CHAPTER 1

SOLID PROGRESS, BUT A LONG WAY TO GO
Chapter 1. Solid progress, but a long way to go

At just under 6 percent, output growth in South Asia is expected to remain stronger than in other regions in 2023–25, even with weak growth in the countries recovering from recent balance-of-payments crises. Foreign exchange and financial markets in these countries have stabilized, in part owing to the introduction of IMF-supported policy programs. But the financial systems of many countries in the region remain vulnerable and fiscal positions remain fragile. In some cases, restrictions on imports and foreign exchange transactions have yet to be fully unwound. The outlook is subject to downside risks from weak financial systems and fiscal positions. Growth prospects would also worsen in the event of a further economic slowdown in China or climate change-related natural disasters. In the short term, policy priorities include preserving financial stability and improving fiscal sustainability. In the longer term, it is important to boost private investment growth, make economies more open to trade, and seize the opportunities offered by the global energy transition.

Introduction

Global output growth continues to slow, but this has had only limited spillovers to South Asia, thus far. At just under 6 percent, growth in the region remains stronger than in any other EMDE region, supported by faster potential output, resilient exports, and increasing remittance inflows. Most countries are making solid progress, with the exception of a few countries recovering from recent balance-of-payments crises.

Headline inflation has been declining in the rest of the world, but has remained elevated in South Asia. Food inflation in the region remains particularly high owing to both high global food inflation and local supply disruptions. As currencies have stabilized and some import controls have been relaxed, inflation is expected to trend down throughout the region. This trend could be interrupted in a variety of ways, however, including by further commodity price increases, exchange rate depreciations, or more persistent second-round effects of past inflation pressures than currently anticipated.

Financial systems in many countries are fragile, with limited capital buffers, high exposure to heavily indebted sovereigns, and high levels of nonperforming loans. Global developments have added pressure as major central banks have continued to raise policy rates to reduce inflation. This has added to depreciation pressures and borrowing cost increases across the region.

South Asia’s output growth is forecast to remain broadly steady in 2023–25, slowing from 8.2 percent in 2022 to 5.8 percent in 2023 and 5.6 percent in 2024 and 2025 (figure 1.1). In all South Asian countries, projected growth will remain below the 2015–19 pre-pandemic average, with the fading of post-pandemic rebounds accentuated by combinations of monetary tightening, fiscal consolidation, and slowing global demand growth. Projected growth will also be insufficient to return output to the path projected before the pandemic. Finally, current growth rates are not strong enough for most countries to reach high-income thresholds within a generation.

Relative to the spring forecast, growth in 2023 has been upgraded by 0.2 percentage points due to stronger-than-expected data in India. The 0.3 percentage-point downgrade to the 2024 growth projection reflects weaker prospects for Bangladesh and Pakistan as both countries struggle to emerge from balance-of-payments difficulties.

A number of downside risks could derail growth from the path projected in the baseline. A deterioration in market sentiment could re-ignite pressures on currencies, triggering renewed capital outflows, currency depreciations, rebounds in inflation, and further increases in borrowing costs. This risk is particularly elevated in countries with fragile financial systems and limited foreign exchange reserves.

The region would also be affected by any further slowdown in China’s economic growth, though by somewhat less than other parts of the world. In addition, South Asia has become increasingly
Output growth in South Asia is projected to remain stronger than in other regions. A sustained acceleration would require stronger private investment growth, which has been weak in most countries. The scope for government support is limited owing to high debt and still large deficits, an important source of which is weak revenue collection. Addressing these shortcomings would free up resources to fund the region’s development priorities and support the growing number of people affected by natural disasters.

### FIGURE 1.1 Overview

Output growth in South Asia is projected to remain stronger than in other regions. A sustained acceleration would require stronger private investment growth, which has been weak in most countries. The scope for government support is limited owing to high debt and still large deficits, an important source of which is weak revenue collection. Addressing these shortcomings would free up resources to fund the region’s development priorities and support the growing number of people affected by natural disasters.

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### A. Output growth in South Asia

<table>
<thead>
<tr>
<th>Year</th>
<th>Other EMDE regions</th>
<th>SAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>2022</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2023e</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2024f</td>
<td></td>
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### B. Real investment growth

<table>
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<th>MDV</th>
<th>IND</th>
<th>PAK</th>
<th>BTN</th>
<th>LKA</th>
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<td></td>
<td></td>
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<tr>
<td>2023e</td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>2024f</td>
<td></td>
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<td></td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

### C. Government revenues, 2020-22 average

<table>
<thead>
<tr>
<th>Region</th>
<th>LKA</th>
<th>BGD</th>
<th>PAK</th>
<th>IND</th>
<th>NPL</th>
<th>MDV</th>
<th>BTN</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percent of GDP</td>
<td>35%</td>
<td>30%</td>
<td>25%</td>
<td>20%</td>
<td>15%</td>
<td>10%</td>
<td>5%</td>
</tr>
</tbody>
</table>

### D. Number of people affected by natural disasters per year, 2013-22

<table>
<thead>
<tr>
<th>Region</th>
<th>LKA</th>
<th>BGD</th>
<th>PAK</th>
<th>IND</th>
<th>NPL</th>
<th>MDV</th>
<th>BTN</th>
</tr>
</thead>
<tbody>
<tr>
<td>Million people</td>
<td>70,000</td>
<td>65,000</td>
<td>60,000</td>
<td>55,000</td>
<td>50,000</td>
<td>45,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Total affected</td>
<td>400,000</td>
<td>350,000</td>
<td>300,000</td>
<td>250,000</td>
<td>200,000</td>
<td>150,000</td>
<td>100,000</td>
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<tr>
<td>Percent of population affected (RHS)</td>
<td>4%</td>
<td>3%</td>
<td>2%</td>
<td>1%</td>
<td>0.5%</td>
<td>0.2%</td>
<td>0.1%</td>
</tr>
</tbody>
</table>

### Sources

International Disaster Database (EM-DAT); WDI (database); WEO (database); World Bank (Macro Poverty Outlook).

Note: (a) = estimate; (f) = forecast; Avg. = Average; BGD = Bangladesh; BTN = Bhutan; EAP = East Asia and Pacific; ECA = Europe and Central Asia; EMDEs = emerging market and developing economies; IND = India; LAC = Latin America and the Caribbean; LKA = Sri Lanka; MDV = Maldives; MNA = Middle East and North Africa; NPL = Nepal; PAK = Pakistan; RHS = right hand side; SAR = South Asia; SSA = Sub-Saharan Africa.

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Vulnerable to natural disasters. These can have substantial near-term economic and human impacts, and can also inflict lasting damage to productivity, especially in the agriculture sector, and food security.

In almost all countries in the region, private investment growth has weakened from its pre-pandemic pace. The slowdown in private investment comes at a time when public finances are severely constrained and a global energy transition is underway. This underscores the need for policies to boost private investment growth by expanding access to finance, improving business climates, ensuring that government support is well targeted, and increasing competition. Greater openness to foreign direct investment (FDI) and international trade would facilitate access to technology. It would also attract investment as advanced economies pivot toward more diversified supply chains.

Countries in South Asia have had persistently large fiscal deficits. Growing government debt burdens have become more costly to service as interest rates have risen. There is an urgent need for governments to reduce their borrowing requirements and the risks of debt default by strengthening government revenue collection and improving spending efficiency. This can include broadening tax bases, reducing subsidies on fossil fuels, and adhering to fiscal rules.

Chronically weak private investment growth and limited fiscal space risk delaying the adoption of technologies needed for the region to keep pace with the global energy transition. The region’s energy intensity of output is twice the global average. The energy transition presents an opportunity to upgrade technologies and boost productivity, cut pollution, reduce reliance on energy imports, and increase employment.

At the same time, the transition to green technologies will have important labor market consequences. In most countries in the region, a larger share of workers is employed in pollution-intensive jobs than in green jobs. The adoption of green technologies will disproportionately favor better-educated workers in the formal sector. About 9 percent of the region’s workers are employed in pollution-intensive jobs and they tend to be lower-skilled and informal. Policies to encourage the use of more energy-efficient technologies will need to be coupled with measures to boost overall job creation. A strong labor market can absorb workers who exit pollution-intensive activities and facilitate a smooth labor market adjustment for vulnerable workers.
Economic activity

Output growth in South Asia in 2023–24 is projected to remain stronger than in other EMDE regions. Nonetheless, it remains below pre-pandemic (2015–19) averages, and several countries are suffering from the aftermath of recent currency crises.

Global developments

Global economic growth is projected to slow further in 2023 and to stabilize in 2024. In the short term, most countries are grappling with continued high inflation and the effects of monetary policy tightening. In the longer term, output growth is projected to continue slowing in many countries, reflecting weakening growth of the labor force, productivity, or investment, or all three (Kilic Celik et al. 2023).

In the United States, there has been an extended period of robust expansion since late 2020, with rapid employment growth and low unemployment. This is now slowing as excess savings accumulated during the pandemic have largely been spent. Credit conditions have tightened along with monetary policy and also as a result of the banking sector turmoil earlier this year.

The euro area continues to struggle with above-target inflation and is expected to face a steep slowdown in growth. Confidence indicators point to persistent weakness and an increased risk of recession in the next few quarters.

In China, the rebound following the post-pandemic economic re-opening appears to have quickly faded. Continued fragilities in the property sector are having widespread spillovers to the rest of the economy, contributing to the emergence of deflation in recent months. Consumer spending has been relatively buoyant this year, but this has been offset by weakness in exports and investment. The government has thus far avoided implementing broad stimulus measures in favor of allowing the overheated real estate sector to cool.

The weakness of global growth is particularly pronounced in the manufacturing sector, whereas global services activity, while cooling, has remained robust. The global manufacturing PMI has been pointing to contraction since October 2022, while the corresponding services index has been at levels consistent with solid growth for most of this year (figure 1.2). The combination of slowing global growth and a shift away from the more import-intensive manufacturing sector means that external demand is providing little support to activity in most countries.

Regional developments

South Asia faces many of the same economic challenges as other regions, including elevated inflation, higher interest rates, the need for fiscal consolidation, and weak external demand. These are mitigated, however, by improving remittance inflows and tourist arrivals since the pandemic, and by the region’s solid potential growth rate (Kose and Ohnsorge 2023). South Asia has also been less affected by slowing global growth than other regions, with export growth remaining relatively resilient. This may be due to differences in the composition of South Asia’s exports, which tend to be more service-oriented. It may also be due to the region’s below-average integration into the global economy as a result of limited transport connectivity and restrictions on trade and foreign currency transactions (World Bank 2016).

In India, robust output growth in the first half of 2023 was supported by a strong expansion of investment and, on a sectoral level, continued strength of services. Government infrastructure projects have supported momentum in the construction sector, which has grown at year-over-year rates of around 10 percent in recent quarters. Export growth has benefited from strong exports of services, such as those related to information technology and consulting, which have been little affected by the slowdown in global growth. India’s services Purchasing Managers Index (PMI) reached 62.3 in August, nearly 10 points above the global index. Employment indicators have been weaker, however, suggesting that with appropriate policies the country’s economic growth could deliver more robust job creation.

Activity in Bangladesh, Pakistan, and Sri Lanka has continued to suffer from the aftermaths of recent
Global output growth is slowing and shifting toward less trade-intensive services activities. South Asia is weathering this slowdown better than other EMDE regions, supported by solid potential output growth, resilient export growth, and strong remittance inflows. In recent years, fiscal deficits widened more in South Asia than in other regions. Now, however, fiscal consolidation as well as monetary tightening are contributing to the growth slowdown.

Potential growth is estimated based on production function approach. GDP-weighted PMIs above 50 (below 50) indicate expansion (contraction). Latest data are August 2023. Purchasing Managers’ Indexes (PMIs) come from IHS Markit and are seasonally adjusted. North Africa; SAR = South Asia; SSA = Sub-Saharan Africa.

Note: EMDEs = emerging market and developing economies; EAP = East Asia and Pacific; ECA = Europe and Central Asia; LAC = Latin America and the Caribbean; MNA = Middle East and North Africa; SAR = South Asia; SSA = Sub-Saharan Africa.

Sources: CEIC; Haver Analytics; Kilic Celik et al. (2023); Oxford Economics; United Nations Conference on Trade and Development; World Bank (GEP June 2023); World Bank (Macro Poverty Outlook).

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**Economic activity**

**A. Global manufacturing and services PMIs**

- Index, 50+=expansion
  - Manufacturing activity
  - Services business activity

**B. Actual and potential output growth**

- Percent
  - Actual growth, 2023
  - Potential growth, 2022-30 average

**C. Goods and services export growth, 2022**

- Percent

**D. Change in average fiscal balance from 2017-19 to 2020-22**

- Percent of GDP
  - Primary balance
  - Non-primary balance

**E. Monetary policy interest rates**

- Percent

**F. Remittance inflows to remittance-dependent SAR countries**

- Index, 2019=100

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**Sri Lanka’s economy has suffered the most severe contraction but appears to be past the worst of its crisis, with shortages of essential inputs easing and tourism recovering. The services PMI has been in expansionary territory since May 2023. Industrial production has been contracting since late 2021, but more slowly recently.**

Pakistan’s economic situation is also fragile. The U.S. dollar value of goods imports shrank by 26 percent in the year to August 2023 as a result of low demand alongside import and capital controls. Input shortages have affected production, with exports declining 5 percent in the year to August and industrial production shrinking by 15 percent in the year to June 2023.

Bangladesh has had the strongest recent growth of the three. However, economic activity is being restrained by supply disruptions from energy shortages and continued import and capital controls. Limited trade credit due to low quantities of foreign exchange in the banking system has also reduced imports. There was a noticeable deceleration in both private consumption and investment growth during FY23 as a result of high inflation and rising uncertainties related to the external sector.

Maldives, Nepal, and, to a lesser extent, Bhutan have been benefiting from the recovery in global tourism. Public investment in Maldives has been robust as a result of multiple ongoing projects, notably the expansion of its international airport. The associated increase in external debt has worsened the country’s financial vulnerabilities, however. Growth in Nepal slowed in FY23, reflecting monetary policy tightening and import restrictions. It has improved more recently as the removal of import restrictions late last year has
increased the availability of productive inputs. Growth in Bhutan has been lifted by spillovers from strong growth in India, despite a contraction in the electricity sector. Construction and manufacturing activities have strengthened, and the services sector has been supported by transport and trade-related services activities.

Afghanistan is adjusting to a structurally lower level of aggregate demand following the cessation of grant inflows and the breakdown of international banking relationships in 2021. Inflation peaked in July 2022 at a year-on-year rate of 18 percent and then declined steeply, leading to deflation since April 2023. Deflation is likely the result of weak aggregate demand, improved supply conditions, and the appreciation of the exchange rate. Surveys show that about two-thirds of Afghan families face significant challenges in maintaining their livelihoods (World Bank 2023a).

Inflation

Inflation in South Asia rose sharply as a result of rising global commodity prices and currency depreciations. It remains above 7 percent in the median country, partly due to continuing increases in food prices.

Global developments

Global headline inflation declined from a peak of 9.4 percent year-on-year in July 2022 to 4.9 percent in July 2023 (figure 1.3). Until recently, falling commodity prices were contributing to this decline. More recently, extended production cuts by OPEC and its partners and high demand from the transportation sector have pushed up energy prices. Global core consumer price inflation remains stubbornly elevated.

Regional developments

Historically, inflation in South Asia has tended to be less driven by global developments than elsewhere, with domestic developments being more important (Ha et al. 2019). Recent events are an exception. The rise in global prices resulting from the end of the pandemic and Russia’s invasion of Ukraine worsened local vulnerabilities in several countries in the region, leading to

**FIGURE 1.3 Inflation**

Inflation has been declining globally, but has remained elevated in South Asia. Falling commodity prices were dampening inflation until energy prices started to increase more recently. Historically, inflation in South Asia has tended to be less driven by global developments than elsewhere, but recent global shocks interacted with local vulnerabilities in many countries, triggering currency depreciations and large increases in domestic inflation. Rising food prices are contributing to continued high inflation in several South Asian countries.
economy. It is also transitioning to an interest rate targeting regime from a system based on targets for monetary aggregates.

In Sri Lanka, inflation peaked around 70 percent year-on-year in September 2022 but has since slowed sharply as the effects of last year’s currency depreciation have faded. Unlike other central banks in the region, the Central Bank of Sri Lanka has been cutting its policy rates since June, in response to steep disinflation and economic contraction.

Financial conditions

Global financial conditions remain challenging, while several South Asian countries are recovering from recent balance-of-payments crises. Many remain vulnerable to further shocks.

Global developments

Between late 2021 and early 2023, central banks in most advanced economies hiked key interest rates at the fastest pace since the 1980s in response to persistent, above-target inflation. In recent months, however, the pace of increases has slowed, and policy rates in many major economies seem close to peaking (figure 1.4). The effects of monetary tightening can be seen in rising borrowing costs and credit standards. Despite these developments, volatility and risk spreads have remained low in most markets, and major stock indexes have risen markedly this year.

Most EMDEs have weathered this period of financial tightness without severe strain. Net capital inflows have been low but positive, and bond issuance has rebounded after a severe contraction last year. Most EMDE currencies have been stable since the beginning of the year. There are, however, pockets of weakness, as many countries with lower credit ratings are struggling with severe and unsustainable increases in borrowing costs. Historically, higher interest rates in advanced economies have often been associated with financial stress in EMDEs, particularly those with greater economic vulnerabilities (Arteta, Kamin, and Ruch 2023).
Regional developments

Recent global stresses helped to trigger balance-of-payments crises in several countries in South Asia. These countries suffered widening current account deficits, sharp exchange rate depreciations, capital outflows, widening credit spreads, and the depletion of foreign exchange reserves. In response to these developments, several countries introduced capital controls and import restrictions, many of which remain in place. The situation stabilized earlier this year due in part to the introduction of IMF-supported policy programs. Severe underlying problems remain, however, and the financial systems of several countries remain vulnerable to adverse shocks.

Financial stresses were most severe in Pakistan and Sri Lanka. In Pakistan, the rupee depreciated sharply between early 2022 and early 2023, and has been broadly stable since. Last year’s attempts to limit capital outflows through import and capital controls diverted remittance inflows from formal channels, contributing to shortages of foreign currency. In Sri Lanka, the rupee has appreciated modestly since the beginning of the year, partially reversing last year’s depreciation of more than 40 percent against the U.S. dollar. Remittances have rebounded as the economy has stabilized, although they remain well below 2019 levels. There has also been a recovery in tourism earnings. In both Pakistan and Sri Lanka, foreign reserve coverage is low, asset quality is weak in both the bank and non-bank financial sectors, and buffers against future shocks are thin.

In India, the financial sector has shown few signs of strain. Bank balance sheets and corporate leverage ratios have improved substantially in recent years. The current account deficit has been predominantly financed by foreign portfolio investment and remittances. Foreign exchange reserves are at a healthy level, while the currency has alternated between periods of stability and mild depreciation. Nonperforming loans in the banking sector are low.

Bangladesh suffers from limited foreign reserves and a reliance on administrative policies—primarily import controls—to stem outflows. Remittance inflows have been volatile, and the currency has been depreciating steadily. The country has previously attempted to contain its current account deficit through exchange and import controls alongside multiple exchange rates. This has encouraged the growth of a substantial informal exchange market. The authorities are committed to unification of the exchange rate this year, but import and capital controls are expected to remain in place for an extended period.

In Nepal, the financial system appears robust. Remittance inflows have surpassed pre-pandemic levels, reaching nearly 22 percent of GDP in 2022 and helping to alleviate pressures on the balance of payments.
Projected output growth in South Asia is stronger than in other regions, but below its potential rate and below pre-pandemic averages in all South Asian countries. Individual countries in the region are generally, but not always, outperforming other EMDEs with similar characteristics.

South Asia’s growth (excluding Afghanistan) is forecast to slow from 8.2 percent in 2022 to 5.8 percent in 2023 and 5.6 percent in 2024 and 2025 (table 1.1). For most South Asian countries, growth in 2023–25 will remain below the pre-pandemic (2015–19) average, with the fading of post-pandemic rebounds accentuated by combinations of monetary tightening, fiscal consolidation, and slowing global demand growth (figure 1.5).

In all South Asian countries, projected growth is insufficient to return output in 2024 to the path projected before the pandemic. Current growth rates are also not high enough for most countries to reach high-income thresholds within a generation. Closing both of these gaps will require additional strong reforms.

Private consumption in the region is expected to be dampened by monetary tightening in response to continued inflation pressures. Import growth in several countries has been constrained in recent years by the combination of economic crises and restrictive policy measures. This is expected to rebound as currencies remain broadly stable and import restrictions are gradually relaxed.

The region’s current account balances are expected to remain in deficit, with little change over the
projection horizon. Strong growth in services exports and remittances is expected to be essentially offset by a recovery in imports and weak growth of goods exports. The regional outlook is predicated on the assumption of no substantial worsening of balance-of-payment pressures.

Investment growth in parts of the region, particularly India, is expected to remain robust, especially due to strong public investment. In many other countries, however, it will be constrained by a combination of factors. These include higher borrowing costs, tighter credit conditions associated with stressed financial conditions and crowding out by public borrowing, and restrictions on access to imported capital goods.

Fiscal policy is expected to weigh on growth. Primary fiscal deficits are expected to narrow over the projection period, particularly in Bangladesh, Pakistan, and Sri Lanka, as these countries consolidate their fiscal positions in line with their IMF-supported policy programs. The Indian government is also tightening its fiscal position modestly, even as it maintains high capital expenditures.

Given the limited fiscal and external buffers of countries in the region, there are considerable downside risks to the baseline growth forecast, including rising import prices, stalled progress on structural reforms, and policy uncertainty.

**Country developments**

In Bangladesh, output growth is expected to slow further as a result of persistent balance-of-payments pressures. Growth is projected to slow from 6.0 percent in FY2022/23 to 5.6 percent in FY2023/24, before picking up to 5.8 percent in FY 2024/25. Investment growth is expected to be particularly weak, as lending is impaired by the financial system’s elevated level of nonperforming and rescheduled loans, the tightening of monetary policy, and policy uncertainty. Import restrictions and shortages of foreign exchange, which are expected to continue in the near term, will also continue to impede growth. While weak global

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**TABLE 1.1 Growth in South Asia**

<table>
<thead>
<tr>
<th>Country fiscal year</th>
<th>Calendar year basis</th>
<th>Fiscal year basis</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>2022</td>
<td>2023(f)</td>
</tr>
<tr>
<td>South Asia region (excluding Afghanistan)</td>
<td>8.2</td>
<td>5.8</td>
</tr>
<tr>
<td>Maldives January to December</td>
<td>13.9</td>
<td>6.5</td>
</tr>
<tr>
<td>Sri Lanka January to December</td>
<td>-7.8</td>
<td>-3.8</td>
</tr>
<tr>
<td>India July to June</td>
<td>7.1</td>
<td>6.0</td>
</tr>
<tr>
<td>Bhutan July to June</td>
<td>4.8</td>
<td>4.6</td>
</tr>
<tr>
<td>Nepal mid-July to mid-July</td>
<td>5.6</td>
<td>1.9</td>
</tr>
<tr>
<td>Pakistan July to June</td>
<td>6.1</td>
<td>-0.6</td>
</tr>
</tbody>
</table>

Sources: World Bank Macro Poverty Outlook; World Bank staff calculations.

Note: (e) = estimate; (f) = forecast. GDP measured in 2015 prices and market exchange rates. Pakistan is reported at factor cost. National accounts statistics for Afghanistan are not available. To estimate regional aggregates in the calendar year, fiscal year data are converted to calendar year data by taking the average of two consecutive fiscal years for Bangladesh, Bhutan, Nepal, and Pakistan, as quarterly GDP data are not available.
the tourism sector will increase capacity, particularly the expansion of Velana International Airport.

In Nepal, growth is estimated to have slowed to 1.9 percent in FY2022/23 as the post-pandemic recovery waned, monetary policy tightened, and policy efforts to close the current account deficit weighed on activity. Import restrictions were put in place between April 2022 and January 2023 to contain the growing trade deficit. This led to shortages of many inputs needed for production, an expansion of informal markets, and a sharp fall in government revenues. Growth is expected to rebound to 3.9 percent in FY2023/24, as these shortages ease, and as tourism inflows and remittances continue to rise. Investment in hydropower remains strong, while activities related to the reconstruction of infrastructure destroyed by the 2015 earthquake is fading.

Pakistan’s economy is estimated to have shrunk by 0.6 percent in FY2022/23, reflecting widespread damage from the 2022 floods, elevated inflation, and difficulties with its balance of payments. Positive growth is projected to return in FY2023/24, but at a rate of only 1.7 percent. The economy remains dependent on capital inflows to finance substantial fiscal and current account deficits. Import controls intended to narrow the trade deficit have also impeded the supply of industrial raw materials and depressed growth more than expected. These controls have been removed this year as an IMF lending program has stabilized the currency and boosted business confidence. Nonetheless, the economy still faces substantial challenges from continued inflation pressures, tight fiscal policy related to debt repayments, and extensive flood damage. Pakistan’s foreign exchange reserves remain low, leaving the country with limited buffers against external shocks.

In Sri Lanka, the economy appears to have bottomed out after its severe recession and is showing signs of recovery. Support from the IMF and other external lenders has helped stabilize the currency and ease import shortages. The economy is also being supported by the recovery of tourism. After contracting by 3.8 percent in 2023, the economy is expected to grow by 1.7 percent in
2024 and 2.4 percent in 2025. The country’s path to recovery is very narrow, however. Its limited fiscal and reserve buffers leave little room for error as it implements a broad set of reforms and restructures its external debt.

No forecast has been formulated for Afghanistan, as official data collection halted in 2021. The country’s economy remains fragile, but surveys indicate that basic food and non-food items are available in sufficient quantities, and that employment and wages have improved this year (World Bank 2023a).

**Risks and vulnerabilities**

Risks to the baseline forecast remain tilted to the downside. The most pressing concerns are financial and fiscal stress, slowing activity in China, and climate change.

**Financial crises**

Several countries in the region are vulnerable to financial market disruptions. Bangladesh, Pakistan, and Sri Lanka have drawn on IMF assistance to weather the global shocks of higher commodity prices and borrowing costs and (in the case of Sri Lanka) reduced tourism earnings, and to stem capital outflows and currency depreciation. Maldives may also require assistance when its interest expenses triple to a peak of about US$1 billion in 2026. The region’s persistent trade deficits have averaged 4 percent of GDP since 2015. These require financing by capital inflows, which can make countries vulnerable to adverse shifts in market sentiment. Such shifts can result from stress in either the private sector—particularly the financial system—or in governments’ fiscal positions. Vulnerability to sudden changes in investor sentiment is particularly high in countries with low foreign currency reserves.

The financial systems of many South Asian economies are under pressure from challenging domestic economic conditions and rising borrowing costs. Nonperforming loans in bank and non-bank financial sectors have recently exceeded 5 percent of total assets in all South Asian countries for which there are data, except Nepal (figure 1.6). This leaves limited buffers against adverse shocks. In Sri Lanka, nonperforming assets, as a proportion of total assets, have recently been as high as 11 percent in the banking sector and 17 percent in the non-banking sector. In Bangladesh, the corresponding figures have been nearly 9 and 23 percent, respectively. In contrast, nonperforming loans in both India and Nepal appear to have been low.

The sovereign-bank nexus is strong throughout the region and could propagate adverse shocks (World Bank 2023b). On average, nearly half of South Asian countries’ financial systems’ assets are claims on the government. This share is higher

**FIGURE 1.6 Financial risks**

Nonperforming loan ratios are rising or are already elevated in most South Asian countries; further increases would erode capital buffers and could eventually alarm financial markets. Large and growing holdings of government debt by domestic financial systems leave them vulnerable to shifts in confidence in the sovereign and risk crowding out private sector credit.

A. Nonperforming loans in banking sectors

<table>
<thead>
<tr>
<th>Country</th>
<th>2010</th>
<th>2021</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bd</td>
<td>1.0</td>
<td>2.0</td>
</tr>
<tr>
<td>In</td>
<td>2.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Mdv</td>
<td>3.0</td>
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B. Nonperforming loans in non-bank financial or microfinance bank sectors

<table>
<thead>
<tr>
<th>Country</th>
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<tbody>
<tr>
<td>Bd</td>
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<tr>
<td>In</td>
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<td>3.0</td>
</tr>
<tr>
<td>Mdv</td>
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<td>4.0</td>
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<tr>
<td>Pk</td>
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C. Financial system claims on general government

<table>
<thead>
<tr>
<th>Country</th>
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<tr>
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<td>3.0</td>
</tr>
<tr>
<td>Mdv</td>
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<td>Pk</td>
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D. Government debt

<table>
<thead>
<tr>
<th>Country</th>
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</thead>
<tbody>
<tr>
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<tr>
<td>In</td>
<td>2.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Mdv</td>
<td>3.0</td>
<td>4.0</td>
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<tr>
<td>Pk</td>
<td>4.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Lka</td>
<td>5.0</td>
<td>6.0</td>
</tr>
</tbody>
</table>

Sources: CEIC; IMF (various staff reports); Kose et al. (2022); national sources; World Bank.

Note: Bgd = Bangladesh; Btn = Bhutan; Emdes = emerging market and developing economies; Ind = India; Lka = Sri Lanka; Mdv = Maldives; Npl = Nepal; Pak = Pakistan; Sar = South Asia.

A. The most recent data is 2023Q1 for Bangladesh, India, Nepal, and Sri Lanka, 2023Q2 for Bhutan, Maldives, and Pakistan.
B. The most recent data is 2022Q2 for Bangladesh, 2022Q3 for Nepal, and 2023Q1 for India, Pakistan, and Sri Lanka. 2021Q1 is used for India’s historical number. The data is for microfinance banks for Pakistan, and for non-bank financial institutions for other countries.
C. GDP-weighted averages (at 2010–19 average prices and market exchange rates).
D. Bars show unweighted averages (at 2010–19 average prices and market exchange rates). Yellow whiskers indicate minimum-maximum range for seven South Asian economies, and interquartile range for Emdes.
In the longer term, capital outflows could increase governments’ reliance on domestic financing. This could crowd out private borrowing, and make it more difficult for less connected and less formal firms to access finance than it already is. It has been estimated that a 10-percentage-point increase in the share of government loans in total bank assets is associated with a 1.6-percentage-point decline in annual loan growth to the private sector (World Bank 2023b). Increased debt service costs could also crowd out other essential public expenditures and increase the rigidity of government spending, and also contribute to high inflation by encouraging governments to “print money” to erode high levels of debt.

**Slowdown in China**

In the baseline forecast, China is expected to support global activity with output growth of 5.1 percent in 2023, 4.4 percent in 2024, and 4.3 percent in 2025. Persistent challenges in China’s real estate market, however, present downside risks to this outlook. Falling housing prices, defaults by major developers, and declining lending are already weighing on consumption and investment.

In a scenario with a sharper-than-assumed real estate sector slowdown, the real estate sector would increasingly weigh on the Chinese economy, possibly reducing growth to 4.9 percent in 2023 and 2.0 percent in 2024. In response, the government could introduce a variety of stimulus measures, including infrastructure spending and support for credit issuance. These measures could push up growth in 2025 to 5.3 percent.

In this scenario, the slowdown and subsequent rebound would have widespread spillovers to other countries, primarily through external demand and commodity prices (figure 1.7). Oil prices would be 22 percent lower in 2024, on average, than in the baseline scenario. Global inflation would move in the same direction, and would be 1.4 percentage points lower at the end of 2024. On balance, central banks worldwide could be expected to begin loosening monetary policy earlier in this scenario than in the baseline. The U.S. Federal Reserve, for example, could begin cutting its policy rate as early as November 2023, reducing it by the end of 2024 to 150 basis points below the baseline.

than in other EMDE regions and has risen sharply over the past decade. As a result, falls in the valuation of government debt can result in significant erosion of the market value of banks’ assets. At 86 percent of GDP in the average South Asian country, government debt is higher than in other EMDE regions. And it is rising as a result of growing government spending, low (and in some cases declining) domestic revenue, and increasing debt service costs (spotlight). Any loss of credibility resulting from fiscal slippages, delays in debt restructuring negotiations, or the revelation of losses at a major state-owned bank or enterprise, could drive borrowing costs and debt to unsustainable levels.

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**FIGURE 1.7 Scenario: Sharper economic slowdown in China**

In a scenario where China’s real estate sector slows down sharply before policy makers intervene with stimulus, global growth, commodity prices, and inflation would all be lower than in the baseline forecast. The spillover to South Asia would be smaller than to other regions.

- A. Deviation of global and Chinese output growth from baseline scenario
- B. Deviation of global oil price from baseline scenario
- C. Deviation of global inflation from baseline scenario
- D. Growth impact of sharper slowdown in China

Sources: Oxford Economics; World Bank.

Note: EMDEs = emerging market and developing economies; SAR = South Asia.

A. Bars show the percentage points deviation between the output growth assuming a sharper slowdown in China and output growth forecasted under the baseline scenario.
B. Solid line shows the percent deviation of the oil price assuming a sharper slowdown in China and the oil price forecasted under the baseline scenario.
C. Solid line shows the percent deviation between global inflation assuming a sharper slowdown in China and global inflation forecasted under the baseline scenario.
D. Bars show growth revisions between the China slowdown scenario and the baseline scenario. SAR includes 6 countries.
The spillovers to South Asia would generally be smaller than to other EMDE regions. South Asian growth could be 0.5 of a percentage point lower in 2024, compared to a 1.0 percentage point growth slowdown for EMDEs overall (excluding China). This is partly because the region is more closed to trade than other EMDE regions, and partly because the region is heavily reliant on energy imports, whose prices would decline.

**Climate change-related disasters**

South Asia is highly exposed to both the short- and long-term adverse effects of climate change, more so than most other EMDE regions (figure 1.8). Much of the region’s population lives in dense river valleys that are increasingly subject to severe floods. A recent example is the floods that submerged one-third of Pakistan last year, causing economic losses equivalent to more than 4 percent of GDP (World Bank 2022a). Bangladesh’s losses from tropical cyclones alone are estimated to average 0.7 percent of GDP per year (World Bank 2022b). According to the Global Climate Risk Index, Bangladesh ranks seventh, Pakistan eighth, and Nepal tenth among the countries most severely affected by extreme weather events globally during 2000–19 (Eckstein, Künzel, and Schäfer 2021). A recent study designated Afghanistan among the countries most at risk from heat waves (Thompson et al. 2023). The countries at highest risk from natural disasters are often already poor and ill-equipped to weather shocks (Rentschler, Salhab, and Jafino 2022).

The growing frequency and severity of weather disasters pose risks to food production in both South Asia and elsewhere. Disruptions to either local or global food supplies could drive up food prices and households’ living expenses. Food is a sizable part of households’ consumption baskets in South Asia, with over 45 percent of the region’s CPI basket consisting of food and non-alcoholic beverages, compared with an EMDE average of about 29 percent.

Rising food prices would hurt the urban poor most, as more than half of their budgets are devoted to food and, unlike their rural counterparts, they do not produce food themselves (Aksoy and Hoekman 2010; Dovonou and Xie 2023; Gill and Nagle 2022; Nasir, Kishwar, and Meyer 2023). High and volatile food prices make it more challenging to maintain a nutritious diet, exacerbating food insecurity, which is widespread in the region.

Increasing climate risks also have longer-term implications, especially since the agriculture sector

---

**FIGURE 1.8 Climate risks**

South Asia is the EMDE region most vulnerable to climate risks, with the largest number of people affected by natural disasters in the past decade. Because of South Asia’s large agricultural sector, extreme weather events can be especially disruptive. Shocks to food markets and prices can exacerbate food insecurity because South Asia is the EMDE region with the highest share of food in consumption baskets.

A. Vulnerability to climate risk, 2017-21 average

<table>
<thead>
<tr>
<th>SAR</th>
<th>SSA</th>
<th>EAP</th>
<th>MNA</th>
<th>LAC</th>
<th>ECA</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.6</td>
<td>0.5</td>
<td>0.4</td>
<td>0.3</td>
<td>0.2</td>
<td>0.1</td>
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</table>

B. Number of people affected by natural disasters, 2013-22 average

<table>
<thead>
<tr>
<th>SAR</th>
<th>EAP</th>
<th>SSA</th>
<th>LAC</th>
<th>MNA</th>
<th>ECA</th>
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</thead>
<tbody>
<tr>
<td>70</td>
<td>60</td>
<td>50</td>
<td>40</td>
<td>30</td>
<td>20</td>
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</table>

C. Share of food in CPI basket and share of agriculture in value added, latest

<table>
<thead>
<tr>
<th>SAR</th>
<th>SSA</th>
<th>EAP</th>
<th>MNA</th>
<th>LAC</th>
<th>ECA</th>
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</thead>
<tbody>
<tr>
<td>60</td>
<td>50</td>
<td>40</td>
<td>30</td>
<td>20</td>
<td>10</td>
</tr>
</tbody>
</table>

D. Prevalence of undernourishment in the population

<table>
<thead>
<tr>
<th>SAR</th>
<th>World</th>
</tr>
</thead>
<tbody>
<tr>
<td>40</td>
<td>30</td>
</tr>
</tbody>
</table>

Sources: FAOData Explorer; Ha, Kose, and Ohnsorge (2023); IMF Consumer Price Index Database; International Disaster Database (EM-DAT); Maldives Bureau of Statistics; Notre Dame Global Adaptation Initiative; WDI (database); World Bank.

Note: AFG = Afghanistan; Avg. = Average; BGD = Bangladesh; BTN = Bhutan; CPI = Consumer Price Index; EAP = East Asia and Pacific; ECA = Europe and Central Asia; EMDEs = emerging market and developing economies; IND = India; LAC = Latin America and the Caribbean; LKA = Sri Lanka; MDV = Maldives; MNA = Middle East and North Africa; NPL = Nepal; PAK = Pakistan; SAR = South Asia; SSA = Sub-Saharan Africa.

A. Regional aggregates computed using 2015 GDP as weights. Values shown are average over 2017-21. Sample includes 148 EMDEs (21 in EAP, 22 in ECA, 22 in LAC, 18 in MNA, 8 in SAR, and 47 in SSA).

B. Bars show the total population affected by natural disasters, and diamond shows the share of total population affected; annual averages over 2013-22. Sample includes 144 EMDEs (22 in EAP, 20 in ECA, 31 in LAC, 18 in MNA, 8 in SAR, and 45 in SSA).

C. Regional aggregate computed using 2015 GDP as weights. The share of food and non-alcoholic beverages in CPI basket for the most recent reporting period is used. Sample includes 137 EMDEs (21 in EAP, 18 in ECA, 29 in LAC, 15 in MNA, 8 in SAR, and 46 in SSA). The share of agriculture, forestry, and fishing value added in GDP (2021-22 average). Sample includes 138 EMDEs (18 in EAP, 22 in ECA, 31 in LAC, 15 in MNA, 8 in SAR, and 44 in SSA).

D. Aggregates computed using 2015 population as weights, excluding countries with missing values. World sample represents 99 percent of world population.
In Bangladesh and India, this rapid growth has been supported by public investment growth of around 10 percent per year—triple the EMDE average. Sustaining this pace of public investment growth may become increasingly challenging as government debt and borrowing costs rise.

In all countries in the region, private investment growth has slowed since the pre-pandemic period (2015–19), or is forecast to do so. The weakness of private investment growth has been mirrored in the region’s below-average net inflows of FDI. In 2021–22, FDI in South Asia accounted for around 1.5 percent of GDP, considerably less than the EMDE average of 2 percent.

Accelerating the pace of catch-up with high-income countries will require substantial new investment and substantial increases in productivity. The productivity gaps are large: productivity levels in South Asia are the second-lowest among EMDE regions after Sub-Saharan Africa (Dieppe 2021). Currently, growth in the region is not strong enough for most countries to reach high-income thresholds within a generation. Potential growth in the region averages about 5 percent, but would have to be 8 percent or higher in most countries to reach high-income status by 2050. Weak investment also threatens to delay the region’s progress with the energy transition.

Strengthening private investment will depend on many factors. These include the presence of complementary infrastructure, a supportive institutional and business environment, a sound financial system, and fewer distortionary policies affecting markets.

- **Public investment.** Effective public investment and high-quality infrastructure can crowd in private investment. Public infrastructure projects, such as the construction of the Padma Bridge in Bangladesh, and various railways and road projects in India, have the potential to spur investment and economic activities in the surrounding area (World Bank 2023c, 2023d). The efficiency of public investment projects in many countries could be improved through a supportive public investment management framework (World Bank 2023e, 2023f, 2023g).
• **Supportive institutions.** Better public institutions also tend to attract more private investment and FDI (Ali, Fiess, and MacDonald 2010; Gwartney, Holcombe, and Lawson 2006; Hellbrun and Whyte 2019). For example, spurs of investment climate reforms, especially in EMDEs, have been associated with an increase in real investment growth of about 6 percentage points per year (Stamm and Voristek 2023). Surveys of firms regularly show that policy and regulatory uncertainty, followed by taxation and burdensome regulations, are the most critical barriers to private sector investment (OECD 2015). Public institutions can also provide critical complementary services to enable functioning markets. For example, in many countries in the region, land records that are complete, transparent, and integrated across different parts of government would help improve the use of land for business purposes (World Bank forthcoming).

• **Business environment.** Allowing greater scope for competition could unleash private investment. For example, in Pakistan, certain tax policies discourage investment in the tradable sector, and certain investment laws discriminate against foreign investors (World Bank 2023f). In Bhutan, Nepal, and Pakistan, reducing subsidies or budgetary support to state-owned enterprises could allow for greater private sector participation while also increasing fiscal space (World Bank 2022c, 2023f, 2023h). In Pakistan, similarly, state-owned enterprises tend to have low investment rates, while also consuming government resources equivalent to around 23 percent of the fiscal deficit in FY2023 (World Bank 2023i).

• **Access to finance.** Private investment also depends on access to finance. Adverse liquidity shocks caused by troubled banks can hinder investment (Kalemli-Ozcan, Kamil, and Villegas-Sanchez 2016). In Sri Lanka, more robust deposit insurance, provisions for nonperforming loan resolution, and prudential supervision of concentrated loan exposures can help strengthen the financial system. Better governance of state-owned

**FIGURE 1.9 Investment weakness**

Investment growth in some South Asian countries has been negative or anemic in recent years, while in others it has been supported by robust public investment. Private investment growth in South Asia has slowed from its pre-pandemic averages. Private investment weakness has in part reflected below-average FDI inflows. Current growth rates are not sufficient for most countries to reach high-income thresholds within a generation.

<table>
<thead>
<tr>
<th>A. Real total investment growth</th>
<th>B. Real public investment growth</th>
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<tbody>
<tr>
<td>Percent</td>
<td>Percent</td>
</tr>
<tr>
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<td>12</td>
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<td>6</td>
<td>9</td>
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<td>-6</td>
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<tr>
<td>-6</td>
<td>-9</td>
</tr>
<tr>
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<td>IND</td>
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<tr>
<td>MDV</td>
<td>BGD</td>
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<td>IND</td>
<td>NPL</td>
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<thead>
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<th>C. Real private investment growth</th>
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<tbody>
<tr>
<td>Percent</td>
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<td>2015-19 Avg.</td>
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<th>D. FDI inflows into EMDE regions</th>
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<tbody>
<tr>
<td>Percent of GDP</td>
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<tr>
<td>2018-22 Avg.</td>
</tr>
<tr>
<td>EMDEs</td>
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<tr>
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<tr>
<td>ECA</td>
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<th>E. FDI inflows into South Asian countries</th>
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<td>Percent of GDP</td>
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<td>2018-22 Avg.</td>
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<td>EMDEs</td>
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<tr>
<td>AFG</td>
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<td>PAK</td>
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<tr>
<td>BGD</td>
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<td>NPL</td>
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<tr>
<td>BTN</td>
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<tr>
<td>F. GDP growth rate required to reach income thresholds by 2050</td>
</tr>
<tr>
<td>Percent of GDP</td>
</tr>
<tr>
<td>2023-25 avg.</td>
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Sources: UN Population Division (database); WDI (database); World Bank (Macro Poverty Outlook). Note: Avg. = Average; AFG = Afghanistan; BGD = Bangladesh; BTN = Bhutan; EAP = East Asia and Pacific; ECA = Europe and Central Asia; EMDEs = emerging market and developing economies; FDI = Foreign Direct Investment; HIC = High-income country; IND = India; LAC = Latin America and the Caribbean; LKA = Sri Lanka; MDV = Maldives; MNA = Middle East and North Africa; NPL = Nepal; PAK = Pakistan; SAR = South Asia; SSA = Sub-Saharan Africa; UMIC = Upper middle-income country. Arithmetic annual averages. Aggregates computed using 2015 GDP as weights.
FIGURE 1.10 Restrictions on trade and foreign exchange transactions

South Asia generally employs an above-average number of trade and foreign exchange restrictions. In response to recent currency pressures, South Asian countries raised import and foreign exchange restrictions further to help address balance of payments issues and to stabilize foreign exchange markets.

A. Non-tariff measures in EMDE regions, 2020

Number of measures

B. Cost of trading in EMDE regions, 2019

Percent

C. Restrictive export measures in SAR countries and other EMDEs

Number of product groups

D. Restrictive import measures in SAR countries and other EMDEs

Number of product groups

E. Capital controls, 2019

Index, Higher-Stronger

F. New foreign exchange restrictions, 2021–22

Number of tightened exchange restrictions

Vigorous private investment is critical not only for growth but also for environmental reasons. Private investment in energy-saving technologies will be key if the region is to keep pace with the global energy transition (chapter 2). Such investment could be encouraged through combinations of market-based regulations, carbon taxes, cuts in fossil fuel subsidies, more reliable grid power, and efforts to increase awareness among businesses of the benefits of energy-saving technological innovations.

Removing trade and foreign currency restrictions

South Asian countries impose more restrictions on trade and capital flows than countries in other EMDE regions (figure 1.10). Applied tariff rates are higher than in any other EMDE regions: the weighted average applied tariff on imports in South Asia was 9.4 percent in 2020, compared with 6.7 percent among other EMDE regions. Non-tariff trade barriers such as long custom clearance times and quantity control measures are also more numerous than the EMDE average. The cost of trading goods between South Asia and the
rest of the world was around 140 percent of the value of the good itself, second highest among EMDE regions. The region also maintains more stringent capital controls than the average EMDE (Fernández et al. 2016). This was true prior to the pandemic and the use of these restrictions has expanded further over the past three years.

In recent years, increases in the prices of energy and other commodities, together with tightening monetary policies in advanced economies, have exacerbated balance-of-payments pressures in South Asia. In response, several countries in the region have increased the use of restrictive import measures, such as quantitative restrictions, tariffs, and more cumbersome custom procedures. In 2022, the number of product groups affected by various restrictive import measures in Bangladesh was seven times the EMDE average, and more than 10 times the EMDE average in Pakistan and Sri Lanka. While these restrictions may have helped reduce pressures in the external sector, they have also led to import shortages and depressed economic activity (World Bank 2023h, 2023k). They also added to fiscal pressures, particularly in countries such as Nepal that are dependent on import duties for government revenues.

Restrictions have also been introduced on the export side. These included a ban on Indian rice exports introduced in July 2023 to slow a rise in domestic rice prices that had resulted from an unfavorable monsoon, and to prepare for the possibility of agricultural productivity losses in the event of a severe El Niño.

Some South Asian countries imposed controls on foreign exchange transactions. Since 2021, many countries in the region adopted additional restrictions on foreign exchange. These included higher minimum financing requirements, more restrictive use of letters of credit, higher advance payments on imports, increased repatriation requirements on exports and other proceeds from overseas, and foreign exchange quotas. The most recent restrictive measures include a profit repatriation requirement for foreign investors in Bangladesh, foreign exchange quotas in Bhutan, increased cash margin requirements in Nepal, and increased scrutiny of the repatriation of revenues from exports in Pakistan (World Bank 2022d, 2023b). Such restrictions can be circumvented, for example by channeling foreign exchange through informal markets such as Hundi and Hawala (Biswas 2012; Steinkamp and Westermann 2022). This circumvention may eventually lead to even greater losses of foreign reserves (Gray 2021).

Lowering these barriers to trade and capital flows could help the region integrate into the global marketplace, with substantial benefits to long-term productivity. Pakistan, for example, could boost productivity, diversify its exports, and increase product sophistication by reforming export subsidy and import duty schemes (World Bank 2022e). The cost of shipping goods to and from Bhutan is elevated, and the country could unlock greater trade opportunities through investment in physical and digital infrastructure, combined with an improved and more predictable regulatory environment (World Bank 2020). Moving toward low and uniform import tariffs in Bangladesh could also spur private investment, increase competitiveness, and promote export diversification (World Bank 2023c).

**Improving fiscal positions**

All countries in South Asia have had persistently large fiscal deficits. As a result, government debt burdens in the region have risen faster than in the average EMDE since 2010 (spotlight). As in other regions, government debt in South Asia soared during the pandemic as fiscal revenues fell and expenditures on support programs rose. The region’s government debt has risen even during periods of strong growth, however. Slowing the rise in debt burdens will likely require continued strong growth, while reforms simultaneously limit financing costs, increase revenues, and improve spending efficiency.

Servicing this debt has become significantly more costly as global and national interest rates rise. To some extent, borrowing costs can be limited by sound and transparent debt management strategies that allows for financing to be provided at longer maturities, at fixed (and favorable) interest rates, and in local currency. On their own, however, such steps are unlikely to be sufficient to substantially reduce financing requirements. In Pakistan, for example, interest payments
FIGURE 1.11 Fiscal challenges

Revenue collection is below the EMDE average across South Asia, contributing to persistently large fiscal deficits. Stronger fiscal rules could help contain rising debt; current rules are generally weaker than the EMDE average. Governments in South Asia face the challenge of bringing government debt and deficits toward their indicative targets.

A. Government revenues, 2020–22 average

B. Strength of fiscal rule

C. Change in EMDE government debt, 2015–22, by strength of fiscal rules

D. Share of debt booms associated with default

E. Debt rule target and actual debt

F. Budget rule target and actual fiscal deficit

Sources: CEIC; IMF Fiscal Rules Dataset, 1985–2021; WDI (database); World Bank (Macro Poverty Outlook).

Note: AFG = Afghanistan; BGD = Bangladesh; BTN = Bhutan; EMDEs = emerging market and developing economies; IND = India; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan; SAR = South Asia. Arithmetic annual averages.


B.C. The fiscal rule strength index is constructed following Davoodi et al. (2022, appendix III), and is a sum of legal basis, monitoring, enforcement, and flexibility, weighted by the rule coverage (national, supranational, or both). SAR sample includes India, Maldives, Pakistan, and Sri Lanka. Sample includes 65 EMDEs (25 for the expenditure rule, 56 for the budget balance rule, and 52 for the debt rule). A higher index means a stronger fiscal rule.

B. Values shown are the unweighted average of fiscal rule strength index for countries in the group, over 2015–2021.

C. Values shown are the unweighted average change (2015–2022) in government debt for countries with above-average strength of fiscal rule ("Strong") or below-average strength of fiscal rule ("Weak"), over 2015–21.

D. Bars show the share of total government debt booms associated with default (of any type), domestic government debt booms associated with domestic default, and external government debt booms associated with external default, up to one year after the end of a boom.

E.F. Latest data available. Budget balance rule for Pakistan is on federal budget deficit excluding foreign grants. Budget balance rule target and debt shown for India are for the central government, accounted for more than half of federal current government expenditures in FY23.

A more direct approach to improving fiscal positions would be to tackle the region’s unusually low government revenue collection. All countries but one (Bhutan) collect less revenue than the EMDE average of nearly 30 percent of GDP, with revenues in Bangladesh and Sri Lanka below 10 percent of GDP (figure 1.11). Bhutan’s revenues are bolstered by external grants from India and other development partners.

A variety of measures can help increase revenues, such as expanding the tax base, closing loopholes, and strengthening collections. These could include reducing special exemptions and concessional rates of existing taxes. For example, targeting VAT exemptions to exclusively the consumption baskets of the poorest 40 percent could increase VAT revenue by 2 percent in Nepal (World Bank 2021). Similarly, in Maldives, halving the personal income tax threshold to MVR300,000 (equivalent to US$19,480) could raise income tax revenue by 0.5 percent of GDP (World Bank 2022f). Since low revenue collection is partly a consequence of large informal economies, a broader-based, simpler tax system that is perceived as fair could raise collections by smoothing the movement of businesses into the formal sector.

Spending efficiency could be improved by reducing subsidies, particularly those on fossil fuels. Energy subsidies in South Asia amounted to nearly 2 percent of GDP in 2021. South Asian governments in part provide such subsidies through fixed prices and support to state-owned enterprises in the energy sector. These subsidies are generally inefficient, regressive, costly, and environmentally damaging (Damania et al. 2023). Reducing these subsidies would improve fiscal sustainability and also speed the energy transition. Some countries in the region would also benefit from steps to avoid election-related increases in public spending (box 1.1).

In many countries globally, fiscal rules have been found useful for containing fiscal deficits (Caselli and Wingender 2018). Four South Asian countries have adopted debt ceilings—60 percent of GDP in India, Maldives, Sri Lanka, and Pakistan—and deficit targets—3 percent of GDP...
BOX 1.1 Fiscal deteriorations around elections

Among EMDEs, primary fiscal deficits, primary government expenditures, and government wage bills have tended to rise significantly around election years. While primary spending increases have tended to be partially reversed in the following year, post-election reversals of primary deficit and government wage bill increases have been more variable and at best partial. The consequent ratcheting up of primary deficits around elections in EMDEs can erode fiscal sustainability over the longer term, while the expansion of government wage bills can result in spending rigidities. In South Asia, in particular, fiscal positions have tended to deteriorate around national elections, and, in some cases, there is also evidence of targeted fiscal actions around subnational elections. While this result is true on average for the region, some countries—notably India in its 2023 budget—have avoided the risk of election-induced current spending increases. This points to a way forward for fiscally constrained governments in South Asia.

Introduction

In 2023 and 2024, parliamentary or presidential elections will be held in seven out of the eight South Asian countries. With fiscal positions already fragile in several South Asian economies and government debt stocks high, spending increases, or revenue decreases around these elections would add to fiscal pressures.

A well-established literature has documented political budget cycles, in both advanced economies and EMDEs. These have been attributed to three factors. First, incumbents may adopt an expansionary fiscal policy designed to benefit voters directly, thus maximizing their chances of re-election (Nordhaus 1975; Dubois 2016). Second, incumbents may introduce policies ahead of elections to spur economic growth, in the hope of demonstrating the strength of their governments (Higashijima 2022; Han 2022). Third, if the expected outcome of an election is unfavorable for the incumbent or is uncertain, the incumbent may issue debt to constrain their successor’s room for maneuver (Alesina and Tabellini 1990). The government wage bill, which accounted for 25 percent of primary spending in the average EMDE in 2010–20 (and 26 percent of paid workers), can be a particularly important instrument for influencing elections (Endegnanew, Soto, and Verdier 2017).

Several empirical studies have found evidence for election effects. A statistically significant—albeit generally small—political budget cycle has been identified in many cross-country studies. This cycle appears to be more prominent in EMDEs, where income levels and governance are typically weaker than in advanced economies (de Haan and Klomp 2013; Kyriacou, Okabe, and Roca-Sagales 2022; de Haan and Gootjes 2023).

Thus, the evidence is that political budget cycles are common in EMDEs. This box examines political budget cycles for South Asia, in particular, to answer the following questions:

- How pronounced are political budget cycles in South Asia?
- How do political budget cycles in South Asia compare with those in other EMDEs?
- What are the policy implications?

This box contributes to the literature in three ways. First, it examines fiscal positions around national elections in South Asia, whereas the existing literature on political budget cycles in the region tends to focus on specific fiscal actions around subnational elections. Second, it documents that one spending category—the government wage bill—is particularly susceptible to political budget cycles around national elections in EMDEs. In contrast, the existing literature focuses on aggregate spending or fiscal deficits (de Haan and Klomp 2013; Kyriacou, Okabe, Roca-Sagales 2022; de Haan and Gootje 2023). Third, this box documents that political budget cycles tend to be only partially reversed after the election whereas the existing literature focuses on fiscal aggregates in the election year itself (Brender and Drazen 2005; Strong 2023).

This box reports the following findings.

Note: This box was prepared by Jakob de Haan (University of Groningen), Franziska Ohnsorge, and Shu Yu.

a. See Brender and Drazen (2005); Shi and Svensson (2006); Vergne (2009); Klomp and de Haan (2011); Philips (2016); and Strong (2023).

b. An exception is Ebeke and Ölçer (2017), who report for a sample of low-income countries that governments have tended to raise trade taxes and cut government investment in the two years after elections, with no significant cuts in government consumption.
In South Asia, primary fiscal deficits tended to widen in or just before national elections, on average by 0.5 percentage point of GDP, and only half of this deterioration was reversed in the two years after the election. For several South Asian countries, the literature finds evidence of narrowly targeted fiscal actions around subnational elections.

Among EMDEs more generally, primary fiscal deficits, primary government expenditures, and government wage bills rose significantly around elections, on average by 0.7, 0.5, and 0.1 percentage point of GDP, respectively. South Asia is among the EMDE regions with particularly pronounced election effects.

On average among EMDEs, primary spending increases averaging 0.5 percentage point of GDP were virtually fully reversed within a year following the election. However, increases in the government wage bill—small (0.1 percentage point of GDP) but statistically significant—were not reversed: in fact, they continued. There was wide variation in the extent to which primary fiscal deficit increases in election years were reversed but, on average, the reversal amounted to less than half of the increase during the election years. The consequent ratcheting-up of deficits as well as wage bills around elections could erode fiscal sustainability and lock in spending rigidities over the longer term.

This box draws on data for 122 EMDEs for 1984–2022. Data on fiscal outcomes and country characteristics are from the IMF’s World Economic Outlook and Government Finance Statistics databases, and the World Bank’s World Development Indicators. Election dates are from the Database of Political Institutions until 2020 and assembled from news reports for 2021–2022.

Political budget cycles in South Asia

Fiscal positions deteriorated considerably around several elections in South Asian countries. The literature has also found evidence of more narrowly targeted fiscal actions around subnational elections in several South Asian countries.

Literature review

The literature on political budget cycles in South Asia has identified significant budget cycles around subnational elections in the region’s two largest countries between the 1960s and the mid-2000s.

In India, the existing literature covers the 1960s to the mid-2000s, restricting itself to frequently held subnational elections, and has documented narrowly targeted fiscal actions around state elections. Significant spending increases around state elections have been reported: in infrastructure-related social programs during 1960–2005 (Khemani 2010); in interest spending on subnational debt during 1960–2006 (Saiz 2016); in capital spending during 1959–2012 (Ferris and Dash 2019, Khemani 2004); and in farm debt waivers in 2001/02 and 2018/19 (Mahambare, Dhanaraj, and Mittal 2022). State banks appear to have increased agricultural lending around state elections during 1992–1999 (Cole 2009). Similarly, contested constituencies benefited from greater improvements in power supply around state elections during 1992–2009 (Baskaran, Min, and Uppal 2015), while commodity revenue collections declined and capital spending rose around state elections during 1974–1995 (Chaudhuri and Dasgupta 2006).

In Pakistan, government spending was significantly higher in election years and significantly lower after elections during 2000–07 (Nasir, Nazir, and Khawaja 2022). Fiscal deficits were significantly larger in election years during 1973–2009 (Sieg and Batool 2012).

In contrast, for Bangladesh, no study has shown clear evidence of political budget cycles. The one study examining the question fails to find any systematic impact of political factors on disaster relief during 2010–14 (Karim and Noy 2020). However, monetary policy appears to have been significantly more accommodative in election years during 1980–2008 (Joarder, Hossein, and Ahmed 2016).

Event study

An event study of government spending around national elections in South Asia since 1991 suggests the presence of political budget cycles in most countries in the region, although of varying intensity.

Including elections planned for 2023–24, there will have been 53 presidential or parliamentary elections in the region since 1990: seven in Bangladesh; four in Bhutan; eight in India; eight in Pakistan; four in Nepal; twelve in the Maldives; and ten in Sri Lanka. Elections
in South Asia have tended to be bunched together about every five years, as they are again in 2023–24.

For the seven South Asian countries in the sample, on average, the primary fiscal balance deteriorated either in the election year or in the year preceding the election by 0.5 percentage point of GDP; only half of this deterioration was unwound over the two years following the election (figure B1.1.1). In some cases, the widening of primary fiscal deficits in the runup to elections reflected spending increases.

Political budget cycles in South Asia and other EMDEs

Data for the South Asia region are severely limited and provide an inadequate basis for reliable policy lessons to be drawn. To broaden the analysis of political budget cycles, the larger group of EMDEs is examined (de Haan, Ohnsorge, and Yu forthcoming). On the assumption that the typical South Asian country behaves similarly to the typical EMDE, once the main country characteristics are controlled for, lessons may be inferred for South Asia.

A generalized-method-of-moments regression is estimated of fiscal outcomes on elections (annex 1.1.1). The fiscal outcomes that are examined are aggregate primary government expenditures, primary fiscal balances, and the government wage bill (all in percent of GDP). The sample includes up to 122 EMDEs for 1984–2022. The regression results are shown in annex tables 1.1.1–1.1.3.

EMDE elections were typically accompanied by a fiscal deterioration (figure B1.1.2). In the average election year, the primary deficit widened by 0.7 percentage point of GDP, mostly because primary government spending rose by 0.5 percentage point of GDP. Government wage bills were higher in election years, on average by 0.1 percentage point of GDP. For robustness, other components of government spending, including government investment, were tested for similar systematic changes around elections but none was found.

Primary government spending increases around elections were short-lived and typically reversed within a year—with the exception of increases in government wage bills, which accounted for about 25 percent of primary expenditures in the average EMDE during 2010–20. Thus, the 0.5-percentage-point of GDP increase in primary government spending in the average election year was virtually entirely unwound in the year after the election. In contrast, the smaller (0.1
percentage point of GDP) but statistically significant increase in the government wage bill in the election year was not systematically unwound in the post-election year. With regard to the primary fiscal balance, the unwinding was more variable and, on average, smaller, than in the case of primary expenditure: in fact, there was too much heterogeneity in post-election movement for a statistically significant unwinding of the election-year increase to be identified.

Since increases in the primary fiscal deficit and the government wage bill around elections are not systematically unwound after elections, they can cumulate to sizable increases over the course of several elections. Since 1990, for example, the average EMDE in the regression sample has held a presidential or parliamentary election every three years. Assuming that fiscal deficits are financed by increases in government debt, the regression coefficients from annex table 1.1.1 imply that government debt would already be more than 10 percentage points of GDP higher and the government wage bill 0.6 percentage point of GDP higher than initially by the time that the fourth election cycle takes place.

Together with three other regions, South Asia has had particularly pronounced political budget cycles (figure B1.1.3). Election-year increases in fiscal deficits, primary balances, or government wage bills were statistically significant only in three regions, and South Asia was one of the only two regions where all three fiscal outcomes increased significantly. The inclusion of regional dummy variables left other coefficient estimates broadly unchanged. In South Asia, specifically, election years were associated with 0.6 percentage point of GDP higher primary deficits, 0.8 percentage point of GDP higher primary spending, and 0.2 percentage point of GDP higher government wage bills than in non-election years. Two of these three regions (including South Asia) were also the regions with more frequent switches between fully democratic and less democratic political regimes. These two regions accounted for two-thirds of all regime switches in EMDEs during 1975–2022.

Policy implications

The empirical analysis suggests that deteriorations in fiscal positions, stemming particularly from spending increases, have been common in EMDEs at election times, regardless of political regimes. Yet the evidence that such fiscal actions affect election outcomes is decidedly mixed. Insignificant, or even adverse, effects on election outcomes for the incumbent government
have been reported for the United States (Peltzman 1992), EMDEs in Eastern Europe (Enkelmann and Leibrecht 2013) and Latin America (Kraemer 1997), and a large cross-country sample (Brender and Drazen 2008). However, more recent cross-country studies have reported that incumbents have benefited from fiscal actions in elections (Bojar 2017; Klomp and de Haan 2013), while voters sometimes punished incumbents for fiscal consolidation (Mulas-Granados 2004), although at other times they did not (Alesina 2012).

The lack of reversals of fiscal deficit increases around elections raises concerns about an erosion of fiscal sustainability over the longer term. Similarly, even the small, but statistically significant, ratcheting-up of government wage bills around elections in the average EMDE will tend to lock in spending rigidities that may become difficult to unwind in times of need.

To help prevent fiscal deteriorations around elections and their longer-term consequences, the establishment of more robust fiscal frameworks and institutional arrangements could be considered, as suggested by the experience of other countries.

- **Fiscal transparency.** There is empirical evidence that greater transparency in fiscal policymaking may make election-motivated fiscal policy action less likely by making them more visible (Alt and Lassen 2006 a, b; Gootjes and de Haan 2022).

- **Fiscal rules.** Fiscal rules, such as the Stability and Growth Pact in Europe and balanced budget requirements in some U.S. states, can constrain incumbents’ ability to engage in election-motivated fiscal expansions (de Haan and Klomp 2013; Rose 2006; Alt and Rose 2009; Cioffi, Messina, and Tommasino 2012; Ebeke and Ölçer 2017; Gootjes, de Haan, and Jong-A-Pin 2021). A growing number of countries have adopted such institutional fiscal constraints: in 2015, 92 countries had fiscal rules in place, up from 7 countries in 1990 (Lledó et al. 2017).

- **Robust governance and control of corruption.** Political budget cycles have been less pronounced in countries with stronger checks and balances, stronger rule of law, and less corruption (Streb, Lema, and Torrens 2009; Shi and Svensson 2006; Lee and Min 2021). Checks and balances in the political system discourage incumbents from using policy for re-election purposes.

There are indications that, at least in some South Asian countries, the 2023–24 election season may break from past practice. In India, for example, the latest government budget is on track for fiscal consolidation amid upcoming elections (World Bank 2023d).
in India; 3.5 percent in the Maldives and Pakistan; and 5 percent in Sri Lanka. Yet, most of these countries are among those in South Asia with the highest government debt-to-GDP ratios. During the pandemic, many countries activated escape clauses to suspend fiscal rules. This allowed governments to provide much-needed support for vulnerable groups, but also added substantial debt. No countries in South Asia are projected to achieve their budget or debt rule targets in 2023. Achieving compliance represents a challenge.

The design of fiscal rules in South Asia is less binding than in other EMDEs, which can diminish their effectiveness. For example, in a sample of EMDEs with fiscal rules over 2015–21, those with weaker designs—measured in terms of coverage, legal basis, monitoring, enforcement, and flexibility—had larger increases in debt between 2015 and 2022. A variety of best practices in the design of fiscal rules has been identified, and could be adopted by South Asian governments (Caselli and Reynaud 2019).

- **Medium-term objectives with short-term flexibility.** A medium-term debt objective can provide the flexibility needed to prevent the erosion of political support for the rule during adverse events. Various types of escape mechanisms can ensure that the rule remains applicable even during economic shocks (Eyraud et al. 2018). In Germany and Switzerland, for example, deviations from target are accumulated over several years. Once this accumulation exceeds a certain threshold, adjustments must be made over the next few years to reduce the fiscal deficit (German Federal Ministry of Finance 2022; OECD 2011).

- **Safeguards for priority spending.** A fiscal rule that excludes capital expenditure can encourage public investment, but it needs guardrails against creative accounting (IMF 2009, 2018). Excluding capital expenditure from an expenditure rule can help ensure that governments’ ability to raise recurrent spending (such as public wage bills) around elections is limited.

- **Transparency.** Effective fiscal rules tend to be clear and simple (Eyraud et al. 2018). Such characteristics can raise the reputational costs to governments of noncompliance and limit their ability to adjust targets around elections. Transparent implementation of fiscal rules, alongside regular reporting and monitoring, can help build their credibility and increase the probability of compliance (Andersen 2013).

**Managing the energy transition**

As the world presses ahead with the energy transition, South Asia will need to improve its energy efficiency to keep pace. In fact, the global energy transition presents an opportunity for South Asia to upgrade technologies and lift productivity, cut pollution, reduce reliance on energy imports, and create jobs. Currently, the energy intensity of the region’s output is twice the global average, and substantially higher than in other EMDEs (figure 1.12).

India and Pakistan already rank among the world’s five EMDEs with the largest public investment in renewable energies (chapter 2). But substantial private investment will be needed for firms to adopt green technologies. Governments can support the adoption of energy-saving and low-emission technologies. Measures could include ensuring the availability of financing, incentivizing a shift toward green energy by removing fossil-fuel subsidies, introducing carbon taxes, or introducing market-based regulation. Firms sometimes vastly underestimate the savings from new technologies. As a result, improving access to information about the availability, cost-saving potential, and competitiveness of green technologies can help boost adoption at limited cost. Access to reliable energy grids can encourage firms to phase out energy inefficient backup energy systems.

The energy transition is likely to create shifts in South Asia’s labor markets (chapter 3). In almost all countries in the region, pollution-intensive jobs outnumber green jobs, and they account for 6–11 percent of all jobs in the region. Pollution-intensive jobs tend to be concentrated among lower-skilled and informal workers. Green jobs tend to be filled by higher-skilled and better-paid workers. Experience from economic transformations in other countries suggests they can have significant employment and earnings
effects, both in the aggregate and for specific groups of workers.

A wide range of policies can facilitate the necessary adjustment in labor markets while protecting vulnerable workers. These include: enhancing access to education and training, finance, and markets; measures to facilitate labor mobility; and strengthening social safety nets. Some countries have already begun to put such policies in place. Nepal’s Green Resilient and Inclusive Development Strategic Action Plan (GRID SAP) aims to combine climate-conscious growth strategies and improved air quality with equitable job creation. Channeling investments into green initiatives and supporting small and medium enterprises in areas that have potential for growth (particularly finance, tourism, resilient connectivity, renewable energy, forestry, waste management, and agriculture), as envisioned in the GRID, can foster labor participation and economic opportunities in the formal economy while reducing job disparities. Similarly, Bangladesh’s Climate-Smart Agriculture Investment Plan aims to support and protect the livelihoods of farmers, especially women, and improve rural workers’ green skill development, through capacity building, knowledge sharing, and financial resources.

An important collateral benefit of the energy transition will be reduced air pollution. The emission of pollutants that accompany South Asia’s currently energy-intensive production processes has been shown to cause material economic and human losses by depressing worker productivity and worsening health and education outcomes (Behrer, Choudhary, and Sharma 2023; World Bank 2023). Nine of the world’s ten most-polluted cities are in South Asia (World Bank 2023). Some 60 percent of South Asia’s population live in heavily polluted areas. Pollution in the region is often trapped in large airsheds shaped by climatology and geography that span multiple countries (World Bank 2023). In some cities, the majority of air pollution originates from neighboring states and countries. Airshed-wide air quality management, requiring cooperation across multiple South Asian countries, can benefit both the region’s people and economy.

**FIGURE 1.12 Managing the energy transition**

The energy transition will require the adoption of greener and more energy-efficient technologies by firms, but such innovation is held back in part by the tendency of firms to underestimate potential savings. In almost all countries in South Asia, the share of workers in green jobs is less than that in pollution-intensive jobs. The energy transition will disproportionately improve job prospects for better educated workers in the formal economy.

The regressions control for industry and subnational entity dummies.

A. Energy intensity, 2020

- **B. Average electricity consumption with old and new technologies**
  - Clutch motor
  - Servo motor
  - kWh
  - Actual consumption
  - Beliefs

C. Shares of workers in green jobs and pollution-intensive jobs

D. Marginal probability of working in a green job

Sources: Annual Survey of Industries, India; European Commission; national statistical offices; OECD Green Growth database; World Bank.

**Note**

- BGD = Bangladesh; EMDEs = emerging market and developing economies; IND = India; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan; SAR = South Asia; Toe = tons of oil equivalent.

A. Energy intensity is defined as energy consumption (in tons of oil equivalent) relative to nominal GDP (in thousands of U.S. dollars) in 2020 (chapter 2).

B. Estimates of mean electricity consumption based on hourly readings of electricity meters installed in one clutch and one servo motor sewing machine in each of 124 intensive treatment firms. Meter readings collected for every day in January. Mean baseline beliefs about daily electricity consumption using a clutch motor and servo motor sewing machine in the full sample of firms measured in the baseline survey.

C. Green jobs are those in occupations with a positive share of environmentally friendly tasks. Pollution-intensive jobs are those with above-median pollution intensity. More details can be found in annex 3.1 (chapter 3). Labor force surveys are available for Bangladesh (2015), India (2018), Sri Lanka (2019), Maldives (2019), Nepal (2017), and Pakistan (2018).

D. Marginal probabilities as estimated in probit regressions of a dummy variable of being employed in a green job, conditional on being in an urban location, having completed secondary or tertiary education, being aged 24–54 or 55 or older, and being informally employed (annex 3.1.3, annex 3.1.4, chapter 3). The regressions control for industry and subnational entity dummies.
ANNEX 1.1.1. Methodology

The panel regression estimate the effect of elections on three fiscal outcomes. The election variable takes the timing of elections into account. Specifically, it prorates the months of the year up to the election date, as in Franzese (2000). The fiscal outcomes that are examined are aggregate primary government expenditures, primary fiscal balances, and the government wage bill (all in percent of GDP).

The regression controls for the following country characteristics: per capita real GDP (in logs; which proxies shifts in voter preferences as incomes rise), real GDP growth (to capture business cycle-related changes to fiscal outcomes), inflation (to control for inflation-related increases in nominal incomes that buoy government revenues), lagged government debt (to control for budget constraints that preclude any spending increases), and the lagged dependent variable (to control for path dependence). To mitigate concerns about endogeneity and the inclusion of the lagged dependent variable, the regression is estimated using a generalized method of moments (GMM) estimator as in Gootjes, de Haan, and Jong-A-Pin (2021). The regression results are shown in annex tables 1.1.1 -1.1.3. The results are robust to excluding insignificant variables such as real GDP per capita.

The sample includes up to 122 EMDEs for 1984-2022. These EMDEs cover all types of political regimes.

ANNEX TABLE 1.1.1 Election effects

<table>
<thead>
<tr>
<th>(in percent of GDP)</th>
<th>Primary balance</th>
<th>Primary expenditures</th>
<th>Compensation of employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Election</td>
<td>-0.65***</td>
<td>0.52***</td>
<td>0.14**</td>
</tr>
<tr>
<td></td>
<td>(0.18)</td>
<td>(0.16)</td>
<td>(0.06)</td>
</tr>
<tr>
<td>GDP growth</td>
<td>0.08***</td>
<td>-0.04</td>
<td>-0.03***</td>
</tr>
<tr>
<td></td>
<td>(0.02)</td>
<td>(0.04)</td>
<td>(0.01)</td>
</tr>
<tr>
<td>Lagged government debt</td>
<td>0.01***</td>
<td>-0.01***</td>
<td>0.00</td>
</tr>
<tr>
<td></td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
</tr>
<tr>
<td>Inflation</td>
<td>-0.00***</td>
<td>0.00***</td>
<td>-0.01</td>
</tr>
<tr>
<td></td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.01)</td>
</tr>
<tr>
<td>Real GDP per capita (logs)</td>
<td>0.18</td>
<td>0.69</td>
<td>0.43</td>
</tr>
<tr>
<td></td>
<td>(0.30)</td>
<td>(0.50)</td>
<td>(0.37)</td>
</tr>
<tr>
<td>Lagged primary balance</td>
<td>0.61***</td>
<td>0.78***</td>
<td>0.74***</td>
</tr>
<tr>
<td></td>
<td>(0.07)</td>
<td>(0.04)</td>
<td>(0.06)</td>
</tr>
<tr>
<td>Lagged primary expenditure</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lagged compensation of employees</td>
<td></td>
<td>0.52***</td>
<td>0.14**</td>
</tr>
<tr>
<td></td>
<td>(0.18)</td>
<td>(0.16)</td>
<td>(0.06)</td>
</tr>
<tr>
<td>Constant</td>
<td>-0.65***</td>
<td>0.52***</td>
<td>0.14**</td>
</tr>
<tr>
<td></td>
<td>(0.18)</td>
<td>(0.16)</td>
<td>(0.06)</td>
</tr>
<tr>
<td>Obs</td>
<td>3,011</td>
<td>3,011</td>
<td>1,521</td>
</tr>
<tr>
<td>Nr of countries</td>
<td>122</td>
<td>122</td>
<td>96</td>
</tr>
<tr>
<td>AR(1) p-val</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>AR(2) p-val</td>
<td>0.21</td>
<td>0.95</td>
<td>0.24</td>
</tr>
<tr>
<td>Sargan-Hansen test p-val</td>
<td>0.32</td>
<td>0.68</td>
<td>0.99</td>
</tr>
<tr>
<td>Cragg-Donald test p-val</td>
<td>0.00</td>
<td>0.02</td>
<td>0.00</td>
</tr>
</tbody>
</table>

Note: Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1. All regressions use the GMM estimator and include year dummies. “Election” is a numerical variable that is constructed using the approach detailed in Gootjes, de Haan, and Jong-A-Pin (2021). The sample includes up to 122 EMDEs for the period 1984-2022. See de Haan, Ohnsorge, and Yu (forthcoming) for details.
### ANNEX TABLE 1.1.2 Election timing effects in EMDEs

<table>
<thead>
<tr>
<th>(in percent of GDP)</th>
<th>Primary balance</th>
<th>Primary expenditures</th>
<th>Compensation of employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lead of election</td>
<td>-0.31** (0.17)</td>
<td>0.20 (0.17)</td>
<td>-0.03 (0.07)</td>
</tr>
<tr>
<td>Election</td>
<td>-0.65*** (0.18)</td>
<td>0.52*** (0.16)</td>
<td>0.14** (0.06)</td>
</tr>
<tr>
<td>Lag of election</td>
<td>0.22 (0.17)</td>
<td>-0.44** (0.17)</td>
<td>0.07 (0.07)</td>
</tr>
<tr>
<td>Observations</td>
<td>2,892 3,011 3,011 2,892 3,011 3,011 1,521 1,521 1,521</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nr of countries</td>
<td>122 122 122 122 122 122 96 96 96</td>
<td></td>
<td></td>
</tr>
<tr>
<td>AR(1) p-val</td>
<td>0.00 0.00 0.00 0.00 0.00 0.00 0.00 0.00 0.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>AR(2) p-val</td>
<td>0.27 0.21 0.25 0.96 0.95 0.99 0.25 0.24 0.99</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sargan-Hansen test p-val</td>
<td>0.19 0.32 0.19 0.82 0.95 0.95 0.99 0.99 0.58</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cragg-Donald test p-val</td>
<td>0.00 0.00 0.00 0.01 0.02 0.02 0.00 0.00 0.00</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1. All regressions use the GMM estimator and include year dummies. All dependent variables are in percent of GDP. "Election" is a numerical variable that is constructed using the approach detailed in Gootjes, de Haan, and Jong-A-Pin (2021). "Lead of election" captures the "Election" in the following year, while "lag of election" captures the "Election" in the previous year. The same set of controls as in annex table 1.1.1 is included but not shown here for brevity. The sample includes up to 122 EMDEs over the period 1984-2022. See de Haan, Ohnsorge, and Yu (forthcoming) for details.

### ANNEX TABLE 1.1.3 Election effects

<table>
<thead>
<tr>
<th>Primary balance</th>
<th>Primary expenditures</th>
<th>Compensation of employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Election (EAP region)</td>
<td>-0.31 (0.40)</td>
<td>0.43 (0.51)</td>
</tr>
<tr>
<td>Election (ECA region)</td>
<td>-0.19 (0.35)</td>
<td>-0.16 (0.41)</td>
</tr>
<tr>
<td>Election (LAC region)</td>
<td>-1.03*** (0.26)</td>
<td>0.97*** (0.30)</td>
</tr>
<tr>
<td>Election (MNA region)</td>
<td>0.95 (0.70)</td>
<td>0.18 (0.64)</td>
</tr>
<tr>
<td>Election (SAR region)</td>
<td>-0.61** (0.24)</td>
<td>0.79*** (0.18)</td>
</tr>
<tr>
<td>Election (SSA region)</td>
<td>-0.90** (0.36)</td>
<td>0.56* (0.29)</td>
</tr>
<tr>
<td>Observations</td>
<td>3,011</td>
<td>3,011</td>
</tr>
<tr>
<td>Nr of countries</td>
<td>122</td>
<td>122</td>
</tr>
<tr>
<td>AR(1) p-val</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>AR(2) p-val</td>
<td>0.19</td>
<td>0.94</td>
</tr>
<tr>
<td>Sargan-Hansen test p-val</td>
<td>0.10</td>
<td>0.93</td>
</tr>
<tr>
<td>Cragg-Donald test p-val</td>
<td>0.11</td>
<td>0.02</td>
</tr>
</tbody>
</table>

Note: Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1. All regressions use the GMM estimator and include year dummies. "Election" is a numerical variable that is constructed using the approach detailed in Gootjes, de Haan, and Jong-A-Pin (2021). The same set of controls as in annex table 1.1.1 is included but not shown here for brevity. The sample includes up to 122 EMDEs for the period 1984-2022. See de Haan, Ohnsorge, and Yu (forthcoming) for details.
References


