CHAPTER 1

Opportunities amid lingering challenges

Introduction

Global energy prices have fallen from their peaks, which has eased domestic inflationary pressures and improved terms of trade for most South Asian countries. But domestic prices remain high, especially food prices, which have dampened growth in private consumption and worsened consumption inequality. While the global services sector is recovering, goods demand remains weak. The weak demand and shortages of imported inputs, due to import restriction policies and a shortage of foreign currency, have limited activities in South Asia’s manufacturing sector. Growth in the region’s services sector remains robust aided by the return of tourists. Because of an uneven sectoral recovery, the recovery in employment has been slow and uneven, which could reduce long-term human capital investment.

Tensions in the external sector have intensified. As import restrictions and improving terms of trade have reduced imports more than the fall in exports, the region’s trade account balance has improved. But net capital outflows have increased, as uncertainty increases in global financial markets. Although interventions in the foreign exchange markets have helped stabilize exchange rates in many South Asian countries, artificially strong exchange rates and increased capital controls have widened the gap between the official and market exchange rates, leading to declines in official remittance inflows and foreign reserves. In Pakistan, intensifying external sector pressures and economic uncertainty led to rapid currency depreciation in early 2023, contributing to rising inflation and exacerbating external sector pressures.

Weaknesses in the real sectors are reflected in the financial sector. Loan moratorium programs during the pandemic have delayed the recognition of distressed assets. But non-performing loan ratios have started rising, in Bangladesh due to high import costs and weak regulatory enforcement, and in Sri Lanka due to rising rates and increased macroeconomic uncertainties, reflecting a deterioration of asset quality. Increased borrowing by the
government from domestic banks has crowded out private credit in Pakistan, while rising sovereign-bank linkages in Maldives, Pakistan and Sri Lanka have further increased the financial sector’s vulnerability.

While the improving global environment may provide opportunities, domestic challenges in the external and financial sectors present difficult policy choices. Import restrictions and exchange market interventions may help reduce short-term fluctuations but tend to hurt long-term growth and competitiveness. Many countries in the region are conducting fiscal consolidation to reduce the fiscal burden. This has included goods and services tax increases and energy subsidy reductions, but it also includes lower budget allocations to programs that support vulnerable households. Monetary tightening that has helped countries contain inflation has also raised domestic borrowing rates, dampened investment, and contributed to financial sector pressures.

The chapter is divided as follows. Section 1.1 puts South Asia in a global context to highlight the challenges and opportunities. Sections 1.2 to 1.4 focus on specific challenges. Section 1.5 views policy choices in the context of these challenges.

1.1 An uneven recovery amid rising uncertainty

South Asian countries face an uncertain global environment with tightening financial conditions. Global energy and fertilizer prices have fallen from the high levels of mid-2022 (Figure 1.1.B), helping to ease domestic inflationary pressure and improve the terms of trade for net energy-importing countries. The reopening of the Chinese economy from pandemic-related lockdowns has helped reduce global supply disruptions. Accordingly, the global Purchasing Managers’ Index (PMI) showed an expansion of overall activities in February 2023, especially in the global services sector, after having remained in contraction territory since August 2022. But the global manufacturing sector has continued to contract as of February 2023, albeit at a slower pace than in previous months (Figure 1.1.A). Owing to weakening global demand for most of 2022, global goods trade fell and continued falling in early 2023. The ongoing monetary tightening in advanced economies and rising stress in the US and European banking sectors since mid-March have contributed to tightening financial conditions and external sector pressures in emerging markets and developing countries (EMDEs).

Industrial activity has declined in South Asia, especially in manufacturing. With high input costs and weak external demand, merchandise exports and industrial production fell in late 2022 in India and Pakistan, and industrial production declined in Sri Lanka (Figure 1.2). Production in Pakistan, Sri Lanka and Bangladesh has been curtailed by import compression due to currency depreciation, a shortage of foreign reserves to pay for imports, and
Figure 1.1. Global services sector is recovering while energy prices are falling

A. Global economic activity has stabilized with recovery in services

B. Global energy and fertilizer prices have fallen

Figure 1.2. Activities in the industrial sector and especially manufacturing have declined

Source: Haver Analytics and World Bank commodity price Pink Sheets.

Note: A. PMI indexes for the world come from IHS Markit and are seasonally adjusted. B. Commodity price indexes are for low- and middle-income countries, an index constructed by the World Bank. Historical average inflation is computed based on monthly inflation levels during 2016-2019 for Afghanistan, and 2015-2019 for the other countries.

Source: CEIC, GEM, and Haver Analytics.

Note: Merchandise exports are in nominal US dollars and not seasonally adjusted; the values are then indexed to the average 2019 value. For industrial production, manufacturing industrial production is used for Bangladesh and Pakistan, while the general index is used for India and Sri Lanka. All industrial production indexes are seasonally adjusted and indexed to the average 2019 value.
import restriction policies. Sri Lanka’s manufacturing PMI points to continued contraction (month-on-month) in manufacturing from June 2022 to February 2023, especially in new orders and production, due to subdued demand in the food and textiles sectors (Central Bank of Sri Lanka 2023). In Bangladesh, exports and industrial production were disrupted in the summer due to shortages of energy and production inputs. However, as import restrictions were relaxed, activities picked up in late 2022, although a shortage of US dollars still limited imports and production. In India, manufacturing output contracted by 1.1 percent on a year-on-year (y-o-y) basis in 2022Q4 (Q3 of FY2022/23) after a 3.6 percent contraction in 2022Q3 (Figure 1.3). While construction expanded in both quarters, helped by public sector spending on infrastructure (Section 1.5), it is a much smaller share of India’s GDP than manufacturing.¹

In contrast to the industrial sector, the services sector has expanded and remains robust (Figure 1.4). In Maldives, tourist arrivals reached 1.68 million in 2022, only slightly lower than the pre-pandemic high. In the first two months of 2023, tourist arrivals increased 23 percent year-on-year, aided by the return of Chinese tourists, which accounted for 15 percent of the increase in total tourist arrivals for the year (as of early March) compared with a year ago. Tourist arrivals continued to recover in India and Nepal but are still below pre-pandemic levels.² Sri Lanka has seen a strong seasonal pick-up in tourist arrivals since December 2022, while the PMI services index shows the country’s services sector oscillated between mild expansion and contraction during the period from August 2022 to February 2023 amid

¹ Manufacturing made up 17 percent of India’s GDP in FY2020/21, while construction and mining were 7.2 and 2.1 percent, respectively.
² Tourist arrival includes only foreign tourists for India.
Figure 1.4. Services sector activity was led by a recovery in tourism

Note: Tourist arrivals include only foreign tourists for India.

subdued consumer demand. After Bhutan reopened its borders to tourists in September, arrivals picked up in 2022Q4, but levels are still significantly below pre-pandemic levels, especially among within-region arrivals, which are also subject to a lower daily charge than international tourists.\(^3\) The robust tourism sector has supported growth in related sectors such as real estate, transport, and trade. Driven by strong demand for IT and professional services, India’s services sector overall continued expanding in 2022Q3 and Q4, with a 6.2 percent y-o-y increase in output in Q4 (Figure 1.3).

Investment growth remains strong in India, while growth in private consumption has moderated. Real GDP grew 4.4 percent in 2022Q4 (FY2022/23 Q3) in India from a year ago, driven by strong growth in investment (Figure 1.5), as the government’s capital expenditure push boosted construction activities and crowded in private investment. Business confidence in India has benefited from strong corporate profits and remains optimistic, in contrast to Pakistan (pessimistic) and Sri Lanka (highly pessimistic). Growth in private consumption, which accounts for over 55 percent of India’s GDP, slowed down in 2022Q4, as still-high inflation created a drag on consumption, especially among low-income groups. Import growth (y-o-y) slowed in 2022Q4 compared with Q3, due to weak demand for manufacturing inputs, contributing to smaller trade deficits.

\(^3\) Bhutan’s tourism levy act 2020 introduced a sustainable development fee (SDF) for regional tourists of BTN1,200 per person per night. This is still significantly lower than the SDF for international arrivals of US$200 per night. This new SDF for regional tourists and the fact that hotels and guest houses below three stars had to close down in line with new tourism regulations, could have deterred regional tourists.
The recovery in employment has remained uneven across sectors and countries. In India, employment expanded month-on-month (m-o-m) in both manufacturing and services in early 2023, albeit at a slower pace than in 2022H2, according to the PMI employment indexes (Figure 1.6). There were also large variations in employment growth across regions and employment types: while employment inched up in urban areas, it stagnated in rural areas according to the latest CMIE data; and while self-employment increased, regular salaried employment fell in 2022, raising concerns about the job quality of new employment. Employment declined in Sri Lanka (Figure 1.6), driven by both subdued economic activities and increased resignations, migrations, and retirements (Central Bank of Sri Lanka 2023). In Afghanistan, the cyclical slowdown of the economy during the winter season translated into a gradual decline in employment and a contraction of income-generating opportunities for self-employed and casual workers (World Bank 2023a). In Bhutan, the youth unemployment rate increased to 29 percent in 2022 from 21 percent in 2021, leading to an increase in outward migration (Drukpa 2022; Tobgay 2022). The slow growth in employment and deterioration in job quality have contributed to slow growth in private consumption. Slow recovery in jobs also tends to reduce human capital investment and could exacerbate the inequality of opportunities in South Asia (Chapter 3).

The nowcast of GDP growth in the most recent quarter also suggests an uneven recovery across countries. The nowcast is based on different high-frequency activity indicators, 

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4 Nowcasting refers to the practice of using recently published data to update key economic indicators that are published with a significant lag, such as real GDP.
in which a LASSO statistical model is used to select the most relevant economic activity indicators for each country (World Bank 2020). Using the data available up to March 27, 2023, the model nowcasts one-quarter ahead of the official release of quarterly GDP data—2023Q1 for India and Sri Lanka, and 2022Q4 for Maldives (Figure 1.7). The nowcast suggests a pick-up in India’s growth rate in 2023Q1 (Q4 of FY2022/23) compared with the previous quarter, as government consumption growth accelerates as it approaches the end of the fiscal year. Supported by continued recovery in tourism, Maldives is expected to grow by more than 10 percent in 2022Q4 from a year ago. Consistent with the weaknesses reflected in PMI, confidence, and industrial production indicators for January and February 2023, the model suggests a continued contraction in Sri Lanka in 2023Q1, reflecting a contraction in demand and production activities that are limited by input shortages.

The new global environment provides opportunities, but challenges remain for South Asia. While weak global activities limited export growth in 2022, improving global demand in 2023 could help boost exports. Falling global energy prices help ease domestic inflationary pressures and improve the terms of trade for South Asian countries, most of which are net energy importers, but stubbornly high food price inflation continues to put at risk access to basic food items (Section 1.2). Countries that were battered by the series of shocks over the past three years entered 2023 with high debt levels, diminished foreign reserve buffers and weakened currencies (Section 1.3). Tight global financial conditions have increased debt service costs and can dampen private investments, along with increased sovereign-bank linkages in some countries (Section 1.4). Falling global energy prices also provide an opportunity for countries to reduce or remove fuel subsidies, as many South Asian countries have done.
1.2 Slow-falling inflation and elevated food prices

Falling global energy prices have helped to ease domestic inflationary pressures in South Asia, although consumer inflation is sticky in most countries. The decline in global energy and fertilizer prices helped lower both consumer inflation and wholesale inflation in 2022Q4 (October–December), compared with the previous quarter (Figure 1.8). The exception is Pakistan, where consumer inflation has continued rising in recent months, as the floods and currency depreciation have increased inflationary pressures in the country. Despite the general downward trend, consumer inflation has been sticky in most cases and is falling very slowly. In all countries, the average inflation in 2022Q4 was above the historical average, and in all except Bhutan it was above the average in 2021Q4. In India, consumer inflation increased in January and February 2023 to above the Reserve Bank of India’s (RBI) tolerance band after falling below the upper threshold (6 percent) in November and December. Similarly, consumer inflation rose in Bangladesh and Nepal in February, breaking the declines seen in the previous months.

Stronger pass-throughs of global commodity prices in 2022H2 may help explain the slow fall in consumer price inflation. Domestic prices became more responsive to changes in
global prices in 2022H2: this was the case for domestic fuel prices in Bangladesh, Pakistan, and Maldives, and for wheat prices in Bangladesh, India and Pakistan (Figure 1.9). Currency depreciation, which led to faster increases in domestic than global prices, has contributed to the stronger pass-through. In addition, the reduction or removal of consumer price...
subsidies—in Pakistan (Reuters 2022) and Bangladesh (Raana 2022)—have led to a catching-up of domestic consumer prices to global prices of the same commodity. This catching-up to global prices has slowed down the fall of domestic consumer price inflation, despite falling energy prices.

Across goods categories, inflation of food items has gone up or stayed high, while energy-related inflation has mostly come down more, compared with summer and fall 2022. With falling energy prices in the global market, domestic inflation of many energy-related goods fell in 2022Q4 compared with 2022Q3 (Figure 1.10). Petrol for vehicles in India saw deflation during the period, while the inflation of motor fuel in Pakistan slowed. At the same time, inflation in certain food items went up. In Pakistan, the inflation of onions has reached over 100 percent since October 2022 and increased to over 500 percent in rural areas in January 2023 following drastic rises in global prices of onion. The prices of wheat and other cereals have also increased fast: in India, the average price of cereals has increased at a monthly rate of above 10 percent since September and reached 16 percent in January, while inflation of wheat reached 25 percent in January. In the aftermath of the floods, the inflation of wheat soared in Pakistan, reaching 78 percent in urban areas and over 100 percent in rural places. In addition, the price of meat in Bangladesh and Maldives has also increased faster than the average consumer inflation in recent months. One exception is Bhutan, where both imported and domestic food prices decelerated in the second half of 2022, as the country increased domestic food production.

Continued food export restrictions contribute to high global food price inflation, and elevated food prices contribute to poverty and inequality. As a response to the war in Ukraine and the initial increase in food shortages around the world, many countries implemented food export restrictions (World Bank 2022a). Many of these restrictions have been extended to the end of 2023 and beyond (Table 1.1). These export restrictions threaten to further increase global food prices by restricting the free flow of food products. The brunt of the impact is borne by countries that import these heavily restricted food products, such as wheat for most South Asian countries. In Afghanistan, although food items are reportedly widely available thanks to good weather and harvests, two-thirds of Afghan households cannot afford basic food items due to a collapse of private income (World Bank 2023a). As a result, estimates by the World Food Programme (WFP) show that the share of the population with insufficient food has stayed above 90 percent in Afghanistan. High and persistent food inflation not only increases the cost of living for all households, but it hits the poor especially hard, as Box 1.1 shows.
Supply disruptions at the local level have contributed to consumer price inflation. In India, cereal prices have risen consistently since early 2022, as unfavorable weather conditions led to weak wheat and rice production. In Pakistan, supply-side disruptions from the floods during June–October 2022 contributed to higher food and headline inflation. In Sri Lanka, shortages of fuel and other basic items have continued to contribute to high inflation.

Box 2.1 in Chapter 2 estimates the impact of weather anomalies on countries’ inflation.
Accordingly, a decomposition analysis shows a rising effect from local-level supply constraints on domestic consumer inflation for India, and Pakistan, and an elevated supply-side effect for Sri Lanka (Figure 1.11).

Exchange rate depreciation has had a major impact on domestic inflation, while the effect of global oil prices has declined as global energy prices fall. Compared with early 2022, many South Asian currencies have depreciated against the US dollar, which contributes to domestic inflation through the higher costs of imported goods (Figure 1.11). As the US dollar exchange rate stabilized since late 2022 (Section 1.3), the contribution of the exchange rate to inflation has moderated in India and Sri Lanka. By contrast, the drastic depreciation of the Pakistani rupee since November has increased the contribution of exchange rate fluctuations to domestic inflation. At the same time, the impact of global oil prices on domestic inflation has declined, and turned negative in Bangladesh, Pakistan and Sri Lanka in 2023Q1, as global energy prices fell compared with a year ago.⁷

Table 1.1. Export restrictions on food by South Asian countries and major trading partners

<table>
<thead>
<tr>
<th>Country</th>
<th>Measure</th>
<th>Expected end date</th>
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<tbody>
<tr>
<td><strong>South Asian countries</strong></td>
<td></td>
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</tr>
<tr>
<td>Afghanistan</td>
<td>Export ban on wheat</td>
<td>12/31/2023</td>
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<tr>
<td>Bangladesh</td>
<td>Export ban on rice</td>
<td>12/31/2023</td>
</tr>
<tr>
<td>India</td>
<td>Export ban on sugar</td>
<td>10/31/2023</td>
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<tr>
<td></td>
<td>Export ban on wheat</td>
<td>12/31/2023</td>
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<td></td>
<td>Export licensing on wheat flour</td>
<td>12/31/2023</td>
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<td></td>
<td>Export taxes on rice</td>
<td>12/31/2023</td>
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<tr>
<td>Pakistan</td>
<td>Export ban on sugar</td>
<td>12/31/2023</td>
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<tr>
<td><strong>Major trading partner of SAR</strong></td>
<td></td>
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<tr>
<td>Russia</td>
<td>Export ban on rice</td>
<td>12/31/2023</td>
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<td></td>
<td>Export taxes on soya beans</td>
<td>8/31/2024</td>
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<td></td>
<td>Export taxes on sunflower oil &amp; meal</td>
<td>12/31/2023</td>
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<tr>
<td></td>
<td>Export taxes on wheat, barley and corn</td>
<td>12/31/2023</td>
</tr>
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⁷ The contribution of domestic energy prices to headline inflation increased for Pakistan in February as the reduction in energy subsidies drove energy prices up domestically.
1.3 External sector pressures meet policy distortions

Falling global energy prices and import restrictions contributed to shrinking trade deficits. The value of imported goods started declining in 2022Q3 due to easing energy prices and import restrictions. In Nepal, Pakistan, and Sri Lanka, where extensive import restrictions were in place (World Bank 2022a Table 1.3), the value of goods imports fell in 2022Q4 compared with 2021Q4 (Figure 1.15.A). While merchandise exports also stagnated in the region due to falling global demand, goods imports fell faster, leading to a narrowing goods trade balance (Figure 1.15.B). Services exports have been supported by the robust growth of IT and professional services in India, and by the return of tourists to Nepal (Figure 1.1.4). As a result, the current account balance improved in Bangladesh, Nepal, and Pakistan in 2022Q4 and in Sri Lanka in 2022Q3, compared with the previous quarter and with the same quarter in 2021.
Box 1.1. Distributional impact of high food and energy inflation in South Asia

South Asia has seen a period of high inflation over the past two years, driven successively by high food inflation due to the COVID-19-related supply constraints and the war in Ukraine, and soaring energy inflation as global demand recovered and the war in Ukraine started (Figure 1.12). In India, monthly food inflation reached above 10 percent in 2020, while inflation of fuel and lighting reached 14 percent in late 2021 and stayed high for much of 2022. In Pakistan, food inflation hit 36 percent in October 2022 due to the floods, while transport inflation, which is closely related to energy prices, reached 60 percent in the summer of 2022. The situation in Sri Lanka was even worse, with food inflation reaching over 80 percent during July—October and transport inflation over 100 percent during June—December 2022. In the aggregate, high inflation erodes the real purchasing power of households. In the cross-section, high food inflation and energy inflation impact different groups of households in different ways because of their different budget shares. This box examines the effective inflation rates experienced by different groups of households.

Figure 1.12. Food and fuel inflation in South Asia

The analysis uses a similar methodology as Nasir, Kishwar, and Meyer (2023) and World Bank (2022b) to construct the consumption expenditure shares by household deciles. Detailed consumption expenditure data from Consumer Pyramids Household Surveys (CPHS) for India (2019), Household Income and Expenditure Survey (HIES) 2016–17 for Bangladesh, 2018–19 for Pakistan and 2016 for Sri Lanka (Table A.1.1) are used to...
compute the expenditure shares. Households sometimes produce for their own consumption, especially in rural areas. Although self-produced consumption also has welfare value for households, it is not directly affected by high inflation. For this reason, we choose to focus on expenditure instead of consumption and exclude consumptions reported as self-produced or gifted. Households are then grouped into deciles according to their real consumption expenditure, adjusted for the number of adults equivalent in the household. Monthly price data come from the country’s statistical offices. Separate urban and rural prices are used for India, Pakistan, and Bangladesh, which allows the analysis to capture different prices paid in the cross section within a country. See Dovonou and Xie (2023) for details on the methodology.

Households in lower deciles spend proportionally more on food, while richer households spend proportionally more on energy-related goods (power, fuel, transport) in the region. This pattern holds across the four South Asian countries studied here and in both urban and rural areas (Figure 1.13). For example, in India food takes up over 50 percent of consumption expenditure for the households in the lowest decile and only around 36 percent for those in the highest decile. Among food items, the lowest decile spends a much larger share on cereal and products than the highest decile does—15 percent versus 7 percent in rural India. This makes the lowest decile especially vulnerable to price increases in food, especially cereal products. By contrast, households in the highest decile spend proportionally more on energy-related items such as fuel, lighting and transport—21 percent versus 11 percent in rural Pakistan.

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8 The Bangladesh and Pakistan surveys distinguish whether a good is purchased, gifted, paid as wage in kind, or self-produced. The India CPHS data record only consumption that is purchased. By excluding self-produced goods, the analysis also does not capture the effect that higher prices can lead to higher incomes for households that trade self-produced goods. Because income data are less reliable than consumption expenditure data in developing countries (Meyer and Sullivan 2003), real consumption measures are used to divide households into deciles. Per adult equivalent real consumption is calculated by dividing household’s real consumption by the number of adult equivalent members: members under 18 years old are accounted for 0.8 adults. For Bangladesh and Pakistan, all consumption (self-produced and purchased) is used for to build the ranking of the deciles. For Sri Lanka, although separate price data are available for Colombo in addition to the national-level data, no separate urban/rural price data are available. For Pakistan, expenditure shares and prices are matched by the 12 COICOP consumption groups, except fuel and lighting which is separated from housing rent, water, etc. For India and Bangladesh, finer categories are used for food (e.g., cereals, meat and fish, edible oils and fats), which helps provide a more precise picture.

9 See Dovonou and Xie (2023) for results for other regions (e.g., Bangladesh urban, India and Pakistan rural) in South Asia.

10 Similarly, the large share of food expenditure among the households in the lower deciles in Bangladesh leaves little room for diversification of consumption on other non-food and non-energy goods and services. By contrast, consumption is more diversified among the upper deciles in Bangladesh. There is also more diversification in India even among those in the bottom decile. Figure A.1.1 shows that over time between 2015 and 2020, as income rose, the average household in India spent less on food and more on non-food and non-energy goods and services, which is consistent with patterns documented in the literature as countries become wealthier (Chai, Rohde, and Silber 2015; Theil and Finke 1983).

11 Energy-related items include fuel, lighting and transport for India, Pakistan and Sri Lanka; fuel, lighting, transport and communication for Bangladesh.
The energy expenditure pattern is consistent with past studies of low-income countries (Baez, Inan, and Nebiler 2021; Nasir, Kishwar, and Meyer 2023; World Bank 2022b; 2022c) but differs from many high- and middle-income countries. In a recent study, Lokshin, Sajaia, and Torre (2023) find that the rich consume proportionally less housing and energy than the poor in most EMDE Europe and Central Asian countries, although the difference is small (see also World Bank 2023c).

Figure 1.13. Consumption expenditure share by household decile in South Asia


Note: The energy category in Bangladesh includes fuel, lighting, transport and communication. The food category in Bangladesh includes food, beverage and tobacco. For other countries, energy includes fuel, lighting and transport, and food includes food and non-alcoholic beverages.

Because food is a larger share of total expenditure for households in lower deciles, an increase in the prices of food impact them more than those in upper deciles, while soaring energy prices make a larger contribution to the effective inflation of the rich (Figure A.1.2). Assuming the consumption pattern does not change over time, decile-effective inflation rates are computed by combining the consumption expenditure shares for each household decile and price data for detailed consumption items (Appendix A.1.1). Because of the large shares of food in their total expenditure, households in
the bottom decile experienced higher inflation than those in the top decile when food inflation was high in 2020 (Figure 1.14). But as energy prices rose in 2021, the inflation for those in the top decile became higher, especially in India.

Figure 1.14. Inflation inequality between households in top and bottom deciles

Over the period 2020–2022, households in lower deciles experienced larger cumulative price increases in Pakistan and Sri Lanka, whereas those in upper deciles saw overall larger price increases in India and Bangladesh. In Pakistan, the larger cumulative inflation for the top decile is driven by higher overall increases in food prices than in energy prices, as energy subsidies dampened domestic energy price increases, while floods in late 2022 pushed up food prices. By contrast, in India and Bangladesh, the converse is driven by larger cumulative price increases in energy than food prices. Higher inflation among the poor is especially detrimental, as these households do not have any buffer savings and are likely to reduce the quality or quantity of consumption or resort to other negative coping mechanisms.

Note: The deciles are defined based on per adult equivalent real consumption on the household level and using data over 201617 for Bangladesh, 2019 for India, 2018–19 for Pakistan, and 2016 for Sri Lanka.
A few caveats apply. First, the analysis assumes that all households in a country/region experience the same inflation for the same goods and services. If, for example, households in lower deciles had lower inflation on cereals than those in upper deciles, because of different types of cereals they consume or different abilities to substitute for other types of cereals, then the decile-effective inflation would not be accurate. Second, it is assumed that households’ consumption patterns do not change during the period and hence the analysis abstracts from behavioral responses. But households sometimes do change consumption patterns over time and in response to changing inflations. Because the consumption data are relatively recent—2019 for India and Pakistan and 2016–17 for Bangladesh and Sri Lanka—the changes in consumption patterns are likely small. Third, these results are best interpreted as short-term impacts of relative price changes. In the medium term, higher energy prices can feed into higher food prices and impact households in the lower deciles more. Over the longer term, purchasing power shrinking effect of higher food prices can lead to damage to health, loss of human capital and negative coping (e.g., asset decumulation) for those in the lowest decile.

In addition to the relative price changes, inflation has a distributional impact through other channels. For example, fast-rising prices can impact household incomes differently depending on whether the income is indexed to inflation or fixed or how much bargaining power workers have. If households in the top decile had higher effective inflation than those in the bottom decile but also much higher income growth, then in real terms the top decile may have experienced a greater improvement (or smaller decline) in welfare compared with the bottom decile.

Understanding the distributional impact of relative price changes is important, because macroeconomic policies such as monetary policy often only consider the headline inflation but miss the driver of inflation and its implication on different households across the income distribution. Policies that target the source of inflation—be it food, energy or others—should be considered and could include measures to relax food supply bottlenecks and shift to more sustainable energy sources.

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14 World Bank (2022c) also found similar consumption patterns for Sri Lanka, with most recent consumption data 2019 HIES. Using the CPHS penal data of India, we constructed the expenditure share for the average household over time from January 2015 to July 2020. It shows that food expenditure share peaked in early 2020, consistent with high food prices. But otherwise, expenditure shares have been relatively stable with a gradual long-term trend but little short-term fluctuation.

15 India’s CPHS data reveal that over 2016–2019 although households in the top decile experienced slightly higher cumulative inflation than those in the bottom decile, the former also had much higher cumulative growth in nominal wage income per adult member.
Although import restrictions have helped reduce the trade deficit, these measures also limited economic activities by contributing to shortages of imported inputs. Import restrictions, such as import bans and US dollar rationing through delays in the issuance of letters of credit, were used to limit the import of luxury and other “non-essential” goods to preserve foreign reserves. But the non-transparent implementation of these policies could give rise to rent-seeking behaviors (Fernandes et al. 2022; World Bank 2022d), distorting the level playing field and reducing overall productivity. The impact of these policy measures could also spill over to capital and intermediate goods imports, exacerbating already limited capacity for these imports, as countries face a shortage of foreign reserves for big-item imports (Pakistan and Sri Lanka), delays in low-priority projects (Bangladesh), and weak global demand for manufactured goods, which tend to be more capital intensive. The import share of some capital goods, such as machinery and transport equipment, fell in Bangladesh, Nepal, Pakistan, and Sri Lanka in 2022Q4 and 2022Q3 compared with 2021 (Figure 1.16). In comparison, the import share of similar capital goods imports did not fall in India, where import restrictions were not in place, or in comparator countries in Asia. The shortage of imported inputs in turn limited production. Industrial production and goods exports fell in Bangladesh during the summer of 2022 and in Pakistan more recently (Figure 1.2).

As current account pressure eased, Nepal and Bangladesh have relaxed or removed import restrictions in recent months (Table 1.3). In Nepal, all remaining import bans were lifted by December 2022, and the cash deposit requirement for import through letters of credit...
was lifted in January 2023. In Bangladesh, cash margin requirements for letters of credit for certain essential imports (e.g., rice, wheat, lubricant and engine oil, and food items in high demand for Ramadan) were lowered in late December and kept at a minimum level to facilitate imports (Mala 2022). In Pakistan, where official import restrictions were lifted in late December (Siddiqui 2022), they have been substituted by high tariffs, while the rationing of letters of credit remains.

Despite improving current account balances, external sector pressure remains high, as capital outflows have increased and capital inflows have declined. In India, portfolio investment remains volatile and driven by shifts in investor sentiments. In January and February 2023, foreign investors turned net sellers of Indian equities, as capital flew to markets in East Asia following China’s post-COVID-19 reopening. The net outflow of foreign institutional and portfolio investment from India’s equity and debt markets totaled over US$3.2 billion in January, the largest net outflow since June 2022 (Figure 1.17.A). In Bangladesh, the financial account has deteriorated since 2022Q2, driven by declining net inflows of other investments, such as loan disbursements and trade credit (Figure 1.17.B), as foreign banks held off loan disbursement due to a lack of confidence. The deterioration in the US and European banking sectors since mid-March has likely led to further capital outflows from the region, as global financial conditions have worsened.

Major currency exchange rates stabilized in late 2022, as countries intervened in the foreign exchange market. Following the rapid currency depreciation in early 2022, major
currencies in South Asia stabilized in 2022Q4 both against the US dollar and in term of the nominal effective exchange rate (Figure 1.18.A).\textsuperscript{16} Behind the stabilizing exchange rates are countries’ interventions in the foreign exchange market (Table 1.3). While mild currency depreciation could help improve export competitiveness, rapid and destabilizing depreciation can lead to high imported inflation, a currency mismatch in external debt repayment, and increased costs of production for sectors that depend on imported inputs. To stabilize the exchange rate, India and Bangladesh carried out market operations to sell US dollars, while Pakistan informally implemented an exchange rate cap in late 2022 and Bangladesh created a multiple exchange rate regime in September 2022 (Box 1.2) to slow depreciation. Reflecting deteriorating sentiment, the Pakistani rupee depreciated sharply on two occasions when the cap was relaxed: on January 26 when the rupee depreciated by 9.6 percent against the US dollar on a single day (Shahid and Shahzad 2023), and on March 2 when it depreciated by 5.9 percent. The official exchange rate depreciated by more than 27 percent from end-June 2022 to the beginning of March 2023.

\textsuperscript{16}The US dollar exchange rate and the nominal effective exchange rate have moved closer since October 2022 (for example for India), reflecting a weakening US dollar against the euro.
Figure 1.18. Exchange rate has stabilized in most countries, but the gap between the informal and official exchange rates widened, which led to a decline in official remittance inflows and contributed to falling reserves in some countries.

A. Major currency exchange rates stabilized vis-à-vis US dollar and trading partners
Dollar exchange rate and nominal effective exchange rate (NEER) index Jan 2022=100

B. Parallel exchange rate gap widened ...
Informal market exchange rate premium
Percent

C. …which contributed to declines in official remittance inflow in Bangladesh and Pakistan
Official remittance inflows
Index 2019=100, 3mma

D. Foreign reserve import cover fell in some countries and rose in others
Foreign reserve import cover
Months of imports

Source: CEIC, Haver Analytics, Bangladesh Bank, Bhutan Royal Monetary Authority, Karachi stock exchange, and World Bank staff calculations.

Note: A. Exchange rates vis-à-vis the US dollar are local currency per US dollar, indexed to 100 in January 2022. The nominal effective exchange rate (NEER) is also indexed to 100 in January 2022 and inverted so that a higher value indicates a depreciation of the local currency. B. For Bangladesh, the unofficial exchange rate published by the Bangladesh Bank and the kerb market rate are used. For Pakistan, the kerb market rate is used. The market rate premium is calculated as the percent difference between the monthly average interbank rate and the monthly average unofficial or kerb rate. D. Foreign reserve import covers are computed using the total imports (goods and services) over the past year. For Bhutan, the average foreign reserve import cover in 2022Q4 does not include December 2022, as the data are not yet released as of the data cutoff date.
Box 1.2. Recent changes in exchange rate policy in Bangladesh

Bangladesh operated a de facto stabilized (de jure floating) exchange rate regime before the rise in external pressures over the past two years. Within this system, authorized dealers were allowed to set exchange rates independently, and interventions by Bangladesh Bank (central bank) were mostly limited to reducing large fluctuations in the Bangladeshi taka (BDT) exchange rate. During the pandemic, when a decline in imports and increased official remittance inflows led to appreciation pressures, Bangladesh Bank purchased US dollars to stabilize the exchange rate.

External sector pressures rose in FY2021/2022 due to rising commodity prices, a strengthening US dollar, sharp increases in imports, and declining official remittance inflows. In response, Bangladesh Bank sold US dollars in June 2021 to limit depreciation, which drew down foreign reserves. To address the mounting pressures, Bangladesh Bank floated the exchange rate in early June 2022. But the policy led to a rapid exchange rate depreciation of 11 percent against the US dollar, and was quickly reversed after just two weeks. As a result of the reversal, the gap between official and unofficial exchange rates widened in August 2022 (Figure 1.18.B), which depleted foreign exchange liquidity in banks.

To manage the widened exchange rate gap and slow depreciation, a multiple exchange rate regime was introduced in September 2022. The new exchange rate regime has been strictly enforced, leading to closures of exchange houses for alleged violations of the new regime.

- **Interbank rate**: The interbank rate is set by market forces without any imposition of rates by Bangladesh Bank. The rate has varied between a low of BDT99.6 to BDT107/US$ so far. The flexibility is designed to provide US dollar liquidity to banks.

- **Remittances**: Remittances from exchange houses and banks can be bought by banks at a rate not higher than BDT107/US$. The relatively high remittance exchange rate is designed to attract inflows of remittance through banks.

- **Exporters**: Export proceeds are purchased by banks at a fixed rate of BDT104/US$, which was increased from an initial fixed rate of BDT101/US$. 
Letters of credit/import bills and outward remittances: Banks can charge a maximum of BDT1 spread over the 5-day weighted average buying cost of export proceeds and remittances. The exchange rate for importers is set lower than for remitters (and kerb market rate). This is designed to lower the local currency prices of imports and curb imported inflation. For example, if an import costs US$1, and the importer needs BDT105 to purchase the US$1, then he will charge BDT105 plus a margin when selling in the domestic market. If the import exchange rate is set higher, e.g., BDT107/US$, then the importer will charge more in the domestic market.

The multiple exchange rate regime was designed to address US dollar liquidity issues, falling foreign reserves, and the widening informal rate gap. But it created new challenges. The lower-than-market exchange rates for export proceeds exacerbated the pre-existing anti-export bias of an overvalued local currency. Because of the gap between the exchange rates for imports and remittances, importers have incentives to over-invoice imports to buy more US dollars from banks and send the profits back as remittances. This rate arbitrage leads to a further decline in bank US dollar liquidity.

Under the IMF program signed at the end of January 2023, Bangladesh is committed to phase out the official multiple exchange system.

Artificially strong official exchange rates led to widening parallel exchange rate gaps in Bangladesh and Pakistan. As the official (interbank) exchange rate was set at an artificially strong level that is inconsistent with the market, the gap between the interbank and the market (kerb) or informal exchange rate widened in Bangladesh and Pakistan (Figure 1.18.B). In Bangladesh, where the exchange rate gap between the interbank and the unofficial rate is historically between 0 and 2 percent of the interbank rate, it reached an average of 12 percent in August 2022, while the gap between the interbank and the kerb rate, which is more reflective of the real market rate, reached 18 percent (of the interbank rate). In Pakistan, where in recent years the gap between the official and the market rates was close to 0, the exchange gap reached 4 percent of the interbank rate in January 2023. As a result, the interbank market became dysfunctional, as dealers were unwilling to sell US dollars at the overvalued rate.

Parallel exchange rates discouraged the inflow of foreign currencies. The widening of the exchange rate gap and the uncertainty about exchange rates in general diverted remittance
inflows away from official channels, especially as remitters can obtain more favorable market rates through unofficial channels (Spotlight). At the same time, a slowdown in growth in migrant host countries has also contributed to slowing remittance inflows. As a result, official remittance inflows have fallen in Pakistan and Bangladesh since September 2022 (Figure 1.18.C). The exchange rate gap also discouraged the repatriation of export proceeds. As Bangladesh moved to a multiple exchange rate regime in September 2022 with a less favorable rate for export proceeds than for remittances, the policy further discouraged exports and the repatriation of proceeds.

Interventions in the foreign exchange market and declining official remittance inflows have reduced most countries' foreign reserves. As countries sold US dollars to stabilize the exchange rate (India, Bangladesh), they drew down foreign exchange reserves. The decline in official remittance inflows and export proceeds put further downward pressure on countries’ foreign reserves. Accordingly, foreign reserves—measured as the number of months of imports covered by the reserves—fell in 2022Q4 in Bangladesh and India compared with 2022Q2. Reserves stayed at low levels in Pakistan and Sri Lanka, barely enough to cover 1–2 months of imports (Figure 1.18.D). The decline of reserve levels in Bangladesh and Pakistan is more drastic in US dollar terms than indicated by the reserve import cover, as imports also declined due to foreign reserve shortages and import restrictions. As of December 2022, reserves have fallen by 27 percent in Bangladesh and 67 percent in Pakistan, compared with a year ago. By contrast, Nepal’s foreign reserve level increased slightly in 2022Q4 compared with the previous two quarters, as official remittance inflows remained robust; the increase is larger in months of imports covered, as import restrictions reduced imports considerably. Falling reserves make it harder for countries to afford imports, limit their capability to stabilize exchange rate volatility, and potentially disrupt external debt repayments.

Faced with depleting foreign reserves and mounting balance of payments pressures, Sri Lanka and Bangladesh approached the IMF for loans, while Pakistan is under review for IMF program continuation. Bangladesh secured a US$4.7 billion loan from the IMF at the end of January, making it the first of the three countries to secure funding. On March 20, Sri Lanka finalized a long-awaited US$3 billion bailout loan after receiving assurances from all major bilateral creditors. In Pakistan, a review is underway to unlock the next installment of a US$1.1 billion IMF loan; although loans from China in February and March helped temporarily (Shahzad 2023a; 2023b), a deal with the IMF is urgently needed to help close the financing gap.
<table>
<thead>
<tr>
<th>Country</th>
<th>Exchange rate management</th>
<th>Quantity controls</th>
<th>Incentive policies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangladesh</td>
<td>Sold foreign currency to contain depreciation; temporarily switched to floating rate in June.</td>
<td>To preserve foreign exchange reserves, Bangladesh Bank announced measures to reduce the size of the Export Development Fund (EDF) and introduce a local currency financing facility. Profit repatriation for foreign investors facing statement.</td>
<td>Interest rate ceiling on non-resident foreign currency deposits withdrawn; ceiling on internet banking transfers and proof of source of income no longer apply for remittances. Remitters exempted from declaration on remittances up to US$20,000 (previously required for remittances over US$10,000). Mobile Financial Services (MFSs) providers allowed to bring in remittances, shortening wait time for remitters. Regulations for the opening of non-resident investor’s taka accounts (NITAs) has been relaxed, allowing non-resident to trade securities using foreign exchanges from abroad.</td>
</tr>
<tr>
<td>Bhutan</td>
<td>Pegged to INR</td>
<td>Bans on imports of vehicles except utility vehicles and agricultural machinery as of Aug 2022. Foreign exchange quota (e.g., private travel quote) as of Feb 2023.</td>
<td>Remittance incentives scheme extended and enhanced from 1 to 2 percent.</td>
</tr>
<tr>
<td>India</td>
<td>Sold foreign currency and operations in the forward and futures markets to contain depreciation.</td>
<td>No existing import quantity controls.</td>
<td>Removed rate cap on non-resident deposits, and banks can freely increase rate to compete for foreign deposits. FPIs can now invest in all-new issuances of G-Secs of 7-year and 14-year tenors</td>
</tr>
<tr>
<td>Maldives</td>
<td>Pegged to the US dollar with a narrow band of ± 20 percent</td>
<td>Convertibility measures: residents are subject to limitations to exchange for foreign currency through banking system. However, residents are allowed to open US-dollar-denominated bank accounts. With certain limitations for international transactions, these accounts can be used for international money transfers through internet and mobile banking.</td>
<td>–</td>
</tr>
<tr>
<td>Nepal</td>
<td>Pegged to the Indian rupee</td>
<td>Cash margin requirements on imports were removed on Jan 19, 2023. Imports restriction measures were removed from Dec 16, 2022.</td>
<td>Migrant workers are allocated at least 10 percent of IPO; FDI threshold reduced from NPR 50 million to NPR20 million from Oct 2022</td>
</tr>
</tbody>
</table>
1.4 Rising financial sector vulnerabilities

Financial sector vulnerabilities are increasing in South Asia. Monetary tightening by advanced economies, tighter monetary policy in South Asian countries, and increased uncertainty in the US and European banking sectors have led to rising borrowing rates and increased sovereign spreads in South Asia (Figure 1.19). The steady rise in the sovereign

Table 1.3. Intervention policies to restore the balance of payments and stabilize exchange rates (continued)

<table>
<thead>
<tr>
<th>Exchange rate management</th>
<th>Quantity controls</th>
<th>Incentive policies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Informal cap on official exchange rate since late 2022; the inter-bank exchange rate was permitted to align with the open market rate on two occasions (Jan 26, 2023, March 2, 2023) resulting in sharp deprecations of the official exchange rate</td>
<td>Government officially removed import restrictions for essential items but raised tariffs. The rationing of letters of credit (LCs) and lags in port clearance continue to be unofficial import restrictions. New procedures for bank to ensure timely realization of export proceeds since Feb 2023. Daily maximum limit for purchasing foreign currency in cash or outward remittance reduced to US$5,000 per person.</td>
<td>Digital accounts introduced in Sept 2020 to allow non-resident Pakistanis easy access to banking services to attract foreign currencies; interest paid to US dollar-denominated deposits in the account at 6–7 percent.</td>
</tr>
<tr>
<td>Managed float since May 12, 2022. Transitioned to flexible exchange rate in March 2023.</td>
<td>Mandatory conversion of foreign exchange inflows (exports and remittances), strict controls on outflows including: (i) a repatriation requirement for exports of goods and services; (ii) a surrender requirement for exporters on proceeds from exports of goods and services; (iii) a surrender requirement for banks on purchases of export proceeds (removed in March 2023); (iv) a surrender requirement for banks on purchases of inward worker remittances (removed in March 2023); (v) suspension of outward remittances on capital transactions; (vi) restrictions on purchases of Sri Lankan Eurobonds by local banks; and (vii) restrictions on outward transfers of funds for emigrants.</td>
<td>Import of electric vehicles is allowed for expat workers who send money through formal channels (currently vehicle imports are temporarily banned).</td>
</tr>
</tbody>
</table>

spreads for Pakistan and Sri Lanka over the past year indicates increasing risks for the two countries and their inability to access international credit markets. The sovereign spreads for India and emerging markets have also displayed increased volatility, highlighting increased risks for emerging markets. Underlying the rising risks are deteriorating asset quality and potential constraints on banks’ ability to lend, which is exacerbated by increasing sovereign-bank linkages and rising sovereign risk.

**Asset quality has deteriorated in Bangladesh and Sri Lanka.** The latest non-performing loan (NPL) ratios remain below 2021 levels and below the 10 percent threshold commonly used to indicate systemic stress in most South Asian countries (Figure 1.20.A). The exceptions are Bangladesh and Sri Lanka, where the NPL ratios reached above the 2021 level—9.4 percent in Bangladesh and 10.9 percent in Sri Lanka in September 2022—suggesting a deterioration in asset quality. In Bangladesh, the NPL ratio has risen due to higher import costs, poor payment discipline of borrowers, and weak regulatory enforcement. The resumption of lax loan rescheduling and asset classification in mid-2022 has delayed the full recognition of distressed assets. In both countries, the NPL ratios among non-bank financial institutions (NBFIIs) are even higher than in the banking sector, reaching over 23 percent in June 2022 in Bangladesh and 17 percent in September 2022 in Sri Lanka (Figure 1.20.B).
Distressed loans are concentrated in sectors that have recovered more slowly or were hit by adverse shocks. In India, while most of the pandemic-era loan moratoria have expired, some are still active and are being gradually phased out. As a result, distressed loans that were previously in the moratorium programs are just starting to be recognized. For example, around 16 percent of the total number of loans under the government’s Emergency Credit Guarantee Scheme, which provided full credit guarantees to micro, small and medium enterprises (MSMEs), were reported as NPLs in September 2022. In Pakistan, the microfinance sector was hit hard by the inflationary shock and losses due to the floods, with an estimated 1.8 million borrowers from areas affected by the floods in 2022. Accordingly, the NPL ratio in Pakistan’s microfinance sector rose in 2022Q3 compared with 2021 (Figure 1.20.B). In Bhutan, the tourism sector has registered high NPLs due to a slow pick-up in tourist arrivals, even though the overall banking sector NPL ratio has declined from over 12 percent in September 2021 to below 8 percent in September 2022.17

17 The decline in Bhutan’s banking sector NPL ratio since September 2021 reflects adjustments in NPL accounting, changes in risk-weights for NPLs, and a writeback of provisions as part of the NPL strategy and resolution framework.
Private sector credit growth has accelerated in Bangladesh, Bhutan, and India (Figure 1.21.A), with growth highest in the services sector in India. In India, private credit growth has helped propel robust growth in private investment (Section 1.1), along with public capital expenditure, which crowds in private investment. This is especially so in the services sector, with credit growth reaching over 20 percent in retail trade and over 30 percent among non-banking financial companies (NBFCs) in January 2023. Credit growth is also high in the mining and quarrying sector, consistent with output expansion in this sector in 2022Q4 (Figure 1.2). In Bangladesh, private credit grew in 2022Q4 at a similar rate as 2022Q3 and faster than a year ago, as borrowers took advantage of a lending rate cap and concessionary financing by Bangladesh Bank.

In three other countries (Nepal, Sri Lanka and Pakistan), private sector credit growth slowed down in 2022Q4 compared with the preceding quarter and the year before. In Nepal, banks have been cautious in taking more credit exposure, while the Nepal Rastra Bank (the central bank) has put in place a new regulation on working capital loans to dampen private sector credit demand. In Sri Lanka, private credit growth continued decelerating due to rising interest rates, macroeconomic uncertainties, and banks’ liquidity issues. In Pakistan, credit to the private sector is largely driven by working capital demand as inflation remains high. As growth of government borrowing accelerated in the aftermath of the floods and reached 35 percent (y-o-y) in November 2022 (Box 1.3), growth of credit to the private sector slowed down compared with the previous year. The large investments in the sovereign expose banks to sizable revaluation losses as the policy rate continues to rise in Pakistan.

Deposit growth has declined in most countries and continues to fall behind credit growth. In Bangladesh and Bhutan, the average deposit growth in 2022Q4 fell below the levels in 2022Q3 and in 2021 (Figure 1.21.B). In Nepal, deposit growth decelerated in 2022 compared with 2021. In Pakistan, deposit growth reached a 14-year low. High inflation tends to reduce deposit growth by lowering savings and reducing real deposit rates. A slowdown in remittance growth, which provides an important source of deposits for Bangladesh, has contributed to slow deposit growth. To mobilize deposits, Nepal provided incentives for remittance-linked deposits. As credit growth continued to outpace deposit growth (Figure 1.21.C), countries’ credit-to-deposit ratios increased, putting pressure on banks’ ability to lend. In Nepal, the ratio reached around 90 percent—the country’s regulatory limit—in June 2022, and, as a result, banks had to limit the amount of new lending.

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Tighter sovereign-bank linkages and foreign exchange market interventions without sterilization reduce banks’ capacity to finance private investments. Most South Asian countries lack a well-developed government bond market, and tightening financial conditions have made it harder for governments to borrow. To help finance government debt, domestic banks have increased their holdings of sovereign debt, thus exposing themselves to sovereign risks. As Box 1.3 highlights, larger sovereign exposures are often associated with slower growth in loans, negatively impacting banks’ ability to finance the real economy. This is especially concerning given the slowing deposit growth in many countries. In addition, foreign exchange interventions in Bangladesh that sell US dollars and purchase domestic currency have reduced bank liquidity, since the operations were conducted without sterilization, which also leads to a lower capacity for banks to lend.
Box 1.3. The sovereign-bank sector nexus in South Asia

Tightening financial conditions and limited access to international capital markets have increased governments’ reliance on the domestic financial sector to meet the sovereigns’ borrowing requirements, deepening the sovereign-bank nexus. Countries in South Asia have come out of the pandemic with record public debt and debt servicing levels. The increase in the public debt-to-GDP ratio was particularly pronounced for Sri Lanka, Maldives and Bhutan, exceeding 100 percent of GDP in 2021. Monetary policy tightening in advanced economies and the accompanying risk aversion have affected the availability and cost of financing on international capital markets, particularly affecting Pakistan. Since the pandemic, exposures of the banking sector to the sovereign substantially have increased (Figure 1.23), particularly in countries experiencing increasing sovereign stress (Maldives, Pakistan and Sri Lanka) (Figure 1.22), as governments have come to rely increasingly on the domestic financial sector to finance themselves. For these three countries, exposures of the banking sector to sovereign reached above 30 percent of their total assets.

Some banks in the region also have effectively worked as conduits to channel resources to financially weak state-owned enterprises (SOEs). In particular, in Sri Lanka and Pakistan, these exposures are rather high, at above 5 percent of total assets (Figure 1.23). Some SOEs in the region have poor financial performances and weak debt-servicing track records. Loans to these SOEs are often provided by public banks

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19 Sovereign-bank nexus is the interconnectedness of banks and sovereigns (incl. state-owned enterprises), whereby shocks originating in one sector may cause a negative “feedback loop” and amplify the effect of the shock in another sector. Traditionally, the concerns evolve around crowding out by sovereign of lending to the households and corporates that are particularly credit-constrained in South Asian countries. More recently, as sovereign debt stresses in various South Asian countries have started to increase, financial stability prospects have become heavily intertwined with the sovereign’s creditworthiness due to heavy exposure of the financial sector to the sovereign debt.

Figure 1.22. Sovereign debt and banks’ holdings of sovereign debt in South Asia, 2013–2021

Source: IMF IFS, IMF FCI, respective central banks, World Bank Finstats, and IMF Global Debt Database.
Note: Countries covered are Bangladesh, India, Maldives, Nepal, Pakistan, and Sri Lanka for 2013–2021.
on the basis of government guarantees, with frequent rescheduling and restructuring to postpone the recognition of credit losses. The availability of easy bank credit creates a moral hazard problem, weakening the incentives for SOEs to be run in a commercially and financially sustainable manner (e.g., public debt that builds up in the power sector due to subsidies and unpaid bills in Pakistan).

Figure 1.23. Exposures to sovereign and SOEs (% of total assets)

State-owned banks have high sovereign exposures on their balance sheets. When looking at banks with different ownership structures, private banks have the lowest exposure to the sovereign, with a median of around 15 percent of total assets (Figure 1.24). At the same time, public banks have a median sovereign exposure of 21 percent of total assets, with exposures being particularly high in Pakistan and India. Public banks usually respond to the needs of governments, as they are directly controlled by the state and can thus be more easily strong-armed into financing the government. It is worth mentioning that public banks are often also involved in lending to financially weak SOEs, with lending being guaranteed by the state, potentially increasing their indirect exposures to the state. Finally, foreign banks have the highest median exposures to the state of around 25 percent of their assets, with a number of outliers having particularly high exposures of above 60 percent of total assets. High exposures of foreign banks to the sovereign can be explained by their profit-seeking behavior, particularly in a low-interest environment that banks have been operating in over the past decade, as well as shortcomings in the enabling environment for private sector lending.
in the host countries. In addition, some foreign banks are regional (often state-owned) banks, from East or South Asia regions, that have investments in government securities as part of their investment strategy.

Ownership and size of banks are the main determinates of their exposures to the sovereign. The econometric analysis based on bank-level data (see Appendix 1.2 for details) suggests that foreign and public banks have sovereign debt holdings to total assets ratio that is 6 and 5.5 percentage points higher respectively, other things being equal, than that of the private banks. In addition, larger and less liquid banks typically have larger exposures to the sovereign. Banks’ other characteristics such as asset quality, capitalization, and profitability do not have a statistically significant impact on banks’ exposures to the sovereign (Appendix 1.2, Table A.1.2, column 1). This suggests that in the South Asian country sample, banks’ concentration of sovereign debt is not determined by banks’ financial health.

Traditionally, concerns about the financial sector’s heavy exposure to the sovereign have focused on crowding out lending to households and private companies. Bank lending to the government and SOEs reduces the scope for banks to finance the real economy. Signs of crowding out of private credit are present throughout the region but are most pronounced in Pakistan, where government exposures account for around 60 percent of total bank credit, with the remaining 40 percent concentrated in a comparatively small group of large corporates. The econometric results suggest that growth in lending is lower in banks with larger sovereign exposures, namely an increase in sovereign exposures to total assets by 10 percentage points, is associated with a decrease in loan growth to the private sector by 1.6 percentage points, other things being equal. In addition, larger banks, foreign-owned banks, and banks with worse asset quality have lower growth in financial intermediation (Appendix 1.2, Table A.1.2, column 2). This further exacerbates the difficulties of underserved sectors in the economy, such as MSMEs and lower-income households, in accessing credit.
More recently, pressures on the sovereign’s creditworthiness have put the spotlight on the stability challenges associated with a high financial sector exposure to the sovereign. Since central banks across the region increased interest rates in response to heightening inflationary pressure, banks experienced mark-to-market losses on their exposures to the sovereign due to the revaluation of their “held for trading” and “available for sale” portfolios. As was the case for Pakistan, the widening gap between book and market values wiped out banking sector profits. In addition, acute sovereign distress points to the possibility of significant credit losses on banks’ holdings of government securities, which banks have been slow to recognize. In line with IFRS 9 (as adopted by some but not all South Asian countries), the increasing sovereign stress should prompt banks to start giving consideration to the possibility of credit losses on their sovereign portfolios, and to provision accordingly. Although cross-country data are not available, the general pattern emerging across the region (but not exclusive to South Asia) is that banks tend not to recognize losses on their government exposures, even when facing significant erosion of the sovereign’s debt-servicing capacity (e.g., in Sri Lanka). Loss recognition on SOE loans tends to be limited as well, with banks often restructuring the loans, thus delaying the recognition of inevitable credit losses. The presence of government guarantees reduces the need to make provisions, even when sovereign stress raises questions about the robustness of these guarantees.

Increasing and often unrecognized sovereign-bank sector nexus warrants scrutiny. It is easy to miss the build-up of the sovereign-financial sector nexus, since standard liquidity and solvency indicators do not capture sovereign risks well, as conventional metrics of banking sector liquidity and solvency treat sovereign exposures as the highest quality, risk-free, liquid assets. Thus, there is a need for in-depth financial sector monitoring and analysis that scrutinizes officially reported liquidity and solvency indicators. Going forward, it is important to address the “enabler” role of the financial sector in financing government needs that treats lending to the government as risk-free. In addition, the urgent priority is to start strengthening the financial sector safety net, including bank resolution, deposit insurance, and crisis management coordination, among others.

Accounting standards necessitate that banks classify their securities as held-to-maturity, held-for-trading, or available-for-sale. Available-for-sale securities are reported at fair value and changes in value between accounting periods are included in accumulated other comprehensive income. Held-for-trading securities are reported at fair value, and unrealized gains/losses are included in income statement. Held-to-maturity securities are reported at amortized costs as the securities are held to collect contractual cash flows.
1.5 Monetary tightening and fiscal consolidation

South Asian countries have continued to tighten monetary policy, while fiscal policies have been characterized by fiscal consolidation to reduce fiscal deficits and capital expenditure push to build capacity. To contain inflation, anchor inflation expectations, and counter capital outflows, countries have continued to increase their monetary policy rates. As inflationary pressure has eased following declines in global energy prices last fall, monetary tightening has also slowed down in most South Asian countries. But continued monetary tightening in the United States and Europe has forced EMDEs, including South Asian countries, to increase rates to prevent rapid capital outflows. Higher rates have raised borrowing costs for South Asian governments, increasing the governments’ incentives to pursue fiscal consolidation to reduce fiscal burden. At the same time, India and Maldives have increased capital expenditure to finance large infrastructure projects and boost economic capacity for improved future growth prospects.

While most South Asian countries were slower to raise interest rates than other EMDEs, Sri Lanka and Pakistan have been most aggressive in rate hikes to contain inflation and external sector pressure. Since the start of this episode of increasing rates, Sri Lanka and Pakistan have increased the key policy rates by 11 and 13 percentage points, respectively (Table 1.4). Pakistan was also the most active, with nine separate rate increases between September 2021 and March 2023. Bangladesh, India, and Nepal started much later, and the overall sizes of rate hikes were also much smaller. As global inflationary pressures ease, rate hikes have become less frequent in Bangladesh and Nepal and smaller in India (Figure 1.25.A). In Pakistan, a sharp currency depreciation since January 2023 (Section 1.3) has made the country more vulnerable to imported inflation and, in response, the State Bank of Pakistan increased the policy rate by 300 basis points to 20 percent on March 2. The rate increases have helped India contain inflationary pressures and prevented more drastic capital outflows in South Asian countries.

While nominal policy rates are now above pre-pandemic levels, real policy rates remain negative for most countries due to increased inflation expectations. In Bangladesh, India, Pakistan, and Sri Lanka, the average real policy rate computed using the one-year ahead inflation expectation was positive before the pandemic (Figure 1.25.B). With monetary loosening and rate cuts, most real rates remained negative during the pandemic. The recent increases in rates pushed real rates to positive levels in Pakistan in mid-2022 and in India in 2022Q4. Positive real rates indicate that the rate increases have raised the real cost of funds. But with increased inflation expectations, Pakistan’s real rate fell back to negative in 2022Q4. In Sri Lanka, the real policy rate remains negative due to high inflation expectations and

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21One-year ahead inflation expectations are from Consensus Economics.
despite the 100-basis-point rate increase in March 2023. The effectiveness of monetary policy rate increases can also be impaired by rate caps. In Bangladesh, interest rate caps introduced in 2020 have prevented banks from passing higher rates to borrowers, undermining the effectiveness of monetary tightening.

Table 1.4. Monetary policy hikes in South Asia since January 2021

<table>
<thead>
<tr>
<th></th>
<th>Bangladesh</th>
<th>India</th>
<th>Nepal</th>
<th>Pakistan</th>
<th>Sri Lanka</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lowest rate since pandemic (percent)</td>
<td>4.75</td>
<td>4.00</td>
<td>5.00</td>
<td>7.00</td>
<td>4.50</td>
</tr>
<tr>
<td>Latest key policy rate (percent)</td>
<td>6.00</td>
<td>6.50</td>
<td>8.50</td>
<td>20.00</td>
<td>15.50</td>
</tr>
<tr>
<td>Cumulative size of hikes (percentage points)</td>
<td>1.25</td>
<td>2.50</td>
<td>3.50</td>
<td>13.00</td>
<td>11.00</td>
</tr>
<tr>
<td>Number of hikes</td>
<td>4</td>
<td>6</td>
<td>2</td>
<td>9</td>
<td>6</td>
</tr>
<tr>
<td>First hike</td>
<td>May, 2022</td>
<td>May, 2022</td>
<td>Mar, 2022</td>
<td>Sep, 2021</td>
<td>Aug, 2021</td>
</tr>
<tr>
<td>Latest hike</td>
<td>Jan, 2023</td>
<td>Feb, 2023</td>
<td>Aug, 2022</td>
<td>Mar, 2023</td>
<td>Mar, 2023</td>
</tr>
</tbody>
</table>

Source: Haver Analytics and World Bank staff calculations.
Note: For Sri Lanka, the rate shown is the standing deposit facility rate.

Figure 1.25. Monetary policy has tightened but real rates remain negative in most countries due to high inflation expectation

A. Monetary policy hikes have continued, albeit at a slower pace in most countries

B. Real policy rates were negative in most countries in 2022Q4

Source: Haver Analytics, CEIC, Consensus Economics, and World Bank staff calculations.
Note: A. India’s policy corridor is computed as the difference between the repo rate and a policy floor rate, which was the reverse repo rate before April 2022 and the standing deposit facility rate afterward. For Sri Lanka, the rate shown is the standing deposit facility rate. B. Real rates constructed using one-year ahead inflation expectations from Consensus Economics.
Fiscal consolidation post-pandemic has been aided by policy shifts away from subsidies. To reduce fiscal deficits and as global commodity prices fell, many countries have reduced the subsidies implemented during the pandemic to help vulnerable groups (Table 1.5). Pakistan reduced electricity and petroleum price subsidies through multiple cuts in May–June 2022 (Business Standard 2022). Bangladesh reduced fuel subsidies in August 2022, which led to a 50-percent increase in the fuel price; the price of gas for industrial use was increased by 180 percent, while electricity prices were increased three times and by 5 percent each time. Nepal reduced subsidies on chemical fertilizers from 71 to 59 percent in March 2023, as higher fertilizer prices increased the fiscal burden. The policies have helped reduce subsidy expenditure. In India and Nepal, subsidies as a share of total expenditure (total center expenditure for India) fell starting in FY2021/22, and in Pakistan, the subsidy share is estimated to have fallen in the first six months of FY2022/23 (Figure 1.26). In contrast, in Maldives subsidies are estimated to have doubled as a share of total expenditure, from 4.2 percent in 2021 to about 9 percent in 2022, as the cost of fuel and electricity subsidies increased during 2022; but the government has included fuel subsidy reform in the 2023 budget to reduce the fiscal burden.

Rising interest payments have reduced fiscal space and allocation of spending to productive uses. As interest rates rise around the world, governments in South Asia also face higher borrowing rates both domestically and in external markets. Higher interest rates, together with the large debt stocks accumulated during the pandemic, have led to increased interest payment expenditures. This is especially the case in Maldives and Pakistan (Figure 1.26). In Maldives, interest payments rose from below 6 percent of total expenditure before 2021 to 8.6 percent in 2022. In Pakistan, the estimated interest payment in the first six months of FY2022/23 is 40.3 percent of consolidated government expenditure, driven by higher domestic interest rates and a weaker currency. Increases in interest payments as a share of government expenditure reduce the available resources for more productive uses. In Nepal, interest payments rose due to currency depreciation vis-à-vis the US dollar, making it more costly to service external debt, while domestic borrowing rates also rose.

Larger capital expenditure can boost productive capacity and crowd in private investment, but long gestation periods of infrastructure projects and the crowding-out of private credit can be a drag on small businesses in the short run. To boost growth momentum post-pandemic, countries have increased capital expenditure (e.g., India, Bhutan), which tends to have high multiplier effects on GDP. The Indian government’s budget shift toward capital expenditure has encouraged private investment and boosted construction sector activities (Section 1.1). Large infrastructure projects can also boost MSME activities by connecting local businesses to broader markets. But, due to the long gestation periods of

---

22 India’s Union Budget for FY2023/24 is set to withdraw free food transfers provided during the pandemic, which will help reduce subsidy and transfer costs but could also have adverse welfare and distributional effects.
infrastructure projects, the positive impact on MSMEs can take a long time to materialize. In the meantime, increased government borrowing through domestic banks to finance spending can crowd out private sector credit (Box 1.3), making it harder for businesses to finance new investments. The positive impact of infrastructure projects on employment is also likely limited in the short term, as most capital expenditure goes into large capital-intensive projects, limiting the capacity for projects to absorb low-skilled labor.

At the same time, long-term public projects also have high uncertainty. In Maldives, about half of all public sector investment spending has gone into large-scale projects, such as the construction and expansion of the international airport (World Bank 2022e),
which have long gestation periods and are financed through short-maturity debts and hence carry rollover risks. The low execution rate of capital expenditure remains an issue. Currency depreciation in Bangladesh and Pakistan makes importing machinery more expensive, while import restrictions in 2022 have spillover effects on capital goods (Section 1.3), limiting the execution of public projects and adding to the uncertainty about project completion.

**Tax revenue has been slow to pick up in most countries, while import restrictions and economic slowdown in some South Asian countries led to falling revenues.** India has seen tax revenue increase over the past two years, while Bangladesh’s revenue has remained flat as a share of GDP (Figure 1.27). Because of a slow increase in tourist arrivals in 2022Q4, Bhutan’s revamped tourism tax has not helped to increase tax revenue, while lower electricity generation and a decline in hydro profit transfers have reduced non-tax revenue, which is a larger proportion of the country’s total revenue compared with other South Asian countries. Owing to the import restrictions in 2022, Nepal’s tax revenue fell in the first half of the current fiscal year, leading to a fiscal deficit in the first half of a fiscal year for the first time in five years for the country. In Pakistan, a slowdown in economic activities due to high inflation, a lack of foreign reserves for imports, and import restrictions is estimated to have reduced tax revenue as a share of GDP.

![Graph showing tax revenue and non-tax revenue](Figure 1.27. Tax revenue has been slow to pick up in most countries and fallen in others)

Note: e = estimate.

Figure 1.27. Tax revenue has been slow to pick up in most countries and fallen in others

Note: e = estimate.
<table>
<thead>
<tr>
<th>Country</th>
<th>Energy subsidy</th>
<th>Food subsidy</th>
<th>Fertilizer subsidy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangladesh</td>
<td>Domestic fuel prices fixed and subsidized, adjusted on discretionary basis. Electricity subsidized through SOE. Public transport regulated price. Fuel subsidies reduced since 2022H2: Domestic fuel price increased by more than 40 percent in August 2022; the prices of gas for industrial use increased by 179 percent; electricity prices increased three times within last couple of months (by 5 percent on each occasion).</td>
<td>Through the state-owned Trading Corporation of Bangladesh (TCB), the government is running its Open Market Sales (OMS) operations which provide necessary food items to the poor at a subsidized rate. Food subsidy at BDT55 billion in FY2021/22.</td>
<td>The government recently increased the price of fertilizer in the domestic market marginally, but subsidy payments are expected to remain elevated. Fertilizer subsidy at BDT120 billion in FY2021/22</td>
</tr>
<tr>
<td>Bhutan</td>
<td>Fixed quantity of LPG imported at subsidized prices from India, consumer prices for LPG regulated. Electricity and public transport subsidized through SOE.</td>
<td>The government fixed the prices of vegetables and fruits in the beginning of 2022.</td>
<td>Fertilizer imported from India via a special concession; prices of fertilizers in the domestic market are fixed.</td>
</tr>
<tr>
<td>India</td>
<td>LPG subsidy, Direct benefit transfer - kerosene; petrol and diesel duties adjusted on discretionary basis. Electricity subsidized through SOE.</td>
<td>Under the Public Distribution System (PDS), grains are procured by the government from farmers at prices above market and sold at subsidized rates or free to vulnerable and poor households. Food subsidies accounted for almost 1.2 percent of GDP in FY2021/22.</td>
<td>100 percent subsidy on various types of fertilizers, paid to fertilizer companies based on sales.</td>
</tr>
<tr>
<td>Maldives</td>
<td>Diesel subsidy to electricity providers through SOEs. Electricity subsidized. Price controls on domestic travel (ferries and buses).</td>
<td>Blanket food subsidies mainly on rice, flour, and sugar. Government’s purchase price for tuna from fishermen was increased in March 2022 to reflect rising global prices for tuna.</td>
<td>—</td>
</tr>
<tr>
<td>Nepal</td>
<td>Consumer prices regulated, and for some (such as LPG), adjusted on discretionary basis. Electricity subsidized for certain segments by usage.</td>
<td>Subsidy on producer side through subsidies on seeds and agricultural equipment and reduced electricity tariff for irrigation. Crop subsidies through minimum support prices, e.g., on rice paddy and sugarcanes.</td>
<td>Subsidies on chemical fertilizers. The subsidy was reduced from 70.8 to 59 percent in mid-March 2023, but was later halted.</td>
</tr>
</tbody>
</table>
Box 1.4. Voices from South Asia

As in the previous eight editions of this report, we conducted an opinion survey among experts and researchers from academia, policymaking and consultancy communities in South Asia. This time, as countries continue to balance policy tradeoffs amid tightening financial conditions and external sector pressures, the survey aims to gain insights into the outlook of economic growth and policy tradeoffs in South Asian economies.23

Experts’ views suggest that the economic recovery is ongoing in South Asia, but views on the future have become less optimistic. Forty-eight percent of the respondents believe that the level of economic activity is above 85 percent of the pre-COVID-19 level, a moderate decrease from 56 percent in the fall of 2022 (Figure 1.28). However, experts are much less optimistic about the future than they were last fall: only 26 percent believe that real GDP growth will increase in the next six months, a large drop from 48 percent last fall. This is consistent with the downgrade of growth in the most recent regional forecast and reflects continuing pressures on the South Asian economies from elevated inflation and external sector

23We received 39 responses from five countries: 31 percent are from Pakistan, 18 percent from Bangladesh, India, and Nepal each; 16 percent from Sri Lanka; 82 percent are men and 18 percent are women; and 82 percent identify as macroeconomists, 77 percent as academic, 56 percent as policy advisors and 13 percent as policy makers.
pressures (Chapter 2). Meanwhile, 69 percent of respondents believe that unemployment will increase in the next six months, which is consistent with the slow recovery of employment and weak performance of the labor-intensive manufacturing sector (Chapter 1).

Figure 1.28. Experts see continuing recovery but views on the future are less optimistic

While inflation continues to be the top perceived risk to recovery, concerns have increased over financial sector stress, sluggish consumption and increasing budget deficits. Thirty-one percent of respondents cite high inflation as the biggest risk to economic recovery over the next six months, compared with 37 percent in fall 2022 (Figure 1.29). An increasing proportion of respondents note sluggish consumption and/or investment as the biggest risk (23 percent compared with 13 percent last fall), reflecting pressures from elevated consumer prices, rising borrowing costs, and slower income growth (Chapter 1). Financial sector stress is also perceived as an increasing risk (23 percent of respondents compared with 17 percent last fall). Around 75 percent of experts think a rising NPL ratio is one of the major risks in the banking sector, while around 50 percent believe deteriorating liquidity or domestic banks’ holding of
own country’s public debt constitute major risks (Figure 1.30). This is consistent with the deteriorating asset quality and the rising sovereign-bank linkages in many South Asian countries (see also Section 1.4).

**Figure 1.29.** While inflation risk is perceived to be receding, experts note financial sector stress and sluggish consumption as rising risks

![Chart showing economic recovery risks](chart.png)

**Note:** Financial sector stress not included as a potential risk in the spring 2022 surveys.

**Figure 1.30.** Experts believe major risks in the financial sector come from deteriorating asset quality, liquidity, and the sovereign-bank nexus

![Chart showing financial sector risks](chart2.png)
Experts believe that the rising cost of imports and falling remittance are the main drivers of declining foreign reserves in South Asia. Amid external sector pressures, countries in South Asia have seen falling foreign reserves as countries face slow-growing remittance inflows and increased capital outflows (Section 1.3). Among the respondents, 75 percent consider the rising cost of imports one of the main drivers of falling foreign reserves over the past six months, the largest share among the potential factors (Figure 1.31). A large proportion thinks falling remittance inflow was one of the main drivers—63 percent this time compared with 30 percent last fall. Slow growth of exports and increased external debt payment are also among the top reasons. To stabilize the exchange rate and preserve foreign reserves, many South Asian countries used capital control measures in 2022, including import controls, restrictions on letters of credit, and foreign currency controls.

Figure 1.31. Drivers of falling foreign reserves

What do you think was the main driver of falling foreign exchange reserves over the past 6 months? Percent of respondents with choices (this question allows multiple selection)

- Rising cost of imports: 75%
- Falling remittance through official channels: 63%
- Growth of exports slower than growth of imports: 50%
- Increased payment on external debt: 50%
- Foreign capital outflows: 40%
- Selling of foreign exchange to stabilize exchange rate: 25%

Around half of the respondents recognize the benefits of capital control measures in helping to stabilize the external sector or help conserve foreign reserves (Figure 1.32). Fifty-five percent of respondents believe that capital control measures help build up foreign reserves, and 49 percent of respondents believe they help stabilize the external sector volatility. There is a large cross-country variation in how the respondents perceive capital control measures. Respondents are more likely to agree with the benefits of capital control if their country benefited from the measures. For example, Nepal used import quantitative controls in 2022, which helped increase the foreign reserve import cover from 6.4 months of import in January 2022 to 9.4 months in January 2023. Accordingly, a larger share of respondents (86...
percent) from Nepal agrees with the benefits of capital control.24 In contrast, a much smaller share of respondents from Bangladesh (57 percent), Pakistan (58 percent), and Sri Lanka (67 percent) agrees with the benefits of capital control, likely because import quantitative controls in these countries over the past year did not work as well as intended.

At the same time, respondents express strong concerns about the limitations of using restrictive measures to preserve foreign reserves (Figure 1.32). A majority of respondents believe that capital control measures can discourage remittance inflows from the formal channel (66 percent of respondents) or encourage firms and individuals to move funds abroad (69 percent). Indeed, as the Spotlight highlights, capital and exchange controls can increase the demand for foreign exchange in the informal exchange market, and this in turn can divert remittance inflows away from the formal channel. In addition, around 72 percent of respondents believe that the implementation of capital control measures lacks transparency and consistency, which can discourage trade and give rise to corruption. Instead, experts believe that alternative policy tools can be used to stabilize the external sector. In particular, monetary and fiscal policies are considered better tools to address the balance of payment tension (80 percent of experts), and improving export performance and foreign direct investment attraction are believed to be better tools to build up foreign reserves (87 percent of experts) than capital controls.

Experts view financing as a major hurdle to green development in South Asia. Because of South Asia’s vulnerability to climate risks, efforts to promote green and resilient development are crucial to prepare the region for increasingly frequent natural disasters. However, survey results reveal the region faces many hurdles to green development. Various challenges in financing emerge as hurdles for green development (Figure 1.33). For example, 67 percent of respondents believe a lack of public financing for green projects is one of the biggest hurdles, and 59 percent each cite the lack of large-scale private capital and a lack of international funding support as one of the main hurdles. Around half of the respondents believe issues with government policy or data limitations create hurdles.

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24 A respondent “agrees” with the benefit of capital control if they answered “strongly agree” or “agree” to at least one of the sub-questions: “They (capital control measures) help conserve and build up foreign reserves”; “They help stabilize the external sector volatility”.
Figure 1.32. Tradeoffs of capital control measures in response to the balance of payment tension

How much do you agree with the following statements about capital control measures (e.g., import controls, restrictions on letter of credit, foreign currency controls) in your country?
Percent of respondents

- Monetary and fiscal policies are better tools to address the balance of payment tension than capital controls: 31% agree, 51% neither agree nor disagree, 15% disagree, 5% strongly disagree.
- Improving export performance and FDI attraction are better tools to build up foreign reserves than capital controls: 54% agree, 33% neither agree nor disagree, 10% disagree, 3% strongly disagree.
- They discourage remittance from coming in through formal channel: 51% agree, 21% neither agree nor disagree, 13% disagree, 8% strongly disagree.
- They encourage firms and individuals to move funds abroad: 46% agree, 23% neither agree nor disagree, 8% disagree, 8% strongly disagree.
- The implementation lacks transparency and consistency which discourage trade: 49% agree, 21% neither agree nor disagree, 8% disagree, 8% strongly disagree.
- They give rise to corruption: 54% agree, 18% neither agree nor disagree, 13% disagree, 5% strongly disagree.
- They help conserve and build up foreign reserves: 52% agree, 10% neither agree nor disagree, 23% disagree, 13% strongly disagree.
- They help stabilize the external sector volatility: 44% agree, 18% neither agree nor disagree, 21% disagree, 13% strongly disagree.

Figure 1.33. Hurdles to green development in South Asia

What do you think is the biggest hurdle to green development in your country?
Percent of respondents with choices (this question allows multiple selection)

- A lack of public financing for green projects: 67%
- Inability to mobilize private capital on a larger scale: 59%
- A lack of international support on funding and capacity development: 59%
- Government climate policies are not aligned with private sector incentives to engage in climate-friendly development: 54%
- Data and technical capacity limitations: 51.28%
- Other: 5%

Reducing economic inequality is another long-term challenge for South Asia. An overwhelming share (87 percent) of respondents believe inequality in their country...
is high or very high, and 85 percent of respondents think inequality has increased (or increased significantly) in their country over the past 20 years (Figure 1.34). This is consistent with the evidence suggesting that people in South Asia are increasingly concerned about economic inequality (Chapter 3). Besides the standard measure of inequality, inequality of opportunity measures inequality due to factors outside individuals’ control, such as race, gender, socioeconomic status, and geographic location. South Asia has one of the highest levels of inequality of opportunity in the world (Section 3.1). Eighty-seven percent of experts believe that their country’s inequality of opportunity is high or very high—consistent with findings in Chapter 3 of high inequality of opportunity in the region—and 56 percent believe it has increased or increased significantly over the past 20 years.

Figure 1.34. Inequality and inequality of opportunity are perceived to be high and rising in South Asia

How would you rate the current level of inequality and inequality of opportunity in your country?
Percent of respondents with choices (this question allows multiple selection)

<table>
<thead>
<tr>
<th>Level</th>
<th>Inequality of opportunity</th>
<th>Inequality</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very high</td>
<td>31</td>
<td>36</td>
</tr>
<tr>
<td>High</td>
<td>51</td>
<td>56</td>
</tr>
<tr>
<td>Moderate</td>
<td>13</td>
<td>13</td>
</tr>
<tr>
<td>Low</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Very low</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Over the last 20 years, in your opinion, inequality and inequality of opportunity in your country has ...
Percent of respondents with choices (this question allows multiple selection)

<table>
<thead>
<tr>
<th>Change</th>
<th>Inequality of opportunity</th>
<th>Inequality</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased a lot</td>
<td>15</td>
<td>26</td>
</tr>
<tr>
<td>Increased</td>
<td>41</td>
<td>59</td>
</tr>
<tr>
<td>Stayed the same</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Decreased</td>
<td>10</td>
<td>26</td>
</tr>
<tr>
<td>Decreased a lot</td>
<td>3</td>
<td></td>
</tr>
</tbody>
</table>

Given the high level of inequality of opportunity in South Asia, experts call for more equal income distribution and public support to promote inclusive growth. Thirty-three percent of experts recommend expanding education expenditure in public schools as a way to improve equality of opportunity for disadvantaged groups (Figure
1.35), consistent with the policy recommended in Chapter 3. In addition, other policies, such as implementing affirmative action policies, improving spatial mobility for workers, redistributing income via progressive direct taxation, and expanding infrastructure in rural areas, also received support from experts.

**Figure 1.35. Inequality of opportunity and policy choices**

Which of the following policies would you recommend to improve equality of opportunity for disadvantaged groups in your country (such as ethnic or religious minorities, women)?

Percent of respondents with choices (this question allows multiple selection)

- Expand education expenditure in public schools: 33%
- Implement affirmative action policies: 18%
- Improve spatial mobility of workers; for example, reduce rural-urban migration obstacles: 18%
- Redistribute income via progressive direct taxation: 15%
- Build or expand infrastructure in rural areas or communities: 13%
- Other: 3%

Inequality of opportunity and policy choices

[Bar chart showing percentages for each policy choice]
## Appendix 1

### Appendix 1.1 Additional tables and figures for Box 1.1

**Table A.1.1. Data sources and coverage**

<table>
<thead>
<tr>
<th>Country</th>
<th>Survey</th>
<th>Price Index</th>
<th>Matched items</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Source</td>
<td>Coverage</td>
<td>Source</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>Household Expenditure and Income Survey</td>
<td>April 2016–March 2017</td>
<td>Bangladesh Bureau of Statistics</td>
</tr>
<tr>
<td>India</td>
<td>Consumer Pyramids Household Surveys</td>
<td>January 2015–August 2020</td>
<td>National Statistical Office (NSO)</td>
</tr>
<tr>
<td>Pakistan</td>
<td>Household Integrated Economic Survey</td>
<td>2018–19</td>
<td>Pakistan Bureau of Statistics</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>Household Integrated Economic Survey</td>
<td>2016</td>
<td>Sri Lanka Department of Census and Statistics</td>
</tr>
</tbody>
</table>
Figure A.1.1. Aggregate consumption pattern over time

India: Consumption expenditure share

Percent

0 10 20 30 40 50 60 70 80 90 100


Household service
Housing
Health
Education
Household goods, furnitures
Pan, tobacco, and intoxicants
Communication
Recreation and amusement
Personal care and effects
Clothing and footwear
Energy
Food and beverages

Source: India CPDX (2015–20) and World Bank staff calculations.

Figure A.1.2. Contribution to price changes in the bottom and top deciles

Bangladesh rural

Percent

0 20 40 60 80 100

Bottom Top Bottom Top

High food inflation, Oct 20
High energy inflation, Sept 22

India urban

Percent

0 20 40 60 80 100

Bottom Top Bottom Top

High food inflation, Oct 21
High energy inflation, Sept 22

Pakistan Urban

Percent

0 20 40 60 80 100

Bottom Top Bottom Top

High food inflation, Jan 20
High energy inflation, Dec 21

Sri Lanka

Percent

0 20 40 60 80 100

Bottom Top Bottom Top

High food inflation, Feb 20
High energy inflation, Sept 22


Note: Bangladesh and India energy include Fuel, lighting, transport and communication. Bangladesh food includes food, beverage and tobacco.
Appendix 1.2 Sample and econometric analysis for Box 1.3

The bank-level data comes from FitchConnect and contains information from bank balance sheet, profit and loss account as well as major prudential ratios. Ownership information (public, foreign, and private) was extracted from the respective Central Banks' websites and/or commercial banks annual reports. The sample covers 248 banks in six countries (Bangladesh, India, Maldives, Nepal, Sri Lanka and Pakistan) for the period of 2013–2022. There are 49 foreign, 69 public and 130 private banks in the sample. The panel is unbalanced meaning that some banks have data available only for some years.

To evaluate the allocation of banks’ exposures to the sovereign across banks with different characteristics, the following regression is estimated:

\[ \text{SovExposures}_{jt} = \alpha + \beta_1 \log(\text{Assets})_{jt} + \beta_2 \log(\text{Assets})_{jt} + \beta_3 \text{RegCapital}_{jt} + \beta_4 \text{NPL}_{jt} + \beta_5 \text{ROA}_{jt} + \beta_6 \text{LiqAssets}_{jt} + \beta_7 \text{Public}_{jt} + \beta_8 \text{Foreign}_{jt} + \gamma_t + \gamma_i + \epsilon_{jt}, (1) \]

where \( i \) denotes country, \( j \) – bank, and \( t \) – year. SovExposures is defined as sovereign debt holdings to total assets, Assets are total assets, RegCapital is a ratio of total regulatory capital to risk-weighted assets, NPL is a ratio of non-performing loans to total loans, ROA is returns on assets, and LiqAssets is a ratio of liquid assets to total assets. Public is a dummy variable taking the value of 1 if bank is fully or majority state-owned, and 0 otherwise. Foreign is a dummy variable taking the value of 1 if bank is a subsidiary or branch of a foreign bank, and 0 otherwise. Standard errors are clustered at bank-level.

To assess the impact of banks’ exposures to the sovereign on financial intermediation, the following regression is estimated:

\[ \text{LoanGr}_{jt} = \alpha + \beta_1 \text{SovExposures}_{jt} + \beta_2 \log(\text{Assets})_{jt} + \beta_3 \text{RegCapital}_{jt} + \beta_4 \text{NPL}_{jt} + \beta_5 \text{LiqAssets}_{jt} + \beta_6 \text{Public}_{jt} + \beta_7 \text{Foreign}_{jt} + \gamma_t + \gamma_i + \epsilon_{jt}, (2) \]

where \( i \) denotes country, \( j \) – bank, and \( t \) – year. LoanGr is defined as a year-to-year growth in private sector lending. All other variables are the same as for equation (1). Standard errors are clustered at bank-level.

The estimation results of equations (1) and (2) are presented in Table A.1.2 below.
Table A.2. Estimation results

<table>
<thead>
<tr>
<th>VARIABLES</th>
<th>(1)</th>
<th>(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sovereign exposures</td>
<td>-0.160***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.0588)</td>
<td></td>
</tr>
<tr>
<td>Log (Assets)</td>
<td>0.876**</td>
<td>-2.111***</td>
</tr>
<tr>
<td></td>
<td>(0.442)</td>
<td>(0.467)</td>
</tr>
<tr>
<td>Regulatory capital ratio</td>
<td>0.0187</td>
<td>-0.0855</td>
</tr>
<tr>
<td></td>
<td>(0.0645)</td>
<td>(0.0563)</td>
</tr>
<tr>
<td>NPL</td>
<td>0.0800</td>
<td>-0.632***</td>
</tr>
<tr>
<td></td>
<td>(0.100)</td>
<td>(0.0876)</td>
</tr>
<tr>
<td>ROA</td>
<td>0.266</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.291)</td>
<td></td>
</tr>
<tr>
<td>Liquid assets ratio</td>
<td>-0.123*</td>
<td>0.0115</td>
</tr>
<tr>
<td></td>
<td>(0.0731)</td>
<td>(0.0977)</td>
</tr>
<tr>
<td>Public</td>
<td>5.473***</td>
<td>0.949</td>
</tr>
<tr>
<td></td>
<td>(2.075)</td>
<td>(1.597)</td>
</tr>
<tr>
<td>Foreign</td>
<td>6.040**</td>
<td>-4.688**</td>
</tr>
<tr>
<td></td>
<td>(2.324)</td>
<td>(2.078)</td>
</tr>
<tr>
<td>Observations</td>
<td>1,487</td>
<td>1,453</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.434</td>
<td>0.157</td>
</tr>
</tbody>
</table>

Source: World Bank staff estimations using Fitch Connect data.

Note: All variables are winsorized at 1% of the lowest and highest values. Robust standard errors in parentheses: *** p<0.01, ** p<0.05, * p<0.1.
References


