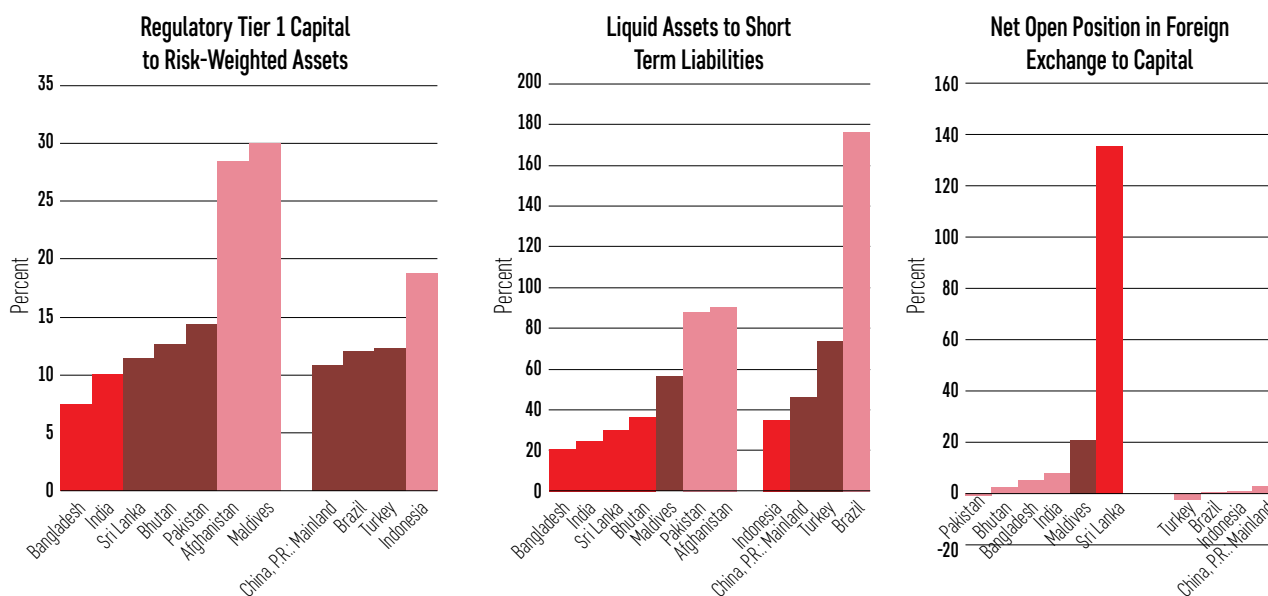
deficits across all regions. With slow-growing revenue, reducing fiscal deficits requires containment with the expenditure side. This is particularly challenging in a context where government consumption has been an important driver of GDP growth in recent years. Against this backdrop, many South Asian countries are delivering a gradual fiscal consolidation at best.

South Asia also displays the highest ratio of government debt to GDP among developing regions. On aggregate, the ratio is estimated at 65 percent in 2015

and forecast to slightly increase to around 66 percent in 2016. This debt level is not immediately threatening and countries in the region generally face a low risk of debt distress. But current trends are a reminder of the difficulty countries face to turn the wheel around on debt. This is despite financial repression generally allowing governments to place public debt at low cost. Public debt is particularly high in Sri Lanka, where large primary deficits, rising real interest rates and exchange rate depreciation have increased its volume from 70.7 percent of GDP in 2014 to an estimated 75.2 in 2015.



Figure 24: Financial sector risks persist across South Asia and may interact with fiscal risks in unfavorable ways



Source: IMF FSI

Maldives and Bhutan remain the odd “debt twins”.

As has often been observed, both countries exhibit large ratios of public debt to GDP, which on the surface makes them more vulnerable to external shocks. Yet, the underlying fiscal situations are very different. In Bhutan, public debt is associated with viable investments in the hydro power sector, which are adequately financed. Fiscal deficits have been contained over the last years, as new hydropower generation investments come on stream. Furthermore, both electricity exports and external debt are denominated in Indian rupees, mitigating currency risks. On the other hand, Maldives’ large medium-term public investment program from 2016 along with rising recurrent public expenditure will lead to rapidly increasing external and public debt, putting the sustainability of its debt burden at risk. The country continues to face vulnerabilities due to its high dependence on potentially volatile tourism revenues.

Besides budgets, financial systems remain potential weak spots

Some South Asian financial systems remain a source of downside risk. Owing to significant financial repression, the balance sheets of South Asian banks hold significant amounts of government debt. Fiscal vulnerabilities and sudden repricing of sovereign

risk could thus adversely impact the soundness of South Asia’s financial systems, in particular those with lower capital buffers and low cash reserves. Bangladesh, India, and possibly Sri Lanka fall in this category. Because some banking systems in the region show significant government ownership, financial sector risks can also amplify fiscal risks. This is what happens when state-owned banks need to be recapitalized—as was recently the case in Sri Lanka, India, Bangladesh, and Nepal. This feedback loop is particularly relevant for countries with weak governance of state owned banks.

Even more so, demand for increasing investment financing will be vulnerable to financial sector weakness. Future growth performance in many South Asian economies – notably India - will strongly rely upon investment growth. While public investment can set the stage, private investment will eventually have to take over. Additional equity financing will be critical for India’s heavily leveraged corporate sector as well as its banks, which also need to become more resilient and efficient. In Bangladesh, addressing financial sector weakness is a central challenge. In particular, weak bank balance sheets – especially for state owned banks – continue to limit lending capacity, divert credit away from productive investments and ultimately curb economic growth.









Outlook

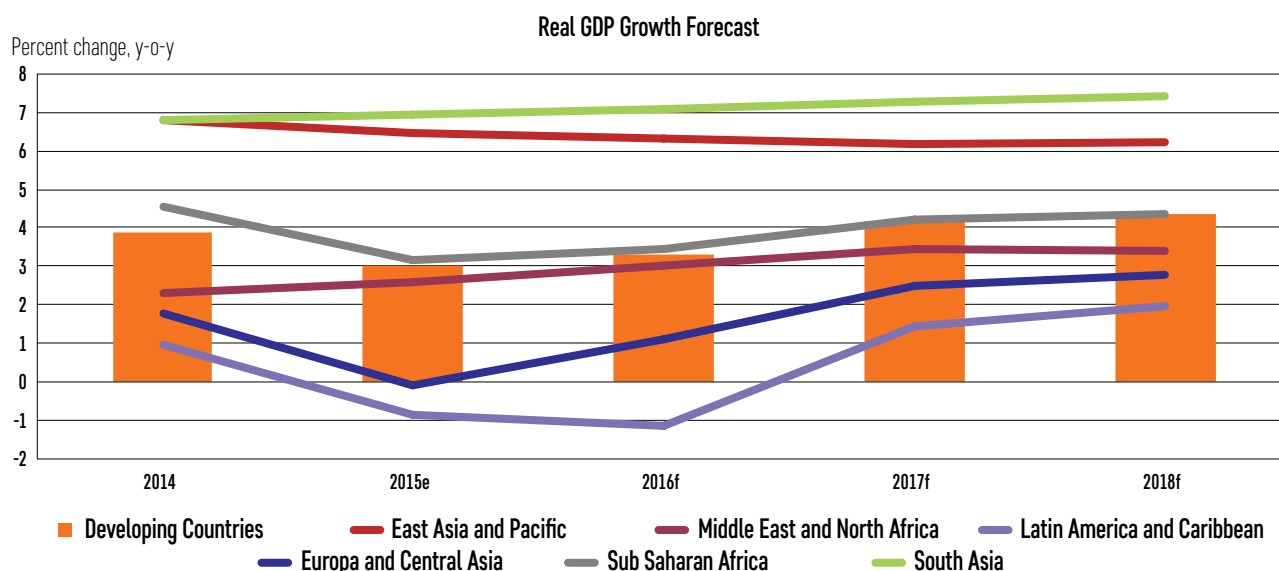
Despite a less favorable global environment, South Asia will consolidate its position as the fastest growing developing region. A gradual acceleration of growth can even be expected. However, the growth path will not be as strong as previously anticipated, owing to the fading tailwinds. Domestic consumption will remain the main driver of growth, but private investment will pick up. Export growth will recover from negative territory, but will remain subdued. India will remain the motor of the region, growing at close to 8 percent. Performance will also strengthen in most other countries in the region, but drivers and challenges may differ.

South Asia's gradual growth acceleration continues

South Asia is set to maintain real GDP growth above 7 percent over the next years. This solid performance puts South Asia increasingly ahead of other developing regions, especially as they face situations ranging from orderly slowdown to outright crisis. Given its weight in regional GDP, India's sustained growth ensures a relatively smooth and stable outlook for the region as a whole. But the upward trend is truly regional, as most other South Asian countries will also be experiencing faster economic growth.



Figure 25: South Asian growth set to stay in the lead



With a stable external situation, growth will be driven by strong domestic demand. Export growth is expected to pick up, but it will be a less important contributor overall. In 2015 the fastest growing component of aggregate demand was government consumption, which expanded by 9.7 percent. Going forward, gross fixed capital formation will take the leading spot, reaching 8.1 percent growth in 2017. Export growth is also expected to increase, from the doldrums. It was almost a negative 3 percent in 2015, but will rebound to 2.7 percent in 2016 and reach 5.9 percent in 2017.

A common upward trend across countries, but different challenges

While the outlook remains stable across South Asia, the underlying factors and challenges are very different. In Afghanistan growth is predicated on a stabilization of the security situation and strong economic management. Pakistan's performance depends on fiscal consolidation and improvements in key sectors, and especially in energy. Bangladesh also enjoys a stable forecast for 2016 at 6.3 percent. This is slightly below the previously estimated 6.5 percent,

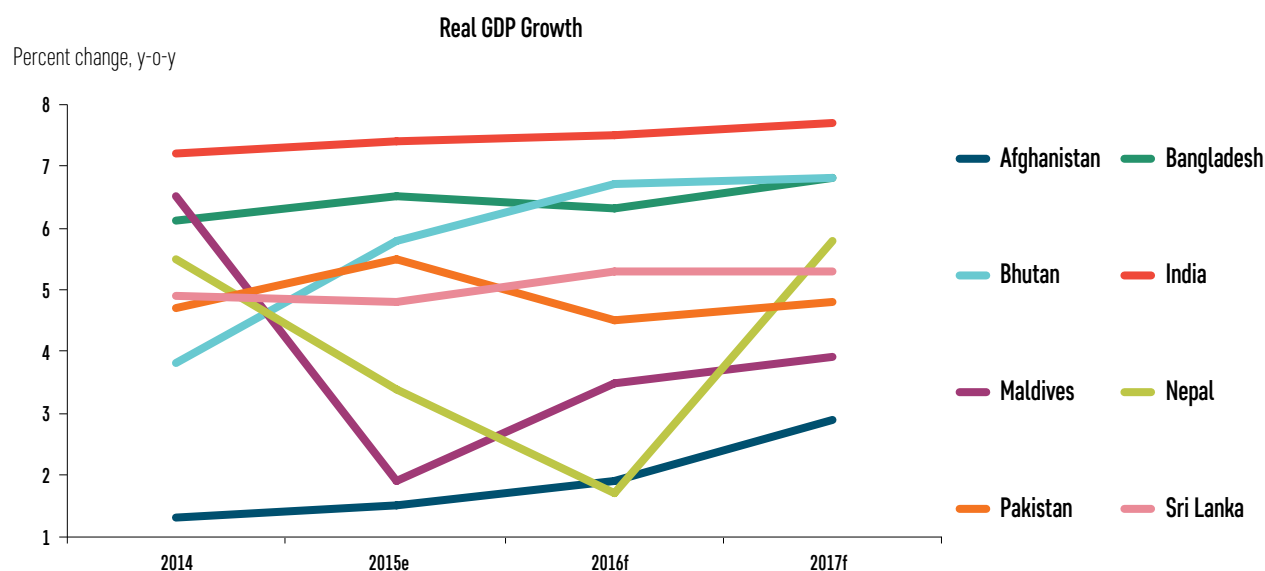
Table 1: Gradual acceleration of growth will need strong export recovery and solid investment pick up.

South Asia regional forecast summary (April 2016)						percentage point difference from January 2016 projections		
	2013	2014	2015e	2016f	2017f	2015e	2016f	2017f
Real GDP Growth (market prices)	6.1	6.8	7.0	7.1	7.3	0	-0.2	-0.2
Private Consumption	5.7	6.0	6.0	6.7	6.8	-0.5	0.1	0.5
Government Consumption	1.6	9.7	9.6	6.6	6.5	1.5	-0.9	-0.1
Gross Fixed Investment	3.9	4.7	6.9	6.9	8.1	2.2	-2.2	-3.3
Exports, GNFS	6.8	2.6	-2.9	2.7	5.9	-5.2	-1.3	0.9
Imports, GNFS	-2.4	0.7	-1.8	1.6	5.0	-3.4	-3	-0.8
Net exports, contribution to growth	2.6	0.4	-0.2	0.1	-0.1	-0.3	0.4	0.3

Source: World Bank



Figure 26: South Asian growth set to stay in the lead



Source: World Bank MFM

reflecting weaker private consumption expenditure than anticipated. India's economic activity is expected to gradually accelerate on the back of a rebound in agriculture as well as consumption stimulus from civil service pay increases. In the short run, strong domestic consumption should offset continued weakness in exports and investment. In the longer run, India's outlook rides upon the premise of public infrastructure investment crowding in private investment. Sri Lanka could grow as fast as 5.3 percent in 2016, but this relatively upbeat forecast is conditional on sustained macroeconomic stability.

In Nepal two major shocks shaved off a significant portion of expected growth in 2015.

The devastating earthquakes of April and May 2015, as well as significant cross-border trade disruptions in the second half of the calendar year, imposed a severe toll on economic activity. GDP growth is expected to slow to 1.7 percent in FY2016. Only the following fiscal year is the economy to see a recovery on the back of strong reconstruction activity. In the near term Nepal will also have to face higher inflation as a result of the trade disruptions and related supply bottlenecks. Another challenge is the potential slowing down of remittance flows, which represent around 30 percent of GDP.

Political risk factors persist across South Asia

Political risk and uncertainty continue to affect the region's performance. In Afghanistan, persisting uncertainty around the security and political

Table 2: Across most of the region a gradual acceleration of growth can be expected

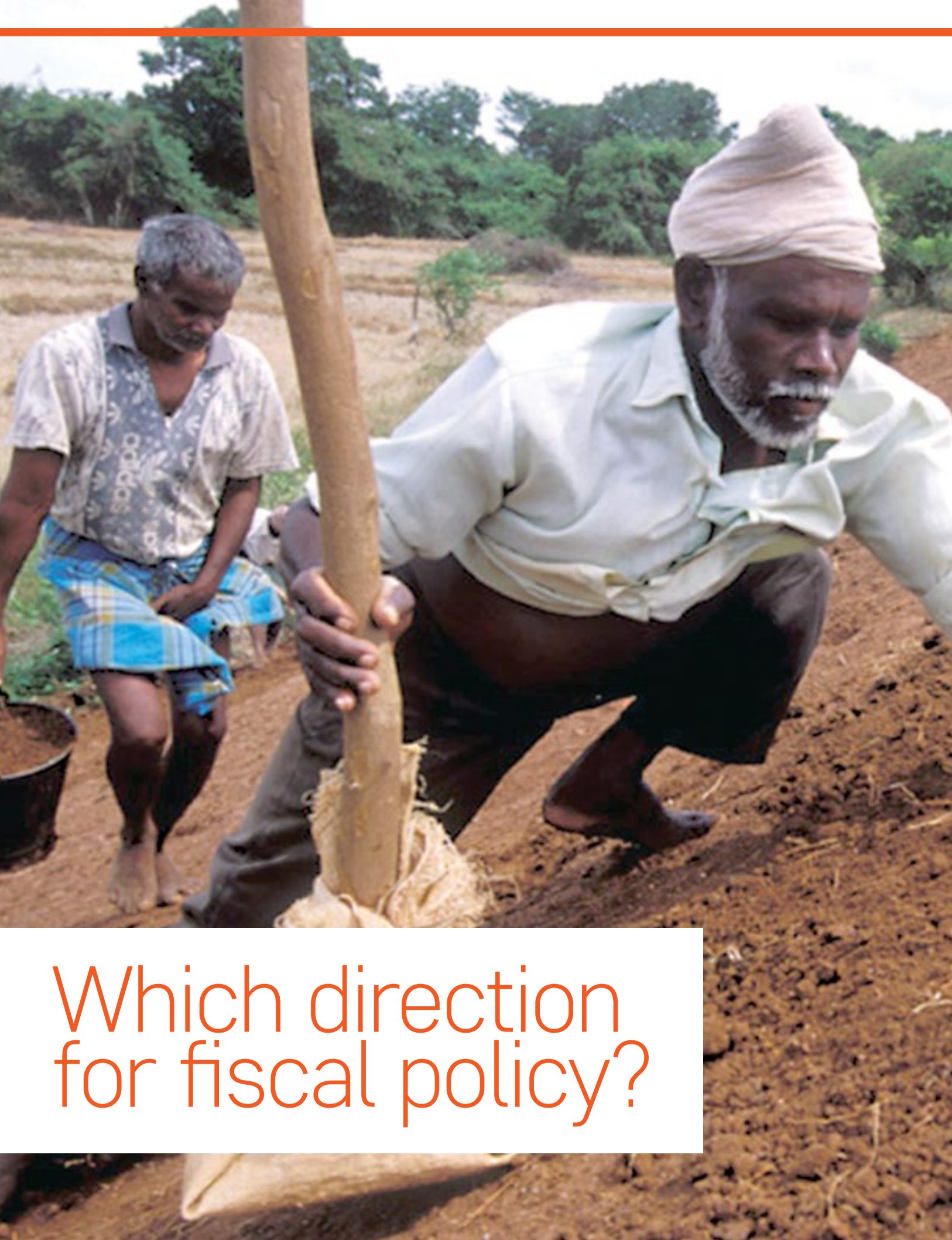
	2014	2015e	2016f	2017f
Afghanistan	1.3	1.5	1.9	2.9
Bangladesh	6.1	6.5	6.3	6.8
Bhutan	3.8	5.8	6.7	6.8
India	7.2	7.4	7.5	7.7
Maldives	6.5	1.9	3.5	3.9
Nepal	5.5	3.4	1.7	5.8
Pakistan	4.7	5.5	4.5	4.8
Sri Lanka	4.9	4.8	5.3	5.3

Source: World Bank MFM

Note: Real GDP growth at market prices (Fiscal Years)

environment has hindered business activities and overall domestic demand. In Nepal, the final months of Nepal's constitutional process have triggered a series of violent protests, strikes, deaths and severe economic and trade disruptions between August and December 2015. Maldives faces continued political turmoil, a factor that is not particularly conducive for a tourism-dependent economy. While politically stable at the moment, both Pakistan and Bangladesh have to continuously deal with terrorism and security threats posing severe risk. In Pakistan CPEC could be a game changer, but the initiative faces political economy risks. For the corridor delivers on its potential, the government will need to address concerns and build consensus among all stakeholders. In sum, South Asia will need continued stability and security to realize its full potential.





Which direction
for fiscal policy?



As the global economy slows down, and some of the tailwinds that had helped South Asia rebound start fading, the overall policy stance at the national level may warrant reconsideration. The region is shielded by relative external stability, and the authorities enjoy some monetary policy space thanks to rebuilt buffers. Together with the gradual acceleration of growth, these are favorable circumstances to continue with the fiscal consolidation the region has undergone in recent years. Consolidation is necessary because South Asia has among the highest fiscal deficits across all regions, together with the highest levels of public debt relative to GDP.

But there could be obstacles on the road to further consolidation. A potential decline in remittances to the region, higher oil prices in international markets, and lower capital inflows could affect aggregate demand and call for a more accommodating fiscal policy stance. Fading tailwinds could also create pressures to increase subsidies and transfers, thus undermining some of the progress accomplished so far. As the authorities steer their economies through a turbulent global environment in the coming years, they will need clarity on the implications of the fiscal choices they make.

The level of government spending and the fiscal deficit have an impact on aggregate demand. Depending on how they are adjusted they can stabilize the economy or amplify its fluctuations. The composition of government spending matters as well. In



Figure 27: South Asia has steadily reduced its fiscal deficit

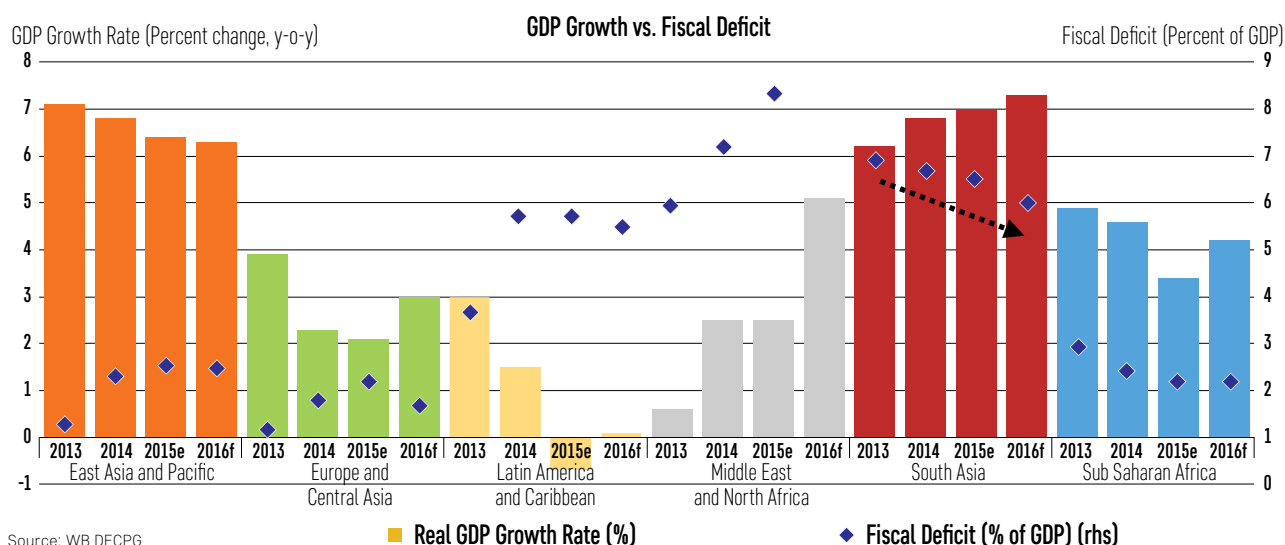
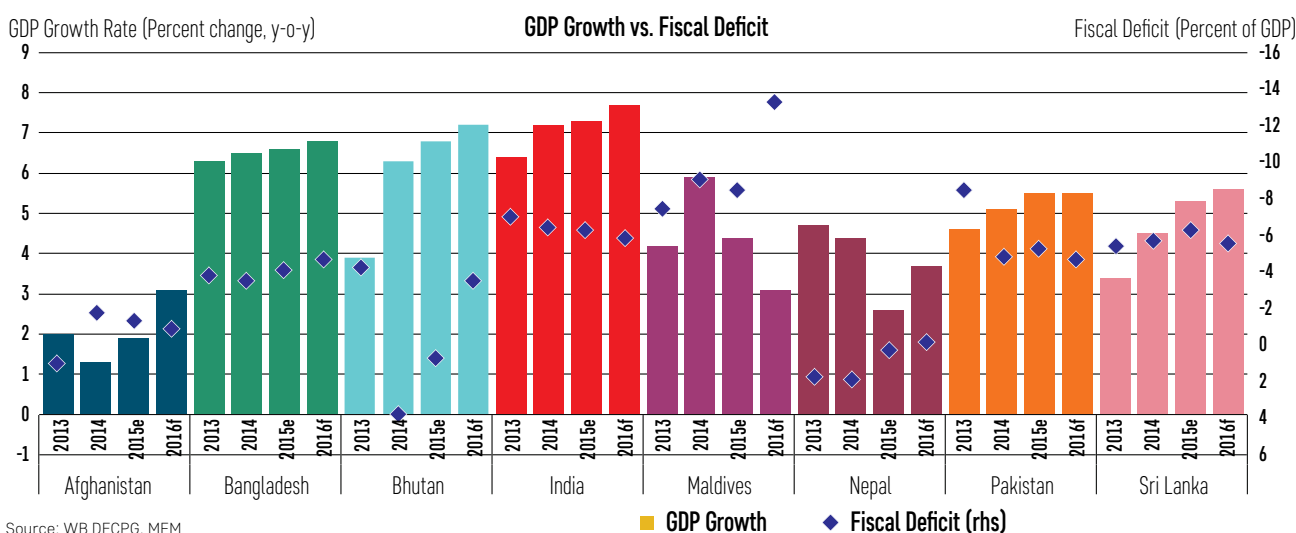


Figure 28: Much of the recent fiscal consolidation happened in India



countries with dramatic infrastructure shortages, capital expenditures are especially important for growth. The structure of government expenditures also matters for equity. Spending in basic services generally is progressive, while some subsidies predicated on equity considerations can be regressive. The same can be said of the structure of government revenue, with direct taxes being generally more progressive than indirect ones. Last but not least, fiscal choices also matter for sustainability. Subsidizing energy consumption leads to larger emissions, whereas explicit or implicit carbon taxation makes producers and consumers internalize the impact of their decisions on the environment.

The recent experience of South Asian countries is informative about their performance on each of these fronts – stability, growth, equity and

sustainability. In fact, it is possible to build a scorecard identifying the stronger and weaker points of each of the four largest economies in the region. This kind of information is potentially useful when thinking about the fiscal policy stance and the quality of fiscal adjustment going forward.

South Asia is on a path to fiscal consolidation

Fiscal deficits in South Asia are among the largest in the world but they have been declining steadily. There are no clear trends in the case of East Asia and the Pacific or Europe and Central Asia, two regions with moderate fiscal deficits in recent years. On the other hand, deficits have skyrocketed



in Latin American and the Caribbean, and even more so in the Middle East and North Africa. These two regions are among the most severely affected by the recent decline in commodity prices, with the collapse in oil prices particularly affecting the latter. Sub-Saharan Africa is the only other region displaying a strong trend towards fiscal consolidation, and this from much lower fiscal deficit levels than South Asia. However, given the importance of natural resources in Sub Saharan Africa's exports, this trend could soon be reversed.

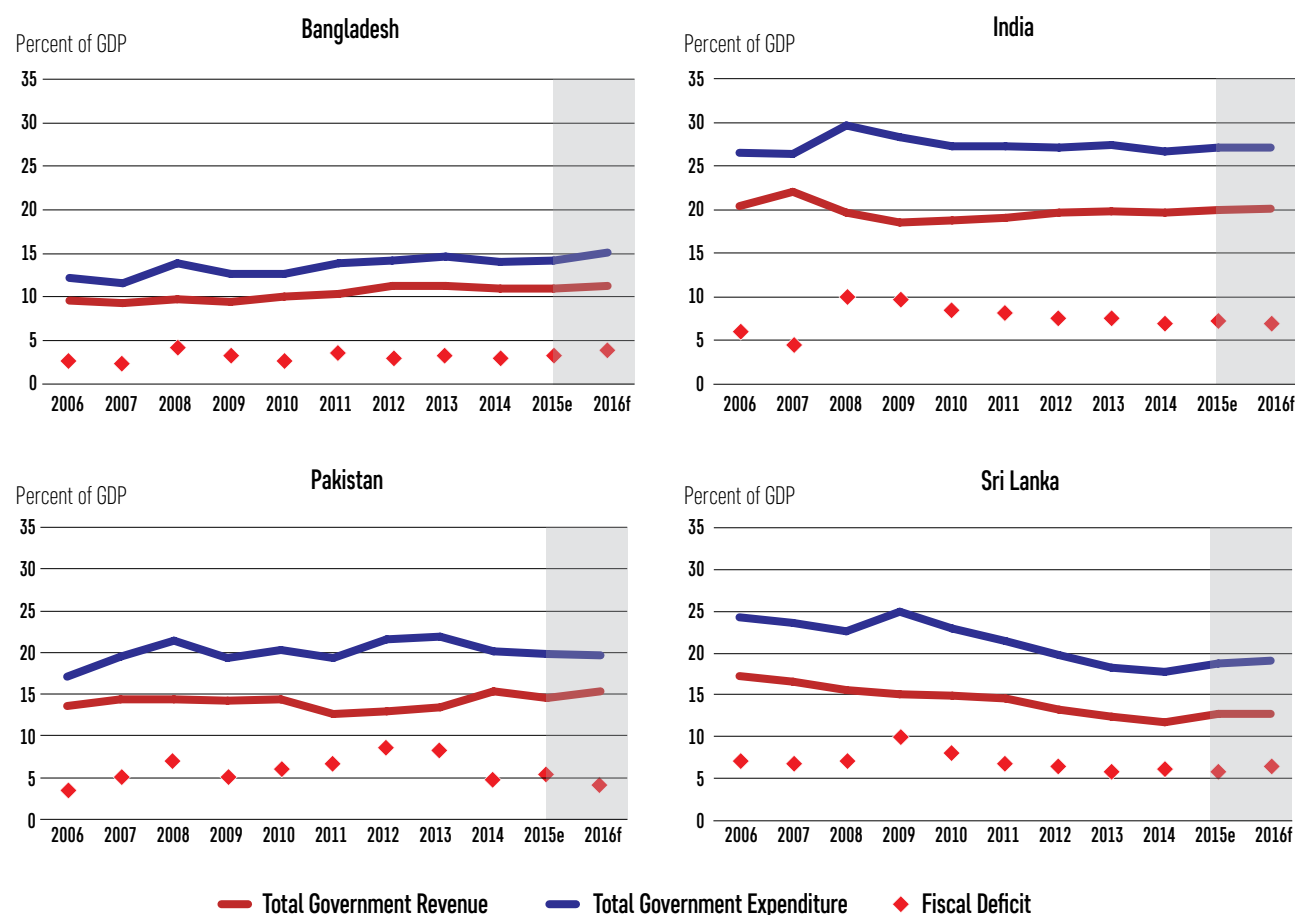
Fiscal consolidation has been embraced by successive governments in India, while other countries in the region had a more mixed performance. When compared to the aftermath of the global crisis, most South Asian economies have managed to reduce their fiscal deficits substantially, though not always back to pre-crisis levels. India and Sri Lanka exhibit the most consistent consolidation paths over time, although fiscal risks have increased in Sri Lanka recently. Pakistan experienced a major fiscal adjustment in 2014, in the context of an IMF-supported program. Interestingly,

the lowest levels of fiscal deficit in the region can be found in a fragile and conflict-affected state (Afghanistan) and in a post-conflict country (Nepal). At the other end, the largest level and potentially the sharpest deterioration of fiscal deficits are associated with Maldives, the country with the highest GDP per capita in the region.

Fiscal policy can contribute to macroeconomic stability

With government revenue generally changing slowly, the fiscal stance is often driven by government expenditures. Sales of government assets and drives to reduce tax avoidance can lead to surges in revenue, but this is more the exception than the rule. The largest economies in the region display a relative stability in the ratio of government revenue to GDP, even when considering an entire decade. Cross-country evidence would lead to expect this ratio to increase with GDP per capita, but this has barely been the case. Relative to their GDP per capita, India has a

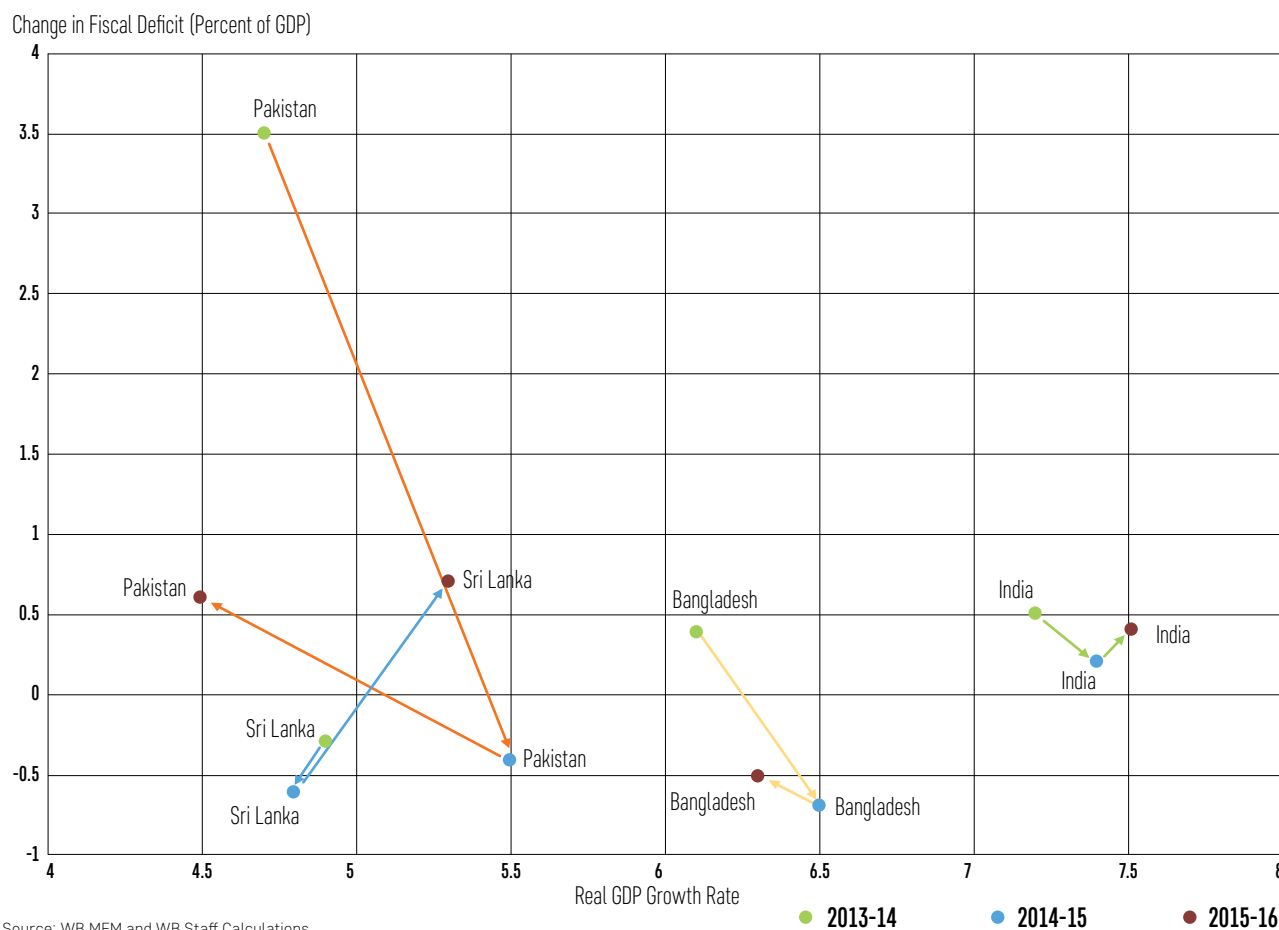
Figure 29: Government revenue has increased very slowly relative to GDP, if at all



Source: IMF WEO



Figure 30: Fiscal balances generally improved and are expected to continue doing so



Source: WB MFM and WB Staff Calculations

Note: A positive value on the y-axis implies a reduction in the fiscal deficit. Points correspond to the respective fiscal years in each country.

level of government revenue commensurate with that of peers, whereas Bangladesh, Pakistan and especially Sri Lanka are considerably below what could be predicted. Sri Lanka is the most striking case, as revenue has actually declined relative to GDP, despite rapid economic growth.

In recent years the fiscal position of the largest economies in the region has improved, or at least has not deteriorated. The biggest change in the fiscal balance was in Pakistan, where it reached almost 3.5 percent of GDP in 2013-14. Most other annual changes were in the range of -0.5 to 1.0 percent of GDP, reflecting relative stability. Interestingly, changes in the fiscal balance did not always operate as macroeconomic stabilizers. Ideally, fiscal deficits should increase when the GDP growth rate decelerates and increase when it decelerates. For instance, between 2013-14 and 2014-15 both Bangladesh and Pakistan saw their GDP growth rate increase by 0.5 percentage points. Yet, during this period both countries went from an improvement in their fiscal balance to a deterioration.

In the short term, fiscal policy in the region does not appear to be clearly pro-cyclical or counter-cyclical.

With relatively stable government revenue, a counter-cyclical stance would require decreasing government expenditures relative to GDP when economic growth accelerates, and reducing expenditures when it decelerates. In terms of figure 31, arrows should display a negative slope for the policy stance to be counter-cyclical. Yet, almost half of the arrows (and especially those related to Sri Lanka) have a positive slope.

When considering longer periods of time, some countries in the region have a clearly counter-cyclical fiscal policy, while others do not.

A couple of years of data may not be enough to identify which countries fall in which group, but a look at longer time periods is revealing. A widely used statistical approach to assess the fiscal policy stance of a country distinguishes between the trend in a country's GDP and the fluctuations around this trend. A counter-cyclical fiscal policy stance should be reflected in larger government spending when GDP is below its trend, and lower spending when GDP is above trend.



Figure 31: Recent changes in government expenditures have been largely independent of the GDP growth rate

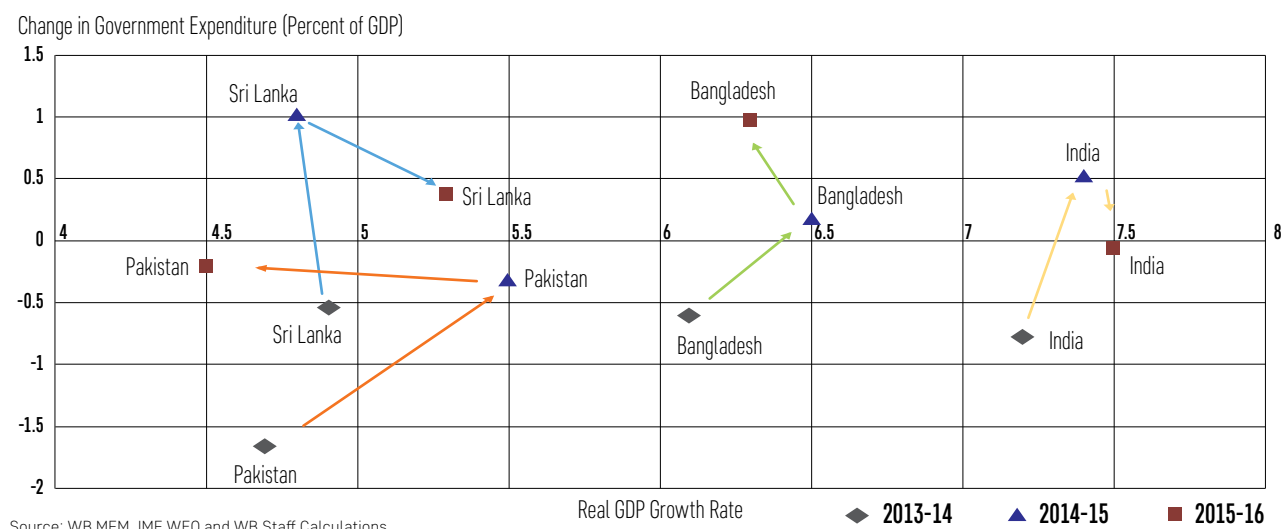
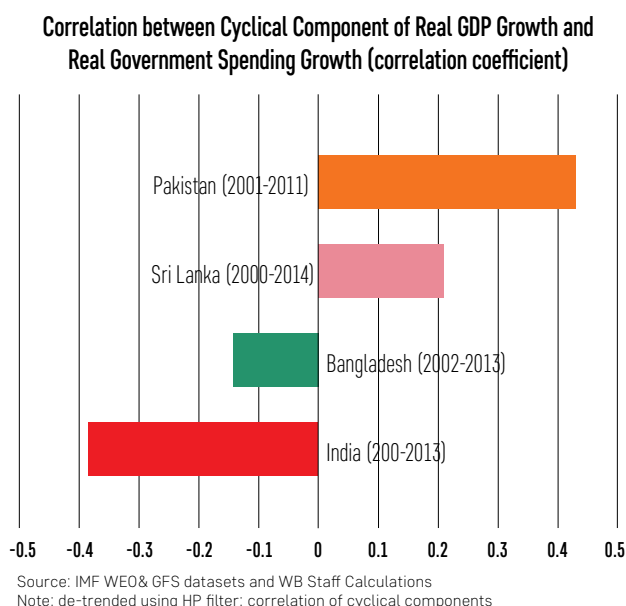


Figure 32: In India and Bangladesh the fiscal policy stance has contributed to macroeconomic stability



The correlation between the two variables can be estimated, and its statistical significance assessed, using time series. Conventional wisdom is that relatively poor countries tend to have pro-cyclical fiscal policies, amplifying fluctuations and making them more prone to crises, whereas richer countries are better able to counter short-term shocks and stabilize the economy. The story in South Asia is more complex though.

Fiscal policy has been counter-cyclical in Bangladesh and India, but largely pro-cyclical in Pakistan and

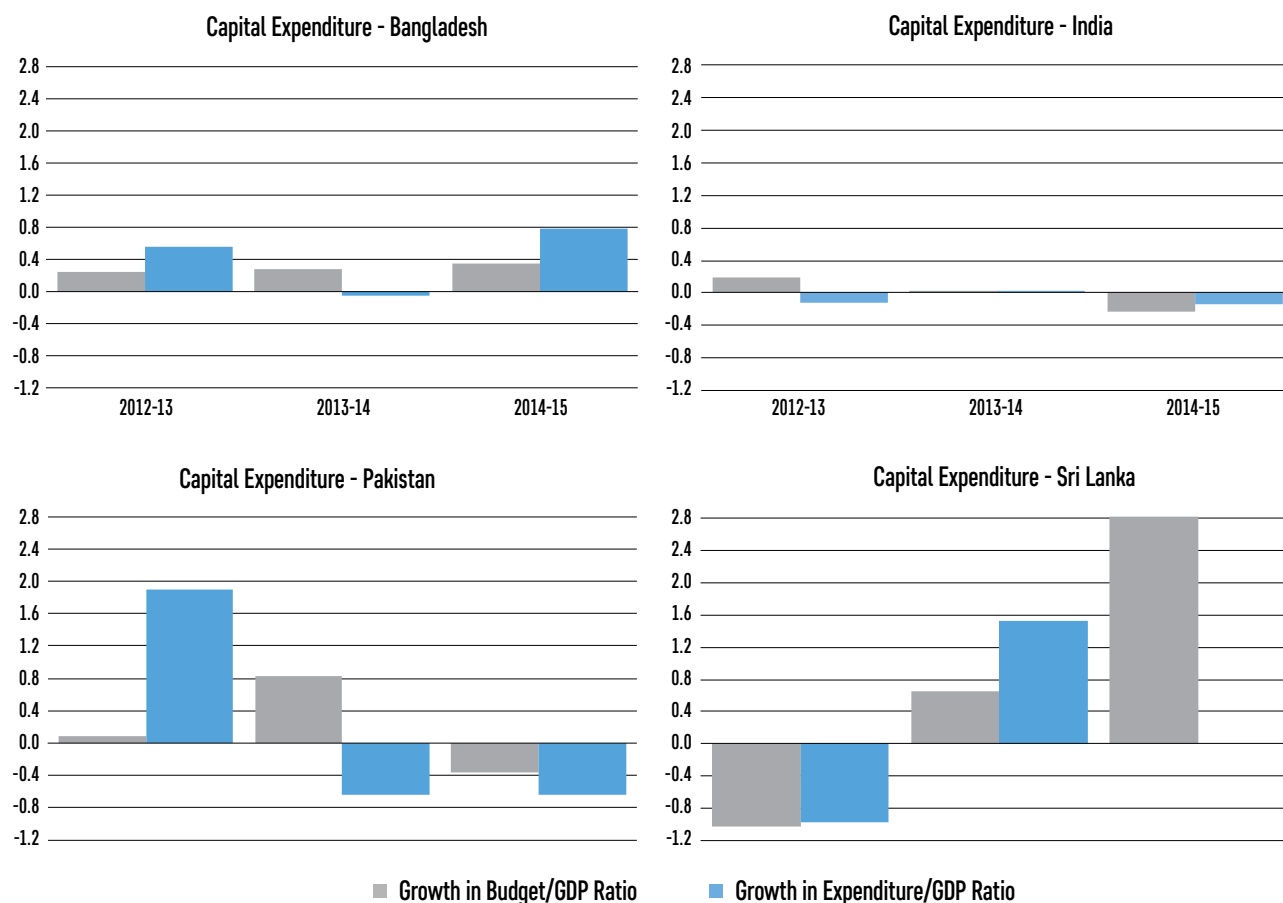
Sri Lanka. Estimates are based on data for the last 15 years, although slightly fewer observations are available in some cases. The correlation between the cyclical component of GDP and growth in government spending is -0.38 in the case of India, which stands out as solidly counter-cyclical. This is also true of Bangladesh, although the correlation is lower in its case. At the other end of the spectrum, the correlation reaches 0.43 in Pakistan, suggesting a generally pro-cyclical stance. The correlation is positive in Sri Lanka as well, although it is not as high.

Fiscal policy can bolster economic growth

Beyond a stable macroeconomic environment, continued growth in the region will be strongly dependent on robust capital accumulation. The region faces dramatic infrastructure gaps, resulting in insufficient access to electricity and unreliable power supply. Infrastructure gaps also lead to congested cities, poor connectivity, and subpar logistics. In parallel, there is a need to upgrade human capital in South Asia, through higher educational attainment, better learning, and skills that are suited to the needs of the private sector. Fiscal policy has an impact on human capital accumulation through spending in education and health. But investments in human capital can take time to translate into growth, because they largely target young populations and deliver their dividends throughout life. On the other hand, investments in infrastructure and physical capital can have large and almost immediate growth payoffs. Some of these investments are made by the government, through capital expenditures whose level depends on the fiscal policy stance.



Figure 33: Sri Lanka expanded capital expenditures significantly, but the pace may not be sustainable



Source: National Authorities, WB Staff Calculations

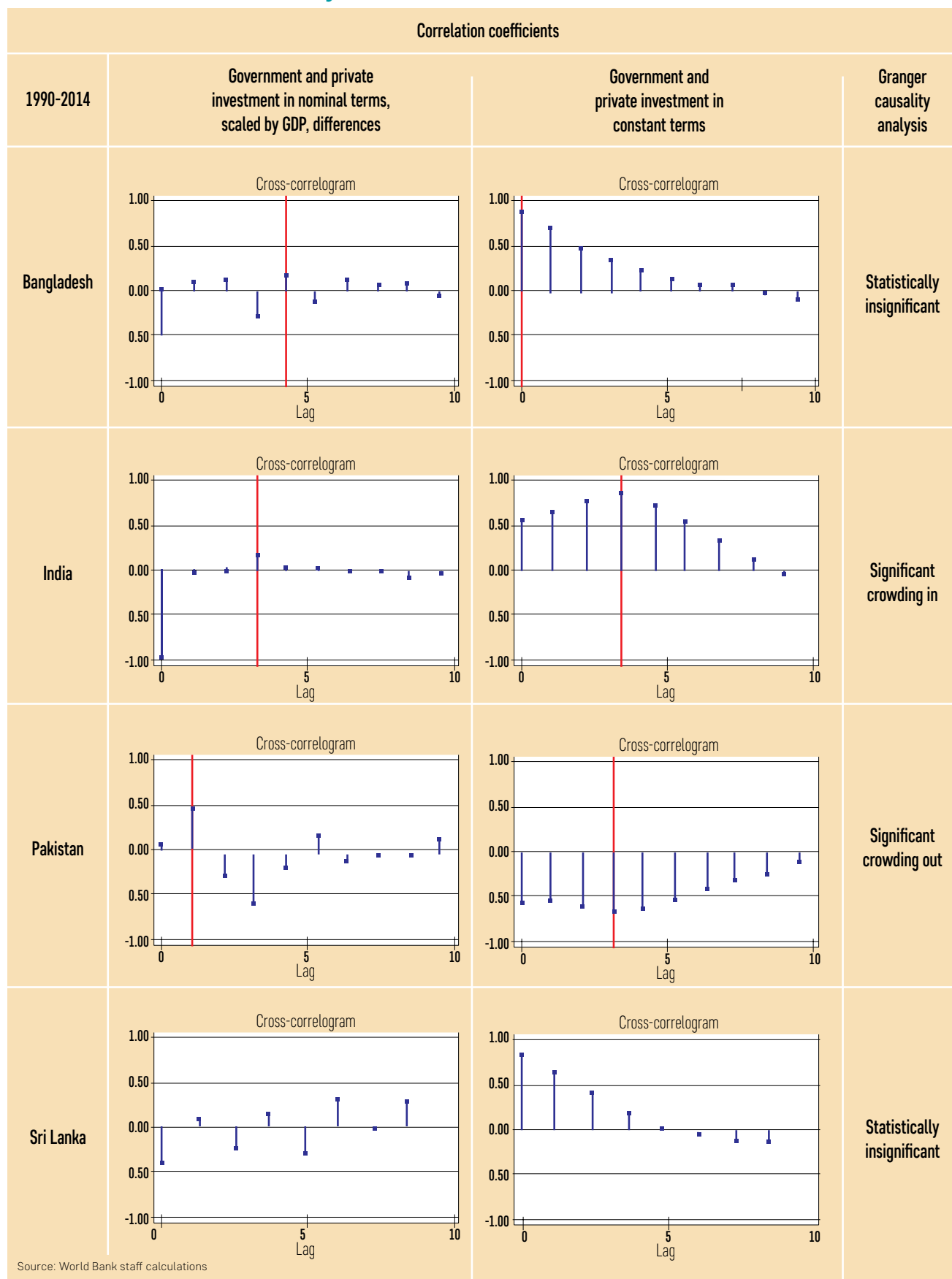
Fiscal consolidation runs the risk of undermining growth if it entails cutting on infrastructure investments. The recent experience of the largest economies in South Asia is quite diverse in this respect. Capital expenditures by the government can be measured in at least two ways. One of them involves the budgeted amount, the other the actual spending. The former reflects the stated priorities of the government, the latter is affected by implementation capacity as well as unexpected developments such as highway projects getting stalled because of slow land reclamation. The fiscal stance in relation to growth can be assessed by measuring the change in budgeted or actual capital expenditures from one fiscal year to the next. The numbers need to be interpreted with caution, as government expenditures are not classified in the same way across countries. For instance, in more federal systems, transfers to provinces or states may not be labelled as capital expenditures even if a share of them is used for that purpose. Recent figures are also subject to revisions that may somewhat modify the assessment. With these caveats in mind, the numbers turn out to be quite diverse in South Asia's case.

The strongest pro-growth fiscal stance in recent years was in Sri Lanka, followed by Bangladesh. Under the previous Sri Lankan government, the development model was very much anchored on public investment. It is less clear that this infrastructure-driven model will continue under the new government, and it may not be affordable in any case. Pakistan had also increased its capital expenditures substantially in 2012-13. But the fiscal adjustment undertaken since 2013-14, while necessary from a macroeconomic stability point of view, has been associated with declines in capital expenditures. Bangladesh has been increasing its capital expenditures, but at a much modest pace than Sri Lanka. And there was almost no change in India's case until 2014-15. More recent data, for 2015-16, suggests that capital expenditures have increased by 0.2 percent of GDP, and this may be one of the main reasons why growth accelerated.

Depending on the nature of public investments, and how they are financed, private investment may be crowded in or out. In a positive scenario, better infrastructure makes firms more profitable, thus



Figure 34: The impact of capital expenditures on private investment varies considerably across countries



encouraging new investments by the private sector. But public investments may also be poorly designed or implemented, and neither “white elephants” nor stalled projects can be expected to contribute much to private sector profitability. Also, the borrowing needs associated with larger capital expenditures may lead to higher interest rates, making private investment less profitable. Because of these multiple possibilities, whether capital expenditures crowd-in or crowd-out private investment is an empirical question. The answer to it is highly relevant. Sustaining a strong performance in South Asia will increasingly depend on investment picking up and gradually taking over from consumption as the main driver of growth. And given the resource constraints, governments alone will not be able to foot the bill. Private investment will need to be crowded in on a large scale.

In recent times capital expenditures might have crowded in private investment in India, while they might have crowded it out in Pakistan. Results are inconclusive in the cases of Bangladesh and Sri Lanka, which fall somewhere in between. These are the conclusions that emerge from analyzing public and private investment series from 1990 to 2014. A very simple variant of the analysis involves computing the correlation coefficient between the level of public investment in one year and the level of private investment in each of the subsequent years. The correlation coefficient is positive if higher capital expenditures are associated with larger private investment down the road, and negative otherwise. A more elaborate approach, called Granger causality analysis, assesses whether past changes in capital expenditures help predict changes in private investment. In many cases these correlation coefficients and dynamic relationships lack statistical significance. This is so with Bangladesh and Sri Lanka. But both approaches hint at India experiencing crowding in and Pakistan crowding out.

Fiscal policy matters for equity

Fiscal choices affect equity through the level and composition of taxes and expenditures. For instance, a larger share of spending devoted to the delivery of basic services is generally progressive. Unfortunately, spending breakdowns by government function are not readily available, and country-specific studies do not lend themselves well to regional comparisons. Revenue and expenditure levels matter as well. The fact that tax revenue represents a low proportion of GDP in some South Asian countries is in itself an indication that distributional impacts are modest.

It shows that a fraction of the population with the capacity to pay taxes is not being called to contribute to public resources, or is managing to avoid doing so. And therefore the capacity to spend on the delivery of basic services may be constrained.

For a given level of taxation, the nature of the tax instruments used also has implications for equity.

Simplifying, government revenue is made of direct taxes, indirect taxes and other revenue. The latter includes items as diverse as fees, grants from development partners and proceeds from spectrum auctions. Direct taxes are paid directly by individuals and firms, on their incomes and profits respectively. Indirect taxes, such as VAT, are charged to the price of goods and services and therefore operate as a tax on consumption. Direct taxes tend to be progressive, in the sense that better-off households pay larger amounts in absolute terms, and most often relative to their income or consumption. Indirect taxes are said to be regressive, because consumption tends to represent a larger share of income among poorer households. But food and other basic products tend to be exempted, or taxed at lower rates. And poorer households rely more on self-consumption and informal markets, so even indirect taxation is likely to be progressive. But it is reasonable to assume that direct taxes are more progressive than indirect taxes.

India relies on direct taxes to a greater extent than other large South Asian economies. At the central level, direct taxes account for more than half of total tax revenue. By contrast, the share is only 36 percent for the central government of Pakistan. And it only reaches 30 percent in Bangladesh, and a mere 19 percent in Sri Lanka, two countries which are more centralized. Over the last few years, the share of direct taxes has increased quite steadily in these three countries, and especially in Bangladesh and Pakistan.

Government subsidies, a salient feature of South Asian fiscal policy, also redistribute resources among the population.

These subsidies are often justified on equity grounds. They aim at making items such as food, fertilizer, petroleum products and electricity more affordable. Taken altogether, they represent an unusually large share of government expenditures, compared to regions. Some are potentially progressive, in the sense of benefitting poorer households more. Others are regressive. Food subsidies tend to fall in the first group although leakages to households who do not need them, or are not entitled to them, make them less progressive than they could be. Subsidies to petroleum products and to electricity, on the other



Figure 35: Indirect taxes prevail in most large South Asian economies

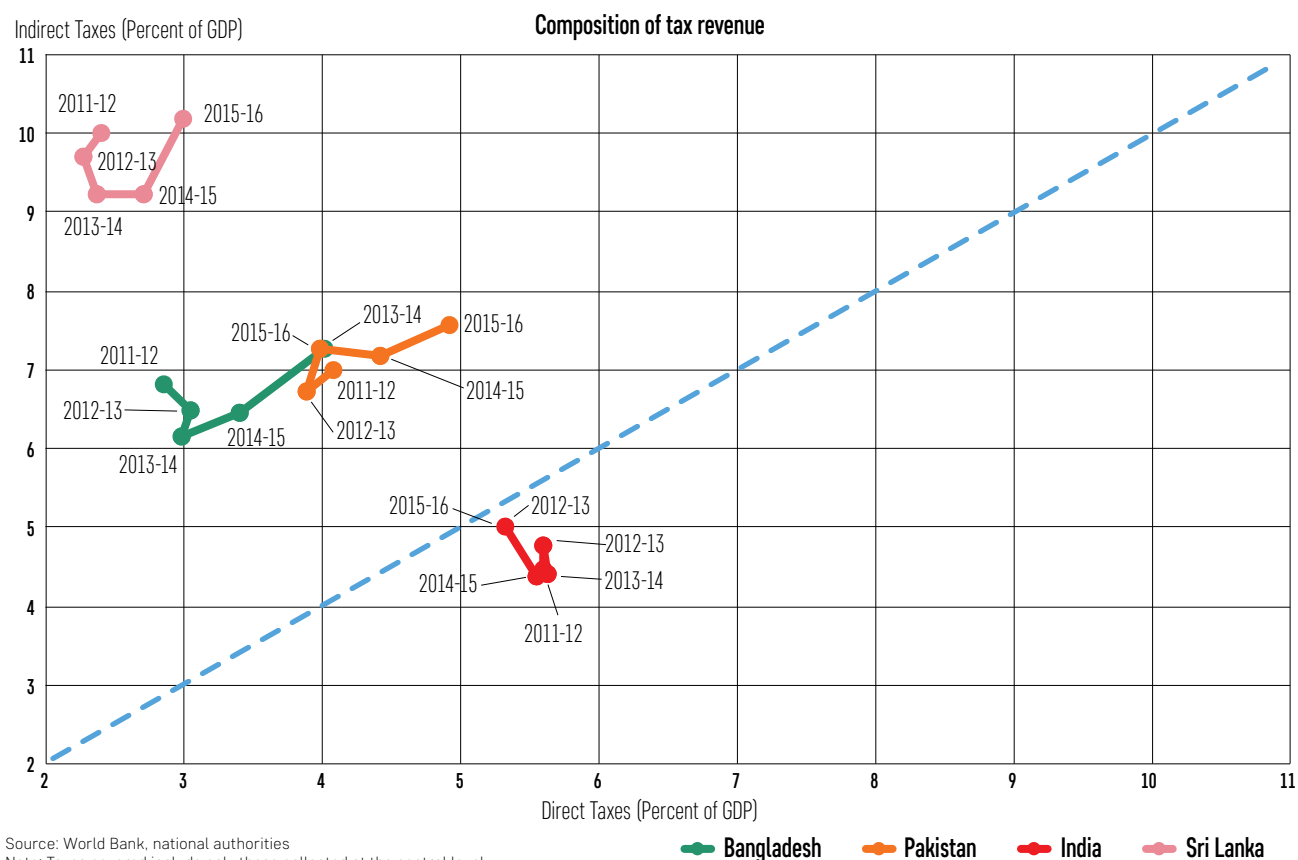
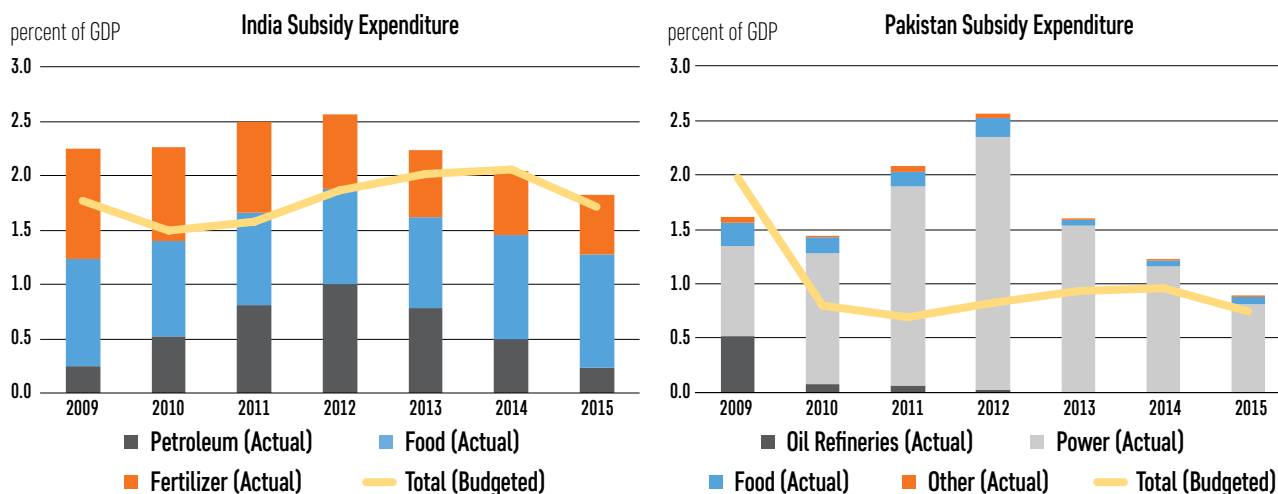


Figure 36: There has been a marked decline in subsidies in Pakistan

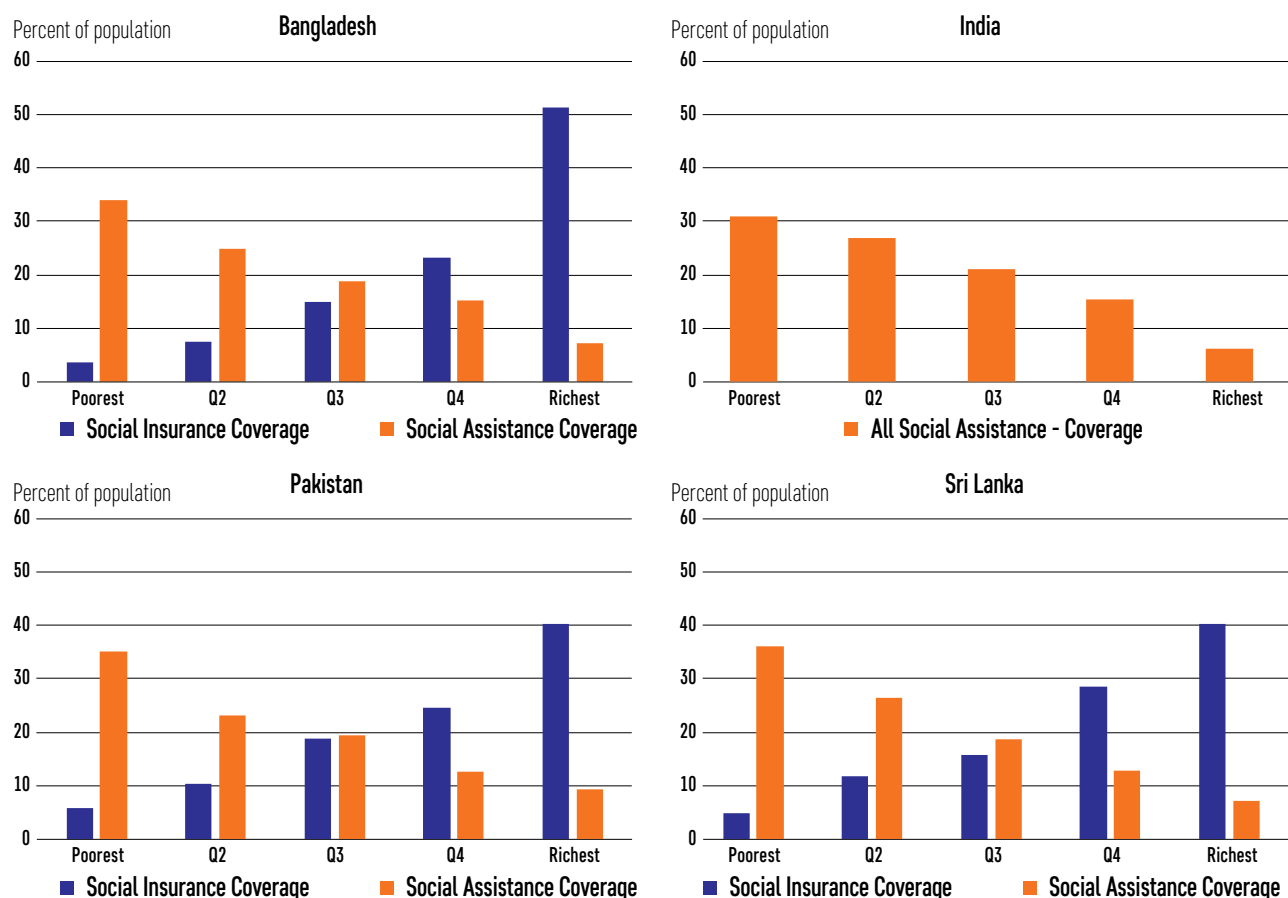


hand, tend to be regressive. Many among the poor do not have access to electricity, and walk or ride bicycles for transportation, so that they do not benefit from subsidies. Fertilizer subsidies fall somewhere in between. Unfortunately, figures on the level of subsidies and their incidence across population groups are not readily available for all countries.

Pakistan has managed to reduce subsidies significantly, while India's subsidy bill is declining more gradually. In India, fertilizers and food account for a large share of the subsidy bill, and their level has remained relatively stable over time. On the other hand, subsidies for petroleum products started declining in 2012, and by now they have shrunk



Figure 37: The coverage of social assistance programs is progressive in South Asia

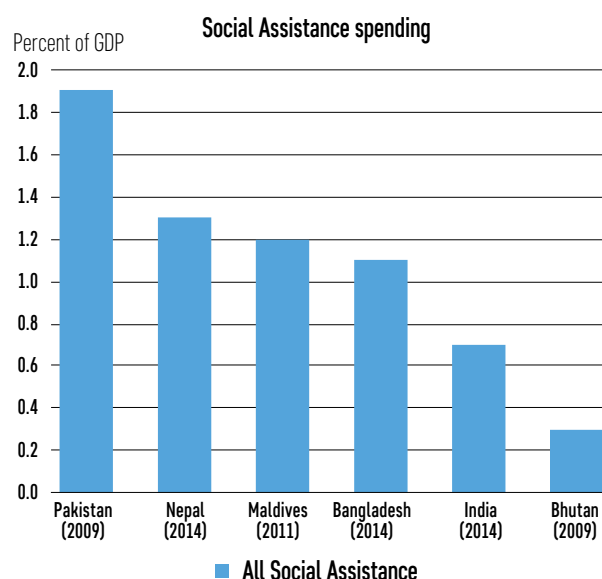


Source: WB ASPIRE and WB Staff Calculations

considerably. In the case of Pakistan, the subsidy bill has steadily declined as part of its IMF-supported program. Given that energy subsidies account for most of the bill and tend to be regressive, this steady decline represents encouraging news from an equity perspective.

The other direct way in which fiscal policy affects equity is through spending in social assistance and social protection. The former includes conditional and unconditional cash transfers to poorer households, public works programs, emergency relief in the aftermath of natural disasters, and support to people displaced by conflict. The latter includes affordable health insurance and participation in pension programs. Social assistance is generally progressive, either because it is explicitly targeted or because participation is not attractive for better-off population groups. Social protection tends to cover urban groups, those working in the formal sector, and the middle class more broadly. This can make it appear regressive, but a careful interpretation requires considering what would be situation in the absence of insurance. For instance, in the case of a major health shock a household without

Figure 38: Pakistan devotes sizeable public spending to social assistance

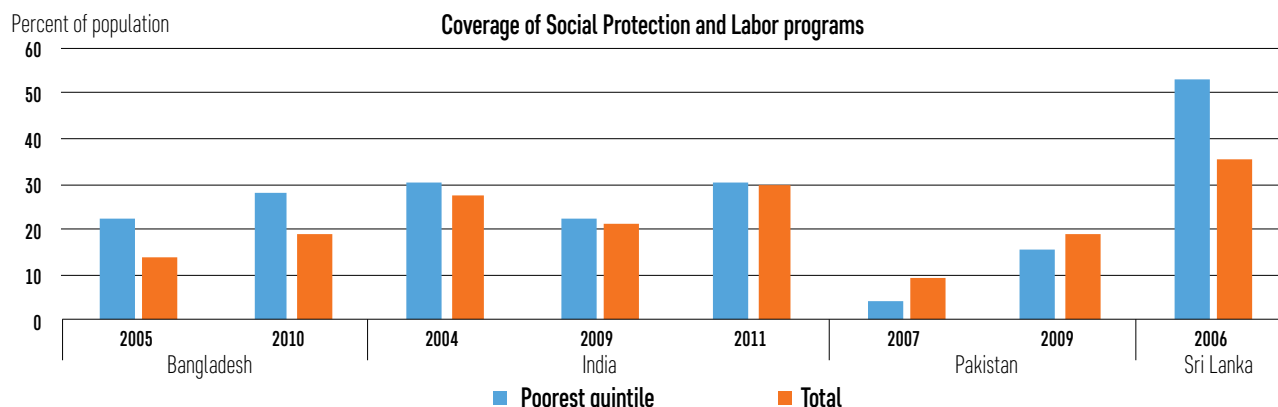


Source: World Bank ASPIRE

insurance could easily fall into poverty. But the data only allows to assess how well-off a household is given that it is covered by social protection, not how well-off it would be in its absence. By redistributing resources



Figure 39: Pakistan experienced the sharpest expansion of social programs, albeit from low levels



Source: World Bank ASPIRE

Note: Definitions vary across countries, but broadly coverage includes social assistance, social insurance, private transfers and labor market programs

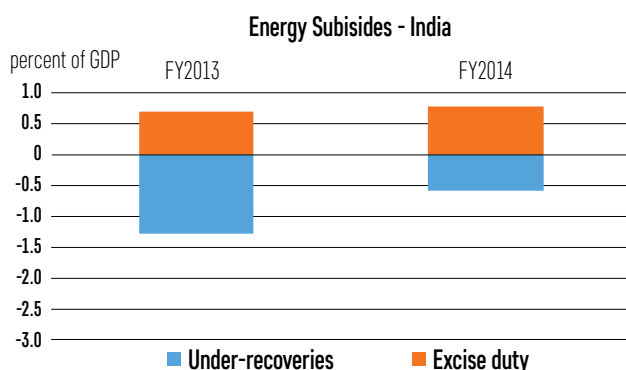
from healthy to sick and from adult to elderly, social protection can also be seen as contributing to equity.

Among the four largest economies in South Asia, Pakistan devotes the biggest share of public resources to social assistance. This spending category includes public works as well as conditional and unconditional transfers. The most important intervention in the latter group is the renowned Benazir Income Support Program (BISP), which provides financial assistance to

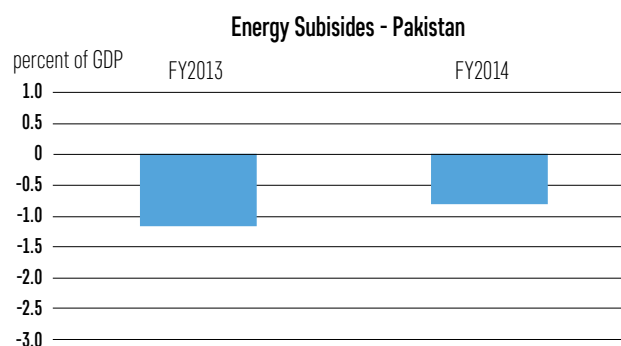
low-income families through bi-monthly cash payments. School feeding is the largest component for Nepal and India while for Pakistan it is fee waivers and cash transfers. The National Rural Employment Guarantee Program, the largest public works scheme in the world, is an important social assistance expenditure category in India.

While data on the overall coverage of social assistance and social protection programs is available with a substantial time lag, the existing

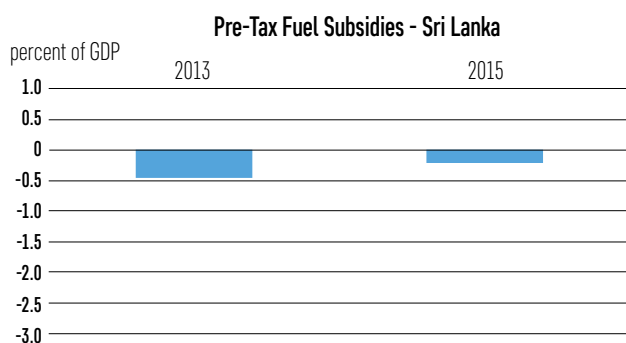
Figure 40: India went farther than other countries by introducing excise tax on diesel and gasoline



Note: Under-recoveries are those of public sector oil marketing companies. Excise duty are those on crude oil & petroleum products.



Note: Energy subsidies are subsidies on power. There is no subsidies on oil refineries.

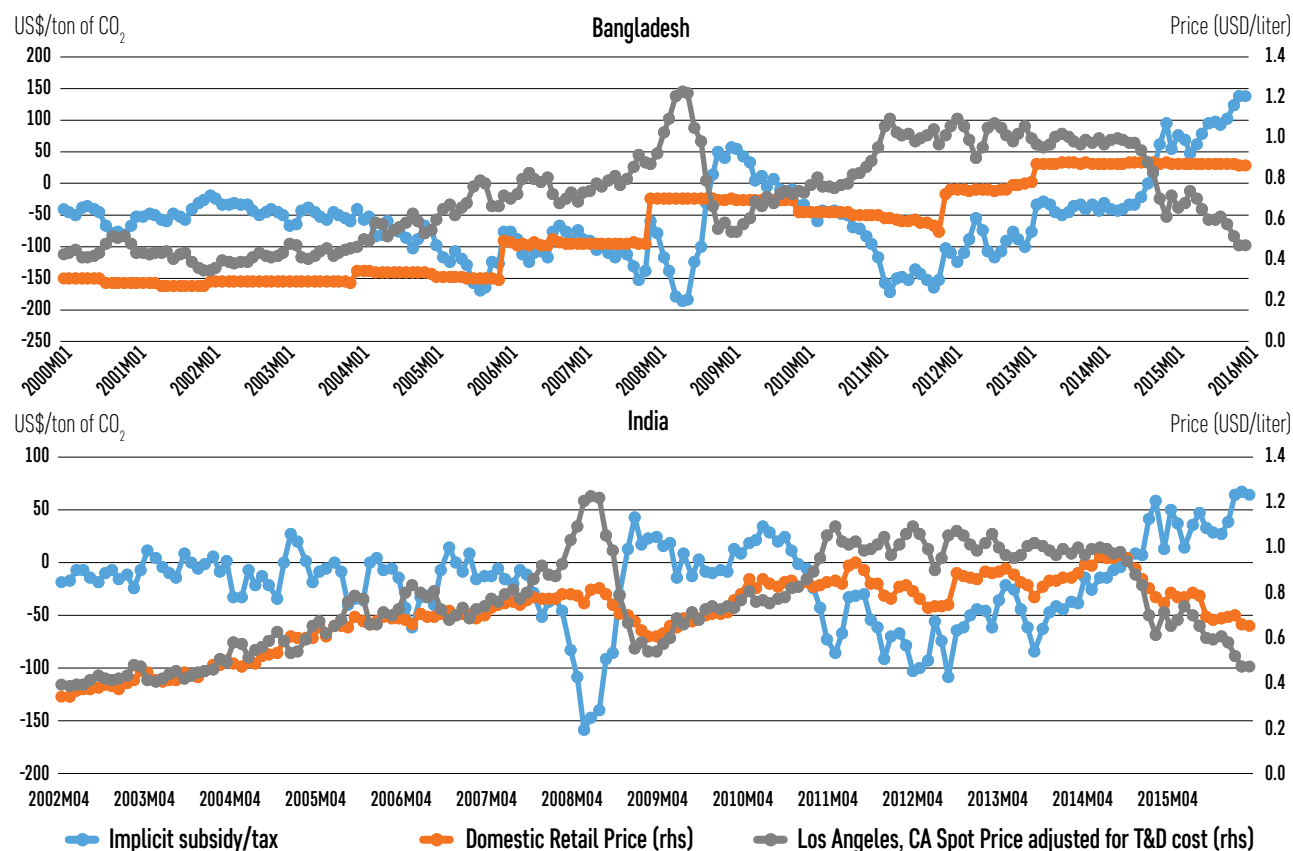


Source: National Authorities

Note: In India the subsidy is computed as under-recoveries public sector companies on diesel, LPG and PDS kerosene; excise duties are those on crude oil and petroleum products. In Pakistan, power subsidies are reported; there are no subsidies on oil refineries. In Bangladesh and Sri Lanka, subsidies are measured as the difference between consumer prices and supply costs



Figure 41: The implicit carbon tax on diesel is now close to the internationally recommended level



Sources: World Bank staff calculations, Bangladesh Petroleum Corporation, India Petroleum Planning and Analysis Cell, Pakistan State Oil, Pakistan Energy Year Book, Ceylon Petroleum Corporation, Thomson Reuters

information reveals considerable improvements over time. Among the four largest economies in South Asia, coverage is higher in Sri Lanka, a country with a strong tradition in social programs. And it is progressive, as shown by the fact that coverage is higher among the poorest population group than among the population at large. Coverage is also strongly progressive in Bangladesh, and it has rapidly increased over time. However, thanks to the introduction of BISP the fastest increase in coverage was in Pakistan.

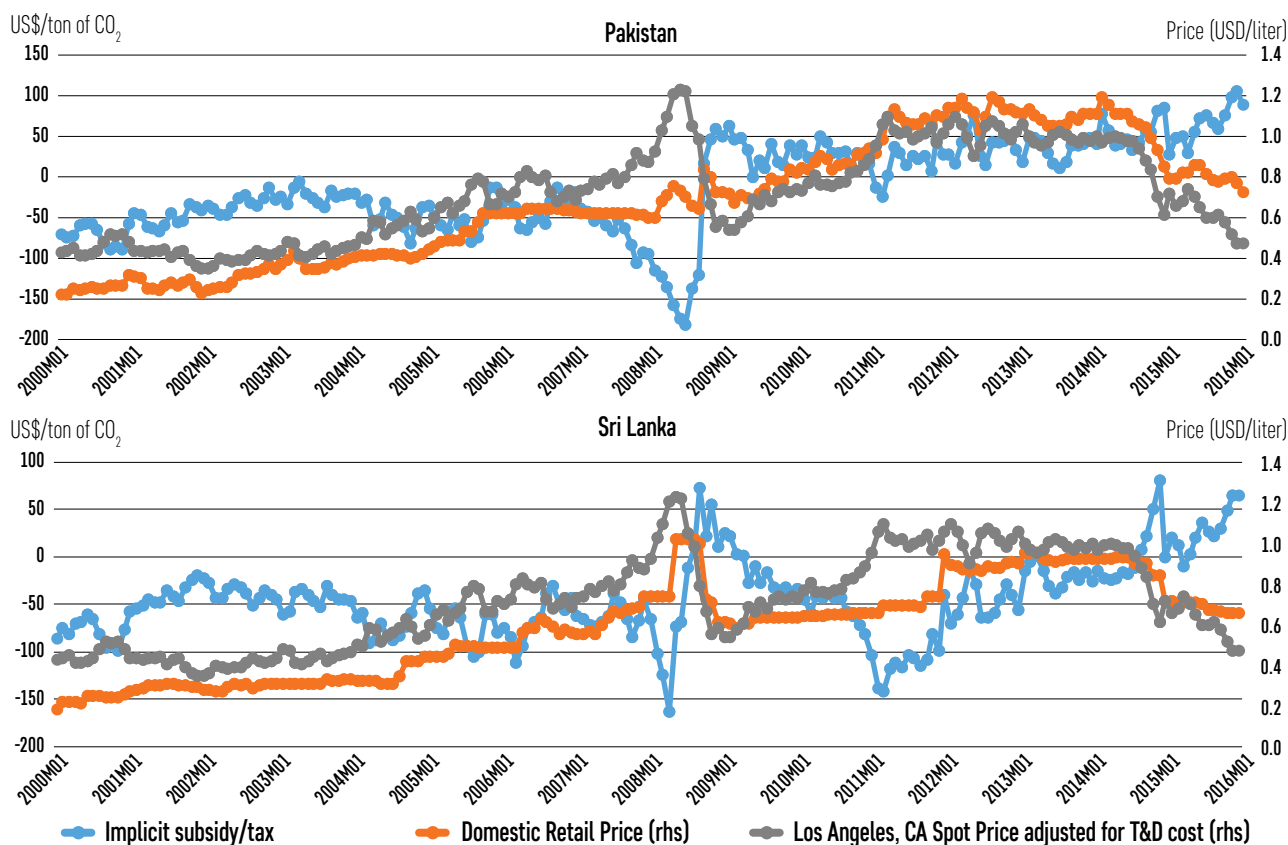
Fiscal policy can help reduce emissions

Energy consumption, an important source of greenhouse gases and black carbon emissions, has traditionally been subsidized in South Asia. Total energy consumption per person, or per unit of GDP, is still very low on a global scale, due to the region's relatively low income levels and major infrastructure gaps. But taking these constraints as given, the subsidization of petroleum products and electricity leads to higher energy consumption than is socially desirable. Subsidization

also discourages the use of environmentally-friendly technologies, from public transportation to drip irrigation to renewable energy. While other countries were already moving towards the taxation of carbon, South Asia seemed to be actively encouraging its use.

The fall in international oil prices has led to a rapid decline in energy subsidies and even allowed to raise resources for the budget out of petroleum products. This shift happened through avoiding a full pass-through of lower international oil prices to domestic consumers. In Bangladesh and Sri Lanka, the domestic retail prices of petroleum products are controlled by the government and adjusted on an ad hoc basis. Sri Lanka partially passed through the international oil price decline to domestic price in 2014 and 2015, while no price pass-through took place in Bangladesh. India and Pakistan, in turn, recently deregulated diesel and gasoline prices. In Pakistan, domestic petroleum prices have followed closely price movements in international markets. India went farther: since November 2014 it has increased the excise duty on diesel and gasoline periodically, so as to match the decline in international crude prices.





Sources: World Bank staff calculations, Bangladesh Petroleum Corporation, India Petroleum Planning and Analysis Cell, Pakistan State Oil, Pakistan Energy Year Book, Ceylon Petroleum Corporation, Thomson Reuters

The implicit level of the carbon subsidy or tax in each country can be estimated by comparing the domestic price of petroleum products to that of equivalent imported products. The latter can be estimated on the basis of Los Angeles spot market prices adjusted for transport, distribution and retailing costs. The carbon subsidy or tax is the gap between the domestic and the hypothetical import price, divided by the volume of carbon emitted per unit of the specific petroleum product considered. Because the price pass-through has been partial or non-existent, by now the domestic price of petroleum products is higher than the hypothetical import price in all cases. An estimation for the case of diesel shows that all four largest economies in South Asia have moved de facto from a carbon subsidization regime to a significant carbon taxation regime.

There would be merit in replacing the implicit carbon tax by explicit taxation of energy, while liberalizing the price of domestic petroleum products. Excise tax like that introduced by India on diesel and gasoline – as well as on coal – is a concrete example of carbon taxation. A regime of ad hoc domestic price

adjustments and subsidies not always paid in time has contributed to the under-performance of local petroleum companies. Under-investment and the accumulation of payment arrears that eventually fall on the budget are among the consequences of this inefficient regime. By now the implicit carbon tax of the largest four economies in the region ranges from \$64 per ton in India and Sri Lanka to \$138 per ton in Bangladesh. This is above internationally recommended benchmarks. However, compared to other regions the domestic prices of petroleum products are still low in South Asia. And there is a risk of reversal if and when international oil prices increase again, which makes this the ideal time to make the switch to explicit carbon taxation.

A fiscal policy scorecard

The analyses presented in the previous sections are no doubt partial and incomplete, but they help highlight the strong aspects of fiscal policy in the four largest economies in South Asia. They also bring attention to the areas where more progress



Figure: Fiscal policy strengths and weaknesses vary across countries in South Asia

Area	Bangladesh	India	Pakistan	Sri Lanka
Stability	Government expenditures mildly counter-cyclical	Government expenditures strongly counter-cyclical	Government expenditures strongly pro-cyclical	Government expenditures mildly pro-cyclical
Growth	Capital expenditures increased mildly	Capital expenditures roughly stable	Capital expenditures unsteady	Capital expenditures increased strongly
Equity	Low tax revenue, mainly from indirect taxes; growing social spending	Solid tax revenue, with a tax mix across government levels; stable social spending	Low tax revenue, mainly from indirect taxes; growing social spending	Declining tax revenue, almost all from indirect taxes; large social spending
Sustainability	High carbon tax; administered prices; no explicit carbon taxation	Moderate carbon tax; deregulated prices; explicit carbon taxation	High carbon tax; deregulated prices; no carbon taxation	Moderate carbon tax; administered prices; no explicit carbon taxation

can be accomplished. Interestingly, all four countries show a mixed performance. None of them has a strong record on stability, growth, equity and sustainability at the same time. Because the exercise is all internal to the region, and the countries considered are at similar levels of development, a scorecard of this sort is not merely aspirational. It should be possible for all four countries to match the best-performing peers in each area. Needless to say, improvements in fiscal policy take time and perseverance. Meanwhile, this tentative benchmarking exercise could inform policy choices as the region enters a period of fading tailwinds.





South Asia country briefs



In alphabetical order

Afghanistan

Bangladesh

Bhutan

India

Maldives

Nepal

Pakistan

Sri Lanka



Afghanistan

Economic recovery is slow. Persisting uncertainty around the security and political environment has hindered business activities and overall domestic demand. Growth is expected to only marginally increase from 1.5 percent in 2015 to 1.9 percent in this year. While the fiscal situation stabilized, risks to fiscal stability over the medium-term remain pronounced as substantial donor grants are required to meet the development needs of the country. Future prospects hinge critically on improvements in security, tapping into new sources of economic growth and creating an enabling environment for the private sector to invest.

2015

Population, million	32.5
GDP, current US\$ billion	19.2
GDP per capita, current US\$	624

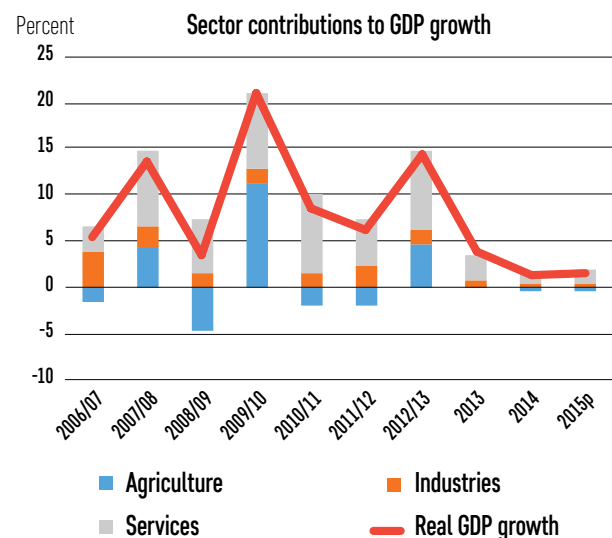
Sources: World Bank, WDI

Recent Developments

Political uncertainty remains high in Afghanistan and recent political developments have not helped much to restore confidence in the economy. The security environment continued to worsen in 2015, with civilian casualties reaching record levels. Consequently, economic growth increased only marginally from 1.3 percent in 2014 to an estimated 1.5 percent in 2015. Domestic demand remains weak, with no signs of a pick-up in private consumption and investment. The number of new firm registrations – as a proxy for business activities – indicate only a marginal increase in new investment activities in 2015, but it remains significantly below the levels of 2012-2013.

Agriculture, which is the second largest contributor to GDP growth after services, declined by a projected 2 percent in 2015. Cereals production declined by 14 percent in 2015 as a result of less favorable rainfall in the country. Fruit production however is estimated to have remained unaffected. Industries and services – the drivers of growth in 2015 – have grown at the slowest pace since 2013.

Inflation dropped into negative territory in 2015. Consumer prices declined by 1.5 percent due to lower global commodity prices and consumption. As most consumer goods are imported in Afghanistan, global prices of food and commodities exert significant impact on local prices. In addition, weakening of

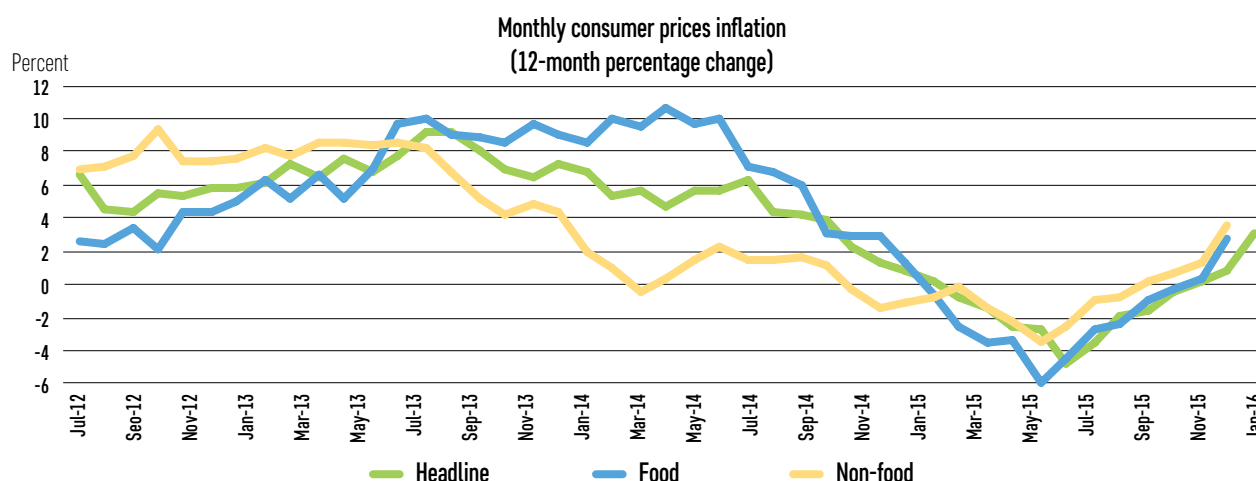


Source: Central Statistics Office and World Bank staff estimates

domestic demand in 2015 led to lower prices for locally-supplied goods and services, including housing and telecommunications.

Fiscal indicators improved following the fiscal crisis in 2014. Revenues which had dropped by 8.5 percent in nominal terms in 2014 increased by 22 percent last year. In percent of GDP, domestic revenues rebounded to 10.6 percent in 2015, after a significant decline to 8.7 percent in 2014. The government also continued to exercise prudent expenditure controls in 2015. Total expenditures increased marginally from 26.2 percent in 2014 to 27.7 percent in 2015. Improvement





Source: Central Statistics Office and World Bank staff estimates

in revenue collection, more realistic budgeting and restraints on expenditures helped to reduce the budget deficit by nearly half to around \$150 million (1.4 percent of GDP) in 2015. The deficit was more of a cash-accounting issue where disbursement of some portion of non-discretionary donor grants were recorded after the close of the fiscal year, and did not represent an actual financing gap for the government.

The exchange rate strongly depreciated by 7 percent against the US dollar in 2015. On the one hand, foreign aid inflows (security and civilian) have declined, which makes foreign currency more valuable vis-à-vis the Afghani. On the other hand, growing uncertainty around the political and security environment have caused demand for Afghani to decline; both through consumer's preference to retain their savings in US dollar, and through lower capital inflows which naturally increase demand for foreign currency. Moreover, increased out-migration might have also been associated with larger capital outflows.

Outlook

The medium-term outlook points towards a slow recovery over the next three years. Growth is projected at 1.9 percent in 2016, assuming that firms and households adjust their behavior to the worsening security environment. Growth is projected to gradually increase from 1.9 percent in 2016 to 3.6 percent in 2018, predicated on political stabilization and stronger reform efforts. However, further deterioration in the security environment could significantly weaken growth prospects for the country. The projected medium-term growth path remains significantly below

the average growth rate of 9 percent experienced in the pre-Transition period (2003-2012).

Inflation is projected to rebound to 3 percent in 2016 up from -1.5 percent last year. For the most part, increases in consumer prices in 2016 are expected to be driven by exchange rate depreciation that took place in the second half of last year. While Afghani depreciated by nearly 12 percent against the US dollar between June and December 2015, it is expected to stabilize in 2016.

Increase in domestic revenues last year, as well as low budget deficit, helped to rebuild the cash reserves in 2016, and the government started the fiscal year with a strong cash position. Further, domestic revenues are projected to increase by around 9 percent this year. However, expenditure pressures are also growing. Total expenditures are expected to increase by 2 percentage points of GDP, inclusive of carried forward expenditures from last year. Budget deficit is projected to further narrow to 0.9 percent of GDP.

Risks to fiscal stability, however, remain pronounced over the medium-term as substantial donor grants are required to meet the development needs of the country. Expenditures are projected to increase from 27.1 percent of GDP in 2015 to 33.5 percent by 2018 – partly due to on-budgeting of security and civilian spending. Domestic revenues, on the other hand, are projected to increase from 10.4 percent in 2015 to only 11.6 percent in 2018. While the resulting deficit is expected to be covered by increasing on-budget grants, the fiscal outlook will remain sensitive to even marginal changes in revenue collection or grant receipts. On-budget donor grants are projected at 21.5 percent of GDP (or US\$4.4 billion) by 2018.



Table: Afghanistan

(annual percent change unless noted otherwise)

	2013	2014	2015e	2016f	2017f	2018f
Real GDP growth, at constant market prices	2.0	1.3	1.5	1.9	2.9	3.6
Private Consumption	2.0	1.5	-0.2	0.9	2.1	2.3
Government Consumption	3.7	8.0	2.3	4.1	0.8	2.1
Gross Fixed Capital Investment	9.4	7.5	6.5	6.3	9.5	10.8
Exports, Goods and Services	22.1	6.8	4.8	3.4	6.9	7.6
Imports, Goods and Services	35.7	-5.6	2.4	3.2	4.0	5.1
Real GDP growth, at constant factor prices	1.9	1.8	1.4	2.2	2.9	3.6
Agriculture	0.0	-0.1	-2.0	-0.5	0.8	1.1
Industry	1.8	2.4	1.4	1.6	2.2	4.1
Services	2.6	2.2	2.8	3.5	4.0	4.2
Inflation (Consumer Price Index)	7.4	4.6	-1.5	3.0	3.5	4.0
Current Account Balance (% of GDP)	7.4	8.0	5.6	4.6	4.2	4.5
Financial and Capital Account (% of GDP)	0.0	-5.9	-0.8	-5.7	-0.2	-4.5
Net Foreign Direct Investment (% of GDP)	0.3	0.6	0.7	1.0	1.4	2.0
Fiscal Balance (% of GDP)	1.0	-1.8	-1.4	-0.9	-0.5	-0.4
Debt (% of GDP)	7.1	6.5	6.7	6.6	5.7	3.1
Primary Balance (% of GDP)	1.1	-1.7	-1.3	-0.8	-0.4	-0.4

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice

Notes: e = estimate, f = forecast.

Risks and Challenges

The National Unity Government presented an ambitious reform agenda in end 2014 to revitalize the economy, tackle corruption and improve investment climate. However, the reform implementation has not yet gained momentum. Upward trends in security, pension and wage spending over the medium-term require immediate attention. The country has significant financing needs for both civilian and security spending; securing continued high levels of donor financing over the coming years is therefore of critical importance for fiscal stability in the country. The fragile security environment and financing constraints, compounded by weak governance capacity pose serious challenges to service delivery in Afghanistan. Any setback in reform implementation would further slowdown the pace of human capital accumulation in Afghanistan and reduce future prospects of growth and poverty reduction.



Bangladesh

Growth is sustained at 6 plus percent, overall inflation has moderated, interest rates have declined, the nominal exchange rate is stable and foreign exchange reserves are adequate. Fiscal deficit has increased, though still modest, and monetary policy has remained cautious. Near term macroeconomic outlook is stable. Political, trade and financial shocks are the main risks. The challenge is to boost private investment by reforming business regulations, mitigating infrastructure deficiencies and addressing financial sector weaknesses.

2015

Population, million	161.0
GDP, current US\$ billion	194.9
GDP per capita, current US\$	1210

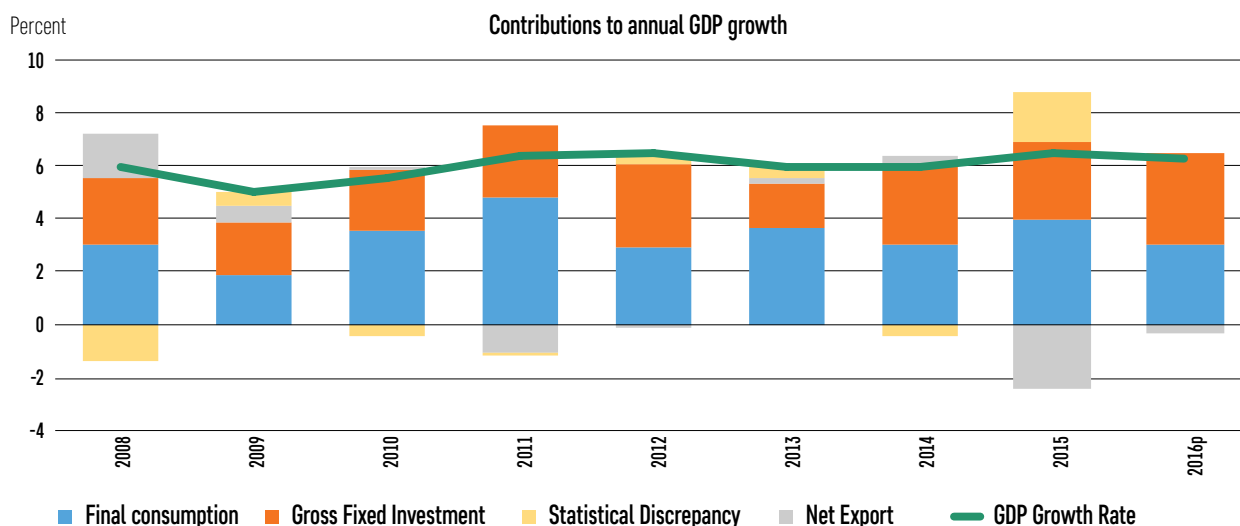
Sources: World Bank, WDI

Recent Developments

Peace in the streets has helped sustain growth despite global headwinds. Domestic demand has underpinned growth in FY16 while export demand is showing signs of recovery. GDP growth averaged 6.2 percent in the past decade despite slower growth in both developed and emerging markets, political turmoil, and structural impediments. Exports, imports, remittances, tax revenue, Annual Development Program (ADP) implementation, and credit growth suggest a modest start in FY16. There are no convincing signs of a pick-up in private sector investment as infrastructure bottlenecks,

gas shortage, high cost of doing business and policy uncertainty continue to drag business confidence.

Headline inflation has moderated, but nonfood inflation risen. Good rice harvests in 2015, declining global prices and stable exchange rate contributed to deceleration in food price inflation, helping headline inflation to ease from 7.4 percent (year-on-year) in December 2013 to 6.1 percent in January 2016. However, nonfood inflation has picked up by 3 percentage points during this period to 8.7 percent. Apart from rise in demand enabled by sustained stability, this uptick likely reflects higher minimum wages in the garment



Source: Bangladesh Bureau of Statistics (BBS) and World Bank staff estimates



Table: Bangladesh

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	6.0	6.1	6.5	6.3	6.8	6.0
Private Consumption	5.1	4.0	5.4	3.1	3.9	4.4
Government Consumption	5.8	7.9	9.4	20.2	20.0	7.8
Gross Fixed Capital Investment	5.4	9.9	9.6	10.8	11.8	11.3
Exports, Goods and Services	2.4	3.2	-3.7	15.5	15.6	13.8
Imports, Goods and Services	1.2	1.2	7.5	13.2	15.7	15.8
Real GDP growth, at constant factor prices	6.1	6.1	6.5	6.3	6.8	6.0
Agriculture	2.5	4.4	3.0	3.9	4.2	3.5
Industry	9.6	8.2	9.6	9.7	9.8	8.7
Services	5.5	5.6	5.8	5.1	5.8	5.1
Inflation (Consumer Price Index)	6.8	7.3	6.4	6.6	6.8	6.6
Current Account Balance (% of GDP)	1.6	0.8	-0.8	0.3	-0.3	-0.1
Net Foreign Direct Investment (% of GDP)	1.2	0.8	0.9	1.3	1.2	0.8
Fiscal Balance (% of GDP)	-3.9	-3.5	-4.2	-4.7	-4.4	-4.3
Debt (% of GDP)	34.5	33.9	34.0	34.2	35.9	36.9
Primary Balance (% of GDP)	-1.9	-1.5	-2.2	-2.8	-2.4	-2.4

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

industry, pay increases for public employees and hikes in electricity and gas tariff.

The external position remains comfortable. Following a moderate deficit (0.8 percent of GDP) in FY15 on account of subdued exports, the Current Account Balance returned to a surplus, despite flat remittances, of about \$2.1 billion in the first half of FY16 as imports fell and exports recovered. There are, however, important structural weaknesses in the external sector. Gross international reserves, at \$28 billion on February 29, are adequate, equivalent to 6.8 months of FY15 imports of goods and services.

Macroeconomic management challenged by revenue shortfall and weak private demand for credit. Fiscal deficit, though below the 5 percent of GDP budget target, is increasing. Tax collections significantly underperformed relative to the FY16 target due to subdued activity, decline in import prices and weaknesses in tax policy and administration. The savings in expenditures, helped by lower fuel subsidies and

the usual under-execution of capital budget, may be insufficient to offset weak revenue performance. Slower bank credit to the public and private sectors has contributed to high liquidity in the banking system and weaker broad money growth. Consequently, short-term interest rates have declined.

Outlook

Stable near term outlook. In FY16, real GDP is projected to grow at 6.3 percent compared with an estimated 6.5 percent in the previous year. The slightly lower than projected earlier rate, reflects weaker economic indicators in the first four to six months of FY16. Private consumption expenditure is projected to grow at 3.1 percent, lower than in FY15. Government consumption expenditure is projected to grow at 20 percent reflecting the implementation of nearly 100 percent pay increase for government employees. Growth is projected to rise to 6.8 percent in FY17 on the back of further increase in government consumption as the



increased benefit package is implemented, increase in public investment, and a recovery in private investment, as regulatory and infrastructure constraints are eased and creditor confidence returns with improvements in governance in the financial sector. Despite the recent REER appreciation, Bangladesh retains a sizeable labor cost advantage, which should make it an attractive source country as competing producers move up the value chain.

Inflation may edge up in FY17–18 on account of higher public sector wages, a one-off effect from the introduction of the new VAT, and overheating with actual output exceeding the potential. The current account deficit is projected to widen to about 0.3 percent of GDP over the medium term. Fiscal deficit is projected to remain stable after rising to 4.7 percent of GDP in FY16. Macroeconomic policies in the near-term need to focus on safeguarding stability. If the economy is hit by large temporary shocks, counter-cyclical fiscal policy responses would be needed. The exchange rate should be allowed to depreciate if the shocks are protracted.

Risks and Challenges

Political, financial and trade shocks are the main risks. Heightened uncertainty surrounding the national election would adversely impact investment, growth, and inflation. Continued weakness in the state-owned banks could undermine growth prospects and affect fiscal sustainability, as would a failure to launch the new VAT. On the external side, a protracted slowdown in the European Union could hurt exports. Implementation of the Trans-Pacific Partnership (TPP), of which Bangladesh is not a member, could erode the competitiveness of exports to TPP member countries, though the impact is likely to be mitigated by Bangladesh's significant cost and scale advantages, TPP's rules of origin requirements and rigorous environmental and labor standards. However, in today's competitive global markets, even small differences in product costs due to tariff and non-tariff barriers can mean the difference between success and failure. Remittances are vulnerable as persistent low oil prices could eventually affect investment and employment in host countries.

The challenge is to boost private investment by reforming business regulations, mitigating infrastructure deficiency and addressing financial sector weaknesses. Disabling regulations and bottlenecks in critical infrastructure, particularly in energy and transport, have become more binding in recent years as the economy

expanded. These constraints stem from low public investment and inadequate infrastructure maintenance. Financial sector weaknesses further derail investment and growth. Weak bank balance sheets and governance limit lending capacity, divert credit away from productive investment, and impose large fiscal recapitalization costs.



Bhutan

Bhutan is in full-swing implementation of its 11th five-year plan now at mid-term. Investment in hydropower remains strong and government consumption and capital spending are supported by higher revenues from the start of Dagachhu power project and officials grants, while private consumption resumed along with bank credit. Bhutan runs a large current account deficit of which half is related to hydropower. Private sector development and asset diversification are keys to reduce vulnerability to donor finance and address rising youth unemployment.

2015

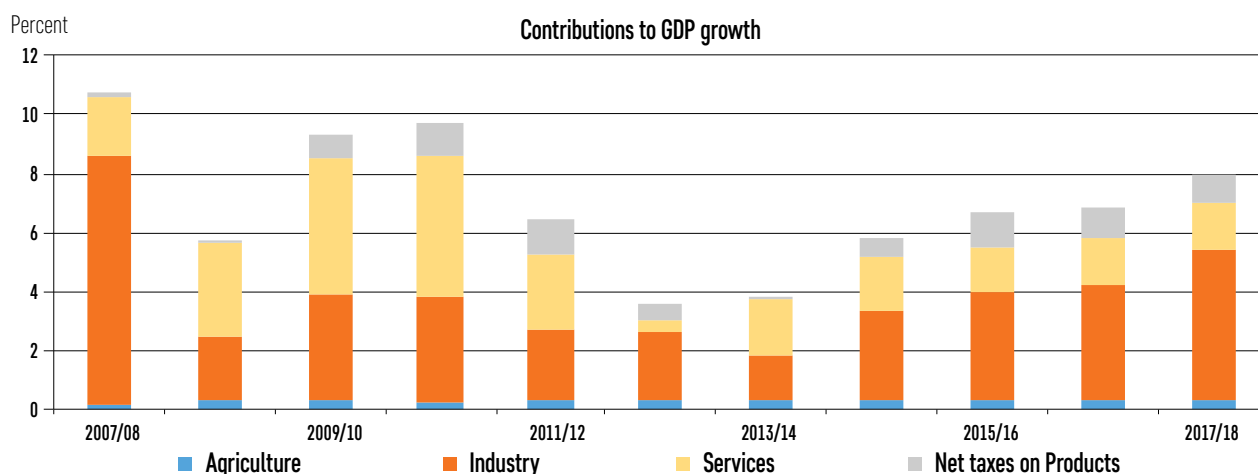
Population, million	0.8
GDP, current US\$ billion	1.9
GDP per capita, current US\$	2439

Sources: World Bank, WDI

Recent Developments

GDP growth in 2015 is estimated at 5.8 percent sustained by a combination of accelerated hydropower mega investments, expansionary fiscal policy to boost the five-year-plan implementation, and credit growth expansion (14 percent year - on- year). Tourism nevertheless disappointed, with a drop of 11 percent of arrivals in 2015, as a possible result of the Nepal earthquake and blockade and terror attacks in Thailand and Europe. Hydropower generation reports an increase of 8 percent in 2015, with good hydrology and the start of the Dagachhu project generation.

On the demand side, private consumption was supported by a resumption of credit (13 percent y-o-y as of January 2016), with vehicles and personal loans showing a growth acceleration. Investments remained robust in hydropower through construction and services. Growth of gross capital fixed investment is estimated to 10.1 percent in 2015, with corresponding expansion in imports (most of the construction materials are imported from India). Real export earnings grew at a slow 5 percent with a slight increase in hydro earnings compensating for lower than expected tourism receipts.



Source: National Statistical Bureau, Royal Monetary Authority, Ministry of Finance, World Bank



Table: Bhutan

(annual percent change unless indicated otherwise)

Fiscal year: July 1st to June 30th	2012-2013	2013-2014	2014-15e	2015-2016f	2016-17f	2017-18f
Real GDP growth, at constant market prices	3.6	3.8	5.8	6.7	6.8	8.0
Private Consumption	15.3	6.1	7.0	8.2	8.3	8.4
Government Consumption	-3.7	-2.6	13.6	9.7	7.4	-0.1
Gross Fixed Capital Investment	-13.0	-4.1	10.1	17.3	17.3	7.6
Exports, Goods and Services	-5.0	16.1	6.0	4.0	5.0	10.0
Imports, Goods and Services	1.1	10.4	12.0	15.0	15.0	6.9
GDP growth, at constant factor market prices	3.6	3.9	5.8	6.7	6.8	8.0
Agriculture	2.6	2.5	2.5	2.5	2.5	2.5
Industry	5.1	5.4	7.0	8.2	7.0	8.0
Services	1.3	3.2	4.8	4.2	3.7	3.5
Inflation (Consumer Price Index)	10.4	8.8	5.6	4.3	4.4	4.2
Current Account Balance (% GDP)	-23.5	-25.3	-26.3	-30.0	-30.0	-26.0
Fiscal Balance (% GDP)	-4.2	3.8	0.6	-3.4	-5.2	3.4
Debt (%GDP)	99.9	96.4	94.6	102.8	107.6	99.1
Primary Balance (% GDP)	-1.6	5.7	2.3	-1.9	-4.0	4.5

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice

Notes: e=estimate, f=forecast.

The fiscal deficit in 2015/16 is estimated to 3.4 percent of GDP. Expenditure are on the rise, with a marked policy to accelerate the implementation of the five-year plan, now at its mid-term. Domestic revenues as a share of GDP have declined over the last three years, from 22 percent to an estimate of 18.7 percent in 2015/16, while grants finance about 30 percent of the budget. Bhutan's public and publicly guaranteed external debt stood at 99 percent of GDP by end 2015, two thirds of which are from commercially profitable hydro projects. Domestic debt is negligible.

Consumer price inflation in Bhutan has slowed to 3.2 percent in January 2016 from 4.7 in June 2015 (y-on-y), driven by the decline in oil prices and India's easing of inflation (Bhutan has a fixed exchange rate with India from which it imports most of its consumption).

Outlook

2016 economic activity is expected to moderately accelerate with real GDP growing at 6.7 percent, driven by large hydropower construction, a marked acceleration

in public capital spending and a resumption of credit expansion. Tourism arrivals are expected to resume growth, supported by a special policy over the summer 2016 for Japanese nationals exempting them from the minimum daily tariff. Agriculture is projected to grow a rate of 2.5 percent, a half percentage point above its historic average, with continued public investments in agriculture productivity. Economic growth will pick up at end 2018, when new hydropower projects come on stream. Domestic demand will be driven by hydropower investment and government spending. Consumer inflation will closely follow India's tracks. The current account deficit is expected to continue growing over the next years, driven by the construction of hydropower projects and their multiplier effect. Fiscal policy in 2016/17 will be expansionary, with a significant increase in capital spending supported by donor grants. The revenue effort will weaken slightly, unless new measures to strengthen the tax base are introduced. Overall, the fiscal deficit is projected at 5 percent of GDP. The risk of Bhutan's external debt distress continues to be moderate. This is based on the commercial viability of the hydropower projects, the risk-sharing agreement with India for hydropower



loans, Bhutan's strong track record of project implementation, rapid growth in energy demand from India, committed donor support, and Bhutan's high level of international reserves.

Risks and Challenges

The outlook is positive but macroeconomic pressures on domestic demand will have to increasingly be managed as Bhutan nears the commissioning dates of the three mega hydropower projects under construction. The impact of the ongoing re-balancing in global markets is expected to remain moderate on Bhutan's economy, mostly through lesser tourism earning and a slowdown of new hydropower projects being approved. While debt risk is still moderate, the rapid-build-up over the recent years calls for caution. Bhutan's debt carrying capacity will improve in the long run reflecting significantly higher electricity exports when hydropower projects come on stream. Efforts to deepen the financial sector must be sustained to provide the country the basis for financing sound and sustainable development.



India

The Indian economy continued to expand. However, favorable overall trends mask important underlying divergences: between urban and agricultural households; between domestic and external demand; and between public and private capital expenditure. So far, the strength of expanding sectors has outweighed the weaknesses of those facing challenges, but the sustainability and inclusiveness of GDP and household income growth going forward will depend on lagging sectors picking up.

2015

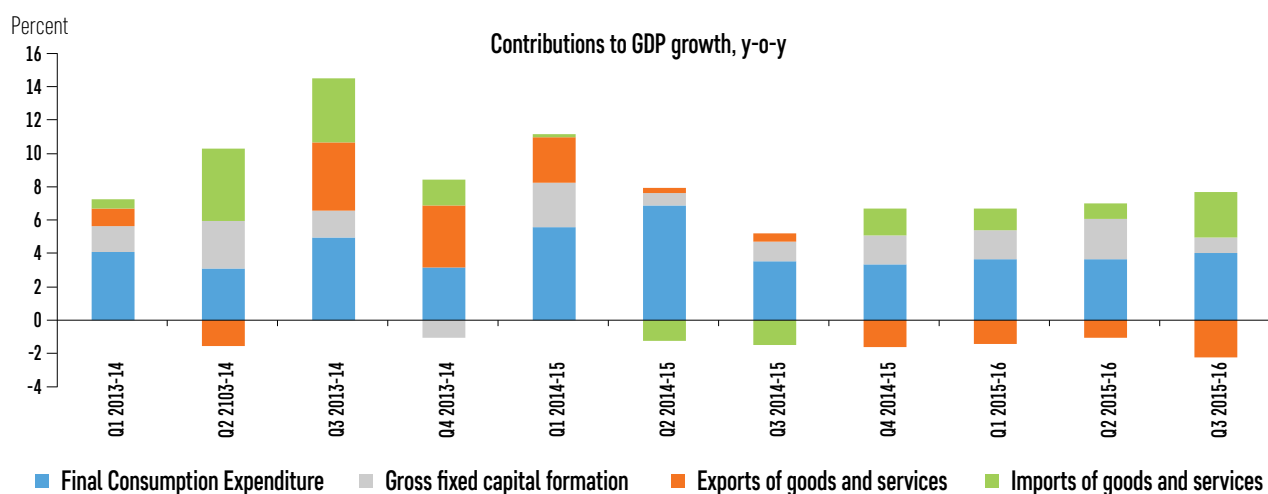
Population, million	1311.1
GDP, current US\$ billion	2216.3
GDP per capita, current US\$	1690

Sources: World Bank, WDI

Recent Developments

The economy continued to expand in April-December 2015. Real GDP (at market prices) expanded by 7.5 percent from the same period in the previous year. Private consumption was the key driver of growth. Fixed investments accelerated from average 4.1 percent in FY13-FY14 to 5.2 percent during the first nine months of FY15-16; recent gains were largely due to a revival in public investment as private investment remains weak. Exports contracted (-6.5 percent y/y in the first three quarters of FY16) due to the slowdown in emerging market growth and India's declining global market share of exports. Domestic demand provided little lift to imports, which contracted by 6.4 percent y/y during Apr-Dec.

The performance of rural and urban areas have diverged. Private consumption growth has been driven by non-agricultural (largely urban) households, as rural areas have been under stress following two sub-par monsoons and declining underground water levels in North India that depressed agricultural output. Increases in minimum support prices have steadily decelerated, and construction sector growth moderated. On the other hand, reliance on the rural employment guarantee scheme (MNREGA) has increased, reflecting latent demand for employment opportunities in rural areas. Urban households meanwhile have benefited from employment growth in services (which grew at 9.2 percent y/y during Q1-Q3 FY16), and lower inflation (down to 5 percent in the first 10 months of FY16 from 10.1 percent in FY14), which supported consumption growth as evidenced for example by higher air traffic and automobile sales (up by 9.1 percent y/y during Apr-Dec).



Source: Central Statistics Office and World Bank staff calculations



Table: India

(annual percent change unless noted otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	6.6	7.2	7.4	7.5	7.7	7.7
Private Consumption	6.8	6.2	6.6	7.8	7.4	7.0
Government Consumption	0.4	12.8	8.5	6.0	6.8	6.7
Gross Fixed Capital Investment	3.4	4.9	7.2	6.2	8.3	8.8
Exports, Goods and Services	7.8	1.7	-6.0	3.5	5.0	7.2
Imports, Goods and Services	-8.2	0.8	-6.5	2.0	5.0	6.7
Real GDP growth, at constant factor prices	6.3	7.1	7.3	7.5	7.7	7.7
Agriculture	4.2	-0.2	1.0	3.5	2.7	2.7
Industry	5.0	5.9	7.3	7.0	7.3	7.5
Services	7.8	10.3	9.2	9.0	9.3	9.1
Inflation (Consumer Price Index)	10.7	6.6	5.0	4.0	4.0	4.0
Current Account Balance (% of GDP)	-1.7	-1.3	-1.3	-1.1	-1.7	-1.8
Financial and Capital Account (% of GDP)	1.7	1.4	1.3	1.1	1.6	1.8
Net Foreign Direct Investment (% of GDP)	1.4	1.1	1.2	1.2	1.1	0.9
Fiscal Balance (% of GDP)	-7.0	-6.5	-6.3	-5.9	-5.0	-4.8
Debt (% of GDP)	64.5	65.2	62.7	60.8	58.8	57.5
Primary Balance (% of GDP)	-2.2	-2.9	-1.4	-1.2	-0.3	-0.7

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice

Notes: e = estimate, f = forecast.

Outlook

Economic activity is expected to accelerate gradually, supported first by a rebound in agriculture on the expectation of a normal monsoon in 2016, which along with the stimulus from civil service pay revisions will support broad-based consumption growth in FY17 and offset continued weakness in exports and private investment. In later years, growth will be underpinned by private investments, which will be 'crowded-in' by the push to accelerate infrastructure spending, a better investment climate, and less leveraged corporate and financial balance sheets. International trade conditions are likely to remain subdued (but still expanding). If India's share of global trade stabilizes, exports should therefore resume modest growth. Imports are likely to accelerate gradually, reflecting the fillip in private consumption and eventually higher demand for capital goods from revived investment. The current account deficit is accordingly expected to gradually widen to 2 percent of GDP by FY19. Real GDP growth is projected to increase to 7.8 percent by FY19.

Inflationary pressures are likely to remain muted in the near term on account of stable global commodity prices and more anchored inflationary expectations as the RBI continues to build credibility of its medium-term inflation target.

Risks and Challenges

Restarting private investments will be critical for sustained rapid growth. But private investment growth continues to face several impediments in the form of excess global capacity, corporate debt overhang and stresses in the financial sector, in addition to regulatory and policy challenges. In the absence of investments and resulting expansion of production capacity, not only faster growth may not materialize, but inflationary pressures could build up in the medium term.

The baseline scenario assumes a sustained expansion of India's physical, human and 'institutional' capital. Realizing the meaningful and sustainable pick-up in investments embodied in the baseline scenario requires effective implementation of reforms along many fronts: from infrastructure investments, to cleaning up banks' balance sheets and building 'institutional capital', which are the policies and institutions that enable private investments – e.g. GST, land acquisition, and insolvency. The credibility of public finances is also critical and in this regard the government's reaffirming its fiscal deficit target of 3.5 percent for FY17 was a positive development that now needs to be implemented. Therefore, the most significant downside risks are domestic, and related to the implementation of the Government's wide-ranging program of reforms.



Maldives

The tourism sector has been hit hard by the slowdown in China and Russia and domestic unrest. The medium-term fiscal plan includes large public investment projects, which will move the risk of external debt distress to high. Fiscal consolidation and more sequencing of the investment projects is needed to contain the level of public debt. A particular concern is youth unemployment with skill mismatch and lack of local economic opportunities being reported as the main cause for unemployment.

2015

Population, million	0.4
GDP, current US\$ billion	3.1
GDP per capita, current US\$	7630.9

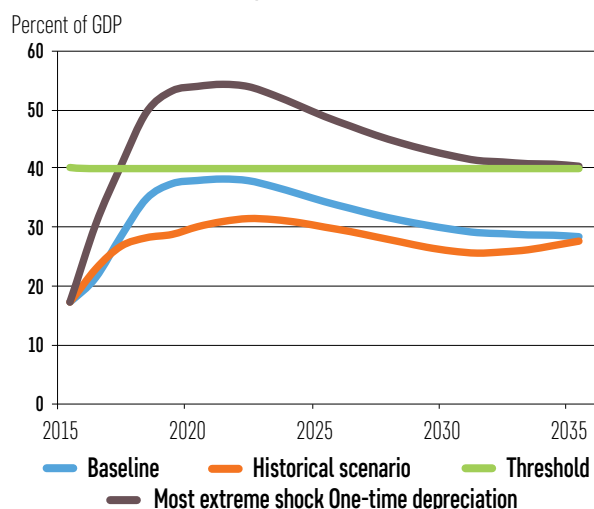
Sources: World Bank, WDI

Recent Developments

GDP growth in Maldives has moderated in recent years. After dipping to 2.5 percent in 2012, GDP growth recovered in 2013-2014, reaching an estimated 6.5 percent. Staff estimates that growth fell to 1.9 percent in 2015, dragged down by a slowdown in tourism arrivals, especially from China and Russia and a number of cancellations of tourism reservations following the state of emergency in November. Construction has overtaken tourism as the most important driver of growth in 2015.

Following the global decline in commodity prices, CPI inflation has slowed down in 2014 and 2015. Annual average inflation in Malé reached 2.4 percent in 2014,

Present value of public external debt to GDP ratio



Sources: Ministry of Finance, World Bank staff calculations, Joint Bank-Fund Debt Sustainability Analysis

Percentage points

Contributors to GDP growth



Source: Central Statistics Office and World Bank staff calculations



Table: Maldives

(annual percent change unless noted otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	4.7	6.5	1.9	3.5	3.9	4.6
Private Consumption	...	...	...	...	...	...
Government Consumption	...	...	...	...	...	...
Gross Fixed Capital Investment	...	...	...	...	...	...
Exports, Goods and Services	...	...	...	...	...	...
Imports, Goods and Services	...	...	...	...	...	...
Real GDP growth, at constant factor prices	4.2	5.9	...	...	...	...
Agriculture	5.1	0.2	...	...	...	...
Industry	-7.6	12.9	...	...	...	...
Services	6.4	5.0	...	...	...	...
Inflation (Consumer Price Index)	4.0	2.4	1.4	1.3	2.5	2.8
Current Account Balance (% of GDP)	-4.3	-4.1	-8.0	-7.7	-14.7	-17.3
Financial and Capital Account (% of GDP)	9.2	11.8	6.7	9.8	19.6	20.3
Net Foreign Direct Investment (% of GDP)	12.9	12.1	10.6	10.0	10.9	10.8
Fiscal Balance (% of GDP)	-7.4	-9.1	-8.4	-13.3	-18.1	-18.9
Debt (% of GDP)	64.8	66.6	73.1	83.1	96.5	109.0
Primary Balance (% of GDP)	-4.9	-6.3	-5.5	-10.8	-14.7	-14.4

Source: Maldives Monetary Authority, Ministry of Finance and Treasury, World Bank staff projections

Note: e = estimate, f = forecast

and fell further to 1.4 percent in 2015, dragged down by food, transport and communication prices.

Maldives' high levels of fiscal deficits and public debt pose a significant risk, as the country is structurally spending beyond its means. Even though high costs of public service delivery can logically be expected in a multi-island country with a scattered population, high levels of public spending in recent years have been primarily driven by the increasing costs associated with the country's redistributive model, including the high public sector wage bill, pensions, universal health insurance and subsidies for food and electricity, and transfers to state-owned enterprises.

Continuing trends from previous years, staff estimates that public spending reached 44.4 percent of GDP in 2015, leading to a fiscal deficit estimated at 8.4 percent of GDP despite a high and increasing level of revenue (35.9 percent of GDP in 2015). In this context, management of the constrained cash flow has become an increasing challenge, leading to the build-up of arrears and costly domestic borrowing. Heavy reliance of domestic sources of financing have also contributed to

increase the exposure of the domestic banking system to sovereign risk.

The 2016 budget is expansionary with large public investment projects and one-off revenue measures. Staff projects revenue to reach 35.6 percent of GDP and expenditure 48.9 percent of GDP driven by public investment. Wages are projected to be frozen in nominal terms, while the budget foresees strong cuts in electricity and food subsidies. The budget includes a number of large multi-year investment projects: airport expansion, a bridge between the capital Malé and Hulhumalé island and housing construction in Hulhumalé island.

Balance of payment pressures have attenuated somewhat in recent months, and the exchange rate has remained stable. Loose fiscal policy and recourse to monetary financing of the deficits have contributed to substantial balance of payment pressures in recent years. Nevertheless, the decline in global commodity prices, and the associated decrease in the import bill (notably for diesel), together with continued FDI inflows in the tourism sector have offset this somewhat.



As a result, gross official reserves increased from USD 368 million at the end of 2013 to USD 564 million at the end of 2015. However usable reserves (net of short-term foreign liabilities to the banking sector) remain low, at only USD 194 million, covering only about 1.2 months of imports of goods and services. Nevertheless, the exchange rate of MVR 15.4 per USD has remained stable. In practice the tourism industry appears to be supplying sufficient quantities of foreign exchange at a stable premium over the official exchange rate.

Data constraints continue to prevent poverty monitoring since the last survey conducted in 2009-10. However, the recent release of Census 2014 data provides interesting insights on inter-censuses labor market trends. Overall, labor market participation of Maldivian resident population improved, with a notable increase in the share of women actively participating in the labor market, which went from 41.4 percent in 2006 to 47.6 percent in 2014. Unemployment rate among Maldivian resident population remains low at 5.2 percent, although much higher rates prevail among youth. Of particular concern, youth unemployment increased from 9.3 percent in 2006 to 12.4 percent in 2014, with skill mismatch and lack of local economic opportunities being reported as the main cause for unemployment.

Outlook

In the near term, growth is expected to be driven by construction, fueled by both private sector construction and large public investment projects, while tourism growth is likely to remain subdued because of a slowdown in China, the recession in Russia and, the appreciation of the MVR (pegged against the USD) against major currencies. Inflation is projected to remain subdued as long as global commodity prices remain low, with positive impacts on the current and fiscal accounts.

The large increase in capital investment will return the risk of external debt distress to high. Driven by a fiscal deficit reaching close to 20 percent of GDP by 2018, public debt would rise fast and could exceed 120 percent of GDP by 2020, while external public debt would breach the policy-dependent thresholds defined under the Low-Income Country Debt Sustainability Framework (LIC-DSF).

A sequenced implementation of investment projects with a more limited fiscal deficit could mitigate this risk to some extent. This scenario would limit the fiscal

deficit and could keep the public debt-to-GDP ratio below 100 percent.

In March 2016, the National Statistics Bureau has started the field work operations for a new Household Income and Expenditure Survey (HIES 2016) which is expected to be completed by the end of the year. The availability of new household survey data will allow the production of new estimates and an updated poverty assessment in 2017.

Risks and Challenges

The immediate macroeconomic challenge is the fiscal and external imbalances driven by high and rising public spending. The projected fiscal consolidation is not enough to bring public debt-to-GDP on a declining path and fiscal consolidation by raising revenue and reducing expenditure will be needed. Limited reserves, a high level of public debt and the short maturity of domestic debt adds additional vulnerability.

Meanwhile, continued domestic political unrest and a slowdown in major tourism-providing countries (China and European countries) might lead to further reductions in tourism visits, which could put pressure on growth, revenue and the balance of payments.

There are limited investment opportunities in the private sector outside tourism, and banks prefer to park their available assets at the central bank and abroad.



Nepal

Nepal experienced a second major shock in the form of near complete cross-border trade disruptions. This has curtailed economic activity, lowering growth prospects to 1.7 percent in FY2016. Trade disruptions have pushed inflation to double digits, affecting the welfare of the poor and vulnerable, while reducing revenue collection and slowing reconstruction efforts. However, a full normalization is expected by the end of FY2016 leading to strong rebound in FY2017. External environment will likely be less favorable with early indications of growth of remittances slowing.

2015

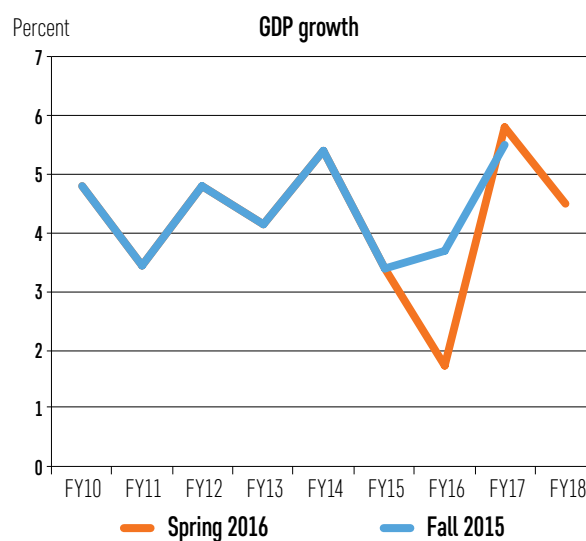
Population, million	28.5
GDP, current US\$ billion	21.1
GDP per capita, current US\$	742

Sources: World Bank, WDI

Recent Developments

In the span of six-months, Nepal has been hit by two major shocks. The first one was the April 2015 earthquakes that have caused a huge loss of life and assets. The second shock has come in the form of a near complete disruption of external trade following the adoption of the new Constitution. Nepal's political parties intensified their efforts to adopt a new constitution, after eight years of deliberations, spurred on by the shift in political priorities following the earthquakes. As the constitutional process drew to an unexpectedly rapid close, protests and clashes erupted in August 2015 across the country's southern belt bordering with India. Following the promulgation of the new constitution on September 20, 2015, protests intensified, leading to a near-complete disruption in cross-border trade. This has resulted in acute shortages of fuel and essential supplies across the country, which in turn has curtailed economic activity.

With varying intensity, the trade disruptions—which lasted more than four months from September 2015 through January 2016—have affected economic activity across the board. Industry came to a near stand-still due to shortage of fuel and raw materials. Service sector has been hit particularly hard as tourism, trade, transport and bank lending were curtailed. Agriculture has been affected by lack of fertilizers and other inputs with production of rice, the largest crop, reaching a seven-year low. Government revenues fell sharply,



Sources: Central Bureau of Statistics (CBS) and World Bank staff estimates

given Nepal's large reliance on trade-related taxes, leading to a decline in public expenditures as well. Imports contracted for the first time in decades resulting in a sharply lower trade deficit. Remittances continued to grow, albeit at a slower pace, and together with the shrinking trade deficit have resulted in a record high current account surplus.

Furthermore, humanitarian effects of the trade disruptions cannot be underestimated with children missing school, hospitals running low on critical supplies, and delays in reconstruction and winterization efforts undermining earthquake recovery in the affected areas.



Table: Nepal

(annual percent change unless noted otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	3.8	5.5	3.4	1.7	5.8	4.5
Private Consumption	3.4	3.4	3.0	-3.6	5.0	3.6
Government Consumption	-6.9	18.0	12.3	6.5	11.1	11.1
Gross Fixed Capital Investment	11.1	8.3	13.3	13.1	21.0	20.7
Exports, Goods and Services	10.3	23.7	5.4	-9.0	9.0	9.0
Imports, Goods and Services	14.2	18.0	9.0	-4.7	13.0	14.0
Real GDP growth, at constant factor prices	3.5	5.2	3.0	1.7	5.8	4.5
Agriculture	1.1	4.7	1.9	1.0	2.6	2.6
Industry	2.5	2.7	2.6	0.5	2.7	2.7
Services	5.6	6.3	4.0	2.6	9.0	6.3
Inflation (Consumer Price Index)	9.9	9.1	7.2	9.4	9.0	8.3
Current Account Balance (% of GDP)	3.4	4.6	5.1	5.0	0.5	-1.8
Fiscal Balance (% of GDP)	1.7	1.8	0.3	-0.1	-1.9	-1.5
Debt (% of GDP)	32.5	29.1	24.8	26.6	29.1	31.1
Primary Balance (% of GDP)	2.4	2.1	1.4	0.7	-1.3	-0.7

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice

Notes: e = estimate, f = forecast.

Outlook

Growth for FY2016 is expected to be below potential for a second year in a row. Prior to the trade disruptions, growth in FY2016 was projected at 3.7 percent given continuing effects of the earthquake destruction, sub-optimal monsoon rainfall and delays in reconstruction activities. Following trade disruptions, growth is expected to slow further to 1.7 percent in FY2016. A rebound in the subsequent years is expected on the back of the increased investment (both public and private) as the political process stabilizes and the earthquake recovery speeds up. Manufacturing in particular is expected to get some boost starting from FY2017 with the apparels and garment industry getting a duty free access in the US market. The high inflation induced by the trade disruptions is expected to moderate towards the end of FY2016, but likely to remain elevated owing to persistent supply-side bottlenecks during the forecast period.

Fiscal deficit is expected to widen during the forecast, but to remain within manageable limits. Government's recurrent expenditure is expected to grow

substantially in FY2016 owing to increase in earthquake related cash assistance while the revenues will fall short of the budgeted amount by about 2 percent of GDP. Slow pick up in capital expenditure, however, particularly those related to reconstruction, will limit the size of deficit in FY2016. For the remainder of the forecast period, the fiscal deficit is expected to widen as reconstruction efforts take full shape. Similarly, current account will likely remain in surplus in FY2016, but is expected to turn to deficit as remittances taper off and imports grow driven by the larger reconstruction efforts.

Risks and Challenges

Normalizing fuel and other supplies to general public, along with effective mobilization of post-earthquake reconstruction are key short-term challenges, particularly in light of fast-approaching monsoon season. Additionally, the trade disruptions have highlighted the need to urgently diversify the Nepalese economy, particularly in terms of trade, transport options and supplies of key resources.



External environment is likely to be less favorable as well. With remittances comprising nearly 30 percent of GDP, Nepalese economy is extremely dependent on these flows. Oil-exporting Gulf Co-operation Countries and Malaysia, which represent almost 97 percent of total Nepali migrants excluding India, are a key source of remittances. As oil prices in particular, and commodity prices in general, are likely to remain low during the forecast period, the possibility of a drop in remittances has increased. Given that remittances enable consumption-centric structure of the Nepalese economy and the government's reliance on taxation of imports as a major source of revenue, a sharp slow-down would have adverse effects on growth, fiscal and external accounts, in addition to curtailing economic opportunities for Nepalis abroad.

In the medium term, Nepal faces several simultaneous and daunting challenges ahead. From completion of political transition and setting up of a new federal structure to challenges of successful leveraging of its endowments (hydropower potential, human capital) to achieve a faster growth, increasing poverty reduction and creating economic opportunities for its citizens at home. Regaining domestic and foreign investors' confidence, particularly for hydropower development, is an added challenge after series of shocks for a country that does not have a favorable track-record in mobilizing large-scale private investment.



Pakistan

Pakistan's mild recovery continues, with some progress on structural reforms which is beginning to yield results. Nonetheless, much of the growth is underpinned by exogenous factors, including falling oil prices and substantial remittances. Sustained and inclusive growth will rely upon investments, chiefly through China Pakistan Economic Corridor (CPEC), recovery in key markets for Pakistan (China and the GCC), and successful implementation of tax and energy reforms.

2015

Population, million	188.9
GDP, current US\$ billion	269.9
GDP per capita, current US\$	1429

Sources: World Bank, WDI

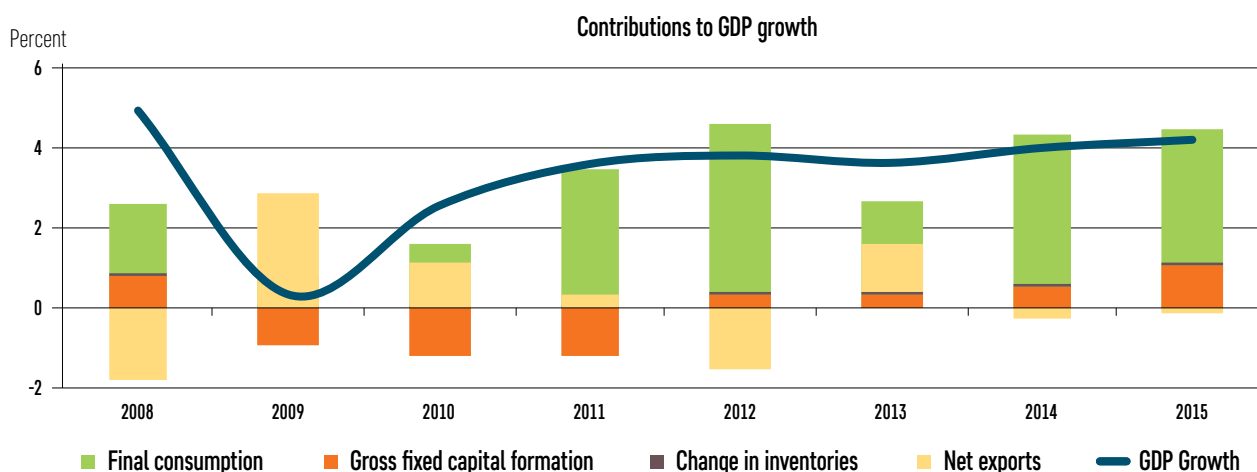
Recent Developments

Aided by falling commodity and fuel prices, increased energy availability and improved security conditions, economic growth is picking up – albeit slowly – in FY2016. Industrial growth is accelerating on the back of higher activity in large-scale manufacturing and construction, the latter being driven primarily by initiation of CPEC infrastructure and energy projects. The improved industrial performance is expected to compensate, to some extent, the weather setbacks observed in the agriculture sector. Moreover, services sector is expected to grow modestly due to adequate financial sector profitability, substantial automobile sales, increased port activity, and higher telecom

profits; although wholesale and retail trade is yet to improve.

Progress continues on business climate, energy, access to credit and tax reform agendas. These efforts appear to have delivered some results to date, with private sector credit showing a sign of revival. Additionally, FBR taxes (comprising 70% of total revenues) continue to grow, achieving 58% of the target during July-February – a marked improvement from previous year.

The external account, though positive, is experiencing some setbacks. China's investment in coal-based power projects under CPEC has delivered a major



Source: Pakistan Economic Survey



Table: Pakistan

(annual percent change unless noted otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	4.4	4.7	5.5	4.5	4.8	5.1
Private Consumption	2.1	5.4	3.6	3.8	4.5	4.8
Government Consumption	10.1	1.5	16.0	6.0	6.2	6.1
Gross Fixed Capital Investment	2.6	4.2	8.3	6.0	6.9	7.3
Exports, Goods and Services	13.6	-1.6	-2.6	-10.2	-0.5	2.3
Imports, Goods and Services	1.8	0.2	-1.1	-7.7	2.4	5.0
Real GDP growth, at constant factor prices	3.7	4.0	4.2	4.5	4.8	5.1
Agriculture	2.7	2.7	2.9	2.1	2.6	2.9
Industry	0.6	4.5	3.6	4.8	5.1	5.4
Services	5.1	4.4	5.0	5.2	5.4	5.7
Inflation (Consumer Price Index)	7.4	8.6	4.5	4.0	4.5	5.0
Current Account Balance (% of GDP)	-1.1	-1.3	-1.0	-1.1	-1.1	-1.3
Financial and Capital Account (% of GDP)	0.4	3.0	2.0	1.8	1.4	1.4
Net Foreign Direct Investment (% of GDP)	0.5	0.6	0.3	0.3	0.4	0.5
Fiscal Balance (% of GDP)	-8.4	-4.9	-5.3	-4.7	-4.4	-4.2
Debt (% of GDP)	64.7	64.7	64.4	63.9	63.1	62.1
Primary Balance (% of GDP)	-3.9	-0.3	-0.5	0.0	0.3	-0.1

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice.

Notes: e = estimate, f = forecast.

boost in FDI¹. However, slower growth in China and weak global demand has taken a toll on exports, revealing Pakistan's vulnerability to a narrow base and a high concentration in few destinations². Imports also contracted in early FY2016 but seem to be recovering since November 2015, particularly in food and machinery. Strong but moderating remittances – mostly from GCC countries – have been enough to cover the resulting trade deficit. This, coupled with CSF monies and healthy IFI disbursements, has helped strengthen foreign exchange reserves. Moreover, exchange rates, after exhibiting volatility following the Asian markets turmoil in August 2015, have largely stabilized.

Inflation continues in single-digit but expectations are shifting towards a gradual increase. More notably, CPI inflation (y-o-y) has started to rise since October 2015,

which has moderated the pace of monetary easing in FY2016 relative to last year. Continued fiscal consolidation efforts have improved the overall deficit by 0.5 percentage points of GDP during H1-FY2016.

Outlook

Growth in Pakistan is projected to accelerate from 4.2% in FY2015 to 4.5% in FY2016 and 5.1% by FY2018, broadly in line with the underlying potential output growth and capital accumulation, supported by a growing industry and services sector on the supply side and strengthening investment flows on the demand side. Any demand-driven economic expansion as a result of CPEC's implementation is expected to be limited in the short-run as increased investment will likely be offset by a significant increase in imports. However, supply-side effects facilitated by higher power generation capacity and better infrastructure will be beneficial for economy in the medium- to long-term.

1 Almost 58% of the net inflows during July-February are from China, more than doubling the share of Chinese investment in a years' time.

2 Only 10% of countries and 3% of items account for 75% of total exports.



A decline in exports in FY2016 (followed by marginal export growth forecasts for the next two years) and an expected increase in imports will weaken the trade account; thus the current account deficit is projected to increase slightly to 1.3% by FY2018. The outlook assumes prolonged low oil prices, and subsequently constrained growth in remittances of around 5.5%³, chiefly due to tightening fiscal policies of the Gulf, and no large volatility in exchange rates over this period. Financial flows, including strengthening FDI, are expected to augment foreign exchange reserves.

Inflation is expected to steadily rise over the projection horizon as the base effect diminishes, domestic energy prices increase, and aggregate demand grows. Moreover, increased public investment partly to support the CPEC transport projects is expected to result in an increase in development spending while rationalization is expected to continue on recurrent expenditure. Additionally, tax collection is projected to improve as the government continues with efforts to rationalize tax exemptions in the upcoming budget, while improving compliance and administration. This is crucial to generate fiscal space while contributing to a declining debt trajectory.

Risks and Challenges

To unlock its high-growth potential, Pakistan needs to maintain the momentum in reforming its business climate, access to finance and trade regime. As the election year approaches in 2018, the government may find it difficult to implement unpopular decisions, particularly on taxation and energy. This, combined with pre-election spending pressures, poses a risk to prudent fiscal policy. CPEC, if completed, could be a game changer for Pakistan, but is currently mired in political economy risks. To ensure the corridor delivers on its potential, the government needs to address concerns and build consensus among all stakeholders. Furthermore, a prolonged slowdown in China could diminish financial inflows under these projects. Pakistan should also monitor a key driver of remittances: public investment cuts and the resulting restrictions on foreign employment in GCC countries, particularly in construction, where many Pakistani migrants are employed.

³ Against the historical 5-year average of 16%.



Sri Lanka

The challenging global environment took a toll on the economy with reduced exports and remittances; and significant capital outflows. Expansionary monetary and fiscal policy supported growth, but were of little help in addressing these challenges, leaving the country with higher public debt, lower reserves and rising core inflation in 2015.

2015

Population, million	20.8
GDP, current US\$ billion	81.3
GDP per capita, current US\$	3,912

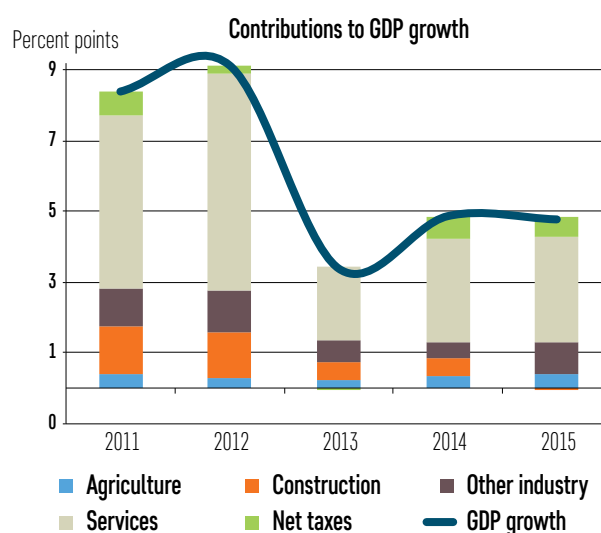
Sources: World Bank, WDI

Recent Developments

Economic growth marginally decelerated to 4.8 percent in 2015 compared to 4.9 percent in 2014 on account of the decline in the construction sector as the new government was reassessing the construction led growth model. The services sector contributed 63 percent of the total growth underlying strong contributions from transport, trade, financial services, real estate and other personal services related sectors. An accommodative monetary environment that led to a 25.1 percent year-on-year expansion of credit to the private sector played an important role in fueling the growth.

Downward price revisions in key consumer items; low global commodity prices; and overall improved domestic supply conditions eased inflationary pressures. As a result, average annual inflation remained benign at 0.9 percent in December 2015. However, core inflation computed excluding fresh food, energy, and transport rose during the latter part of 2015. It reached 4.5 percent on year-on-year basis in December 2015, indicating demand pressures in the economy.

The fiscal deficit rose sharply in 2015 due in part to two successive election-time budgets, with increased salaries and subsidies, reduced consumption taxes, and increased interest costs on resultant deficit financing. Although one-off revenues proposed in the 2015 budget helped mitigate the impact, the deficit increased to an estimated 6.3 percent of GDP from a budgeted 4.4 percent of GDP. A high primary deficit, rising real interest rates and the currency depreciation increased the public debt to GDP ratio from 70.7 percent in 2014



Source: Department of Census and Statistics, World Bank staff calculations

to an estimated 75.2 in 2015, while treasury guarantees are estimated at 5.8 percent of GDP.

Expansionary fiscal and monetary policy led to a surge of non-oil imports, almost offsetting the low commodity price windfall. Meanwhile, capital outflows from the government securities market fueled by tight global financial conditions and scheduled external debt obligations contributed to heightened exchange rate pressures. Due to uncertainty in a complex political environment, FDI inflows remained lower than expected. Despite higher than budgeted foreign borrowings and swap arrangements with the Reserve Bank of India, the official reserves declined from the equivalent of 4.3 months of imports of goods and services in end-2014, to 3.8 months of imports



Table: Sri Lanka

(annual percent change unless noted otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	3.4	4.9	4.8	5.3	5.3	5.3
Private Consumption	7.8	5.7	6.5	4.8	5.3	5.3
Government Consumption	0.1	6.1	10.3	2.8	1.9	1.4
Gross Fixed Capital Investment	5.0	-3.2	1.0	2.8	11.8	9.8
Exports, Goods and Services	6.6	4.3	4.7	4.8	4.6	3.9
Imports, Goods and Services	-1.5	9.6	10.6	-0.5	8.1	6.1
Real GDP growth, at constant factor prices	3.8	4.7	4.6	5.3	5.3	5.3
Agriculture	3.2	4.9	5.5	5.2	5.2	5.2
Industry	4.1	3.5	3.0	5.3	5.0	5.0
Services	3.8	5.2	5.3	5.4	5.4	5.4
Inflation (Consumer Price Index)	4.7	2.1	2.8	4.3	4.2	4.2
Current Account Balance (% of GDP)	-3.4	-2.5	-2.2	-0.7	-1.5	-2.0
Financial and Capital Account (% of GDP)	4.2	2.5	2.2	0.7	1.5	2.0
Net Foreign Direct Investment (% of GDP)	1.2	1.1	0.7	1.2	1.2	1.3
Fiscal Balance (% of GDP)	-5.4	-5.7	-6.3	-5.7	-5.2	-5.1
Debt (% of GDP)	70.8	70.7	75.2	75.1	75.0	75.0
Primary Balance (% of GDP)	-0.8	-1.5	-1.5	-1.0	-0.6	-0.3

Source: World Bank, Macroeconomics and Fiscal Management Global Practice
Note: f = forecast

of goods and services by end-2015, due mainly to continued sales of foreign currency. Nevertheless, the LKR depreciated 10 percent against the USD during the year.

Belatedly, steps were taken in late 2015 towards tightening monetary policy, providing greater flexibility to the currency and curbing growth in private credit and imports. Policy rates were increased in February 2016, for the first time in almost four years. Some measures were proposed to the parliament to increase fiscal revenues in March 2016 that included increasing the VAT rate from 11 percent to 15 percent.

During the past year, labor market trends have been mixed. Employment in agriculture continued to fall, boosting productivity and contributing to declines in poverty. Between Q3 2014 and 2015, the share of employment in agriculture fell from 29.0 to 27.4 percent. But unemployment, while remaining manageable, ticked upwards from 4.2 to 5 percent. Female labor

force participation remains low and lags male rates by nearly 40 percentage points.

Outlook

Growth is expected to increase to 5.3 percent in 2016 and beyond, driven by increased public investment and postponed FDI in 2015. The reduced drag from imports thanks to continued low commodity prices and the recent policy measures to curb import growth would also contribute to the increase in growth.

The impact of past currency depreciation and the increase of VAT rate are expected to lead inflation to rise in 2016. However, relatively low international commodity prices are expected to maintain downward pressure.

The trade balance is projected to improve with reduced imports on policy tightening and continued low oil



prices. The current account deficit is also projected to narrow thanks to growing tourism inflows, while remittances are projected to grow below nominal GDP growth because of continued low oil prices affecting the Middle East.

The fiscal deficit is projected at 5.6 percent of GDP for 2016 after considering a few key policy measures, including the increase in VAT rate, announced as amendments to the Budget.

Risks and challenges

Immediate challenges include managing external balances with significantly large forex drains due in 2016; and implementing the proposed revenue measures to reduce the 2016 fiscal deficit. Structural challenges include increasing fiscal revenue in the medium term to meet the requirements of a middle income country; and narrowing a persistent current account deficit linked to structural competitiveness issues in the export sector. With the country approaching upper middle income status, borrowing terms are becoming more commercial, which could affect affordability. Finally, with limited national savings compared to national investment, Sri Lanka needs to attract more FDI to sustain a high growth path with emphasis on manufacturing and export sectors.





South Asia at a glance

(Notes)			AFG (1)	BGD (4)	BTN (8)	IND (12)	MDV (16)	NPL (17)	PAK (22)	LKA (27)	SAR (31)
BALANCE of PAYMENTS	Real GDP Growth	2013	2.0	6.0	3.6	6.9	4.7	3.8	4.4	3.4	6.1
		2014	1.3	6.1	3.8	7.2	6.5	5.5	4.7	4.9	6.8
		2015e	1.5	6.5	5.8	7.4	1.9	3.4	5.5	4.8	7.0
		2015 Q3	..	..	..	7.5	..	..	..	5.7	
		2015 Q4	..	..	..	7.5	..	..	..	2.3	
		2016f	1.9	6.3	6.7	7.5	3.5	1.7	4.5	5.3	7.1
	Inflation (Consumer Price Index)	2013	7.4	6.8	10.4	10.7	4.0	9.9	7.4	4.7	..
		2014	4.6	7.3	8.8	6.6	2.4	9.1	8.6	2.1	3.3
		2015e	-1.5	6.4	5.6	5.0	1.4	7.2	4.5	2.8	..
		2016f	3.0	6.6	4.3	4.0	1.3	9.4	4.0	4.3	..
		2016 Jan	..	6.0	..	5.7	..	..	3.4	..	5.7
		2016 Feb	..	5.6	..	5.2	..	..	4.1	..	5.2
	"REER (CY)"	2013	100.8	84.1	98.2	99.4	98.6	98.5	88.6	95.1	95.4
		2014	97.7	97.0	99.4	98.7	98.2	99.0	96.2	96.8	97.9
		2015	97.6	103.2	99.3	104.9	106.6	101.9	105.2	97.0	102.0
		2015 Nov	94.5	104.5	98.3	105.4	110.1	102.5	106.3	94.4	102.0
		2015 Dec	94.5	104.1	98.3	105.3	110.9	102.7	106.9	93.8	102.1
	Current Account (% of GDP)	2013	7.4	1.6	-23.5	-1.7	-4.3	3.4	-1.1	-3.4	-3.2
		2014	8.0	0.8	-25.3	-1.3	-4.1	4.6	-1.3	-2.5	-2.2
		2015e	5.6	-0.8	-26.3	-1.3	-8.0	5.1	-1.0	-2.2	-1.2
		2016f	4.6	0.3	-30.0	-1.1	-7.7	5	-1.1	-0.7	-1.0
	Trade Balance (% of GDP)	2013	-43.4	-7.2	-21.8	-3.0	19.3	-26.8	-6.8	..	-4.1
		2014	-39.6	-6.5	-21.1	-2.3	18.9	-29.6	-6.4	..	-3.5
		2015	..	..	..	..	..	..	..	..	..
	Imports, Goods and Services Annual Percent Change (FY)	2013	35.7	1.2	1.1	-8.2	..	14.2	1.8	-1.5	-2.4
		2014	-5.6	1.2	10.4	0.8	..	18.0	0.2	9.6	0.7
		2015e	2.4	7.5	12.0	-6.5	..	9.0	-1.1	10.6	-1.8
		2016f	3.2	13.2	15.0	2.0	..	-4.7	-7.7	-0.5	1.6
	Exports, Goods and Services Annual Percent Change (FY)	2013	22.1	2.4	-5.0	7.8	..	10.3	13.6	6.6	6.8
		2014	6.8	3.2	16.1	1.7	..	23.7	-1.6	4.3	2.6
		2015e	4.8	-3.7	6.0	-6.0	..	5.4	-2.6	4.7	-2.9
		2016f	3.4	15.5	4.0	3.5	..	-9.0	-10.2	4.8	2.7



(Notes)			AFG (1)	BGD (4)	BTN (8)	IND (12)	MDV (16)	NPL (17)	PAK (22)	LKA (27)	SAR (31)
BALANCE of PAYMENTS	Foreign Reserves in Months of Import (CY)	2013	..	5.0	..	7.5	2.5	..	2.6	5.5	6.9
		2014	..	6.0	..	8.1	3.0	..	2.9	6.2	7.6
		2015	..	7.6	..	10.7	..	..	4.6	5.5	9.8
		2015 Nov	..	..	..	11.9	..	..	5.3	..	11.0
		2015 Dec	..	..	..	11.6	..	..	5.3	..	10.7
	Remittances (US\$ Mil) (CY)	2013	..	-2.4	..	5.3	..	15.7	4.4	7.0	..
		2014	..	8.0	..	20.8	..	6.66	17.9	9.5	..
		2015	..	2.58	..	-2.67	..	14.67	12.53	-0.33	..
		Q3	..	-1.9	..	-5.0	..	18.47	4.0	1.1	..
		Q4	..	2.2	..	-29.9	..	7.19	8.7	-6.7	..
GOVERNMENT FINANCES	Fiscal Balance (% of GDP)	2013	1.0	-3.9	-4.2	-7.0	-7.4	1.7	-8.4	-5.4	-6.9
		2014	-1.8	-3.5	3.8	-6.5	-9.1	1.8	-4.9	-5.7	-6.7
		2015e	-1.4	-4.2	0.6	-6.3	-8.4	0.3	-5.3	-6.3	-6.5
		2016f	-0.9	-4.7	-3.4	-5.9	-13.3	-0.1	-4.7	-5.7	-6.0
	Public Debt to GDP (%)	2013	7.1	34.5	99.9	64.5	64.8	32.5	64.7	70.8	61.6
		2014	6.5	33.9	96.4	65.2	66.6	29.1	64.7	70.7	64.1
		2015e	6.7	34.0	94.6	62.7	73.1	24.8	64.4	75.2	65.2
		2016f	6.6	34.2	102.8	60.8	83.1	26.6	63.9	75.1	66.2
CONSUMPTION and INVESTMENT	Private Consumption Annual Percent Change (FY)	2013	2	5.1	15.3	6.8	..	3.4	2.1	7.8	5.7
		2014	1.5	4.0	6.1	6.2	..	3.4	5.4	5.7	6.0
		2015e	-0.2	5.4	7.0	6.6	..	3.0	3.6	6.5	6.0
		2016f	0.9	3.1	8.2	7.8	..	-3.6	3.8	4.8	7.0
	Government Consumption Annual Percent Change (FY)	2013	3.7	5.8	-3.7	0.4	..	-6.9	10.1	0.1	1.6
		2014	8	7.9	-2.6	12.8	..	18.0	1.5	6.1	9.7
		2015e	2.3	9.4	13.6	8.5	..	12.3	16.0	10.3	9.6
		2016f	4.1	20.2	9.7	6.0	..	6.5	6.0	2.8	6.6
	Gross Fixed Capital Investment Annual Percent Change (FY)	2013	9.4	5.4	-13.0	3.4	..	11.1	2.6	5.0	3.9
		2014	7.5	9.9	-4.1	4.9	..	8.3	4.2	-3.2	4.7
		2015e	6.5	9.6	10.1	7.2	..	13.3	8.3	1.0	6.9
		2016f	6.3	10.8	17.3	6.2	..	13.1	6.0	2.8	8.1
	Net Foreign Direct Investment (% of GDP)	2013	0.3	1.2	..	1.4	12.9	0.4	0.5	1.2	1.4
		2014	0.6	0.8	..	1.1	12.1	0.0	0.6	1.1	1.5
		2015e	0.7	0.9	..	1.2	10.6	..	0.3	0.7	..
		2015 Q1	..	0.3	..	0.5	..	..	..	0.1	..
		2015 Q2	..	0.3	..	0.5	..	..	..	0.2	..
	Portfolio Investment, net (BoP, current US\$ Mil)	2013	53	-133	..	-6858	53	..	-27	-2068	..
		2014	..	-529	..	-37740	2	..	-3844	-1996	..
		2015	..	..	..	..	..	..	..	..	..



Notes

est	Estimate
f	Forecast
CY	Series for Calendar Year
FY	Series for Fiscal Year

Sources World Bank MFM, World Bank DECPG, World Bank WDI, IMF IFS, IMF WEO, national authorities and Haver

Real GDP Growth	Real GDP growth rates (percent) at market prices
Inflation	CPI inflation period average
REER	period averages
Trade Balance	Balance on goods and service (% of GDP), WB WDI
Foreign Reserves in Months of Import	World Bank DECGM, WB Staff Calculations
Import Growth	Imports of goods and services (annual % growth)
Export Growth	Exports of goods and services (annual % growth)
Portfolio Investment, net (BoP, current US\$ Mil)	WB WDI

Afghanistan

- 1 2013 onwards is calendar year, preceding years correspond to solar year (Apr-Mar)
- 2 Current Account: Including grants
- 3 Fiscal Balance: Not Including grants

Bangladesh

- 4 These numbers are for fiscal year (July-June) unless otherwise mentioned. For example; for 2014 numbers, 2013-2014 values are used.
- 5 Consumption and Investment: WB Staff Calculations
- 6 Net Foreign Direct Investment (% of GDP): WB, IMF WEO, and WB Staff Calculations

Bhutan

- 7 These numbers are for fiscal year (July-June) unless otherwise mentioned. For example; for 2014 numbers, 2013-2014 values are used.
- 8 Consumption and Investment: WB Staff Calculations
- 9 Net Foreign Direct Investment (% of GDP): WB WDI



	India
10	These numbers are for fiscal year (Apr-Mar) unless otherwise mentioned. For example; for 2013 numbers, 2013-2014 values are used.
11	Consumption and Investment:WB Staff Calculations
12	Quarterly Real GDP Growth: DECGM & WB Staff Calculations
13	Net Foreign Direct Investment (% of GDP): WB, IMF WEO, and WB Staff Calculations
	Maldives
14	These numbers are for calendar year unless otherwise mentioned.
	Nepal
15	These numbers are for fiscal year (16 July-15 June) unless otherwise mentioned. For example; for 2014 numbers, 2013-2014 values are used.
16	Consumption and Investment:WB Staff Calculations
17	Net Foreign Direct Investment (% of GDP): WB WDI
	Pakistan
18	These numbers are for fiscal year (July-June) unless otherwise mentioned. For example; for 2014 numbers, 2013-2014 values are used.
19	Real GDP growth reported at factor cost
20	Consumption and Investment:WB Staff Calculations
	Sri Lanka
21	These numbers are for calendar year unless otherwise mentioned.
22	Consumption and Investment:WB Staff Calculations
23	Quarterly Real GDP Growth: Sri Lanka Department of Census, HAVER, WB Staff Calculations
24	Net Foreign Direct Investment (% of GDP): WB, IMF WEO, and WB Staff Calculations
	SAR
25	These numbers are for calendar year unless otherwise mentioned.
26	Remittances: WB Staff Calculations
27	Public Debt to GDP: WB Staff Calculations
28	Inflation: DECPG & WB Staff Calculations
29	Net Foreign Direct Investment (% of GDP): WB WDI
30	Fiscal Balance (% of GDP): WB DECPG
31	Public Debt to GDP (%): IMF WEO Oct. 2015, WB staff calculations





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