



CHAPTER 1

RISING TIDE, HIDDEN ROCKS

Chapter 1. Rising Tide, Hidden Rocks

Output growth in South Asia is on track to exceed earlier expectations, at 6.4 percent in 2024 and 6.2 percent a year in 2025–26, in a broad-based upturn. It is expected to remain higher than in all other emerging market and developing economy (EMDE) regions. This outlook is subject to downside risks from extreme weather events, social unrest, debt distress, and reform delays. The region’s fragile fiscal and external positions leave few buffers against these downside risks. Boosting productivity growth and employment, especially among women, while adapting to climate change remain core policy challenges. Raising employment among women to levels comparable to those among men could raise output by as much as one-half in the long term. Increased openness to global trade and investment, along with the removal of obstacles to the growth of firms, could attract foreign investment, accelerate the diffusion of new technologies, and spur the private investment needed for job creation.

Introduction

Global growth has surprised on the upside over the past six months. Similarly, in South Asia, output growth in 2024 is on track to exceed earlier expectations, largely because of stronger-than-anticipated domestic demand in India and faster recoveries elsewhere across the region (figure 1.1).

After peaking in 2022, inflation in South Asia has declined faster than in other emerging market and developing economies (EMDEs), down to its lowest since 2020. With inflation within or below policy target ranges in most South Asian countries, several central banks have cut policy rates. The exception is Bangladesh, where exchange rate depreciation, upward adjustments to administered energy and food prices, and import restrictions contributed to elevated inflation.

As in many other EMDEs, financial conditions have eased in South Asian countries that had been under fiscal and balance-of-payments pressures. Remittance inflows have strengthened and trade balances have improved. Nonetheless, international reserves remain critically low in some countries, including Maldives and Pakistan, and have declined in Bangladesh.

With growth of 6.2 percent per year over 2025–26, South Asia is expected to grow slightly faster than projected in April and remain the fastest-

growing EMDE region. The region’s expansion is being driven by robust growth in domestic demand and, in some countries, tourism and hydropower exports.

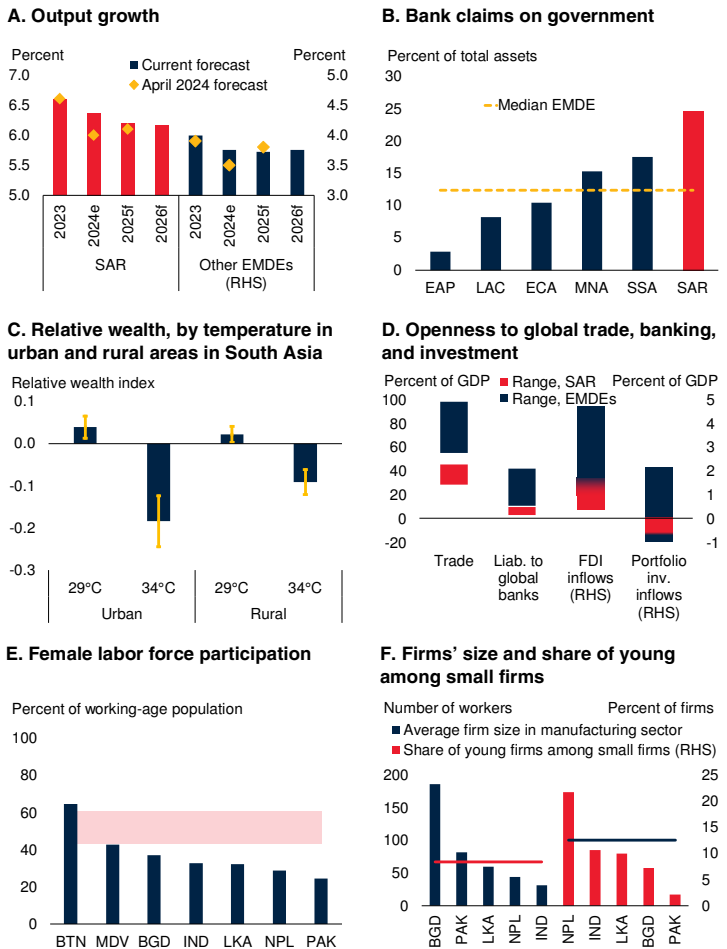
A number of risks, particularly those arising from domestic events, threaten to upend this outlook. Among domestic risks, slippages in planned reforms in International Monetary Fund (IMF)-supported programs, social unrest, and political instability could undermine investor confidence and disrupt economic activity. Externally, global financial market stress or creditors’ reluctance to defer debt service payments could raise debt service costs and force abrupt actions to reduce fiscal deficits. The region’s geography and dependence on agriculture makes it particularly vulnerable to climate changes and weather-related disasters, which have been increasing in frequency and intensity. Rising temperatures are likely to exacerbate poverty in hotter parts of the region. Most South Asian countries have limited capacity to absorb external or domestic shocks, given high levels of government debt and, in some cases, low levels of international reserves.

South Asia has considerable untapped potential to boost growth in the medium term. For example, South Asia currently only employs one-third of its working-age women. Creating jobs to raise women’s labor force participation rate to that of men would increase the region’s output in the long term by up to one-half, especially if the additional female employment is accompanied by private capital accumulation and a shift of women into equally productive jobs as men. Some of these additional jobs could be generated through greater

Note: This chapter was prepared by Zoe Xie, with contributions from Maurizio Bussolo, Lynn Hu, Patrick Kirby, Hagen Kruse, Md Shah Naoaj, Rully Prasetya, Jonah Rexer, Juan Felipe Serrano Ariza, Siddharth Sharma, Margaret Triyana, and Xiao’ou Zhu.

FIGURE 1.1 Overview

Output growth in South Asia is on track to exceed earlier expectations in a broad-based upturn. The region's growth is vulnerable to shocks in fiscal and external sectors, and to climate shocks that particularly threaten the poor. Greater openness to global trade and investment, higher female labor force participation, and faster-growing firms are key to rapid non-agricultural job creation, private investment growth, and climate adaptation.



Sources: Aiyar and Ohnsorge (2024); Balance of Payments and International Investment Position Statistics (IMF); CEIC; Consolidated Banking Statistics (BIS); Coordinated Direct Investment Survey (IMF database); ERA5-Land database; Haver Analytics; ILOStat (International Labour Organization); *Macro Poverty Outlook* (World Bank); Relative Wealth Index (Chi et al. 2022); World Bank; World Bank Enterprise Survey (database); World Development Indicators (database).

Note: e = estimate; f = forecast; BGD = Bangladesh; BTN = Bhutan; EAP = East Asia and Pacific; ECA = Europe and Central Asia; EMDE = emerging market and developing economies; FDI = foreign direct investment; IND = India; inv = investment; LAC = Latin America and the Caribbean; Liab = liabilities; LKA = Sri Lanka; MDV = Maldives; MNA = Middle East and North Africa; NPL = Nepal; PAK = Pakistan; SAR = South Asia; SSA = Sub-Saharan Africa.

A. Bars show the average for fiscal year. Aggregation method is weighted average.
 B. Bars show banks' claims on central government in percent of banks' total assets. Latest observation is from June 2024. Sample comprises 121 countries, whereas the South Asia sample consists of 5 countries. Median values are used for aggregation.
 C. The bars are regression coefficients relative to sample mean. Whiskers denote 95 percent confidence intervals. The estimation controls for state fix effects. Data are from 2014–18.
 D. Trade is defined as the sum of goods and services exports and imports. Excludes small states and Afghanistan. Data are the average for 2020–23. Only India has FDI inflows in the interquartile range for EMDEs (1.7 percent of GDP, compared to bottom quartile of 1 percent of GDP).
 E. Pink shaded region indicates interquartile range of EMDEs, excluding South Asia. EMDE averages are weighted by working-age population. Female (male) labor force participation rate is the share of the female (male) working-age population (15+) employed or looking for work, measured using ILO's ILOStat modeled data. Even when national data, based on national definitions, were used for South Asia, all countries except Bhutan and Maldives would remain in the bottom quartile among EMDEs. Afghanistan has not published any official statistics since 2021.
 F. Horizontal lines mark the median level firm size in manufacturing and share of young among small firms in other EMDEs.

openness to global trade and investment, especially if coupled with efforts to alleviate other constraints to women entering the workforce, such as access to safe transport and working environments. Such steps would be more effective if social norms became more favorable toward working women. Greater economic openness could give South Asian countries, which are currently among the world's least open, better access to global value chain participation. It could also help them take advantage of the reshaping of global value chains that is currently underway.

Economic activity

South Asia continues to be the fastest growing EMDE region. Growth in the region has exceeded earlier expectations, mainly because of stronger-than-anticipated domestic demand in India and faster-than-expected recoveries elsewhere in the region.

Global developments

Global growth continues to be near its estimated long-term sustainable rate. However, signs of weakness emerged in mid-2024. Global manufacturing activity weakened unexpectedly in July 2024 after six months of expansion (figure 1.2). This was mitigated by continued strength in global services.

Growth in the United States in 2024 is now widely expected to be stronger than projected in the April 2024 edition of this report. With moderating inflation and signs of a cooling labor market, the U.S. Federal Reserve cut the monetary policy rate by 0.5 percentage point in September 2024 and further rate cuts are widely expected.

Economic activity in the euro area has recovered steadily, led by the services sector. Although surveys point to continued stagnation in manufacturing and investment growth remains weak, euro area growth for the year as a whole is expected to exceed earlier expectations. In August 2024, inflation in the euro area declined sharply to 2.2 percent from 2.6 percent in July.

Activity in EMDEs appears to be firming, except in China, where growth continues to slow. This

slowing reflects softening consumption, partially offset by solid export growth. The Central Bank of China lowered its policy interest rate in July 2024 and rolled out plans in August to boost consumption by lowering effective lending rates for small loans and easing mortgage lending requirements.

Regional developments

South Asia (excluding Afghanistan) is projected to grow by 6.4 percent in 2024, 0.4 percentage point faster than projected in the April 2024 edition, reflecting better-than-expected growth in Bhutan, India, Nepal, Pakistan, and Sri Lanka. Once again, South Asia is expected to be the fastest-growing EMDE region.

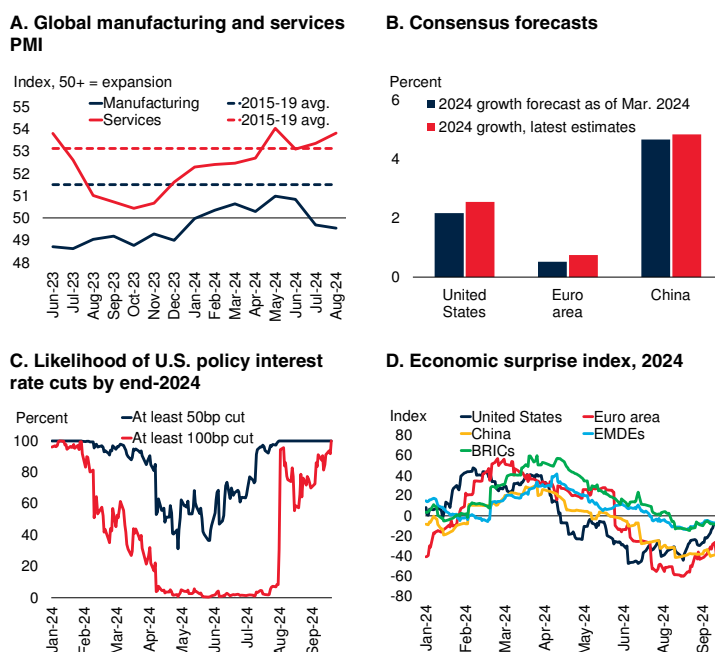
Manufacturing activity has strengthened more than in other EMDEs. India's manufacturing Purchasing Managers' Index (PMI) has recently shown solid expansion, well above the average for other EMDEs (figure 1.3). The region's merchandise export growth turned positive in February 2024 and has remained so even though it lost some momentum in June. Consumer sentiment has recovered to pre-pandemic levels in India, after lagging behind other EMDEs for two years, but remains deeply pessimistic in Pakistan amid elevated inflation.

Services activity has been more robust than manufacturing. India's services PMI has signaled expansion for more than 30 months and remains well above long-run averages and the manufacturing PMI. Tourist arrivals have recovered faster in South Asia than globally, although tourist spending in the region outside India has not rebounded as strongly as tourist arrivals.

In *Bangladesh*, output is estimated to have grown by 5.2 percent in FY2023/24 and is projected to slow to 4 percent in FY2024/25. An interim government took office following the resignation of the former Prime Minister on August 8, 2024, in response to widespread student-led protests. These events caused significant economic disruptions, including a decline in industrial and services sector activities, export shipments, and remittance inflows. Since then, the economy has stabilized and remittance inflows increased.

FIGURE 1.2 Global economic activity

A solid and strengthening expansion in global services has recently been accompanied by a faltering recovery in manufacturing. Financial conditions have continued to improve.



Sources: Bloomberg; CME FedWatch; Consensus Economics; Haver Analytics.

Note: bp = basis point; BRIC = Brazil, Russia, India, and China; EMDEs = emerging market and developing economies; PMI = Purchasing Managers' Index.

A. Readings above (below) 50 indicate expansion (contraction). Last observation is from August 2024.
 B. Bars denote the expected average real GDP growth from individual consensus forecasters' predictions for calendar year 2024. Last estimate is from September 2024.
 C. Probabilities refer to the likelihood—as implied by 30-day federal funds futures prices—of changes in the U.S. Federal Funds rate by December 18, 2024 of: at least 100 basis points and at least 50 basis points. Last data point is from September 18, 2024.
 D. Solid lines show the Citi Economic Surprise Index. A positive reading means that data releases have been stronger than expected, and a negative reading means that data releases have been worse than expected. Last observation is from September 23, 2024.

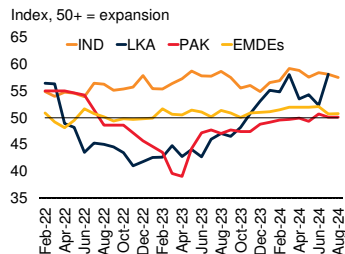
Bhutan's growth so far this year has been faster than expected, supported by a strong recovery in tourism.

In *India*, growth accelerated in the fiscal year that ended in March 2024 to 8.2 percent year-on-year, higher than expected and up from 7 percent in FY2023/24. Better-than-expected manufacturing performance in the first quarter of 2024 was supported by declining input costs as global oil prices moderated (World Bank 2024a). Growth normalized to 6.7 percent in the second quarter of 2024 and reflected a strong recovery in private consumption and resilient services exports. Robust growth is likely to have continued into the third quarter of 2024. In July, India's composite PMI stood at 61.4, well above both its long-term trend and the global average—with strong performance in both manufacturing and services.

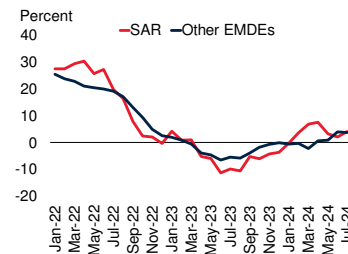
FIGURE 1.3 Economic activity in South Asia

Merchandise exports and tourism in South Asia have picked up faster than elsewhere. Purchasing managers' surveys suggest continued improvements in manufacturing and services. Consumer confidence has strengthened in India but remains deeply pessimistic in Pakistan.

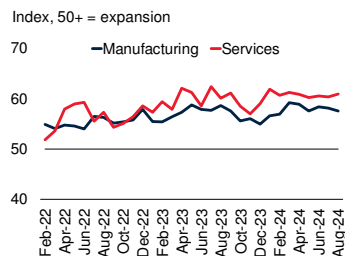
A. Manufacturing PMI



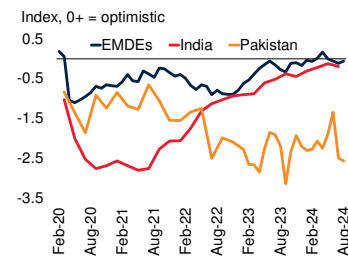
B. Merchandise export growth



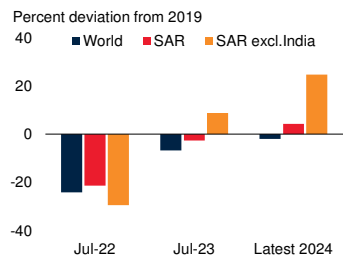
C. India: Manufacturing and services PMI



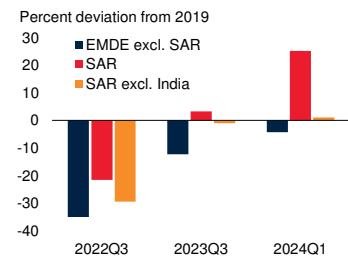
D. Consumer sentiment



E. Tourist arrivals



F. Tourist spending



Sources: CEIC; Direction of Trade Statistics (IMF); Maldives Bureau of Statistics; S&P Global/Haver Analytics; UN Tourism.

Note: EMDE = emerging market and developing economies; IND = India; LKA = Sri Lanka; PAK = Pakistan; PMI = Purchasing Managers' Index; SAR = South Asia.

A. Readings above (below) 50 indicate expansion (contraction). The series for Sri Lanka shows a three-month moving average. Last observation is from August 2024. "EMDE" is the weighted average value of 22 countries.

B. Value is a three-month moving average of the median year-on-year growth rate in each country group. "Other EMDEs" include 68 countries. The South Asia sample consists of Bangladesh, India, Maldives, Pakistan, and Sri Lanka.

C. Readings above (below) 50 indicate expansion (contraction). Last observation is from August 2024.

D. Standardized deviation of consumer confidence from the 2015-2019 average. The EMDE trend is based on the average across 12 economies. Latest data are for August 2024 for EMDE and Pakistan, and July 2024 for India.

E. Figure shows the percent deviation of monthly tourist arrival in South Asia and the World, compared to the same month in 2019. The latest 2024 data for South Asia are from June 2024, and for the World is from July 2024. The South Asia sample consists of India, Maldives, Nepal, and Sri Lanka.

F. Bars show the deviation of tourist spending from the same quarter in 2019. Tourist spending includes personal travel credit and personal transport credit. The latest 2024 data are from 2024Q1. The South Asia sample consists of Bangladesh, India, Maldives, Nepal, Pakistan, and Sri Lanka. The EMDEs sample covers 52 countries.

In *Maldives*, construction on major projects began to slow in the first quarter of 2024 with sector output down 12.8 percent from the previous quarter, in part driven by the government's efforts to curtail capital expenditure. The economy is on track for a contraction in the second quarter of 2024, as business activity in all sectors reportedly declined, and employment dropped steeply among businesses in the tourism sector and the construction sector.

In *Nepal*, remittance inflows have steadied after growing at double-digit rates in 2023 and early 2024. This steady inflow has continued to boost consumption in the remittance-dependent economy. Growth in the early part of FY2023/24 was supported by strong hydropower generation and a recovery in tourist arrivals.

Pakistan's economy grew by 3.1 percent year-on-year in the second quarter of 2024. This marks the fourth quarter of expansion following a contraction in early 2023. Income generated by bumper crops of rice and wheat supported a robust pickup in private consumption. Nevertheless, growth is less than half its long-run average and consumer confidence remains weak.

In *Sri Lanka*, growth strengthened to 5.3 percent year-on-year in the first quarter of 2024. Growth in 2024 as a whole is expected to reach 4.4 percent, 2.2 percentage points higher than anticipated six months ago, with output rebounding from the deep contraction of 2022–23. Tourist arrivals have recovered to levels close to those before the economic and political crisis of 2022, but remain below the 2018–19 levels.

Afghanistan's economic activity continues to be sluggish. Exports, which had supported growth in 2023, declined by 16 percent in the first five months of 2024 compared with the same period in 2023. This decline was driven by real currency appreciation and disruptions along trading routes (World Bank 2024b).

Inflation

Global inflation continues to normalize, and global commodity prices have been broadly stable. In most South Asian countries, inflation has fallen to within or below policy target ranges, allowing several central banks to further ease monetary policy.

Global developments

Global inflation continues to slow but remains above pre-pandemic averages (figure 1.4). In advanced economies, median headline consumer price inflation has declined by 0.7 percentage point since March 2024, but remains above target in most advanced economies. Major central banks have started, or continued, to reverse post-pandemic interest rate hikes, with the U.S. Federal Reserve cutting the policy rate by 0.5 percentage point in September in its first interest rate cut since March 2020. Among EMDEs, median headline consumer price inflation has increased by 0.7 percentage point since March but remains well below the pandemic-era high of 9.9 percent in July 2022.

Regional developments

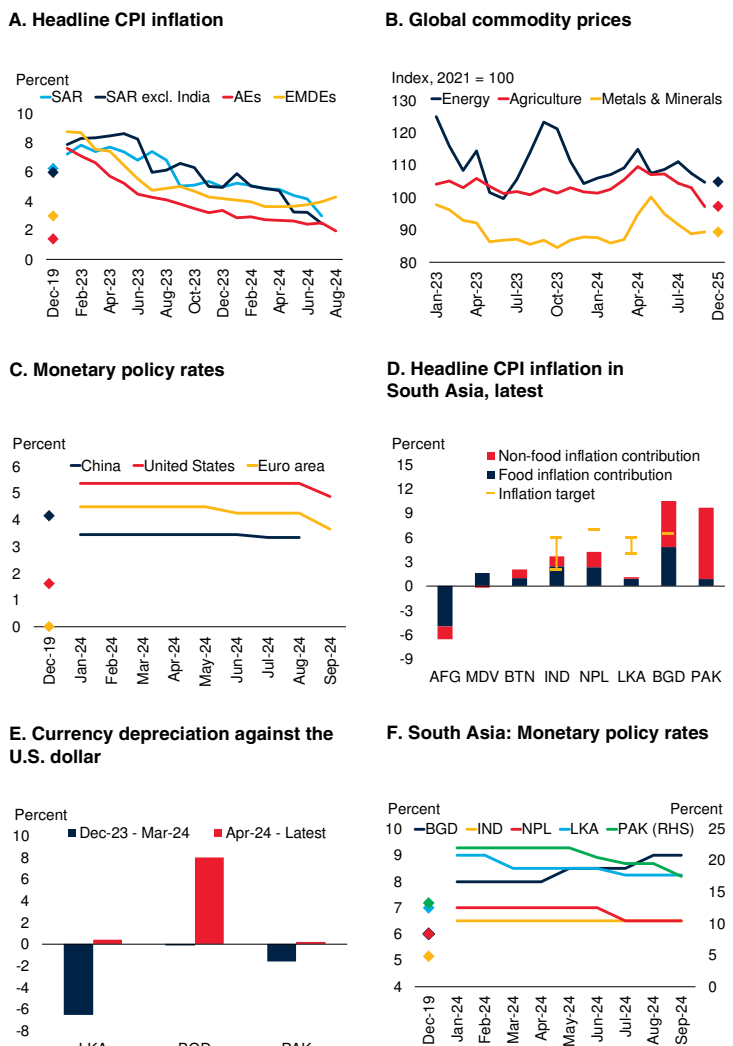
Inflation has declined in South Asian countries and was below the EMDE median in July 2024. Median consumer price inflation in South Asia fell to 3 percent in July, 0.5 percentage point below the EMDE median, compared with 1.2 percentage points above the EMDE median in March 2024.

Headline inflation has fallen to within or below target ranges in most inflation-targeting countries in South Asia, the exception being Bangladesh. Food price inflation continues to account for half or more of consumer price inflation in most countries in the region.

Inflation in the region is expected to moderate further, as it is globally, as the impacts of currency depreciation and supply constraints over the past year fade. Easing inflation pressures have allowed central banks in Nepal, Pakistan, and Sri Lanka to cut monetary policy rates further since March 2024. That said, rates remain well above pre-pandemic levels.

FIGURE 1.4 Inflation

Inflation has declined to within or below policy target ranges in most South Asian countries, as the impacts of currency depreciation and supply constraints over the past year fade and helped by broadly stable global commodity prices. The exception is Bangladesh where currency depreciation has contributed to continued above-target inflation. Monetary policy has eased only gradually in most South Asian countries as they await further rate cuts in major advanced economies.



Sources: CEIC; *Commodity Markets Outlook* (World Bank, April 2024); Federal Reserve Bank of New York; Haver Analytics.

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

- A. Solid lines show the median of year-on-year headline inflation. Last observation is August 2024.
- B. Diamonds show 2025 forecasted values from the April 2024 edition of the World Bank's *Commodity Markets Outlook*. Last observation is August 2024.
- C. Solid lines show the policy rate for each country/area. Last observation is August 2024 for China and September 2024 for the United States and euro area. Diamonds show policy rates as of December 2019.
- D. Yellow whiskers denote inflation target bands of central banks. Last observation is from August 2024 for Bangladesh, India, Pakistan, and Sri Lanka, July 2024 for Afghanistan and Bhutan, and June 2024 for Maldives and Nepal.
- E. Positive values denote year-on-year depreciation of monthly average exchange rates against the U.S. dollar. Latest data point is from August 2024.
- F. Solid lines show the policy rate for each country, as of September 20, 2024. Diamonds show policy rates as of December 2019.

In *Bangladesh*, inflation has remained elevated and above Bangladesh Bank's target since June 2022. Headline inflation averaged 9.7 percent in FY2023/24, driven by a steady depreciation of the currency and increases in domestic prices of gas, electricity, and fuel. Headline inflation surged to 11.7 percent in July 2024 due to supply chain disruptions and political tensions. In response to inflationary pressures, the monetary policy rate has been increased by 2.5 percentage points since July 2023, to 9 percent in August 2024; however, the rate remains well below inflation.

In *India*, inflation has remained within the Reserve Bank of India's target range of 2–6 percent since September 2023, falling to just below the mid-point of the target range in July and August 2024 on easing food inflation. Inflation in food and beverage prices, which accounts for around half of the consumer price inflation basket, has been elevated since July 2023.

In *Pakistan*, headline inflation declined to 9.6 percent in August 2024 from a peak of 38 percent in May 2023, supported by a stabilizing currency, improved domestic supplies of perishables and staple foods, and a rebound in wheat and rice crops that were severely damaged by floods in 2022. As a result, the State Bank of Pakistan lowered its policy rate to 17.5 percent in September from 22 percent in May 2024.

In *Sri Lanka*, inflation has remained below the target range of 4–6 percent since March 2024. Headline consumer price inflation was 2.5 percent in July. A strengthening currency, reductions in administered energy prices that partly reflected lower global oil prices, and easing food prices helped lower inflation. Consequently, the Central Bank of Sri Lanka reduced its policy rate by 0.25 percentage point in July.

Elsewhere in the region, headline inflation remains below 5 percent. Afghanistan has experienced deflation since April 2023, reflecting weak demand.

Financial conditions

As in other EMDEs, financial conditions have eased in most South Asian countries, the exception being Bangladesh.

Global developments

Global and EMDE financial conditions have continued to ease, reflecting solid risk appetite and actual and expected monetary easing by advanced-economy central banks (figure 1.5). Global financial market volatility has been subdued for most of 2024, with the exception of a brief episode of volatility during August.

Regional developments

In most countries of South Asia, financial conditions have been easing, and, in some cases, have returned to pre-pandemic conditions. Currencies have generally appreciated or remained stable in foreign exchange markets and private sector credit growth has picked up or remained robust. The exception is *Bangladesh*, where the currency has depreciated further and private sector credit growth remains sluggish. Nonperforming loan ratios, a gauge of asset quality in the financial sector, have fallen or held steady in about half of South Asian countries since the first quarter of 2024.

In *Bangladesh*, despite further increases in the nominal policy rate, persistently high inflation has kept real (net of actual inflation) policy rates negative. For the banking system as a whole, the nonperforming loan ratio has been about 10 percent since the first quarter of 2023. For state-owned banks, however, the ratio rose to 27 percent in June 2024, signaling persistent challenges in the financial sector and among borrowers. Growth of credit to the private sector has been below the pre-pandemic average (2015–19). Financial conditions tightened during the social unrest in July and August and remain tight amid heightened uncertainty.

In *India*, the monetary policy rate remains at 6.5 percent. Domestic credit to the commercial sector grew by 13.5 percent in July—the fastest in South Asia. To slow lending, the Reserve Bank of India has increased regulatory scrutiny of lenders.

In *Maldives*, foreign exchange holdings of both the government and the financial sector remain low. The decision and subsequent reversal by the country's largest commercial bank on August 25

to limit foreign transactions was followed by significant volatility in the parallel exchange rate market and highlighted the severity of the foreign exchange shortage. Access to credit has remained tight in the first two quarters of 2024 and business surveys suggest an expectation of a further tightening, especially in the construction, transportation, and communication sectors.

In *Pakistan*, monetary policy remains tight. The key policy rate stands at 17.5 percent: in real terms, at around 8 percent, despite cumulative interest rate cuts of 4.5 percentage points in June–September 2024 as inflation declined even faster. Growth of credit to the private sector accelerated from 1 percent in March to 3 percent in July, below pre-pandemic levels, with banks' lending activities continuing to be constrained by sizable sovereign exposures. The quality of assets held by the banking sector remains broadly stable, with the nonperforming loan ratio at 7.6 percent in the second quarter of 2024.

In *Sri Lanka*, the central bank cut the policy rate by 0.25 percentage points in July 2024 as inflationary pressures had eased but monetary policy remains tighter than before the pandemic. Asset quality remains a concern as the economy recovers from the recession of 2022–23. The nonperforming loan ratio remained elevated at 13 percent in the first quarter of 2024, with the ratio above 30 percent in the tourism and transportation sectors despite the upturn in economic activity. Growth of credit to the private sector rebounded to 6 percent year-on-year in June, supported by decreasing interest rates, but remains below the pre-pandemic average.

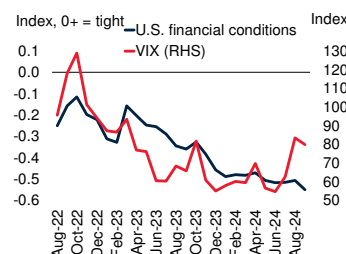
Trade and capital flows

Current account balances have improved in most South Asian countries, supported by robust remittance inflows, solid export growth and, in some cases, reduced imports. Foreign reserve levels have improved in some South Asian countries but remain critically low in others.

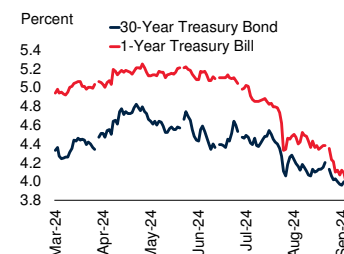
FIGURE 1.5 Financial conditions

Financial conditions have eased globally, including in many South Asian countries that were previously in crisis. Private sector credit growth in Pakistan and Sri Lanka has turned positive but remains weak.

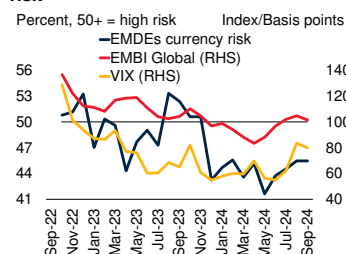
A. U.S. financial conditions and stock market volatility



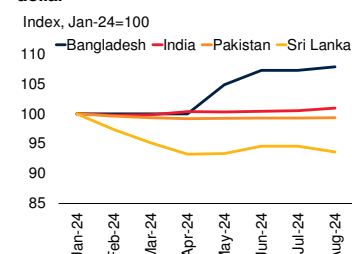
B. U.S. Treasury yields



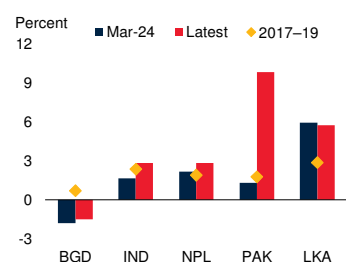
C. EMDE interest rates and currency risk



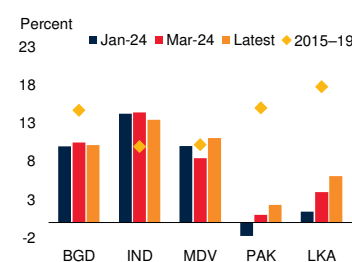
D. Exchange rates against the U.S. dollar



E. Real monetary policy rates



F. Private sector credit growth



Sources: CEIC; CME Group; Federal Reserve Bank of St. Louis; FedWatch; Haver Analytics; Financial Soundness Indicators (IMF database); J.P. Morgan EMBI emerging market bond index.

Note: BGD = Bangladesh; EMDEs = emerging market and developing economies; IND = India; LKA = Sri Lanka; NPL = Nepal; PAK = Pakistan; VIX = Chicago Board Options exchange volatility index.

A. The U.S. index is the National Financial Conditions Index (NFCI), which provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets and the traditional and "shadow" banking systems. Positive values of the NFCI indicate financial conditions that are tighter than average, while negative values indicate financial conditions that are looser than average. Last observation is from September 2024.

B. Lines show the daily U.S. 30-year Treasury bond yield and 1-year Treasury bill yield at constant maturity (percent per annum). Last data point is from September 16, 2024.

C. The EMDE currency risk uses the Citi Early Warning Signal, which measures stress in economic and financial variables that have historically been good predictors of currency weakness. Model is based on 12 equally weighted variables per country. The composite index equally weights 22 EMDE indices and ranges between 0 percent (low risk) and 100 percent (high risk), with 50 percent being neutral.

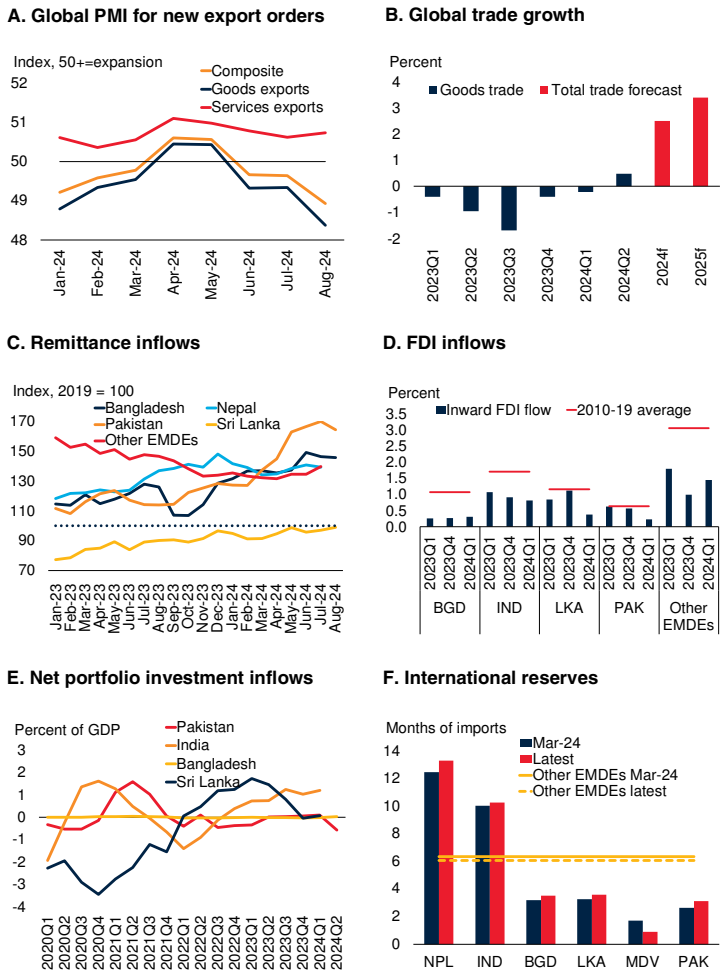
D. Official nominal exchange rate, in units of local currency unit per U.S. dollar.

E. Bars show real monetary policy rates for each country. Diamonds show the average real policy rate during 2017–19. Real policy rate is calculated as the difference between nominal policy rate and the headline inflation. Latest data are from August 2024 for Bangladesh, India, Nepal, Pakistan, and Sri Lanka.

F. Year-on-year growth of private sector credit. Growth of commercial credit for India. Latest data are from July 2024 for Bangladesh, India, and Pakistan, and June 2024 for Maldives and Sri Lanka.

FIGURE 1.6 Trade and capital flows

Robust remittance inflows, a recovery in Sri Lanka’s services exports, and robust growth in India’s services exports have contributed to improvements in current account balances in South Asian countries. However, foreign reserve import cover remains low in Maldives and Pakistan.



Sources: Balance of Payments and International Investment Position Statistics (IMF); CEIC; CPB Netherlands Bureau of Economic Analysis; *Global Economic Prospects* (World Bank, April 2024); Haver Analytics; *Macro Poverty Outlook* (World Bank); Maldives article IV consultation; World Bank.
 Note: BGD = Bangladesh; EMDEs = emerging market and developing economies; FDI = foreign direct investment; IND = India; LKA = Sri Lanka; PAK = Pakistan; PMI = Purchasing Managers’ Index.
 B. 2024Q2 is based on April–May 2024 data. Year-on-year growth rates reflect volume growth.
 C. Other EMDEs comprise Colombia, Georgia, Kenya, Morocco, Paraguay, the Philippines, and Türkiye.
 D. Other EMDEs comprise 58 economies. Weighted by GDP at market price, in U.S. dollars. Quarterly GDPs are converted from annual GDPs for other EMDEs, Nepal, and Pakistan.
 E. Quarterly GDP for Nepal and Pakistan are derived from current-year GDP from the World Bank’s *Macro Poverty Outlook*. 2024Q2 GDP for Bangladesh is assumed to be the same as 2024Q1.
 F. Other EMDEs comprise 37 countries. Latest is from July 2024 for all countries except for Pakistan and Sri Lanka (August 2024). Comparison data is from April 2024 for Maldives and March 2024 for all other countries.

Global developments

Global PMI indices suggest that after a brief expansion in April and May 2024, global goods trade resumed its contraction since June (figure 1.6). This partly reflects the effects of conflict,

the rising use of trade-restricting measures, and the post-pandemic unwinding of high demand for manufactured goods. Services exports continued to expand. Trade growth has increasingly been driven by trade among countries that are aligned on foreign policy (box 1.1). In 2025, global trade growth is expected to accelerate but remain below its 2015–19 average (World Bank 2024c).

Regional developments

While export growth has strengthened in all South Asian countries except Bangladesh and Afghanistan, import growth has remained muted. Slower import growth, coupled with increasing remittance inflows (Nepal, Pakistan, and Sri Lanka), has helped improve current account balances across much of the region, except in Afghanistan, where the current account deficit has widened. Pakistan is expected to have a near-zero current account balance, while Nepal and Sri Lanka are projected to run current account surpluses in 2024.

In *India*, growth in goods exports has remained muted, while services exports have continued to be resilient. Services exports growth has also remained robust in *Sri Lanka*. In *Bangladesh*, exports of ready-made garments slowed due to ongoing energy shortages, as well as disruptions amid social unrest. In addition, the recent revision of the balance of payments data by Bangladesh Bank revealed significantly lower merchandise exports than previously recorded for FY2022/23 and FY2023/24. In *Pakistan*, exports have continued to recover from the floods of 2022.

Import growth has picked up in *Sri Lanka* since the removal of most trade restrictions in 2023, and in *Afghanistan*, as domestic demand slowly recovers. In *Pakistan*, import growth remains slow, notwithstanding some pickup in year-on-year growth in May and June 2024. Elsewhere in the region, import growth has remained muted. Countries have continued to remove or relax trade restrictions. For example, *India* cut import tariffs on smartphones in July 2024 and Bhutan lifted import bans on cars in August.

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia^a

The global economy is fragmenting along geopolitical lines. South Asian economies have limited exposure to geopolitical shocks as they are among the quarter of EMDEs that are least open to global trade and investment. However, their lack of openness is not only protective. It also limits their ability to take advantage of the reshaping of global supply chains and trade. Although South Asian countries maintain fairly diverse trade and investment ties, they would benefit from further opening to global trade and investment, improvements in infrastructure and logistics, and greater institutional effectiveness. Cultivating diversified trading partners and creditors across the geopolitical spectrum could help South Asian countries mitigate vulnerabilities in a more open and dynamic economy.

Introduction

The global economy is fragmenting along geopolitical lines, a process that has been dubbed “geoeconomic fragmentation.” Over the past decade, the share of trade and foreign direct investment (FDI) between countries with similar geopolitical stances has been growing (Gopinath et al. 2024; IMF 2023a). This process has been accompanied by rising restrictions on international trade and financial transactions between both blocs (IMF 2023a).

Geopolitical concerns are creating incentives for firms to reorganize and diversify their supply chains by investing in a wider range of emerging market and developing economies (EMDEs). This strategy has been called a “lengthening” of existing supply chains and a “China-Plus-One” strategy (Freund et al. 2023; Qiu, Shin, and Zhang 2023; Seong et al. 2023). For some countries, the reshaping of global value chains presents a window of opportunity to engage with countries across the spectrum of geopolitical views (Aiyar and Ohnsorge 2024; Cerdeiro et al. 2024; Gopinath et al. 2024). Some South Asian countries, too, aspire to integrate into global value chains and bridge geopolitical blocs, building on their long history of being geopolitically non-aligned (Dinkel 2016; Reuters 2024).

Questions. This box examines the implications of geoeconomic fragmentation for South Asia. Specifically, it addresses two questions.

- How vulnerable is South Asia to geopolitical risks?
- Which policies could help South Asia thrive amid shifts in global supply chains and trade?

Contribution. This box adds to the existing literature in two ways. First, it provides a systematic empirical assessment of the implications of geoeconomic

fragmentation for South Asia. Earlier research has largely focused on global trends and patterns (Aiyar, Malacrino, and Presbitero 2024; Aiyar and Ohnsorge 2024; Gopinath et al. 2024; IMF 2023b) or the effectiveness of country-specific trade policies (Alfaro and Chor 2023; Fajgelbaum et al. 2024; Freund et al. 2023). Second, this box elaborates on policies that could help South Asia leverage opportunities created by shifts in global supply chains and trade.

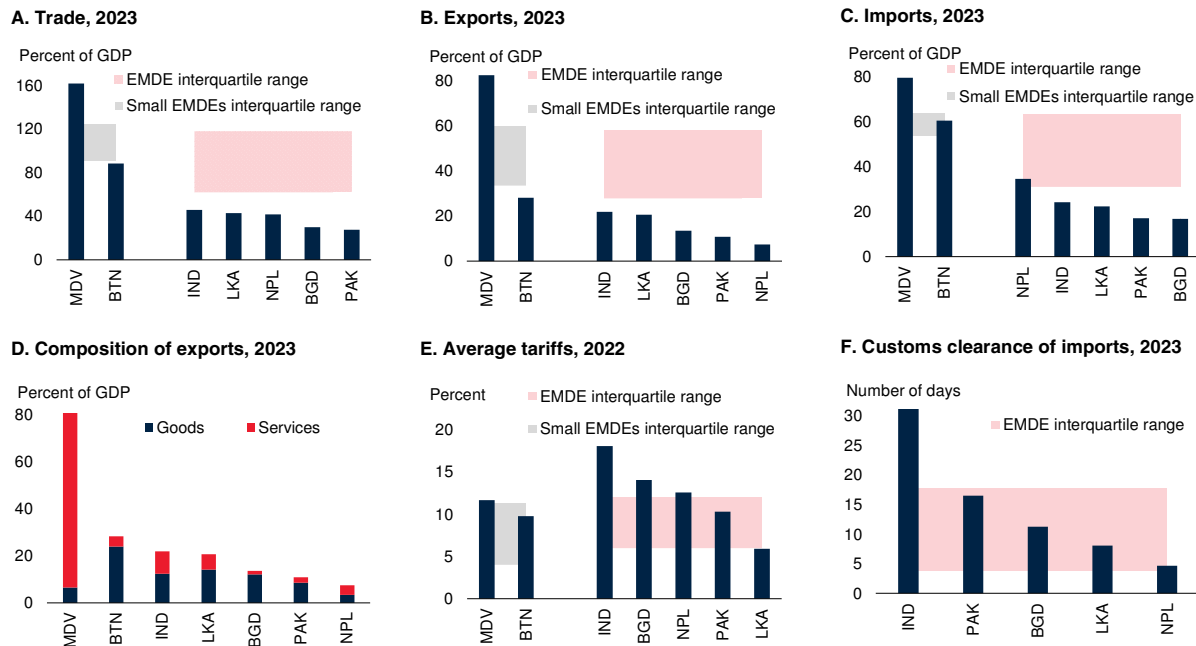
Methodology. Geopolitical distance is a concept that is difficult to measure. Here, in line with the existing literature, the geopolitical distance between two countries is measured using UN voting patterns (Bailey, Strezhnev, and Voeten 2017). This box defines an economy's *geoeconomic vulnerability* as the trade- or liability-weighted average geopolitical distance to its trading partners or creditors. A country or region is more vulnerable if it interacts with geopolitically more distant partners. The index is scaled by trade-to-GDP or by liabilities-to-GDP to account for the fact that less open economies are less vulnerable to all external shocks, including geopolitical ones. By construction, this measure of geoeconomic vulnerability cannot capture future cross-border interactions that have not yet emerged. Nor can it capture the vulnerabilities inherent in rare cross-border interactions such as debt relief negotiations. And it is constrained by the availability of bilateral data and therefore cannot capture important other cross-border transactions such as tourism exports or remittances. In addition to geoeconomic vulnerability, this box examines the diversity of South Asia's economic partners across the geopolitical spectrum. This is captured in the *geopolitical connectedness* index, defined as the trade- or liability-weighted standard deviation of geopolitical distance from trading partners and creditors (Aiyar and Ohnsorge 2024). The focus in this box is on foreign exchange-generating activities, that is exports and financial liabilities.

^a This box was prepared by Hagen Kruse and Xiao'ou Zhu.

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (continued)

FIGURE B1.1.1 South Asia's openness to global trade

South Asian countries are among the least open to global trade. In part, this reflects higher tariffs and more cumbersome customs procedures than in other EMDEs.



Sources: Aiyar and Ohnsorge (2024); World Development Indicators (database); WTO World Tariff Profiles (database); World Bank.

Note: Red shades denote interquartile ranges for other EMDEs. Gray shades denote interquartile ranges for other small states. BGD = Bangladesh; BTN = Bhutan; EMDE = emerging market and developing economies; IND = India; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan.

A. Trade is defined as the sum of goods and services exports and imports. Maldives uses 2022 data. Other EMDEs comprise 72 economies, and other small states comprise 13 economies (as defined in World Bank 2024).

B.-D. Sub-components of overall trade in GDP by sector or trade flow. Same coverage and aggregation as in A.

E. Simple average of the ad valorem most favored nation duties applied in 2022. Sample comprises 120 other EMDEs, of which 25 are small states.

F. Other EMDEs comprise 68 economies between 2017 and 2023. Sri Lanka uses 2011 data. Nepal uses 2023 data. Bangladesh, Pakistan, and India use 2022 data.

Findings. This box presents several new findings.

- South Asia is more insulated from global shocks, including geopolitical ones, than most other EMDEs because most South Asian economies are less open to global trade and investment.
- Since 2016, the year before trade-restricting measures began to be more widely used globally, most South Asian countries have aligned their geopolitical stance more closely with their major export markets and creditors. This has helped lower their geoeconomic vulnerabilities.
- Although South Asia trades with and receives investment from an unusually diverse set of partner countries, its overall lack of openness limits its ability to take advantage of the foreign investment

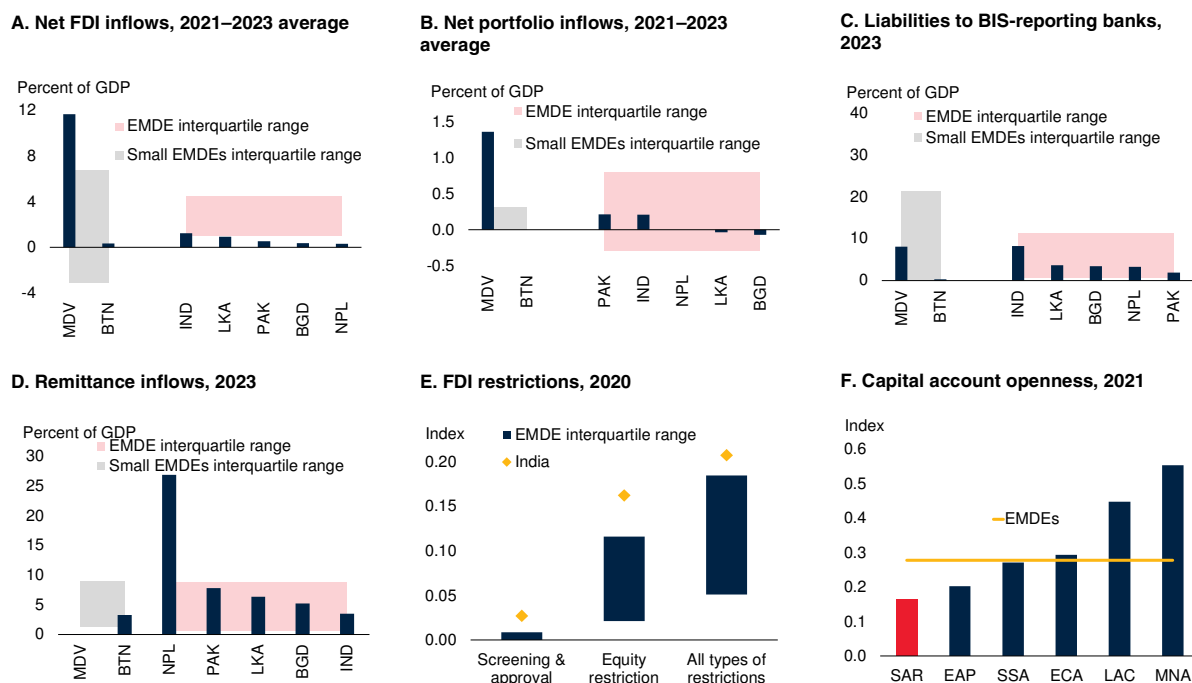
and export market opportunities that result from shifting global supply chains. To better seize such opportunities, South Asian economies may need to open further to global trade and investment, including by lowering import tariffs, easing restrictions on FDI, improving infrastructure and logistics, and deepening financial markets. Joining a wide range of different trade agreements can help maintain a diverse set of trading partners and creditors and mitigate vulnerabilities to external shocks.

Geoeconomic fragmentation: Implications for South Asia

Nearly all South Asian economies are among the quarter of least open EMDEs to global trade and investment,

BOX 1.1 Sheltered: Implications of Goeconomic Fragmentation for South Asia (continued)**FIGURE B1.1.2 South Asia's openness to global investments**

South Asian countries are among the least open to global finance, except for remittance inflows.



Sources: Aiyar and Ohnsorge (2024); IMF Balance of Payments and International Investment Position Statistics (database); OECD Foreign Direct Investment Regulatory Restrictiveness Index (database); World Bank Enterprise Survey (database); World Development Indicators (database); World Bank.

Note: BGD = Bangladesh; BTN = Bhutan; EMDE = emerging market and developing economies; IND = India; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan. Other EMDEs exclude China.

A.-D. Red shades denote interquartile ranges for other EMDEs, comprising 67 economies (A), 64 economies (B), 174 economies (C), and 169 economies (D). Gray shades denote interquartile ranges for small state EMDEs (as defined by World Bank 2024), comprising 8 economies (A), 7 economies (B), 29 economies (C), and 28 economies (D).

C. Bank liabilities refer to stock data.

D. Maldives' share is 0.1 percent and data for Bhutan are for 2022.

E. Latest data are for 2020. Sample comprises 50 EMDEs. India is the only South Asian country covered.

F. Chinn-Ito index of capital account openness. Unweighted averages for each region. Latest available data are for 2021.

which limits their vulnerabilities to external shocks, including geopolitical ones (figures B1.1.1, B1.1.2). Since 2016, South Asia's goeconomic vulnerabilities have mostly fallen further.

Lack of openness

Openness. South Asian economies' lack of openness to global trade and investment limits their vulnerability to all global shocks, including geopolitical ones. All South Asian economies except Maldives are among the least open EMDEs to global trade, FDI, and lending from global banks and have limited portfolio investment liabilities. The only dimension in which South Asia is

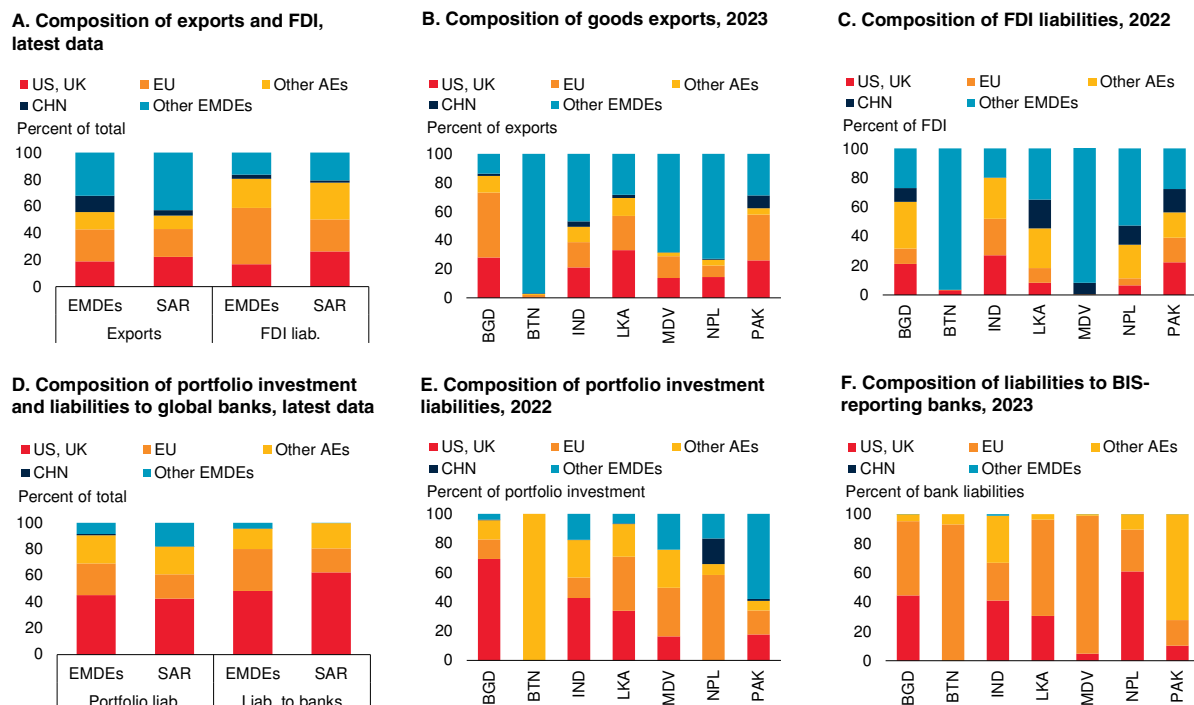
more open than other EMDEs is in remittance inflows (spotlight 2). In part, this has reflected explicit or implicit policy decisions, such as South Asia's above-average FDI-restrictions, capital controls, tariffs, and customs delays.

Composition of external partner countries. Similar to most EMDEs, South Asia's main export markets and creditors are advanced economies. Unlike most EMDEs, however, South Asia lacks an export market and source of FDI in China and the European Union. Instead, South Asia exports more to EMDEs other than China and receives more FDI from the United States and the United Kingdom (figure B1.1.3). That said, there is wide heterogeneity across South Asian countries.

BOX 1.1 Sheltered: Implications of Goeconomic Fragmentation for South Asia (continued)

FIGURE B1.1.3 Composition of South Asia's exports and liabilities

Similar to other EMDEs, South Asia's main export markets and largest investors are the United States and European countries, although with some cross-country variation. China, meanwhile, is a less important export market or source of FDI than for other EMDEs. Less portfolio investment and less bank lending to South Asia originates in Europe than for other EMDEs.



Source: Aiyar and Ohnsorge (2024); World Bank.

Note: AEs = advanced economies; BGD = Bangladesh; BTN = Bhutan; EMDE = emerging market and developing economies; FDI = foreign direct investment; IND = India; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan; SAR = South Asia. FDI, portfolio investment and bank liabilities all refer to stock data. China, Denmark, France, Netherlands, New Zealand, United Kingdom, and United States include their special administrative regions and overseas territories. Data are for 155 EMDEs.

A. Data are from 2023 for exports and from 2022 for FDI.

C. Only positive FDI stock data are considered.

D. Data are from 2022 for portfolio investment liabilities and from 2023 for liabilities to BIS-reporting banks.

E. Bhutan refers to 2020 data.

D.F. BIS-reporting banks do not include banks from mainland China and most EMDEs.

- **Exports.** Bhutan, Maldives, and Nepal ship particularly large shares of their exports to other EMDEs, including India, and Bangladesh and Pakistan to Europe.
- **FDI.** Sri Lanka and Pakistan receive above-average shares of FDI from China; Bhutan and Nepal from India; India from Mauritius; and Maldives from Thailand and Mauritius.
- **Portfolio investment.** Nepal stands out for receiving negligible portfolio investment from the United States but sizable investment from China; a large

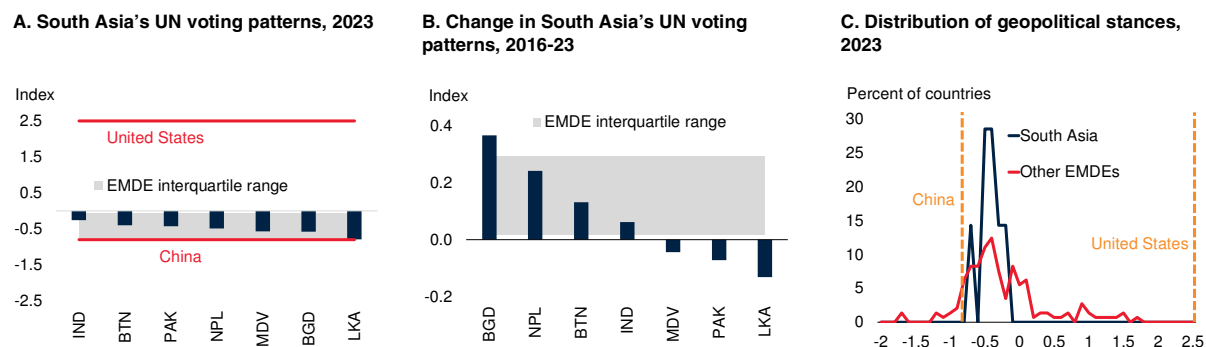
share of Pakistan's portfolio investment is from other EMDEs (such as Saudi Arabia).

Geopolitical stance. Traditionally, the UN voting patterns of most EMDEs, including those in South Asia, have aligned more closely with China than with the United States (figure B1.1.4). Since 2016, however, most South Asian countries' voting patterns have moved closer to those of the United States—again, similar to most EMDEs. Maldives, Pakistan, and especially Sri Lanka were exceptions, consistent with evidence of geopolitical flexibility among countries with limited financial capacity (Brazys and Panke 2017).

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (continued)

FIGURE B1.1.4 South Asia's geopolitical stance

Like most EMDEs, South Asia's UN voting aligns more closely with China than with the United States, although most South Asian countries have moved closer to the United States since 2016.



Sources: Aiyar and Ohnsorge (2024); Bailey, Strezhnev and Voeten (2017); World Bank.

Note: BGD = Bangladesh; BTN = Bhutan; EMDE = emerging market and developing economies; IND = India; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan. Figures are based on the ideal point index of country voting patterns in the UN General Assembly. The index ranges from -2.5 to +2.5 points. Gray shades indicate the interquartile range of other EMDEs, including 137 economies.

Vulnerability to geoeconomic risks

Limited vulnerability. The vulnerability of most South Asian countries' exports to geopolitical disruptions is comparable to that of other EMDEs (figure B1.1.5). Nepal, Bhutan, and Maldives are the exceptions, ranking among the least vulnerable EMDEs. Nepal and Maldives are less vulnerable because of their low goods export openness, and all three predominantly rely on geopolitically close export markets, such as India and Thailand. For most South Asian countries, FDI has limited vulnerability to geopolitical shocks, largely because of their exceptionally low FDI inflows. Most countries in South Asia are in the least vulnerable quartile of EMDEs for exports and FDI, and in the less vulnerable half of EMDEs for portfolio investment.

Mostly falling vulnerabilities since 2016. Geoeconomic vulnerabilities in South Asia have fallen more than in other EMDEs since 2016, the year before trade- and investment-restricting measures began to be used more widely around the world. However, there was considerable heterogeneity around this average. Geoeconomic vulnerabilities can change either because of changing geopolitical stances or because cross-border transactions change over time. In South Asia, these factors have sometimes offset each other, and sometimes worked in the same direction.

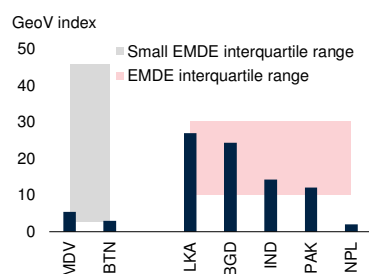
- **Bangladesh.** Bangladesh's geopolitical pivot toward advanced economies—the most pronounced among South Asian countries—aligned it more closely with its main source of foreign exchange inflows, exports, FDI and portfolio investment. As a result, the geoeconomic vulnerability of all of Bangladesh's main sources of foreign exchange declined.
- **Bhutan.** Bhutan's UN voting patterns have increasingly aligned with India and advanced economies. This has helped lower the measured geoeconomic vulnerability of its goods exports, as well as its FDI and portfolio investment sources.
- **India.** India's exports and FDI liabilities have shifted toward partner countries whose UN voting patterns differ considerably from India, that is, countries that are geopolitically distant. Specifically, an increasing reliance on exports to geopolitically distant markets (for example, the United States) and FDI from geopolitically distant sources (for example, the United Kingdom) have increased India's vulnerabilities to geopolitical shocks.
- **Maldives.** Maldives' UN voting patterns have diverged somewhat from its main sources of FDI (Thailand, Mauritius), suggesting a marginally higher geoeconomic vulnerability of its FDI.

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (continued)

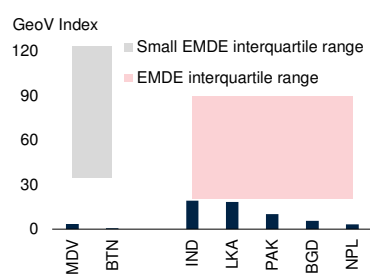
FIGURE B1.1.5 Geopolitical vulnerabilities of exports and liabilities

Most South Asian countries' goods exports, FDI inflows, and portfolio investment inflows are less vulnerable to geopolitical risks than those of other EMDEs. Changes in vulnerabilities have mostly been more favorable in South Asia than in other EMDEs since 2016.

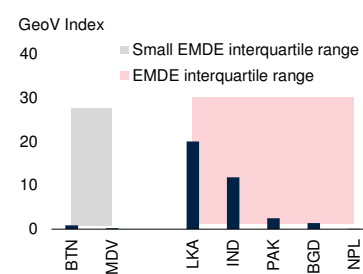
A. Goods exports, 2023



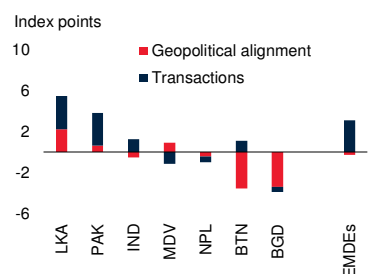
B. Foreign direct investment, 2022



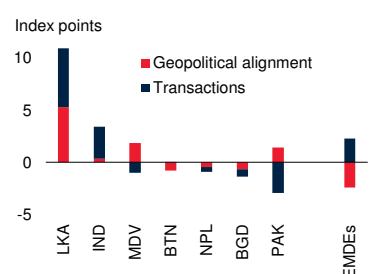
C. Portfolio investment, 2022



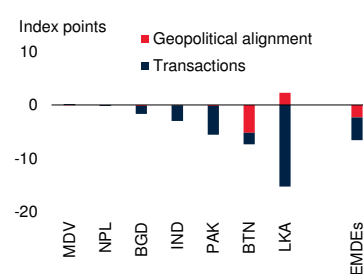
D. Goods exports: Changes during 2016–23



E. Foreign direct investment: Changes during 2016–22



F. Portfolio investment: Changes during 2016–23



Sources: Aiyar and Ohnsorge (2024); IMF International Investment Position Statistics (database); World Bank.

Note: BGD = Bangladesh; BTN = Bhutan; IND = India; EMDE = emerging market and developing economies; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan. Other EMDEs exclude China. Geoeconomic vulnerability (GeoV index) measures the trade- or liability-weighted average geopolitical distance of a country to its trading partners or creditors. Red shades in A–C denote interquartile ranges for other EMDEs. Gray shades denote interquartile ranges for other small-state EMDEs (as defined in World Bank 2024). Aggregates are GDP-weighted averages. All charts show geoeconomic vulnerability indices scaled by the share of total transactions in GDP; when aggregate transactions are not available, bilateral aggregates are used.

A.D. Exports refer to merchandise exports. Bhutan uses 2022 data. Other EMDEs comprise 140 economies and 34 small states. Using share of total merchandise and services export as scalar for GeoV gives similar results. Bhutan uses 2022 data for GeoV index and both 2016 and 2022 data for tracking changes.

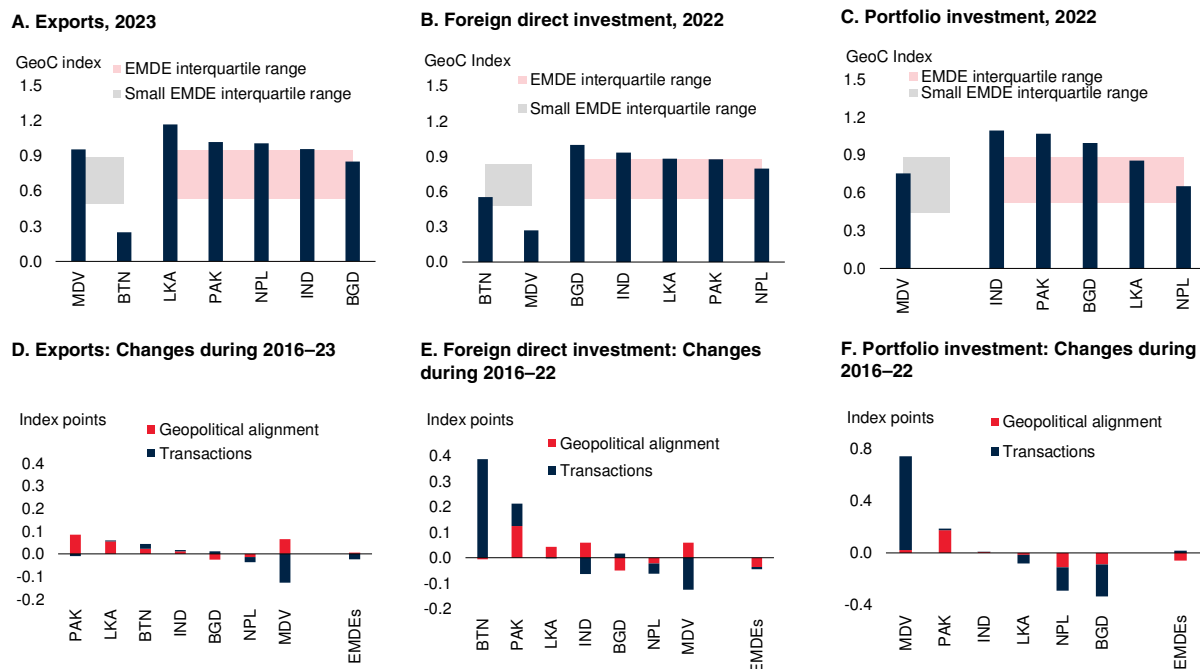
B.C.E.F. Red shades denote interquartile ranges for other EMDEs, comprising 127 economies (B and E) and 117 economies (C and F). Gray shades denote interquartile range for small states, comprising 26 economies (B and E) and 20 economies (C and F).

C.F. Bhutan uses 2020 data for GeoV index and both 2015 and 2020 data for tracking changes.

- **Nepal.** Along with Bangladesh, Nepal stands out among South Asian countries in both having aligned geopolitically more closely with its main external partners (India and advanced economies) and increasingly shifting its external ties towards countries with more similar UN voting patterns. As a result, similar to Bangladesh, it has reduced all aspects of its current geoeconomic vulnerability.
- **Pakistan.** Pakistan's geopolitical shift toward China has brought it geopolitically further from its main export markets in Europe. This has increased the vulnerability of Pakistan's exports while its portfolio investment and FDI vulnerabilities have fallen as a result of sharply higher inflows from other, geopolitically closer EMDEs (especially those in the Gulf).
- **Sri Lanka.** Between 2016 and 2023, Sri Lanka's UN voting patterns, and hence its geopolitical alignment, diverged from those of the United States, the United Kingdom, Singapore, and India—its largest export markets and sources of FDI. This divergence was only partially reversed in 2023. As a result, the measured geopolitical vulnerability of Sri Lanka's exports and sources of FDI has increased.

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (continued)**FIGURE B1.1.6 Geopolitical diversity of export markets and creditors**

Most South Asian countries have more diversified export markets and sources of foreign investment than other EMDEs. Shifts in geopolitical alignment have played a significant role in increasing connectedness since 2016.



Source: Aiyar and Ohnsorge (2024); World Bank.

Note: BGD = Bangladesh; BTN = Bhutan; EMDE = emerging market and developing economies; IND = India; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan. Geoeconomic connectedness (GeoC index) measures the trade or liability-weighted standard deviation of the geopolitical distances to export destinations (A, D) or creditors (B, C, E, F); the index captures the diversity of geopolitical views among partner countries. Charts show geoeconomic connectedness index (A-C) or change in geoeconomic connectedness index since 2016 (D-F). Red shades in A-C denote interquartile ranges for other EMDEs, and grey shades denote interquartile ranges for other small states. Other EMDEs exclude China. Aggregates are GDP-weighted averages.

A.D. Exports refer to merchandise exports. Other EMDEs comprise 139 economies and other small states comprise 33 economies.

B.C.E.F. Red shades denote interquartile range for other EMDEs, including 140 economies (B and E) and 121 economies (C and F). Gray shades denote interquartile range for small state economies, including 34 economies (B and E) and 22 economies (C and F).

C.F. Bhutan has no observation as it only has one partner in 2020, the latest available year.

This assessment is necessarily backward-looking since it is data-driven. Geoeconomic vulnerabilities may also arise in the context of future economic ties that have yet to be developed and whose development may be impeded by geopolitical considerations.

Services exports. In addition to vulnerabilities in goods exports, South Asia faces geoeconomic risks from services exports. South Asia has an above-average share of services exports in GDP (figure B1.1.1), especially services exported to geopolitically distant markets such as the United States and Europe (World Bank 2021a, 2024d). Services exports are particularly vulnerable to geopolitical tensions because services trade—whether tourism, call centers, or back-office functions—is closely linked to buyers' trust in the seller (Bhattacharya, Patnaik, and Shah 2012; Wagner 2014).

Diversification of geopolitical risks

Missed opportunities. South Asia's lack of openness to global trade and investment reduces its ability to benefit from the reshaping of global supply chains and trade (Khandelwal 2022). If South Asia were more open to global trade and investment, it might be in a good position to benefit from these shifts because of the diverse set of countries with which it already engages.

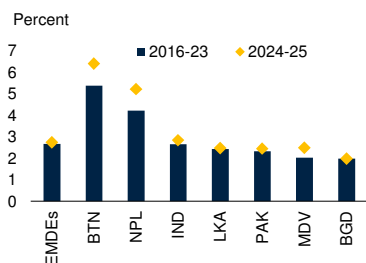
Diverse set of partner countries. Currently, most South Asian countries are in or near the quartile of EMDEs with the most geopolitically diverse export markets, FDI sources, and portfolio investment sources—as captured by the geoeconomic connectedness index, which measures the standard deviation of partner countries' geopolitical stances (figure B1.1.6). However,

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (continued)

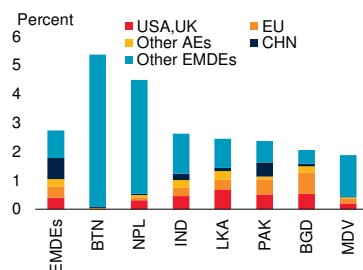
FIGURE B1.1.7 Exposure to growing markets

Since 2016, South Asia's export markets have grown more slowly than those of the average EMDE and are expected to continue to do so over the forecast horizon. Meanwhile, investment growth in most South Asian countries' (except India's) FDI sources has been faster than in the average EMDE and this is also expected to continue.

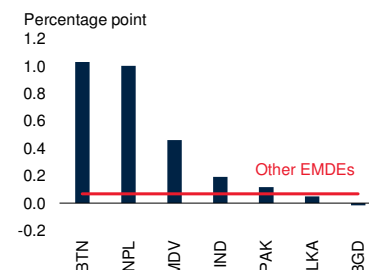
A. Export market growth



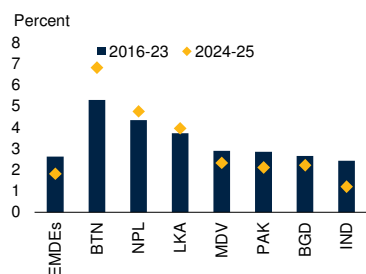
B. Composition of export market growth, 2023



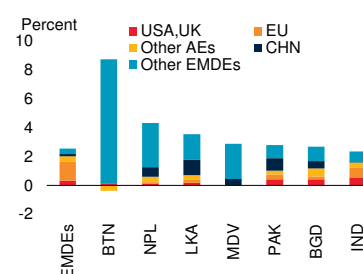
C. Changes in export market growth between 2016–23 and 2024–25



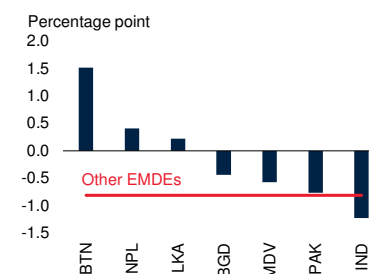
D. Investment growth of FDI sources



E. Composition of investment growth of FDI sources, 2023



F. Changes in investment growth of FDI sources between 2016–23 and 2024–25



Sources: Aiyar and Ohnsorge (2024); IMF World Economic Outlook (database).

Note: BGD = Bangladesh; BTN = Bhutan; EMDE = emerging market and developing economies; IND = India; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan. Red lines denote the median level of other EMDEs. Other EMDEs comprise 146 economies and exclude China.

A.-C. Growth of export markets is measured either as the annual average (A, B) or as the change (C) in annual export-weighted growth. Export market growth between 2016 and 2023 is derived as the export-weighted annual average growth across all export partners between 2016 and 2023. Export market growth between 2024 and 2025 is derived from first computing annual average forecast growth of each export market between 2024 and 2025, then aggregating using 2023 exports as weights, before computing the annual average of these two years.

D.-F. Investment growth of FDI sources is measured as the annual average (D, E) or as the change (F) in FDI-weighted investment growth. FDI sources' investment growth between 2016 and 2023 is derived as the FDI-weighted annual average investment growth across all FDI sources between 2016 and 2023. FDI sources' investment growth between 2024 and 2025 is derived from first computing annual average forecast investment growth of each FDI sources between 2024 and 2025, then using 2022 FDI shares as weights, before computing the annual average of these two years.

official statistics may exaggerate the diversity of South Asia's FDI sources. For example, India receives an above-average share of FDI from geopolitically close Singapore and Mauritius, as well as from geopolitically distant Japan and the European Union—which covers much of the spectrum of geopolitical stances as captured by UN voting patterns. However, between 2004 and 2014, 90 percent or more of FDI from Mauritius and Singapore to India have been estimated to indirectly channel FDI from other countries—including from Indian investors (Jaiswal 2017; Kathuria, Yatawara, and Zhu 2021).

Growing diversity of partner countries. Since 2016, India, Pakistan, Sri Lanka, and Bhutan have increased

the diversity of their export markets, as well as their sources of FDI. Pakistan has also widened its sources of portfolio investment (figure B1.1.6). For Bangladesh, in contrast, the reduction in geoeconomic vulnerabilities was accompanied by a narrowing range of geopolitical views of the country's export markets and FDI sources as Bangladesh moved its geopolitical stance closer to that of its main export markets and sources of FDI in advanced economies.

Below-average growth in export markets, above-average growth in FDI sources. Because most South Asian countries have exported less than the average EMDE to China over the past decade, and China was

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (continued)

one of the world's fastest-growing economies, South Asia's export market growth has mostly been below that in other EMDEs (figure B1.1.7). This lack of exposure to export markets in China is also expected to allow for an acceleration in most South Asian countries' export markets over 2024–25, whereas export market growth of the average EMDE is expected to be broadly stable. Even with this acceleration, however, export market growth for most South Asian countries (except Bhutan, Nepal, and India) is expected to remain below the EMDE average. Meanwhile, since 2016, most South Asian countries (except Bangladesh and India) have received FDI from sources with higher investment growth than other EMDEs—mainly because of their above-average reliance on FDI from other EMDEs. Above-average investment growth in South Asia's FDI sources is expected to continue to support FDI inflows in most countries in the region over 2024–25. Only India faces a considerably steeper investment growth slowdown in its sources of FDI than the average EMDE over the forecast horizon.

Policy implications

To take advantage of the reshaping of global value chains, policy priorities for South Asian countries include removing obstacles to trade and foreign investment, further improving infrastructure and logistics, and increasing institutional effectiveness.

Some South Asian countries may hope to build on their long-standing non-aligned geopolitical stance to become globally connected manufacturing and services hubs. In this ambition, they face competition from other EMDEs that are similarly non-aligned and also aim to take advantage of shifts in global supply chains. To achieve their aspirations in a competitive global environment, South Asian countries need to implement policies that attract FDI and unlock new export markets and sectors. Cultivating a diversified set of trading partners and creditors across the geopolitical spectrum could help them manage any increases in vulnerabilities in a more open, dynamic economic model. More connected countries tend to have lower tariffs, more efficient logistics, deeper financial markets, predictable policies, and participate in larger free trade areas (Aiyar and Ohnsorge 2024).

Further improving infrastructure and logistics

Upgraded transportation networks and efficient logistics can lower trade costs for exporters and firms importing intermediate inputs. This increases the cost competitiveness of domestic firms in international trade. In particular, the absence of delays related to unexpected transport disruptions at the border or within the country supports participation in global supply chains (Brancaccio, Kalouptsidi, and Papageorgiou 2024).

Multiple large public infrastructure projects, including road and railway networks, as well as ports and airports, have improved the connectivity of South Asia in recent years (EIU 2023; World Bank 2023a). India's National Logistics Policy, announced in 2022, and the Padma bridge construction in Bangladesh illustrate recent efforts by South Asian governments to upgrade the region's infrastructure and connectedness. Despite these improvements, South Asia still tends to score below the EMDE median on indicators for infrastructure quality, as well as on logistics performance (figure B1.1.8). India and Sri Lanka are the two notable exceptions. Both countries score above the median on timeliness of logistics and keeping track of shipments.

The WTO Trade Facilitation Agreement—which entered into force in 2017 and has been ratified by all South Asian countries except Bhutan—provides a clear roadmap for further policy measures. It aims to reduce non-tariff barriers to trade by simplifying, modernizing, and harmonizing import and export regulations and logistics across countries. Member countries can request technical assistance and monitoring for the implementation of specific reforms. As of July 2024, South Asia's median implementation rate has been 78 percent, but Nepal and Sri Lanka have implemented less than 40 percent of all measures.

Increasing institutional effectiveness

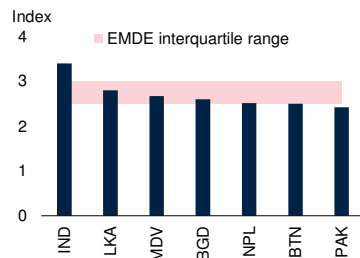
A stable political environment and effective public institutions promote international trade and attract foreign investment (Beverelli et al. 2024; Heilbron and Whyte 2019). Firm surveys have repeatedly identified policy and regulatory uncertainty as one of the most significant constraints on expanding activities to other countries, especially in EMDEs (Stamm and Vorisek 2024). Uncertainty can, for instance, arise from

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (continued)

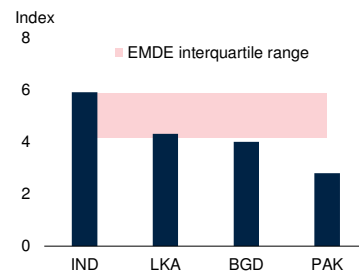
FIGURE B1.1.8 Factors associated with greater diversity of economic partners

Many South Asian countries score poorly on country characteristics associated with openness to trade and finance, as well as on measures of financial depth. South Asia's geoeconomic connectedness might have been higher had its logistics performance been better and its tariffs lower.

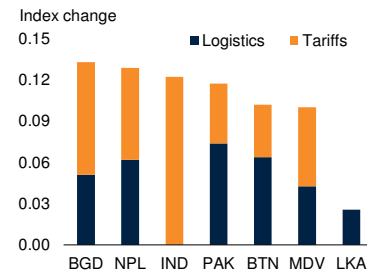
A. Logistics performance



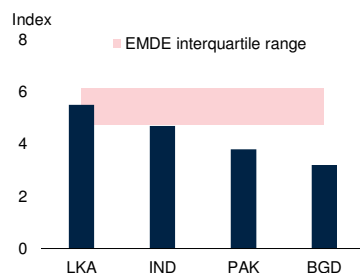
B. Political stability and institutional effectiveness



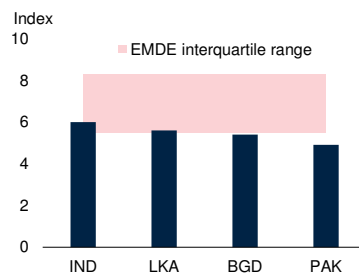
C. Predicted differences in geoeconomic connectedness for exports



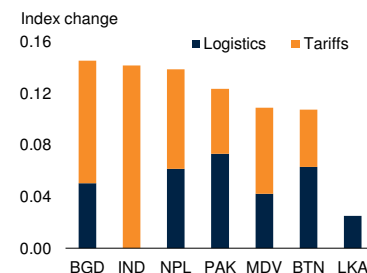
D. Quality of infrastructure



E. Openness of foreign trade and exchange regime



F. Predicted differences in geoeconomic connectedness for intermediate inputs



Sources: Aiyar and Ohnsorge (2024); Economist Intelligence Unit Business Environment Rankings (database); World Bank International Logistics Performance Index (database); WTO World Tariff Profiles (database); World Bank.

Note: BGD = Bangladesh; BTN = Bhutan; EMDEs = emerging market and developing economies; IND = India; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan. Red-shaded areas show the interquartile range for EMDEs. Unless noted differently, data from 2023.

A. Sample comprises 94 other EMDEs. Bars for Maldives, Nepal, and Pakistan show values for 2018.

B,D,E. Sample comprises 44 other EMDEs.

C,F. Estimated through bivariate ordinary least squares regressions in annex B1.1.1. Bars indicate the hypothetical difference in geoeconomic connectedness in exports (C) or intermediate goods exports (F) if South Asia had the same logistics performance and the same average tariffs as the quartile of EMDEs with the lowest tariffs and the best logistics performance. This is derived by multiplying the correlations coefficients by the difference between the 75th percentile EMDE value and the country score on the respective explanatory variable. The geoeconomic connectedness index measures the trade or liability-weighted standard deviation of the geopolitical distances to export destinations or creditors; the index captures the diversity of geopolitical views among partner countries. Sample covers 99 EMDEs for logistics regressions and 105 EMDEs for tariff regressions in 2023.

problems with contract enforcement or unlawful expropriation (for example, as described in Goel and Goel 2020). Reducing such uncertainties and streamlining regulatory frameworks can lower transaction costs for firms and improve the climate for foreign investment and trade (Gao et al. 2024).

The institutional and policy environment in the average South Asian country is considered less stable than in the median EMDE (figure B1.1.8). Three of the four largest South Asian countries rank in the bottom

quartile of EMDEs for their institutional and policy environment. This is consistent with firm surveys citing political uncertainty and corruption as significant constraints on doing business in South Asia (World Bank 2024d), which makes credible long-run policy commitments a priority. India's National Logistics Policy could serve as a promising example of such a long-run commitment. To be able to undertake large public investments in other countries, restoring and committing to sound macroeconomic policies will be an important prerequisite (World Bank 2024j, 2024k).

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (*continued*)

Removing obstacles to trade

Besides reducing indirect costs through upgraded infrastructure, efficient logistics, and supportive institutions, countries can become more connected by lowering tariffs (Ohnsorge and Quaglietti 2024). Access to cheaper intermediate inputs, in turn, increases the cost competitiveness of domestic firms on international markets (Feng, Li, and Swenson 2016). However, tariffs in South Asia remain well above those in other EMDEs. Bangladesh, India, and Nepal rank among the quartile of EMDEs with the highest average applied tariffs (figure B1.1.1).

Removing obstacles to foreign investment

Openness to foreign investment is crucial to integrating into global supply chains. Multinational corporations, through FDI, establish local subsidiaries that incorporate host countries into their networks. This fosters the diffusion of advanced technology and managerial expertise through extensive supplier relationships and distribution channels. Increased competition also drives domestic firms to become more productive and improve international competitiveness, further embedding the host economy into global supply chains (Qiang, Liu, and Steenbergen 2021).

Many South Asian countries have introduced new restrictions on cross-border financial transactions since 2021. Such measures include increased profit repatriation requirements for foreign investors, foreign exchange quotas, and higher minimum financing requirements (World Bank 2023a). In some cases, legal frameworks specifically discriminate against foreign investors (World Bank 2023b). The removal or easing of these restrictions could help attract FDI.

Deep trade agreements

One option for deepening global trade and investment integration is to initiate or join deep trade agreements with other countries, which go beyond tariff reductions to include provisions that facilitate investment and trade. Deep trade agreements, which have become common, offer an opportunity to ease FDI restrictions.

Several Southeast Asian countries—such as Malaysia and Vietnam—have joined large trade and investment agreements, including the 2018 Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and the 2020 Regional Comprehensive Economic Partnership (RCEP). Meanwhile, India does not participate in mega trade blocs such as RCEP, and some of its trade agreements have narrower scope than others. For example, the India-EFTA Trade and Economic Partnership Agreement (TEPA) excludes key sectors such as digital trade, e-commerce, pharmaceuticals, and small and medium enterprises (World Bank 2024a). None of the other South Asian countries is a member of RCEP or CPTPP. This means that there is ample potential for countries in South Asia to expand their network of regional trade agreements to include a wider range of countries along the geopolitical spectrum. This can help improve connectedness and reduce vulnerabilities to geopolitical shocks (Maloney et al. 2023).

Potential magnitude of gains

How much more diversified might South Asia's trading partners and creditors have been if South Asia's policy environment had matched that of the top EMDE quartile? Although they cannot establish causality, correlations suggest that economies with lower average tariffs and better logistics performance tend to be more connected in their exports (table B1.1.1). All but one South Asian country scores below the top EMDE quartile on either measure. If all these countries had the same logistics performance as the top EMDE quartile and the lowest EMDE quartile for tariffs, South Asia's median export diversification could have been about 13 percent higher, on par with Malaysia and Indonesia (figure B1.1.8).

A key channel for the positive association between exports and better logistics, or lower tariffs, is the increased availability of cheaper intermediate inputs. This is supported by a strong correlation between the connectedness of intermediate inputs and logistics performance or tariffs. The empirical estimates suggest that South Asia might have had the connectedness of major supply chain participants such as Vietnam or Poland in intermediate inputs if its logistics and tariffs had been on par with those in the best quartile of EMDEs.

In *Bangladesh*, current account balances improved in FY2023/24, as restrictions weighed on imports and remittances rose. In July 2024, remittance inflows fell to a 10-month low, as uncertainty rose amid social unrest, and internet and banking services were disrupted, before bouncing back in August. In *India*, a steady surplus in services trade helped offset a widening deficit in goods trade in April–August 2024. In *Nepal* and *Pakistan*, robust remittance inflows and growth in tourism (in Nepal) offset deficits in goods trade, with goods trade deficits declining in FY2024 but remaining large. In *Sri Lanka*, growth in services exports and remittance inflows have propelled the current account deficit into a surplus.

Meanwhile, portfolio investment and FDI inflows remain subdued across most of South Asia. Net portfolio investment inflows, in particular, have been close to zero in most South Asian countries. *India* is an exception, where net portfolio inflows have been robust and near pre-pandemic levels since March 2024. Net portfolio inflows have been positive and rising for eight quarters, mirroring trends in several other large EMDEs (except China) and driven in part by the inclusion of rupee-dominated Indian government bonds in global bond indices. For the region as a whole, FDI inflows have yet to recover to pre-pandemic levels and are well below the average for other EMDEs.

Improving current account balances and inflows of remittances have boosted official international reserves of *Pakistan* and *Sri Lanka*. In *Sri Lanka*, foreign reserves have increased to 3.6 months of import cover in August, up from 3.3 months in March 2024. In *Pakistan*, expectations of an approval of an IMF arrangement helped stabilize its foreign exchange market. Despite rising reserve levels, in both *Pakistan* and *Sri Lanka*, reserve covers remain significantly below the EMDE average.

In *Bangladesh* and *Maldives*, foreign reserve levels have declined since early 2024 as a result of persistent current account deficits. In *Bangladesh*, gross reserves at the end of June covered 3.3 months of prospective imports after a disbursement under the IMF arrangement. On May 8, 2024, a crawling peg exchange rate regime

was adopted, as a first step toward a more flexible foreign exchange policy, and the exchange rate was devalued to be closer to the kerb market rate. In *Maldives*, foreign reserves in August were sufficient to cover only one month of imports, with the currency under increasing pressure from external debt service commitments and declining foreign exchange earnings during the low tourism season, amid two rating downgrades by Fitch Ratings in June and August. The foreign exchange shortage constrained domestic economic activity by limiting imports in construction, wholesale, and retail trade sectors.

Outlook

Growth in South Asia is projected to remain above that of other EMDE regions. For most countries in the region, growth in 2024–26 is likely to be faster than previously projected in April.

Regional outlook

Growth in South Asia is projected to reach 6.2 percent in 2025–26, again higher than in other EMDE regions (figure 1.7). For five South Asian countries, forecasts have been upgraded from six months ago; only the forecasts for *Bangladesh* and *Maldives* have been downgraded (table 1.1). The widespread upgrades reflect robust growth in private consumption in *India*, and stronger tourism or hydropower exports in *Bhutan*, *Nepal*, and *Sri Lanka* than previously projected.

More than in other EMDEs, domestic demand is expected to remain the main driver of growth in South Asia. Nevertheless, domestic demand growth is expected to slow somewhat from 2023, reflecting the effects of tightening fiscal policies after elections in five South Asian countries over the past year. Export growth is expected to pick up, supported by India's initiatives to boost manufacturing exports and a broad recovery in tourism. Current account deficits are projected to remain at a median of 1 percent of GDP in 2024 and narrow slightly during 2025–26, remaining considerably smaller than the pre-pandemic average of 3 percent of GDP.

Headline inflation is expected to moderate further in most South Asian countries during 2024–26 from its 2023 levels, partly reflecting stabilizing exchange rates and broadly stable commodity prices. The exceptions are *Bangladesh* and *Maldives*, where disruptions from unrest (*Bangladesh*) and the removal of price subsidies resulting from fiscal reforms (*Maldives*) are expected to raise inflation in 2025.

Fiscal policies in the region are projected to tighten throughout the region. *Bangladesh*, *Pakistan*, and *Sri Lanka* are expected to implement reforms under their IMF-supported policy programs. The median fiscal deficit is expected to narrow to 5.6 percent of GDP during 2024–26, still wider than pre-pandemic levels but down from 6.8 percent in 2023. In *India*, the fiscal deficit is projected to shrink by 0.7 percentage point of GDP in FY2024/25 to 7.5 percent of GDP, as a result of higher revenues after improved compliance with the Goods and Services Tax (GST) and a broadening of the personal income tax base. With government debt levels expected to remain elevated in the region, debt service costs will continue to constrain fiscal policies.

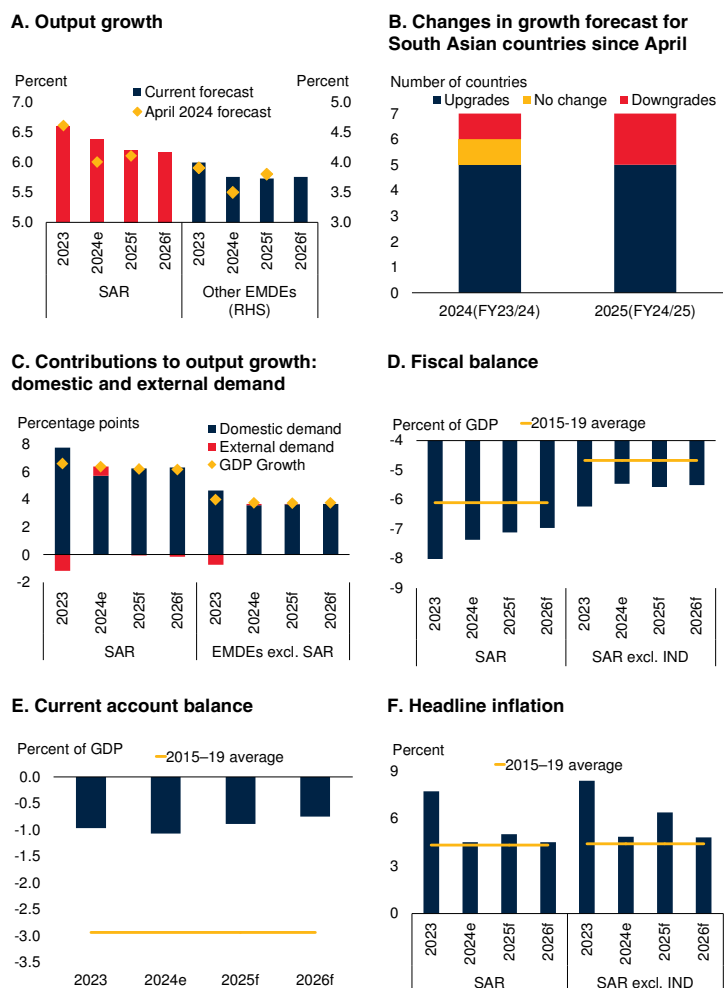
Country outlooks

In *Bangladesh*, output growth is expected to slow from 5.2 percent in FY2023/24 to within the range of 3.2–5.2 percent (with a mid-point of 4.0 percent) in FY2024/25. The wide range of the growth projection reflects the lack of available or reliable data in recent months, and significant uncertainties around the political and economic outlook following the recent political turmoil. In the short term, political uncertainties are expected to keep investment and industrial growth subdued. Recent floods are expected to set back agricultural production modestly. In the medium to long term, growth is expected to pick up gradually, benefiting from critical reforms in the financial sector, increased domestic resource mobilization, improved business climate, and increased trade.

Bhutan's economy is expected to grow by 7.2 percent in FY2024/25, a 1.5-percentage-point upgrade from April, boosted by a faster-than-expected recovery in tourism and strong public

FIGURE 1.7 Outlook for output growth

Growth in 2024 is projected to be faster than previously expected, driven by strong private consumption growth in India and stronger-than-expected tourism or hydropower export growth in Bhutan, Nepal, and Sri Lanka. Outside of India, growth is expected to pick up, with recovery firming in Pakistan and Sri Lanka. Fiscal consolidation is expected to shrink fiscal deficits, while inflation is projected to decline in most countries, with global commodity prices remaining stable.



Sources: *Macro Poverty Outlook* (World Bank); World Bank.

Note: e = estimate; f = forecast. EMDE = emerging market and developing economies; IND = India; SAR = South Asia.

A. Bars show average for fiscal year. Aggregation method is weighted average.

B. Sample includes seven South Asian countries with GDP forecast.

C. GDP aggregates are calculated using real U.S. dollar GDP weights at 2015 prices and market exchange rates. Contribution to growth from domestic demand and net exports is based on GDP forecasts. Sample comprises 117 EMDEs, of which 6 are in South Asia. Statistical discrepancies and change in inventories are included as part of the domestic demand.

D. Aggregation method is weighted average. Sample comprises seven countries in South Asia.

E. Bars show the median current account balance. Sample comprises seven countries in South Asia. Solid line shows the average median current account balance over the period 2015–19.

F. Bars show the median of the expected inflation. Horizontal line shows the average of the median inflation from 2015–19. Sample includes seven countries in South Asia.

investment at the beginning of a new five-year plan. Growth is expected to moderate to 6.6 percent in FY2025/26 as the effect of the tourism rebound fades.

TABLE 1.1 Growth in South Asia

Country fiscal year		Real GDP growth at constant market prices (Percent)				Revision to forecast from April 2024 (Percentage point)	
		2023	2024(f)	2025(f)	2026(f)	2024(f)	2025(f)
Calendar year basis							
South Asia region (excluding Afghanistan)		6.6	6.4	6.2	6.2	0.4	0.1
Maldives	January to December	4.1	4.7	4.7	4.6	0.0	-0.5
Sri Lanka	January to December	-2.3	4.4	3.5	3.1	2.2	1.0
Fiscal year basis		22/23	23/24(e)	24/25(f)	25/26(f)	23/24(e)	24/25(f)
Bangladesh	July to June	5.8	5.2	4.0	5.5	-0.4	-1.7
Bhutan	July to June	5.0	5.3	7.2	6.6	0.4	1.5
India	April to March	7.0	8.2	7.0	6.7	0.7	0.4
Nepal	mid-July to mid-July	2.0	3.9	5.1	5.5	0.6	0.5
Pakistan	July to June	-0.2	2.5	2.8	3.2	0.6	0.5

Sources: *Macro Poverty Outlook* (World Bank) and World Bank staff calculations.

Note: (e) = estimate; (f) = forecast. GDP measured in average 2010–19 prices and market exchange rates. Pakistan is reported at factor cost. Growth projections for Afghanistan are not available. To estimate forecasts for regional aggregates in the calendar year, fiscal year forecasts are converted to the calendar year by taking the average of two consecutive fiscal years for Bangladesh, Bhutan, Nepal, and Pakistan because quarterly GDP forecasts are not available.

Growth in *India* is projected to reach 7.0 percent in FY2024/25 and 6.7 percent in FY2025/26. Larger-than-expected agricultural output, along with policies designed to raise employment growth, are expected to contribute to strong private consumption growth, while growth in public consumption is projected to moderate in line with budgeted fiscal consolidation. Investment growth is expected to moderate from a high base. Projected growth is close to India's pre-pandemic, FY2016/17–FY2018/19, average growth rate and higher than for most other major EMDEs. Fiscal consolidation is expected to continue over the medium term, driven by robust revenue growth and a modest increase in current spending.

In *Maldives*, output growth is expected to remain modest, at 4.7 percent in 2025 and 4.6 percent in 2026. These represent a 0.5-percentage-point downgrade for 2025, and 0.5-percentage-point upgrade for 2026, mainly reflecting delays in the construction of the new airport to serve the tourism sector, which represents 25 percent of GDP. The growth outlook assumes that major government debt repayments coming due to bilateral creditors can be rescheduled to avoid a disorderly default.

In *Nepal*, growth is projected to pick up to 5.1 percent in FY2024/25 and 5.5 percent in FY2025/26, a slight upgrade from April, with economic activity outside the hydropower sector expected to be supported by monetary policy easing. Services sector activity is expected to strengthen amid growing tourist arrivals, an expanding hotel sector, and a recovery in goods imports after earlier restrictions were relaxed.

Pakistan's recovery from the recent balance-of-payments crisis is expected to continue. Growth in agricultural activity is expected to moderate after the bumper rice and wheat harvest in FY2023/24. Manufacturing activity is projected to pick up in FY2024/25 as import controls and monetary policy are loosened, lifting growth forecast to 2.8 percent in FY2024/25 and 3.2 percent in FY2025/26. Inflation is expected to remain high in late 2024 because of rising administered energy prices, but is projected to ease in FY2025/26 as this effect fades. The projected recovery assumes that the IMF-supported reform program remains on track.

In *Sri Lanka*, growth is expected to continue to strengthen to but remain below the pre-pandemic average. Output is projected to grow by 3.5

percent in 2025, a 1-percentage-point upward revision from April, and 3.1 percent in 2026, supported by stronger-than-expected rebounds in industrial activity and in tourism-related sectors. Inflation is expected to remain muted as depreciation pressures subside. The forecast assumes that debt restructuring and structural reform implementation remain on track.

No forecast has been produced for *Afghanistan*.

Vulnerabilities and risks

Risks to growth forecasts are tilted to the downside. Downside risks include reform delays and policy missteps, social unrest and political instability, climate shocks, and debt distress. The region's fragile fiscal and external positions leave little room for absorbing adverse shocks.

Limited room to absorb shocks

Both the public and private sectors in South Asia have limited room to respond to adverse shocks. Average government debt is 76 percent of GDP, the highest among EMDE regions. At 56 percent of GDP, private debt is also above the EMDE average (figure 1.8). The effective interest rates that governments pay on their debt are higher in most South Asian countries than in the median of other EMDEs, and government debt service payments are expected to remain higher than elsewhere (Das and Ghatge 2022).

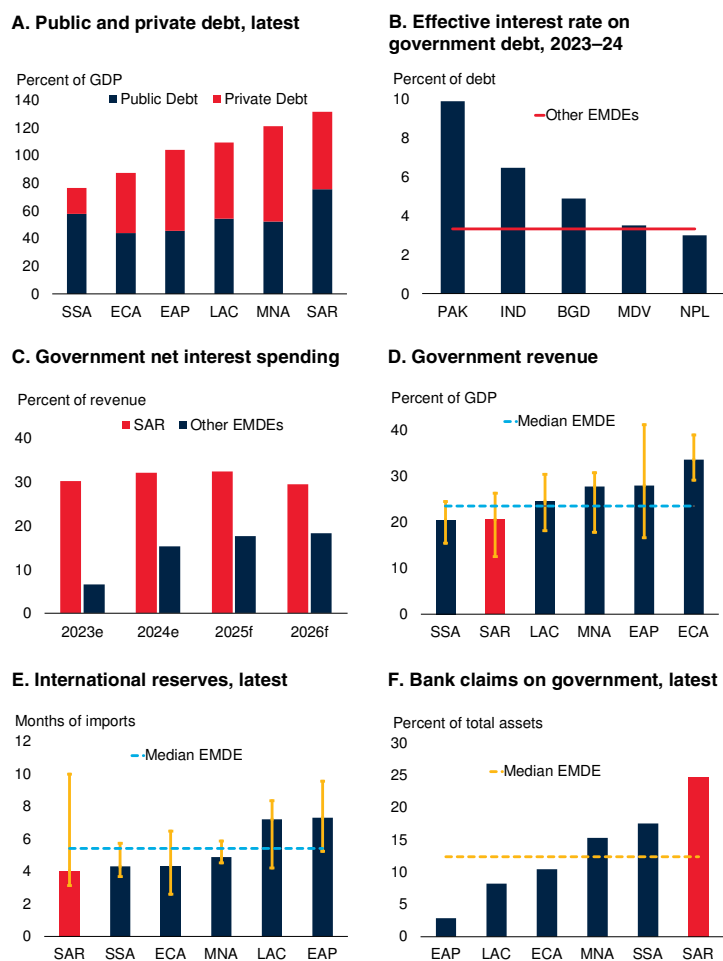
Elevated government debt in South Asia partly reflects low government revenues which, at 20 percent of GDP in 2024, are the lowest among EMDE regions. Moreover, the revenues rely heavily on trade-related taxes, with little revenue raised domestically—most notably in Bangladesh, Maldives, Nepal, and Sri Lanka—which discourages trade and limits revenue generation (World Bank 2024d).

The region's international reserve levels are also the lowest among EMDE regions. In part, this is a legacy of previous crises in countries where reserves have yet to return to adequate levels.

In *Maldives* high public spending, driven by infrastructure investment and financed by external debt, has raised debt and depleted foreign reserves.

FIGURE 1.8 Limited room to absorb shocks

South Asia has high debt, low government revenue, and low international reserves, leaving its countries with limited room to absorb shocks.



Sources: Bloomberg; CEIC; Global Debt Database (IMF); Haver Analytics; International Financial Statistics (IMF); *Macro Poverty Outlook* (World Bank); World Bank; *World Economic Outlook* (IMF).

Note: e = estimate; f = forecast. BGD = Bangladesh; EAP = East Asia and Pacific; ECA = Europe and Central Asia; EMDEs = emerging market and developing economies; IND = India; LAC = Latin America and the Caribbean; MDV = Maldives; MNA = Middle East and North Africa; NPL = Nepal; PAK = Pakistan; SAR = South Asia; SSA = Sub-Saharan Africa.

A. Public debt is the total stock of debt liabilities issued by the central government. Private debt includes debt, loans and debt securities. Latest observation for both private and public debt is 2022. For Sri Lanka, private debt data are from 2019, and for Bhutan, they are from 2021.

B. Bars show the average net government interest spending as a percent of general government gross debt. All indicators are in local currency. Other EMDEs consists of 147 countries. Median value is used for the aggregation.

C. Bars show yearly net government interest spending in percent of general government revenue. All indicators are in local currency. SAR comprises Bangladesh, India, Nepal, Pakistan, and Maldives. Other EMDEs comprises 147 countries.

D. Bars show the average of monthly medians for FY2024 data. Whiskers show the interquartile range. Dotted line represents the median EMDE economy.

E. Bars show simple average of monthly medians in 2024 through July. Sample includes up to 55 EMDEs of which 5 are in SAR. Whiskers show the interquartile range. Dotted line shows the median EMDE economy.

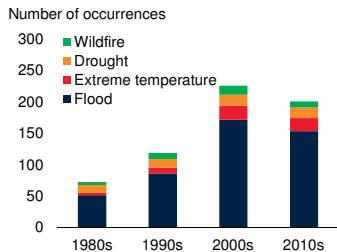
F. Bars show banks' claims on central government in percent of banks' total assets. Latest observation is June 2024. Sample comprises 121 countries, whereas the SAR sample consists of 5 countries. Median value is used for the aggregation.

Pakistan's high public debt, high interest-to-revenue ratios, and low international reserve coverage leave the economy vulnerable to increases in global interest rates and high global energy prices. Such shocks could lead to capital outflows,

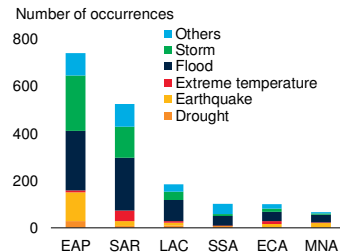
FIGURE 1.9. Climate risk

South Asia is especially vulnerable to extreme temperatures and flooding, the frequencies of which have increased over time. The poor in South Asia are especially vulnerable to heatwaves, the deaths from which have risen. Climate change could also exacerbate fiscal weaknesses.

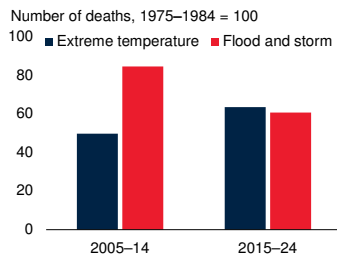
A. Number of extreme weather events



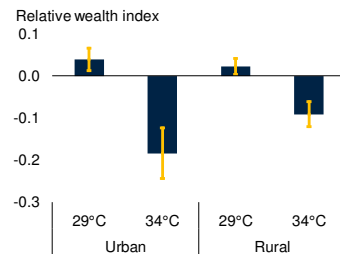
B. Number of extreme weather events by region, 1980–2024



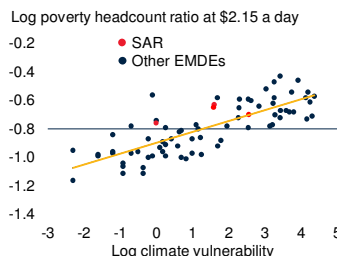
C. South Asia: Death by event type



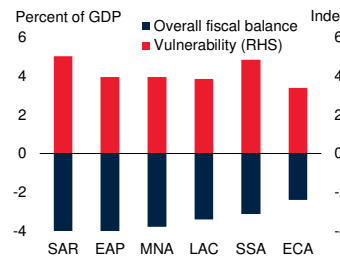
D. Relative wealth, by average temperature of urban and rural areas in South Asia, 2014–18



E. Climate vulnerability and poverty across countries



F. Climate vulnerability and overall fiscal balance



Sources: EM-DAT (International Disaster database); ERA5-Land database; Global Flood Database; Macro Poverty Outlook (World Bank); Notre Dame-GAIN Index; Poverty and Inequality (World Bank database); Relative Wealth Index (Chi et al. 2022); World Bank.

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

B. Regional aggregates are computed as population-weighted averages of cumulative extreme weather events from 1980 to 2024.

C. Chart shows the number of deaths due to extreme temperature events and flood and storm events from 2005–14 and 2015–24. Numbers are indexed to 100 in the period 1975–84.

D. Chart shows the estimated average relative wealth index by average maximum temperature between 2014 and 2018. The estimation controls for state fixed effects. Whiskers show the 95 percent confidence interval.

E. Scatterplot shows the relationship between the natural logarithm of climate vulnerability and the poverty headcount ratio at US\$2.15 a day (2017 PPP), measured as a percent of the population. The poverty data are from the most recent period, 2018 to 2023, while the climate vulnerability data are from 2021.

F. Bars show overall fiscal balance as a percent of GDP and the climate vulnerability index. The climate vulnerability index is re-weighted for clarity. Regional aggregates computed using a simple average for 2010–23. Sri Lanka is not included because of a lack of data.

currency depreciation, and a credit crunch that threatens the government’s ability to refinance maturing government debt.

The region’s domestic banking sectors hold a larger share of their assets in government debt than those of other EMDEs. This high exposure to government debt leaves the region’s financial systems vulnerable to government financing pressures. Sovereign distress can lead to losses on banks’ holding of government securities and reduce banks’ profitability and ability to lend (World Bank 2023a).

High debt, low international reserves, and low revenues leave little room for policy mistakes and limit the scope for governments to provide economic support in the event of adverse shocks. With growth still below pre-pandemic averages in most South Asian countries, above-average debt and below-average job creation outside agriculture limit the private sector’s ability to cope with further downturns and, in particular, constrain households’ ability to respond to extreme weather events.

Extreme weather events

The frequency of climate-related disasters worldwide has risen significantly since the 2000s. The number of flood events has nearly doubled since the 1990s, and the number of extreme temperature events has more than doubled since the 1990s (figure 1.9). South Asia is more vulnerable to an increase in the frequency of floods and extreme temperatures than other EMDE regions, partly because of its large agriculture sector, which employs about 40 percent of its workforce and contributes 20 percent of total output. Severe floods in the southeast region of *Bangladesh* in August 2024 affected more than 5 million people and damaged nearly one-fifth of the country’s total croplands. In *Afghanistan*, climate-related shocks compound other drivers of fragility, exacerbating inequalities and disproportionately affecting the most vulnerable, notably women and girls.

Frequent or severe flooding reduces agricultural productivity, destroys infrastructure, and increases forced migration. The adoption of early warning systems, improved infrastructure, and community-based approaches have enhanced South Asia’s

resilience against flooding and landslides, particularly in the coastal areas of *Bangladesh*, mountainous regions in *India*, and urban areas in *Sri Lanka* (Grover and Sharma 2022; Rakapakse et al. 2022; World Bank 2024e). These climate adaptation efforts have contributed to reducing the number of deaths from flooding in the region during the past two decades.

By contrast, deaths from extreme temperatures have increased. Heatwaves pose a growing risk to lives and livelihoods, especially for the poor. The poor often live in at-risk areas, where they are disproportionately exposed to hazards (Hallegatte et al. 2020). Studies of South Asia show that households with less wealth are more exposed to extreme heat (spotlight 1). The poor also tend to rely on activities that are most affected by climate change, such as agriculture, forestry, and aquaculture (Hallegatte et al. 2016; Kahn 2005; World Bank 2022a). Poor households often lack the resources needed to invest in protective measures against climate risks, are less able to respond to shocks when they occur, and have limited access to post-disaster relief mechanisms (Anttila-Hughes and Hsiang 2013; Hallegatte, Fay, and Barbier 2018).

Because the poor are disproportionately impacted by climate shocks, climate change-related risks could increase poverty and upend development progress. Countries with higher poverty levels are more vulnerable to extreme weather events. Thus, increases in mortality rates following extreme weather events are generally larger in poorer countries (Kahn 2005). Globally, climate change is expected to push an additional 135 million people into extreme poverty by 2030 (Jafino et al. 2020).

Frequent extreme weather events strain South Asia's weak fiscal positions. The limited fiscal space also hampers the governments' to provide the climate adaptation infrastructure and support that are crucial for offsetting the impact of extreme weather events and expediting recovery (World Bank 2021a).

Risk of social unrest

Despite rapid improvement in per capita incomes over the past decade, people's life satisfaction has trended down relative to other EMDEs and growth remains below pre-pandemic rates in all South

Asian countries other than India (figure 1.10). There has been considerable social unrest and political instability in the region over the past five years. More large-scale protest events have taken place in South Asia since 2022 than in other EMDE regions except one (Europe and Central Asia).

If there were renewed social unrest or political instability in the region, the growth outlook would likely worsen. Around the world, past social unrest has been linked to diminished investor confidence, weaker financial market performance, and slower output growth (Acemoglu, Hassan, and Tahoun 2018; Ghosh 2016). The effects have been more pronounced following more prolonged periods of unrest, larger in more authoritarian regimes, and larger around violent uprisings than around collective protests (Ghate, Le, and Zak 2003).

The effects can be long-lived and larger in countries with weak institutions and limited policy space (Hadzi-Vaskov, Pienknagura, and Ricci 2023; Saadi Sedik and Xu 2020). This is a challenge for South Asia, where regulatory quality is weaker and public debt higher than in most other EMDE regions. Conversely, like other crises, social unrest may be an opportunity for emerging markets to implement the needed economic reforms (World Bank 2024f).

Reform slippages and policy mistakes

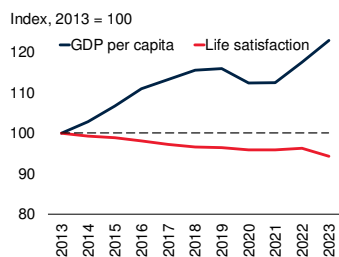
Most countries in the region are planning ambitious reforms, in some cases as part of IMF-supported programs (*Bangladesh*, *Nepal*, *Pakistan*, and *Sri Lanka*) or World Bank projects. The growth forecasts assume that policies will be implemented as planned and policy responses to unanticipated shocks will be appropriate.

Bangladesh plans to carry out financial sector and other reforms to help diversify its economy and build resilience. *Bhutan*'s Gelephu project aims to enhance infrastructure, economic development, and regional connectivity (World Bank 2024g). *India* plans to boost employment and increase worker skills, improve productivity and resilience in agriculture, and promote investment in manufacturing and services. *Maldives* plans to rationalize spending and reform state-owned enterprises. *Nepal* is negotiating trade and FDI agreements with Bangladesh and India.

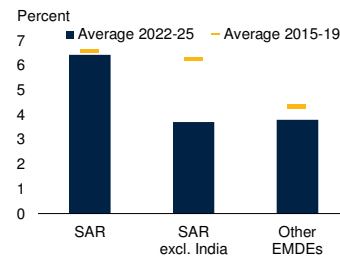
FIGURE 1.10 Risk of social unrest

Life satisfaction in South Asia has declined relative to other EMDEs over the past decade, and output growth outside India has slowed markedly since the pandemic. There have been more large-scale protests in South Asia than in most other EMDE regions. Studies suggest that economic disruptions from social unrest and political instability tend to be largest in countries with weak regulatory quality.

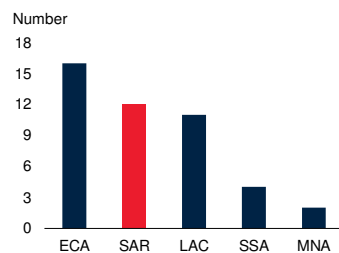
A. South Asia: GDP per capita and life satisfaction, relative to other EMDEs



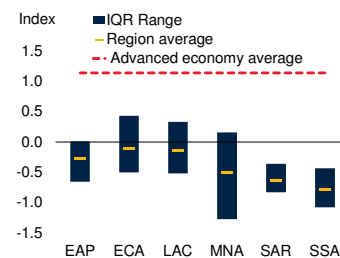
B. South Asia: Output growth



C. Large protest events, 2022–May 2024



D. Regulatory quality, 2018–22



Sources: Global Protest Tracker (database); *Macro Poverty Outlook* (World Bank); World Bank; World Development Indicators (database); World Values Survey (database); Worldwide Governance Indicators.

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

A. Chart shows trends in GDP per capita (PPP in constant 2021 international dollars) and life satisfaction in South Asia relative to other EMDEs over the past ten years. Survey data are interpolated within countries. For countries with only one survey observation, data are assumed constant for the two years prior and after. The regional aggregation uses population as a weight and is then normalized to 2013 = 100. The final series displays trends in South Asia relative to other EMDEs.

C. Large events are defined as having a peak crowd size of above 10,000 people.

D. For each EMDE region, the bar shows the inter-quartile range in the region averaged over 2018–22, with the yellow line indicating the regional average, and the dashed red line showing the advanced-economy (“AE”) average. Scores range between -2.5 and 2.5. The aggregate number is an unweighted average.

Pakistan plans to privatize loss-making state-owned enterprises to reduce fiscal costs and improve efficiency. *Sri Lanka* has announced reforms to state-owned banks and plans further tax, trade, and investment reforms.

In addition, growth forecasts are predicated on the assumption that significant debt vulnerabilities will be addressed in *Maldives* and debt restructuring is successful in *Sri Lanka*. Delays in reaching an agreement with creditors, or failure to reach agreement, could put pressure on foreign reserves, increase fiscal costs, and diminish investor confidence.

Failure to implement planned policy reforms, or other policy missteps, could set back growth prospects. In *Pakistan*, political polarization has led to frequent government changes, which have contributed to delays in program implementation and a lack of consistency in policy direction. Renewed political tensions could lead to fiscally unsustainable policy decisions, particularly in the energy sector (World Bank 2024h). In *Bangladesh*, policy uncertainty could delay the implementation of planned reforms. *Maldives* is at a high risk of external and overall debt distress, and is highly vulnerable to rising sea levels and sea temperature. Failure to implement planned fiscal reforms could culminate in a crisis and delay measures to strengthen climate resilience (World Bank Group 2024).

Effects of reform delays could be particularly severe in countries where IMF support is critical to sustaining investor confidence. If confidence falters, capital outflows and fund withdrawals from financial systems could increase the risk of financial, fiscal, and currency pressures, raising borrowing costs for both governments and the private sector (World Bank 2024d). Private sectors could then cut back further their already-weak private investment.

Consider a scenario in which reform implementation is delayed and private investment in 2025–26 falls below the baseline by 1 percentage point of GDP per year—an effects that would be on par with the largest annual decline in South Asia’s private investment during 2015–19. In this scenario, model simulations suggest that South Asia’s output growth would be 0.5 percentage point lower per year over 2025–26 (figure 1.11). Labor productivity growth typically increases by 0.3 percentage point per year following successful reforms (World Bank 2020a). If, in addition to lower private investment, annual productivity growth was 0.3 percentage point lower due to delays in reform, then output growth would be 0.8 percentage point lower each year during 2025–26.

Several governments have implemented industrial policies intended to support domestic production or employment in priority sectors. These include *India*’s Production-Linked Incentives; *Bangladesh*’s policy to boost domestic technology; and *Pakistan*’s industrial park policies. The risk remains

that these fail to deliver on their goals and, instead, increase fiscal burdens, spending rigidities, and inefficiencies in resource allocation. As discussed below, historical evidence suggests that industrial policies can tackle market failures, such as environmental pollution, and drive meaningful structural change—provided the policies are implemented in the right enabling environment.

Geoeconomic fragmentation

Global trade growth has weakened over the past decade, in tandem with declining global output growth. Much of this slowdown originated in the major economies—including China, the United States, and the euro area—amid rising trade tensions and growing use of restrictive trade measures (figure 1.12). Some of these restrictions have been motivated by conflicts in Ukraine and the Middle East, and others by supply chain and security concerns (Evenett et al. 2024).

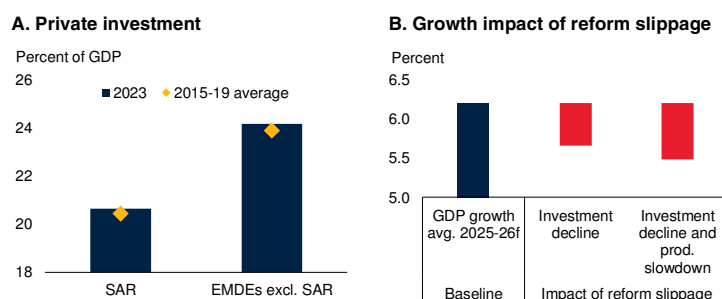
An intensification of such trade fragmentation motivated by geopolitical tensions (“geoeconomic fragmentation”) could further deepen the slowdown in trade growth already projected in the baseline for the forecast period (World Bank 2024c). Historically, countries’ increased participation in global markets, especially through global value chains, has been a driver of economic growth and poverty reduction in EMDEs (World Bank 2020b). A further slowdown in trade growth could diminish output and productivity growth by limiting competition, technology diffusion, and capital accumulation and by restricting local firms’ access to less costly inputs sourced from the global market.

Geoeconomic fragmentation may also obstruct the global energy transition. If geopolitical fragmentation limits access to the cost effective technologies produced by other EMDEs, EMDEs may struggle to transition to sustainable energy sources (Cerdeiro et al. 2024).

For South Asia, the risks from geoeconomic fragmentation are limited. Most South Asian countries rank among the least open EMDEs in terms of global trade, investment, and bank lending (box 1.1; World Bank 2024a). However, pockets of South Asia’s economic activity are highly sensitive to geopolitical risks. *Sri Lanka’s*

FIGURE 1.11 Risk of reform delays

Delays in planned reforms could create fiscal and currency pressures, further delaying accelerations in investment, productivity, and output.



Sources: *Macro Poverty Outlook* (World Bank) and World Bank.

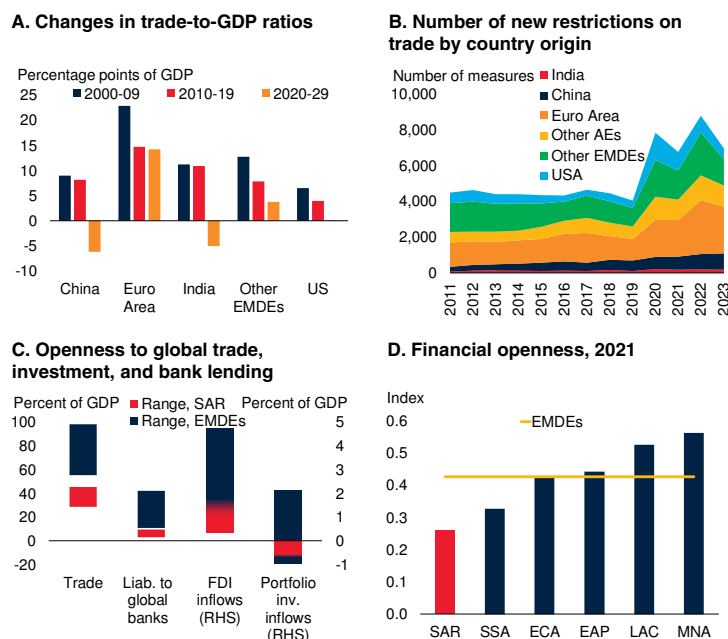
Note: f = forecast. avg. = average; EMDEs = emerging market and developing economies; prod. = productivity; SAR = South Asia.

A. Sample comprises 89 countries of which 5 are in South Asia.

B. The simulated impact of reform slippage assumes that fixed capital investment is, on average, one percentage point of baseline GDP lower in each year over 2025–26, and that the increase in trend productivity growth is 0.3 percentage point lower annually. South Asia excludes Afghanistan and Bhutan due to lack of data.

FIGURE 1.12 Risk from geoeconomic fragmentation

Geopolitical considerations of larger countries have contributed to a growing number of trade restrictions. Global trade growth has slowed since the first decade of the 2000s. South Asia’s low integration in global trade and FDI lowers the risk of geopolitical tensions.



Sources: Balance of Payments Statistics (IMF); Chinn and Ito (2008); Global Trade Alert (database); International Investment Position Statistics (IMF); World Bank; World Bank Enterprise Survey (database); World Development Indicators (database); *World Economic Outlook* (IMF); WTO World Tariff Profiles (database).

Note: AE = advanced economies; EAP = East Asia and Pacific; ECA = Europe and Central Asia; EMDEs = emerging market and developing economies; FDI = foreign direct investment; inv. = investment; LAC = Latin America and the Caribbean; liab. = liability; MNA = Middle East and North Africa; SAR = South Asia; SSA = Sub-Saharan Africa.

A. Chart shows the change in trade-to-GDP ratio during each of the three decades. Trade in future years is based on projections in the IMF’s *World Economic Outlook* database. Other EMDEs comprise 76 economies.

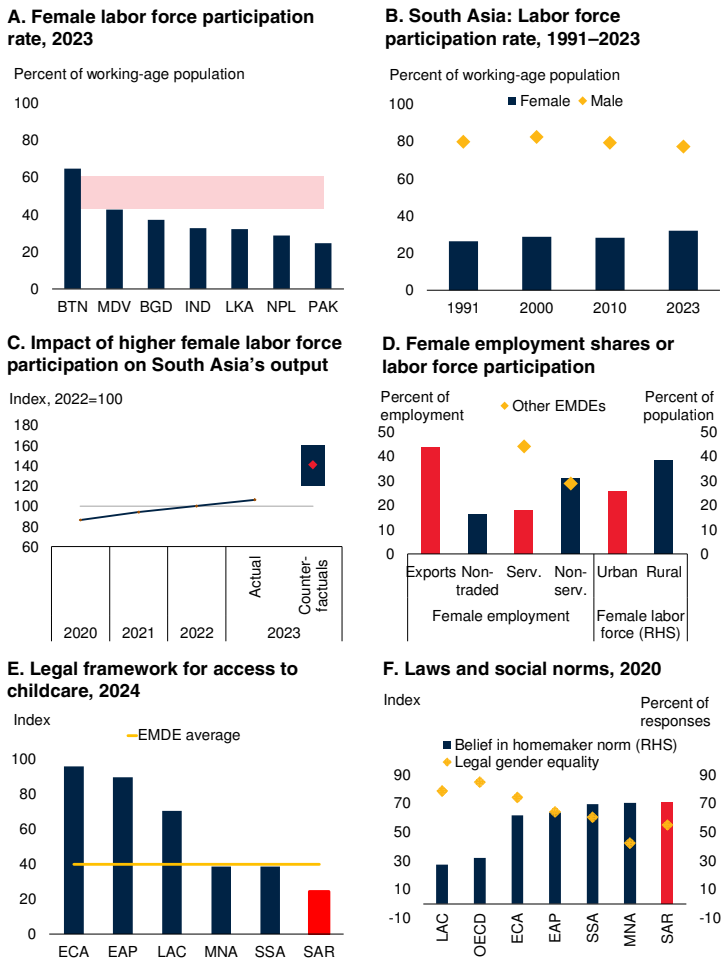
B. Sample comprises 187 economies.

C. Trade is defined as the sum of goods and services exports and imports. Excludes small states and Afghanistan.

D. Bars show the normalized Chinn-Ito Index for the year 2021. Sample comprises 136 countries of which 7 are in South Asia. Simple average of country groups.

FIGURE 1.13 Raising female labor force participation

Female labor force participation rates in most South Asian countries are in the bottom quartile among EMDEs and far below male participation rates. Female labor force participation is held back by supply-side constraints, restrictive laws, and conservative social norms, despite economic shifts that typically favor female employment.



Sources: Global Labor Database (World Bank, labor force survey microdata); ILOStat (International Labour Organization); Women, Business and the Law (World Bank); World Bank; World Bank-Facebook Survey on Gender Equality at Home; World Development Indicators (database).

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

A. Shaded region indicates interquartile range of non-South Asia EMDEs, weighted by working-age population. Female (male) labor force participation rate is the share of the female (male) working-age population (15+) employed or looking for work, using ILOStat modeled data. Afghanistan has not published any official statistics since 2021.

B. Female (male) labor force participation is the share of working-age women (men) aged 15 to 64 who are employed or looking for work.

C. Box indicates the range of model projections of the impact on South Asia's regional real GDP if female employment is raised to parity with male employment. Black line indicates prior GDP data from 2020–23. See chapter 2 and annex 2.2 for details on the models.

D. Bars indicate the female share of employment in export, non-traded, services, or non-services sectors, as well as the female labor force participation of urban and rural women in South Asia. Diamonds indicate values in other EMDEs. Export sectors are defined as in chapter 2. Female shares of services and non-services sectors come from ILO, and are the averages of 2021–23 weighted by female population in 2023. Female labor force participation rates come from GLD and SARLD microdata for: 2022 for BGD and IND, 2021 for LKA, 2020 for PAK, and 2017 for NPL.

E. Bars show the regional average score of childcare from the World Bank's Women, Business and the Law database, which measures the adequacy of legal frameworks concerning the availability, affordability, and quality of childcare. Regional averages are weighted by working-age population.

F. Bars show the share of respondents who agreed with the "female homemaker" norm by region, with data is from 2020. Diamonds represent the average legal index score by region. All regional averages are weighted by working-age population.

debt restructuring involves countries from both sides of the geoeconomic fault line and *Maldives* relies on tourists from both Europe and China.

Policy challenges

In the short term, South Asia's growth prospects are robust. The region has considerable untapped potential to raise them further over the medium term. Raising employment among women to levels comparable to male employment could raise per capita incomes by as much as one-half over the long term. Enhancing openness to global trade and investment, along with removing obstacles to the growth of firms, could attract foreign investment, accelerate the diffusion of new technologies, and spur the private investment needed for productivity growth and job creation.

Raising female labor force participation

Three decades of rapid economic growth in South Asia have been accompanied by major structural changes, including trade liberalization, a sectoral shift toward service-oriented activity, and legal changes favoring greater gender equality. Nevertheless, the region's employment rates among women remain exceptionally low (chapter 2). Female labor force participation rates in all South Asian countries except Bhutan are 5–25 percentage points lower than would be expected based on their per capita incomes.

Most of the women who would typically be employed are absent from the labor force entirely. Only 32 percent of working-age women in South Asia (excluding Afghanistan) were in the labor force in 2023—well below the 77 percent participation rate of South Asian men and the 54 percent EMDE average for women (figure 1.13). Across the region, female labor force participation is low, even across subnational areas.

Low female employment means a substantial loss of aggregate and per capita incomes. Raising women's labor force participation rate to parity with men would increase regional GDP by 13–51 percent, with larger impacts if capital and labor markets are more flexible.

Typically, the transition to services-based and more export-oriented economies is accompanied by rising demand for female labor (Petrongolo and Ronchi 2020). Indeed, women in South Asia earn substantial wage premiums in the services sector and export-oriented firms. And yet, female employment shares are low in key services sectors that, in other EMDEs, employ large shares of women.

The shortfall of female labor force participation and employment is most pronounced after marriage. Women in South Asia reduce their employment rates by 12 percentage points upon marrying, even before they have children (Rexer and Triyana 2024).

Despite a narrowing of the gender gap in education across South Asia, a lack of childcare, unsafe transport, limited mobility, and conservative social norms continue to act as barriers to female employment. On the demand side, hiring discrimination constrains female employment: a recent experiment revealed that employers in Pakistan would require a 15 percent wage subsidy to hire a woman (Bussolo et al. 2024).

South Asian countries have legal frameworks that are among the least favorable to gender equality in the world. They also have some of the globe's most conservative gender attitudes, with 70 percent of the population expressing opposition to women working outside the home. Both conservative social norms and legal institutions tend to be associated with low female labor force participation. Low female labor force participation in South Asia may also reflect large labor market frictions, including limited access to employment networks (Anukriti et al. 2020) and information asymmetries (Jensen 2012).

The diversity of factors influencing female labor force participation underscores the need for a multi-pronged policy effort. On the supply side, obstacles to women's desire to work outside the home—such as the lack of safe transport or quality childcare, as well as the legal biases—need to be removed. Increased use of working-from-home arrangements could help increase female employment within prevailing social norms (Jalota and Ho 2024).

On the demand side, a shift toward more export-oriented and more services-based economies would benefit female employment. Local labor markets in South Asia with greater export exposure have had higher rates of female labor force participation. Increased trade integration could bring more women into the workforce, provided local firms become sufficiently productive to compete in export markets.

Policies to promote female employment will be more effective if combined with a shift in gender norms. For example, increased visibility of female role models in public life (Beaman et al. 2009; Deininger et al. 2022; Pande 2003), information provision (Bursztyn et al. 2023), and women's economic empowerment (Field et al. 2021) have all been shown to shift gender norms and increase female employment.

Reducing impediments to the growth of firms

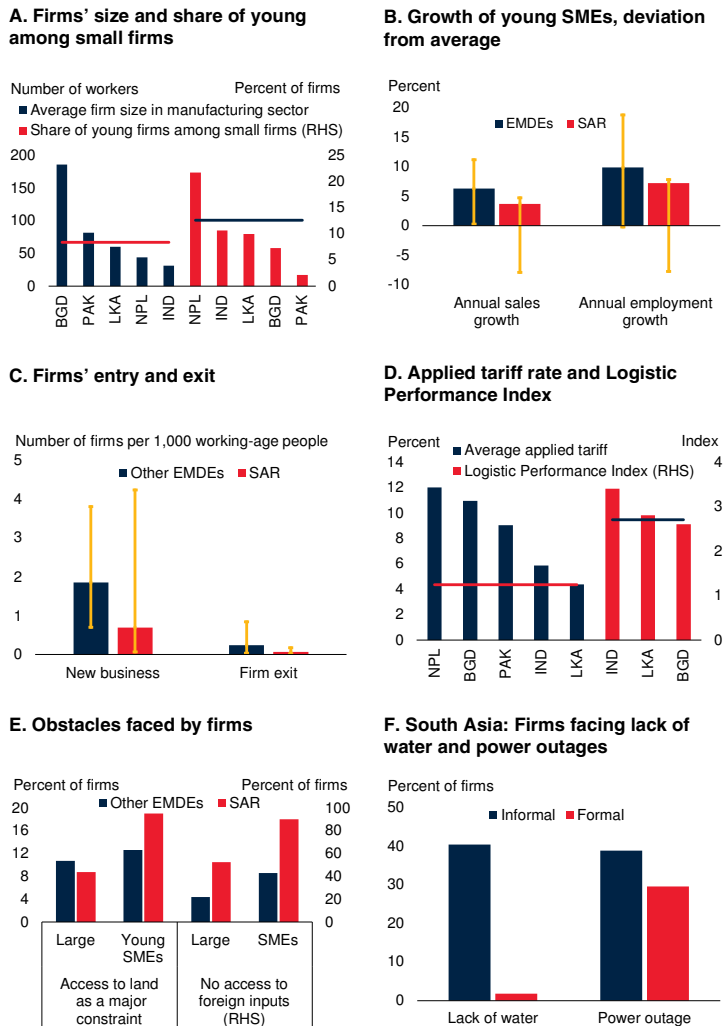
Growth of firms is crucial for rapid job creation and the expansion of private investment growth. As firms grow, they help create more, and more productive, jobs in the non-agricultural sector, where South Asia is lagging well behind other EMDEs (World Bank 2024d). Non-agricultural job creation is critical for climate adaptation by households (Rexer and Sharma 2024). More dynamic and faster-growing firms as well as fewer barriers to firm entry and exit could also support investment.

Faster growth of firms can result both from existing firms adopting new practices and technologies, and from the entry of more dynamic new firms into the market, with firms that are less productive exiting and releasing resources for more productive uses (Aghion and Howitt 1992; Akcigit 2024; Akcigit and Kerr 2018). Studies suggest that 50 to 70 percent of productivity growth results from resource reallocation among firms (Foster, Haltiwanger, and Krizan 2001; Lentz and Mortensen 2016).

In South Asia, firms often remain small and unproductive, in part because of policies that favor smaller establishments (World Bank 2024f). Compared with EMDEs in other regions, the average firm in India and Nepal is smaller than in other EMDEs, and the average small firm in all

FIGURE 1.14 Reducing impediments to the growth of firms

Young, small, and medium-sized firms in South Asia face greater impediments to growth than their peers elsewhere and grow more slowly. Additionally, the region's large number of informal firms face



Sources: Entrepreneurship Database (World Bank); World Bank; World Bank Enterprise Survey (database); World Development Indicators (database).
 Note: BGD = Bangladesh; EMDE = emerging market and developing economies; IND = India; LKA = Sri Lanka; NPL = Nepal; PAK = Pakistan; SAR = South Asia; SME = small and medium enterprises.
 A. Horizontal lines mark the median level firm size in manufacturing and share of young firms (five years old or younger) among small firms in other EMDEs.
 A.B.E. Young firms are firms that are five years old or younger. SMEs have 99 employees or fewer. Small firms have 20 employees or fewer. For the World Bank Enterprise Surveys, the South Asia sample comprises Bangladesh, India, Pakistan for 2022, Nepal for 2023, and Sri Lanka for 2011. EMDEs comprise 71 countries between 2017 and 2023. Total sample comprises 59,117 firms.
 B. Chart shows the deviation of the growth of young SMEs from the average growth of all firms in all countries, adjusted for country-level sector composition. This is estimated using OLS regressions of firms' annual growth on year and sector fixed effects.
 C. For new business, the South Asia sample includes Bhutan, India, Maldives, Pakistan, and Sri Lanka for 2022, and Nepal for 2020. EMDEs comprise 99 countries between 2020 and 2022. For firms' exit, the South Asia sample is India, Maldives, Pakistan, and Sri Lanka for 2022. EMDEs comprise 60 countries between 2020 and 2022.
 D. Average applied tariffs are trade-weighted in 2021. The Logistic Performance Index is for 2023. Horizontal lines mark the median level of other EMDEs, which include 47 economies for applied tariff and 94 economies for the Logistic Performance Index.
 F. For informal firms, South Asia uses 2021 data for India and 2022 data for Bangladesh and is the weighted average using real GDP in 2010–19 at average market prices and exchange rates.

South Asian countries except Nepal is older (figure 1.14). Young small and medium enterprises (SMEs) in South Asia grow more slowly in sales and employment than their peers in other EMDEs. Firms' entry and exit rates in South Asia are considerably lower than in other EMDEs, suggesting scope for greater competition.

South Asia's unusually small average firm size is accompanied by unusually large informal sectors. Close to 90 percent of workers in South Asia work in the informal sector, compared with 50 percent in other EMDEs. Nearly two-fifths of the world's informal workers are in South Asia (Ohnsorge and Yu 2022). Informal firms grow more slowly and are less productive, with sales per worker only 15 percent of those in formal firms (La Porta and Shleifer 2014). Compared with formal firms, informal firms in South Asia face greater operational disruptions, such as water or electricity outages, which set back their growth and deter innovation.

The literature has identified several common impediments to the growth of firms.

- *Lack of economic openness.* South Asia is more closed to international trade than other EMDE regions (box 1.1). This is associated with slower adoption of more advanced foreign technologies and practices, which tends to hold back growth (Coe and Helpman 1995; Keller 2004; World Bank 2024f). Trade and FDI are more restricted in South Asian countries than in other EMDEs, as reflected, for example, in higher applied tariff rates. Bangladesh and Bhutan exhibit lower logistics performance than other EMDEs. In Pakistan, increased import duties on intermediate inputs have been associated with lower productivity of firms (Lovo and Varela 2022; World Bank 2022b).
- *Inefficient land and product markets.* Land markets in South Asia are characterized by restrictive tenancy laws and poor quality of land records, which manifest in unusually low levels of land sales and use of land rental agreements (Bolhuis, Rachapalli, and Restuccia 2021; Vos 2019). Inefficient land markets are a significant constraint on young SMEs in South

Asia, more so than for large firms in the region or young SMEs in other EMDEs, preventing them from using land to secure finance or expand production. Compared with their peers in other EMDEs, SMEs in South Asia are also less likely to use inputs sourced from foreign markets in their production and hence less likely to benefit from lower production costs and higher productivity.

- *Government regulations.* Regulations can dampen business dynamism (Bachas, Fattal Jaef, and Jensen 2019; Dabla-Norris et al. 2018). More young SMEs in South Asia report that they encounter corruption and spend more time on regulatory compliance than in other EMDEs. Corruption and compliance costs divert resources from production and innovation and discourage informal firms from formalizing (Buera and Fattal-Jaef 2018; Li and Rama 2015). Size-dependent policies encourage firms to stay small (World Bank 2024f).
- *Large incumbents and market concentration.* Incumbent firms may collude to raise the barriers to entry, preventing new, more productive firms from entering the market and slowing productivity growth (Akçigit, Baslandze, and Lotti 2023; Cunningham, Ederer, and Ma 2021). State-owned and private conglomerates play critical roles in energy, infrastructure, food, and transportation in many South Asian countries, with the largest competitors having significantly higher market shares than their peers in EMDE regions.

These common obstacles tend to keep young SMEs in South Asia small and unproductive. Reforms that increase openness to global trade and investment, enhance the efficiency of input markets and improve governance could stimulate the growth of firms in the region.

- *Greater openness to global trade and investment.* Reducing tariff and non-tariff barriers to trade and easing restrictions on FDI can foster competition, encourage firms' entry and exit, and incentivize incumbents to upgrade

productivity. Less restrictive capital controls could help firms purchase advanced technologies from abroad (World Bank 2024f). Successfully competing in international trade is a strong signal that local firms are becoming more productive and attaining global standards rather than benefiting from a protected position in the domestic market.

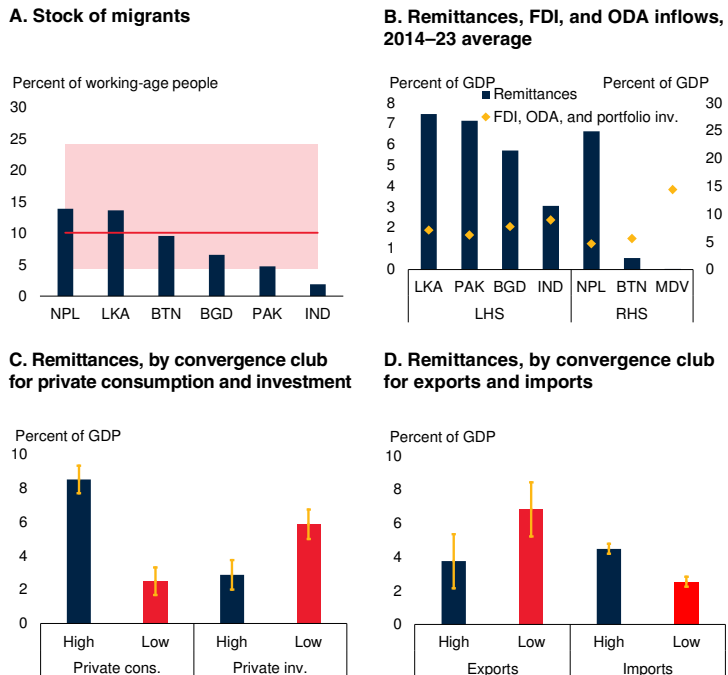
- *More efficient input markets.* Creating and maintaining up-to-date land registries, revising land regulations to improve security of tenure, and removing barriers to land rental and sales could help create more efficient land markets (Chen, Restuccia, and Santaaulalia-Llopis 2022; Deininger and Feder 2001; Fenske 2011; Lawry et al. 2017). The spread of digital payment systems could provide opportunities to expand access to finance (Balyuk 2023; Dubey and Purnanandam 2023; Gopal and Schnabl 2022).
- *Regulatory and policy reforms.* Streamlining administrative processes, including moving compliance processes online, could reduce regulatory burdens on firms and curtail opportunities for corruption. Size-dependent policies, which may inadvertently encourage firms to remain small, could be relaxed. For example, the removal of India's Small-Scale Reservation Laws has been found to promote firm growth and job creation (Martin, Nataraj, and Harrison 2017).
- *Disciplining incumbents.* Competition policies could level the playing field to allow greater firm entry and exit. This requires strong institutions to prevent large incumbents from abusing market power (World Bank 2024f). A relaxation of size-dependent policies could weaken incentives to remain small.

Making the most of remittances

Poor prospects for non-agricultural jobs and income growth have contributed to large-scale emigration from South Asia. The remittances sent home by the diaspora now far exceed FDI, development financing, and portfolio inflows

FIGURE 1.15 Boosting and using remittances

South Asian countries have large remittance inflows, which have tended to be associated with lower private investment, exports, and non-agricultural employment.



Sources: *Macro Poverty Outlook* (World Bank); United Nations; World Bank; World Development Indicators (database).

Note: BGD = Bangladesh; BTN = Bhutan; cons. = consumption; EMDE = emerging market and developing economies; FDI = foreign direct investment; IND = India; inv. = investment; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; ODA = official development assistance; PAK = Pakistan.

A. Data is from 2020. Pink shaded region is the interquartile range of other EMDEs. Red line refers to median level of other EMDEs. Other EMDEs comprise 137 economies.

B. Remittances as a percent of GDP, and the sum of FDI, ODA, and portfolio inflows as a percent of GDP for each SAR country except Afghanistan.

C.D. Bars show average remittances as a percent of GDP for countries in the high and low convergence club during 1990–2022. “High” indicates the convergence club with the highest private consumption, private investment, goods and services exports, or goods and services imports as a percent of GDP; “low” indicates the club with the lowest private consumption, private investment, exports, or imports as a percent of GDP. Whiskers indicate 90 percent confidence intervals.

combined in all South Asian countries except for Bhutan and Maldives (figure 1.15).

Remittances tend to increase household incomes, improve education and health outcomes, and help smooth consumption around domestic income shocks. However, large-scale remittances can create real exchange rate appreciation pressures that dampen the most productivity-enhancing engines of growth: private investment, exports, and non-agricultural sector activity (spotlight 2). Indeed, countries, including those in South Asia, that have had higher remittances have also had lower private investment, lower non-agricultural employment ratios, and weaker exports—all challenges with which most South Asian countries have been struggling (World Bank 2023a, 2024d).

To better leverage remittances as a powerful source of inclusive growth, policy measures can encourage remittance inflows through official channels, such as by reducing fees on remittance transfers. Policies can also limit the adverse side effects of large remittances. For example, tax structures can be shifted away from trade and labor to encourage trade and job creation. Better business climates can support firms that face competitive pressures from real exchange rate appreciation. Measures to encourage domestic job creation can help reduce the number of people seeking opportunities abroad, increasing output and reducing any distortions from large remittance flows.

Implementing well-designed industrial policy

Industrial policies have been used to promote growth in priority sectors around the world. Between 2017 and 2022, the use of industrial policies surged six-fold (Juhász, Lane, and Rodrik 2024). These policies had a spectrum of economic objectives, from stimulating innovation, productivity, and economic growth, to facilitating climate transition, creating quality jobs, and promoting exports or import substitution. Industrial policies can take various forms, including subsidies, import protection, and regulatory exemptions.

Industrial policies can be helpful in overcoming externalities, such as those associated with pollution or climate change. Green industrial policies have successfully fostered innovation in climate change mitigation, exemplified by Morocco’s solar and wind energy sector and China’s electric vehicle industry (Altenburg, Feng, and Shen 2017; Vidican Auktor 2017). In South Asia, industrial policies appear to have been motivated more by the objectives of strategic competitiveness and resilience in non-food supply, and less by climate change, than in other EMDEs (figure 1.16).

Historically, countries including Japan in the 1950s, the Republic of Korea in the 1970s, and China since the 1990s, have utilized industrial policies to foster growth in specific sectors (Juhász, Lane, and Rodrik 2024; Song, Storesletten, and Zilibotti 2011). But industrial policies have often disappointed, such as in Africa and Latin America.

A large body of studies suggests that industrial policies can be successful in driving structural change given the right implementation and institutional setup (Aghion et al. 2015; Choi and Levchenko 2021; Liu 2019).

Since 2009, advanced economies have outpaced EMDEs in adopting industrial policies (Juhász et al. 2022). Nearly half of all industrial policies implemented in 2023 originated in the largest economies—China, the European Union, and the United States—at fiscal costs of 0.3–1.5 percent of GDP (DiPippo et al. 2022; Evenett et al. 2024). Current industrial policies are typically geared toward promoting exports, in contrast to the inward-looking, protectionist policies of the past. Recently, policies have often been applied to specific firms, rather than the broad import tariffs characteristic of earlier industrial policies (Juhász et al. 2022).

In 2023, South Asian countries implemented over 140 new industrial policies, a significant increase from an average of 44 per year during 2009–19 (Juhász et al. 2022). The policies introduced in recent years have yielded varying outcomes.

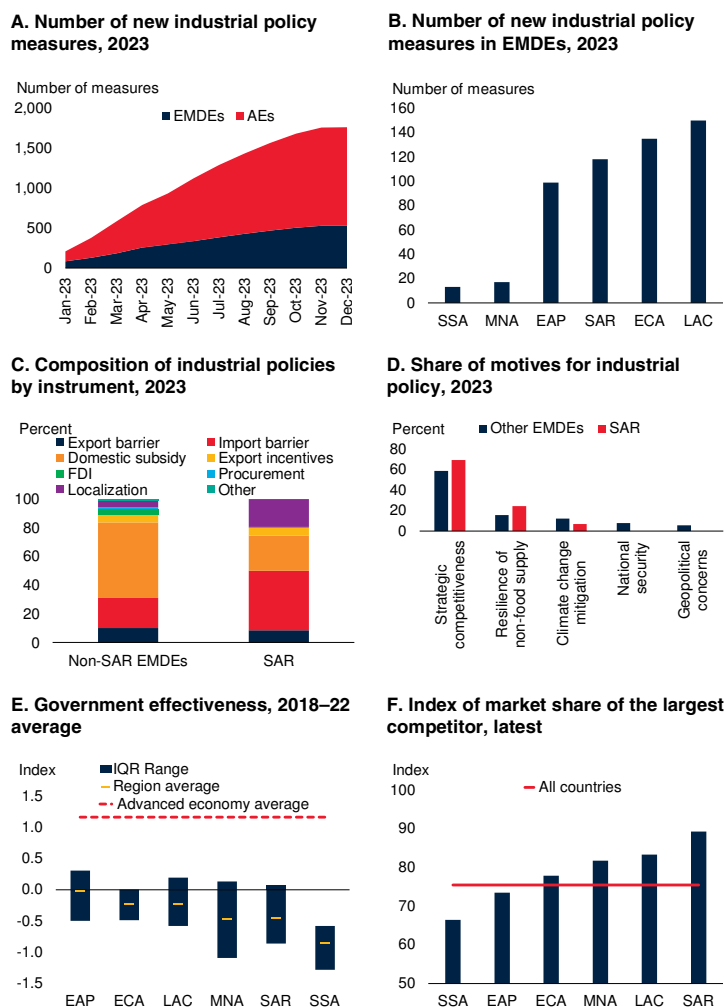
India's “Production Linked Incentives” scheme targets 14 key sectors and has been accompanied by significant FDI and exports in electronics, medical devices, and pharmaceuticals, although not in other targeted sectors such as textiles (Shukla 2024). The scheme offers incentives of up to 20 percent on the value added by successful applicant firms for up to five years (Government of India 2024).

In *Bangladesh*, industrial policies aimed at boosting domestic technological development and employment—such as technology transfer caps, sectoral equity caps, and stringent controls on expatriate skilled workers—have hindered private investment by preventing a reallocation of credit and labor toward more productive firms (World Bank 2018).

Pakistan's industrial park policies, designed to create clusters of export-oriented, green, and women-friendly industries, have fallen short of expectations, in part because of a failure to select locations suitable to industrial development (World Bank 2021b).

FIGURE 1.16 Implementing well-designed industrial policy

Industrial policy measures have increased since 2017, especially among advanced economies and large EMDEs. Compared with other EMDEs, South Asia's industrial policies have made more use of import barriers and localization approaches, and have been less motivated by climate change mitigation. Limited government effectiveness and competition could curtail the impact of industrial policies in South Asia.



Sources: Global Trade Alert database; New Industrial Policy Observatory; World Bank; World Bank Enterprise Survey (database); World Development Indicators (database); Worldwide Governance Indicators.

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

A. Figure shows the number of trade-distorting new industrial policies implemented in 2023. Aggregate numbers are calculated as unweighted averages.

C. Figure shows the share of distortive industrial policies by policy instrument in SAR and non-SAR EMDEs, 2023. Aggregate number is unweighted average.

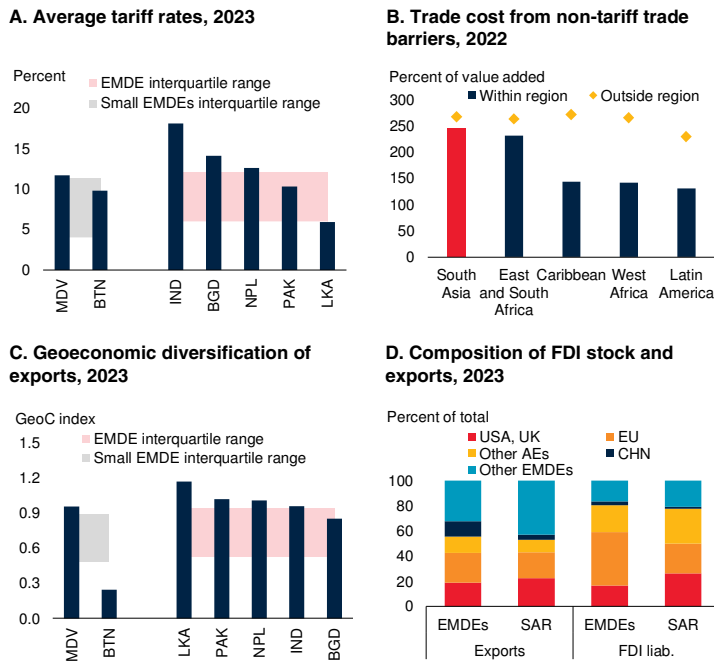
D. Policy measures from 2023. Each policy measure can have more than one motive. “Other EMDEs” comprise 30 jurisdictions, including the economic areas of Eurasian Economic Union, the Gulf Cooperation Council, Mercosur, and Southern Africa Customs Union. South Asia comprises Bangladesh, India, Nepal, and Pakistan.

E. Figure shows worldwide governance indicator (2018–22 average). The yellow line shows EMDE regional average, the blue bar shows the interquartile range in each EMDE region, and dashed red line shows the advanced economy average. The Worldwide Governance index captures perceptions of the quality of public services, the quality of the civil service and its independence from political pressures, the quality of policy formation and implementation, and the credibility of the government's commitment to these policies. WGI scores range between -2.5 and 2.5. Aggregate number is unweighted average.

F. Index reflects the market share of firms' largest competitor, in terms of sales, in the market where these firms sold their main product or offered their main service. Sample comprises 50 EMDEs. South Asia includes Bangladesh, Nepal, and Pakistan. Latest data are from 2021–23.

FIGURE 1.17 Opening to global trade and investment

South Asia has diversified trading partners and sources of foreign investment, but high tariffs and non-tariff restrictions could cause the region to miss out on opportunities created by shifting global value chains.



Sources: Aiyar and Ohnsorge (2024); World Bank; World Development Indicators (database); WTO World Tariff Profiles (database); UN ESCAP-World Bank Trade Costs database.

Note: AEs = advanced economies; BGD = Bangladesh; BTN = Bhutan; CHN = China; EMDEs = emerging market and developing economies; FDI = foreign direct investment; IND = India; liab. = liability; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan; SAR = South Asia.

A. Simple average of the ad valorem most favored nation duties applied in 2023. Sample comprises the South Asian countries and 120 other EMDEs, of which are 25 small states.

B. Chart shows the non-tariff component of costs of goods traded internationally (within and outside the region) in excess of the same goods traded domestically, expressed as ad valorem tariff equivalents. Regional groups are South Asia (South Asian Association for Regional Cooperation), East and South Africa (Common Market for Eastern and Southern Africa), Caribbean (Caribbean Community), West Africa (Economic Community of West African States), and Latin America (Southern Common Market). Data are for 2022. Bilateral trade costs, defined as the excess cost of a good traded internationally compared with the same good traded domestically, are expressed as ad valorem tariff equivalents. When 2022 data are not available, latest available data are used.

A.C. Pink shading denotes interquartile ranges for other EMDEs. Grey shading denotes interquartile ranges for other small states.

C. Geoeconomic diversification is captured by the geoeconomic connectedness index of Aiyar and Ohnsorge (2024).

D. EMDEs consist of 153 economies for exports and 155 economies for FDI.

These examples underscore the need for adequate institutional capacity for effective industrial policy implementation. On average, South Asian countries lag their counterparts in other EMDE regions and advanced economies in government effectiveness. Improved governance practices, including regular and transparent monitoring and evaluation of firms' performance, are crucial to curbing favoritism and ensuring accountability during the implementation of industrial policies (Altenburg and Rodrik 2017). Stronger institutional capacity allows governments to identify sectors in the economy to target (Reed 2024).

It is also important that supported industries face adequate market competition (Cherif and Hasanov 2019). The success of industrial policy in the Republic of Korea relied on intense competition in both domestic and international markets. Product markets in South Asia are often dominated by a few large players that do not face such intense competition. Because global markets are often more competitive than domestic ones, industrial policies that encourage participation in export markets tend to be more successful. However, among export-oriented industrial policies, those that have aimed to attract foreign firms have sometimes disappointed. For example, Malaysia's focus on attracting multinational companies and technology transfers limited the effectiveness of its industrial policy (Cherif and Hasanov 2019).

Successful industrial policies often use a broader range of instruments beyond the traditional subsidies and trade protection measures (Juhász, Lane, and Rodrik 2024). Compared with their EMDE peers, South Asian countries are more likely to rely on import barriers and localization policies. Such policies can discourage trade and FDI, areas where South Asia already lags other EMDEs. Bangladesh, Maldives, and Nepal rely more on subsidies than other EMDEs, which can be fiscally costly. The government of Nepal, for example, provides subsidies of 3–5 percent for the exports of some products. The provision of public services—such as infrastructure, education, and legal systems—that boost local business productivity and that are tailored to business needs, could be a more effective and cost-efficient approach than relying on subsidies or import barriers.

Opening to global trade and investment

With the world economy currently fragmenting along geopolitical fault lines and large economies increasingly implementing industrial policies to protect their interests, South Asia could benefit from policies that promote openness to global trade and investment. This could boost South Asia's non-agricultural job creation, especially for women, foster competition and the growth of firms, improve productivity through technology adoption, and promote more efficient use of remittances.

Currently, trade policies in South Asia are more restrictive than in other EMDEs. Average tariff rates in half of South Asia's countries are in the top quartile of EMDEs (figure 1.17). The costs associated with non-tariff barriers are higher than among countries that are members of other regional trade agreements and are among the highest for goods traded outside regional trade agreements.

South Asia's lack of openness limits its ability to take advantage of the reshaping of global supply chains that is underway. The region has an exceptionally diverse set of export markets and sources of investment, with five countries in the top quartile of comparable EMDE groups for geoeconomic

diversification (box 1.1). Were the region more open, it might be able to leverage its diverse set of trading and investment partners and non-aligned political stance to position itself as a connector that bridges the global geoeconomic divide.

By trading with, and attracting investment from, countries across the geopolitical spectrum, South Asian countries could integrate further into global supply chains. With the increasing global demand for low-carbon goods and services, greening trade could also speed up export diversification (World Bank 2024a, 2024i). Indeed, India recently announced the lifting of import taxes on minerals crucial for the adoption of clean energy.

ANNEX TABLE B1.1.1 Correlates of geoeconomic connectedness

Variables	(1) Exports	(2) Intermediate inputs	(3) Exports	(4) Intermediate inputs
Logistics performance	0.1272** [0.0523]	0.1260*** [0.0418]		
Average tariff			-0.0101** [0.0047]	-0.0117*** [0.0044]
Constant	0.3941*** [0.1443]	0.3924*** [0.1244]	0.8387*** [0.8387]	0.8160*** [0.0465]
Observations	99	99	105	105
R-squared	0.047	0.064	0.031	0.052

Sources: Aiyar and Ohnsorge (2024); World Bank International Logistics Performance Index (database); WTO World Tariff Profiles (database); World Bank.

Note: *** p<0.01, ** p<0.05, * p<0.1. Robust standard errors reported in brackets. Ordinary least squares estimation. All specifications are for EMDEs only. Number of observations reflect number of EMDEs covered in both the respective policy variable and in Aiyar and Ohnsorge (2024).

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