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This report is a joint product of the Office of the Chief Economist for the South Asia Region (SARCE) and the Macroeconomics, Trade and Investment (MTI) Global Practice. Its preparation was led by Robert Beyer (Economist, SARCE) under the oversight of Hans Timmer (Chief Economist, South Asia Region), in close collaboration with Manuela Francisco (Practice Manager, MTI). Substantive contributions were made by Sebastián Franco-Bedoya, Milagros Chocce, Rucheta Singh, Waewnet Sukkasem (all SARCE) and Gonzalo J. Varela (MTI). The report greatly benefitted from inputs from Temel Taskin and other colleagues in the Prospects Group (PG) under the supervision of Ayhan Kose (Director, PG). Useful comments and suggestions were provided by Poonam Gupta, Sebastian Saez, Enrique Blanco Armas, Sanjay Kathuria, Gonzalo J. Varela, Zahid Hussain, Aurélien Kruse, Fernando Gabriel Im, Tae Hyun Lee, Florian Blum, Kene Ezemenari, Rangeet Ghosh, Adnan Ashraf Ghumman, Kishan Abeygunawardana, Nazmus Sadat Khan, Amit Singhi, Thi Thanh Thanh Bui (all MTI) and Rinku Murgai (Lead Economist, Poverty Global Practice), as well as by Christian Eigen-Zucchi (Program Leader, Bangladesh, Bhutan, Nepal CMU) and Tatiana Nenova (Program Leader, Sri Lanka CMU). Colleagues providing information for country briefs include Aurélien Kruse, Tae Hyun Lee, Habiburahman Sahibzada, Zahid Hussain, Yoichiro Ishihara, Tenzin Lhaden, Rangeet Ghosh, Fernando Gabriel Im, Kene Ezemenari, Nayan Krishna Joshi, Enrique Blanco Armas, Zehra Aslam, and Kishan Abeygunawardana under supervision of Manuela Francisco (Practice Manager MTI). Alejandro Espinosa at Sonideas was responsible for the layout, design and typesetting and William Shaw edited the chapters. Alexander Ferguson (Senior Manager) and Yann Doignon (Online Communications Officer) at South Asia External Communications coordinated the dissemination, Gonzalo Alberto Villamizar De La Rosa created accompanying videos, and Neelam Chowdhry and Clydina Luikham Anbiah provided valuable administrative support.

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

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South Asia Chief Economist Office

Macroeconomics, Trade and Investment Global Practice

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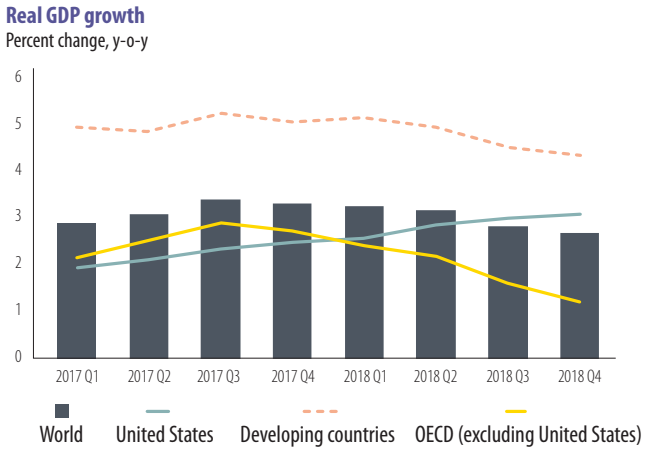
Recent economic developments

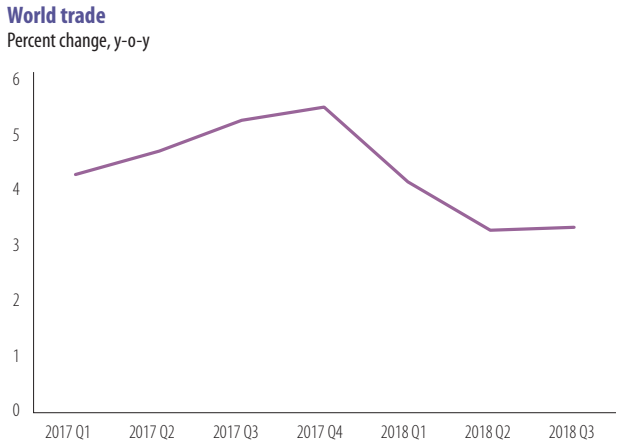
South Asia remained the fastest growing region in the world last year. However, growth moderated from 7.2 percent in 2017 to 6.9 percent in 2018, along with the deceleration of growth in the rest of the world. Regional growth remained driven by domestic demand – and not exports – which resulted in another year of double-digit volume growth of imports. The value of imports was further pushed up by rising oil prices. The widening current account deficits became more difficult to finance after the Federal Reserve gradually tightened monetary policy. These tensions triggered capital outflows, depreciation pressures, increases in credit default swap spreads, and falling stock prices. In some countries the strong growth of domestic demand or currency depreciation led to rising core inflation, although decelerating food prices kept overall inflation below target levels in most countries. In recent months, the data shows a more positive picture. Oil prices declined again at the end of last year. The pressure on exchange rates and reserves eased and exports rebounded. These recent high-frequency data could signal that the challenging situation has bottomed out, but the risks associated with excessive domestic demand growth remain.

Figure 1: Global GDP and trade growth moderated last year.

Global GDP growth slowed from 3.3 percent in the fourth quarter of 2017 to 2.7 percent in the fourth quarter of 2018, driven by moderating growth in developing countries and a strong deceleration in advanced countries excluding the United States. Together with global GDP growth, world trade growth decelerated to 3.9 percent in 2018, down from nearly 5 percent a year before.



Source: World Bank.



Source: World Trade Organization.

Global growth moderated

The growth of global GDP slowed gradually from 3.3 percent in the fourth quarter of 2017 (y-o-y) to 2.7 percent in the fourth quarter of 2018 (Figure 1). The decline was broad-based. Growth in developing countries slowed from 5.1 percent in the fourth quarter of 2017 to 4.4 percent in the fourth quarter of 2018. In OECD countries excluding the United States, growth decelerated strongly from 2.7 percent in the fourth quarter of 2017 to only 1.2 percent in the fourth quarter of last year. Together with global

Figure 2: Oil price volatility remained high and oil prices declined at the end of last year.

The average oil price in 2018 was 72 USD per barrel and hence considerably higher than in 2017. After rising from 66 USD per barrel in January of last year to 85 USD per barrel in October, the price dropped temporarily to a low of 49 USD in January of this year. However, it started rising again and reached 65 USD per barrel at the end of March.

Note: The year 2017 represents the average price in 2017.
Source: Haver Analytics.

GDP growth, world trade growth decelerated. Global trade grew 5.5 percent in the fourth quarter of 2017 but only 4.2 percent in the first quarter of last year and 3.3 percent in the following two. For all of 2018, global trade growth is estimated to have been 3.9 percent.

Oil price volatility remained high and oil was more expensive in 2018 than in 2017 (Figure 2). After rising for most of last year, the price of oil reached 85 USD per barrel in October. It then dropped rapidly at the end of the year and reached a low of 49 USD per barrel in January, which was below the average price in 2017. However, the price reversed course once more and the price reached 65 USD per barrel at the end of March. With an average price of 72 USD per barrel in 2018, the price was still much lower than before the oil price collapse in 2014 – the average price of oil during the first half of 2014 was 109 USD per barrel – but much higher than in 2016 and 2017, when the average price was only 45 USD per barrel and 55 USD per barrel respectively. That said, current accounts in South Asia tend to be resilient to oil prices in the mid-60 USD range. But since South Asian countries are net importers of oil, the high volatility of international oil prices exerts continuously changing pressure on their external balances (see Chapter 3).

South Asia grew fast, but the tide turned

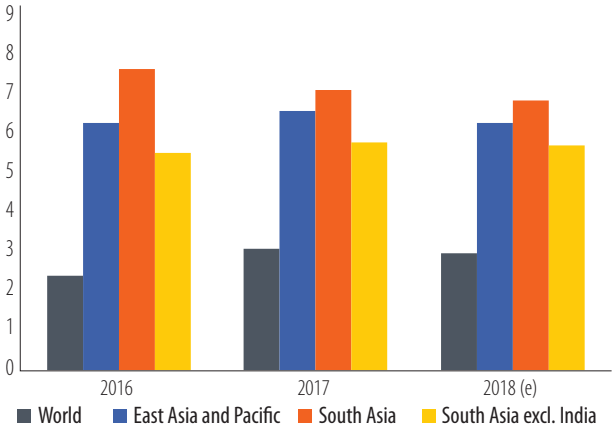
Growth in South Asia remained the fastest in the world, but it moderated for the second year in a row (Figure 3). The region grew by 7.7 percent in 2016, by 7.2 percent in 2017 and by 6.9 percent last year. Growth in East Asia and Pacific, the second fastest growing region, was 6.3 percent last year. As in the past, South Asia excluding India grew much slower, namely at 5.4 percent last year. Only India and Sri Lanka are reporting quarterly GDP growth rates in South Asia. In both countries GDP growth slowed over the course of 2018. India grew above 8 percent (y-o-y) in the first half of 2018, but growth declined to 7.0 percent in the third and to 6.6 percent in the fourth quarter. In Sri Lanka, growth declined from 4.0 percent (y-o-y) in the first quarter to 3.5 percent in the third and dropped to 1.8 percent in the fourth.

Over the last years, growth in South Asia has been driven by domestic demand resulting in high import growth. On average, government consumption in South Asia grew 11.1 percent over the last two years and investment by 9.3 percent (Figure 4a). Both components hence contributed substantially to the high growth over these two years. The strong domestic demand resulted in very high import growth of

Figure 3: South Asia remained the fastest growing region in the world, but growth slightly moderated over the last two years.

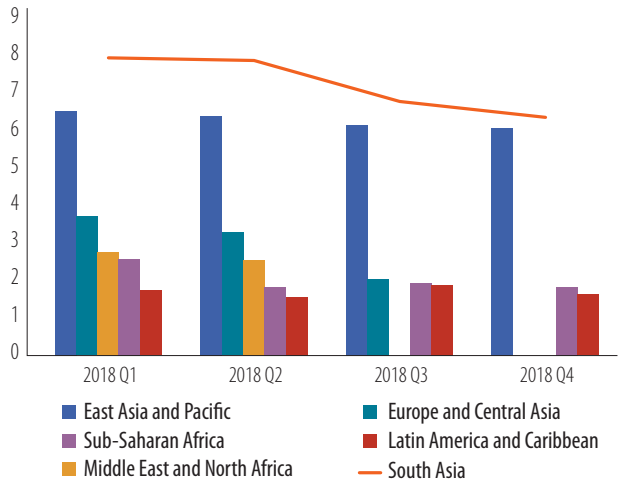
South Asia remained the fastest growing region in the world last year, but its growth moderated slightly from 7.2 percent in 2017 to an estimated 6.9 percent in 2018. Growth in East Asia and Pacific, the second fastest growing region in the world, declined from 6.6 percent to 6.3 percent.

Annual real GDP growth in the world, East Asia Pacific and South Asia
Percent change, y-o-y



Note: Real GDP growth is in calendar years.
Source: World Bank.

Regional quarterly real GDP growth
Percent change, y-o-y



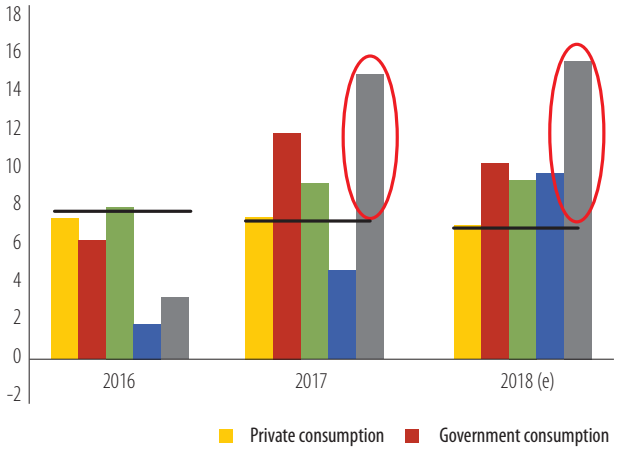
Notes: Data is for countries that report quarterly data. In South Asia this is only India and Sri Lanka.
Source: World Bank.

Figure 4: Growth last year continued to be driven by domestic demand resulting in high import growth.

In the last two years, government consumption and investment grew fast in South Asia. The former averaged 10.3 percent compared to 6.3 percent in 2016 and the latter 9.4 percent compared to 8.0 percent in 2016. The strong domestic demand resulted in very strong import growth of around 15.6 percent in both years, which is nearly twice as high as export growth.

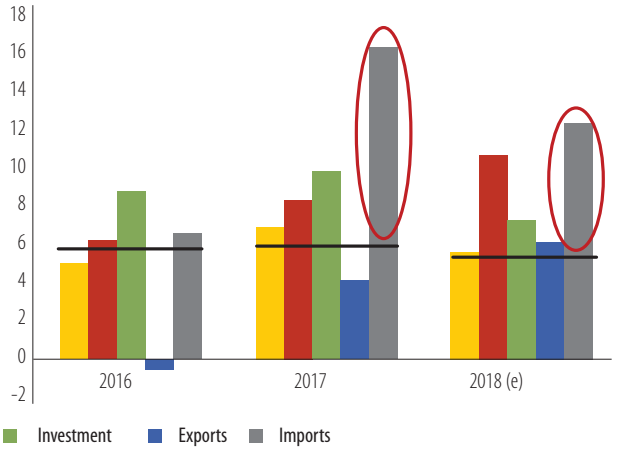
a) South Asia

Volume growth of GDP components in South Asia
Percent change, y-o-y



b) South Asia excluding India

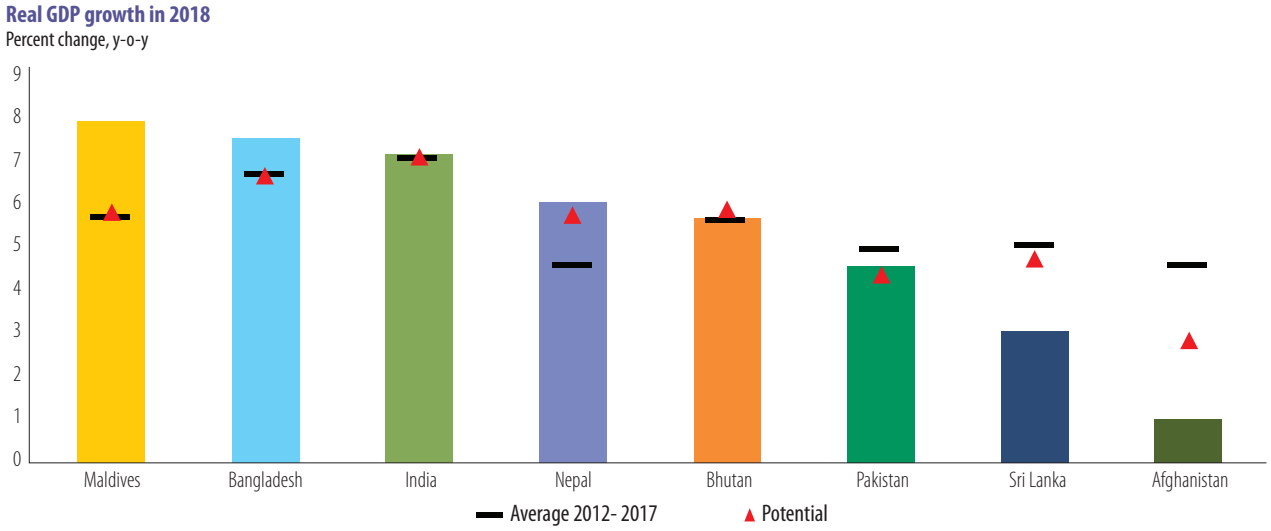
Volume growth of GDP components in South Asia excl. India
Percent change, y-o-y



Notes: The horizontal line represents the real GDP growth. All variables are in calendar years.
Source: World Bank.

Figure 5: Fewer countries are still growing above their potential and long-run averages.

Growth rates differ across South Asian countries and fewer countries grew above their potential last year. Maldives, Bangladesh, and India headed growth in 2018 and Afghanistan continued to lag behind.



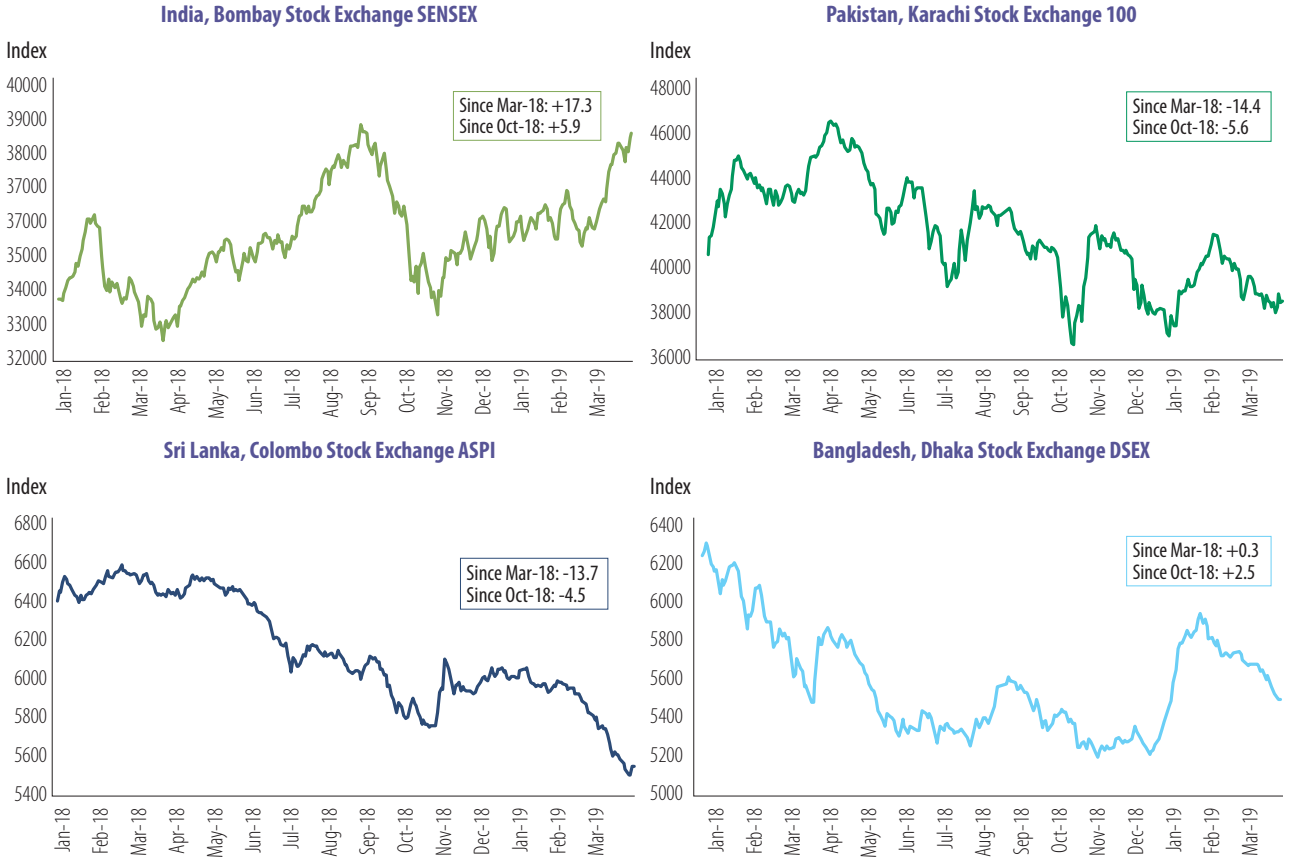
Notes: (e)= estimate. Bars represent data from 2018(e); horizontal line, the average growth between 2012 and 2017. Real GDP growth is in calendar years for all countries. For countries reporting growth in fiscal years, we compute weighted averages of annual growth rates and for India calendar years are aggregated using quarterly data. Triangles represent the potential growth.
Source: World Bank.

14.9 percent in 2017 and 15.6 percent in 2018. Private consumption and investment remained robust last year, as a slowdown in Pakistan was offset by solid growth in the rest of the region. The growth composition is similar when India is excluded from the regional aggregate (Figure 4b). Growth was again driven by government consumption and investment and import growth was unusually high. The difference is that in South Asia with India, government consumption moderated in 2018 while investment accelerated. In the region excluding India, on the other hand, government consumption accelerated while investment moderated. Overall, the growth in the last years has hence been driven mostly by domestic demand, though export growth picked up from low levels.

Regional heterogeneity in growth rates persisted and in 2018 fewer countries than a year ago grew above their long-run average and their potential (Figure 5). Over the calendar year 2018, Maldives was the fastest growing country in South Asia, owing to the contribution from tourism, wholesale and retail trade and construction. Tourist arrivals and bed nights increased, supported by infrastructure investments on the international airport, opening of new resorts, and the expansion of the guest house sector. In Bangladesh, growth picked up because of an acceleration in exports and a boost in domestic consumption thanks to a rise in remittances and better agricultural production. Due to its size, India drives the regional performance and its growth has remained stable. Data for the first three quarters of the fiscal year 2018-19 suggests that growth has been driven by an acceleration in industrial growth – owing to strong performance of manufacturing, the electricity sector and construction – and a steady performance of agriculture during the first half of the year. However, growth in the third quarter slowed to 6.6 percent, the weakest growth in the past five quarters. Consequently, the Central Statistical Office downgraded its growth forecast to 7.0 percent for fiscal year 2018-19 from an earlier projection of 7.2 percent at the end of February. In Nepal, growth was still partly driven by reconstruction. In addition, Nepal experienced a record level of tourist inflows and the industrial sector expanded capacity, supported by improved access to electricity. In Bhutan, growth was driven by the services sector, especially hotels and restaurants, retail trade and transportation. Pakistan's GDP growth is projected to slow down to 3.4 percent in fiscal year 2018-19, from 5.8 percent a year before, reflecting a broad-based weakening in domestic demand as monetary and fiscal policies have been tightened to contain macroeconomic imbalances. The current macroeconomic challenges in

Figure 6: Stock prices moved in line with macroeconomic developments.

Stock markets have dropped by 14 percent in Pakistan and Sri Lanka, gained 17 percent in India (up 6 percent from October), and returned to the same level in Bangladesh.



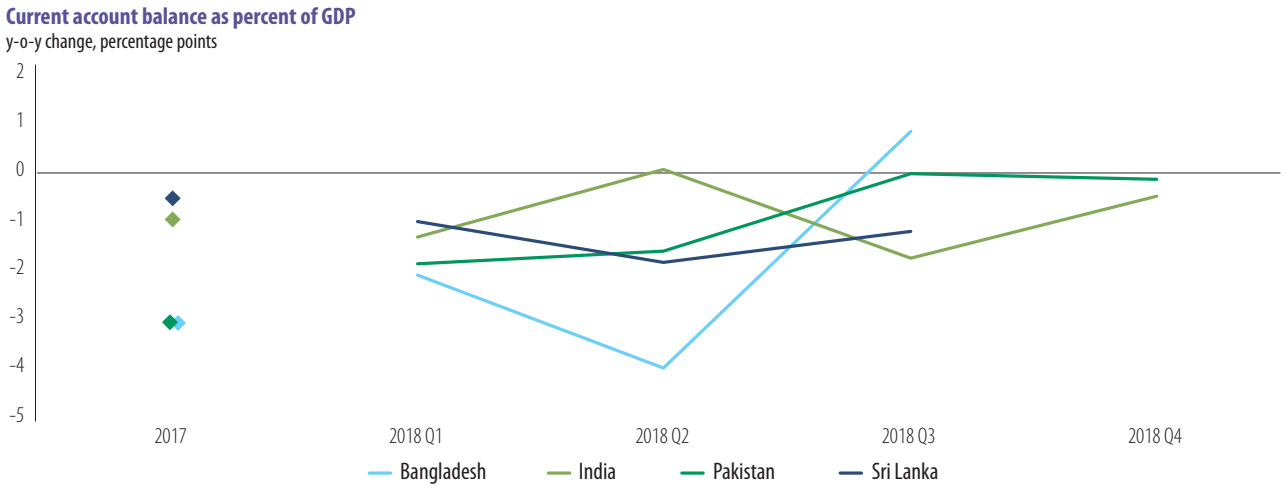
Notes: Growth rates are calculated using daily price data. For the 12-month rate, last observation available of 2019 (Mar-28/Mar-29) was compared against the value of Mar-28/Mar-29 in 2018. For the 6-month rate, last observation available of 2019 (Mar-28/Mar-29) was compared against the value of Oct-01 of 2018.
Sources: Haver Analytics and staff calculations.

Pakistan are primarily the result of past policy choices and there has been some adjustment over the past year. However, further adjustments will be needed. In Sri Lanka, growth dampened significantly in 2018, partly due to political tensions which impacted international business confidence. Leading rating agencies revised their assessments and Fitch, S&P, and Moody's downgraded Sri Lanka's sovereign ratings. In Afghanistan, output growth slowed because of a severe drought that affected wheat production and livestock pasture. In addition, heightened political uncertainty and election-related violence negatively affected business confidence and growth.

In line with broader macroeconomic developments, since March 2018 stock prices have declined in Pakistan and Sri Lanka, increased in India, and returned to the same level in Bangladesh (Figure 6). Since March of last year, stock prices declined by 14 percent in Pakistan and in Sri Lanka and in both countries the decline continued over the course of the last six months. In Pakistan, stock prices declined strongly between April and July due to growing concerns about external imbalances and political uncertainty ahead of the July elections. After a short recovery, the Karachi Stock Exchange (KSE) index dropped to its lowest level since May 2016 in October, as investors continued to pull out amid economic uncertainty. Yet, prices jumped strongly within the first 10 minutes of trading on October 24, following a USD 6 billion bailout package from Saudi Arabia that boosted investor confidence. Since then, however, the downward trend continued due to the unresolved macroeconomic imbalances. In Sri Lanka, political uncertainty led to foreign selling and stock prices declined from March until October of last year, when a sudden and unexpected change in the country's political climate seems to have led to a temporary

Figure 7: Current account balances continued to decrease but bottomed out.

Current account balances continued to decrease in the first half of last year, but apart from Sri Lanka they bottomed out. In Pakistan and Sri Lanka, the deficit in the fourth quarter has been similar to a year ago and in Bangladesh it has been smaller. In Sri Lanka, however, it continued to decline.



Notes: Quarterly GDP for Bangladesh, Pakistan and Nepal were derived from annual GDP and assumed to be constant for all four quarters. The year 2017 represents the average of 2017.
Sources: Quarterly current account data is from Trading Economics. Quarterly GDP data for India and Sri Lanka is from Haver Analytics.

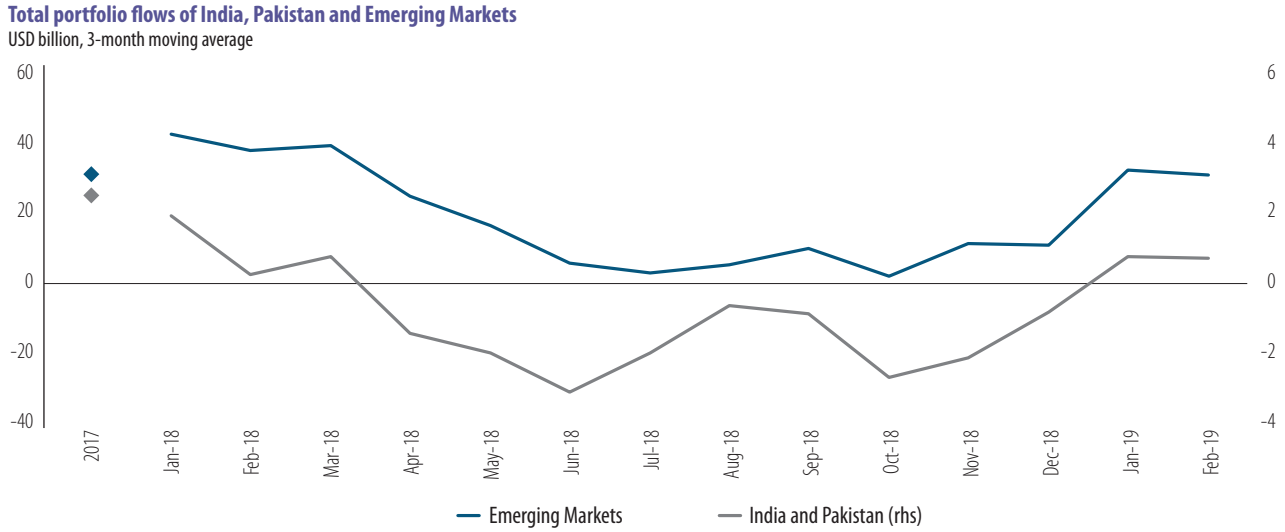
increase. In Bangladesh, stock prices are back at the level of March last year. The Dhaka Stock Exchange (DSE) entered a strategic partnership with a Chinese consortium by selling 25 percent of its shares to the Shenzhen Stock Exchange (SZSE) and the Shanghai Stock Exchange (SSE) in May of last year, which strengthened investor confidence. Stock prices rose strongly after the general election at the end of last year but declined subsequently again. In India, stock prices are now 17 percent higher than in March of last year and 6 percent higher than in October. The strong decline of Indian stock prices between September and October last year can partly be explained by a temporary worsening of the external situation. But since then the market has bounced back strongly.

External vulnerabilities persisted but may have bottomed out

Current account balances continued to decrease in the first half of last year, but they bottomed out in most countries (Figure 7). In Pakistan, the current account deficit continued to widen but stabilized over the course of last year and it stood at 5.2 percent of GDP in the fourth quarter of 2018. The current account deficit reached 8.8 USD billion (3.3 percent of GDP) at the end of February 2019, compared to 11.4 USD billion (3.7 percent of GDP) the year before. In Sri Lanka, where remittances remained almost flat (Figure 13) and increased dividend and interest payments exerted pressure on the current account, the current account deficit widened during the first three quarters of last year. In India, the current account deficit stood at 2.5 percent of GDP in the last three months of 2018. In Bangladesh, accelerated export growth, strong remittances growth, and slower import growth reduced the current account deficit. In Nepal, where no quarterly data is available, the current account deficit rose to 8.2 percent of GDP in fiscal year 2018, up from 0.4 percent the fiscal year before, due to increased imports for the establishment of local government offices, reconstruction activities, and intermediate goods imports for the industrial sector. In Maldives, the current account deficit is estimated to have widened to 24 percent of GDP in 2018, up from 22 percent a year before. In Bhutan, the other country with a very large current account deficit in recent years, the deficit moderated. The import of capital goods for hydropower construction declined because of the completion of the Mangdecchu project and delays in the construction of the other two main hydropower projects. In addition, because of elections and a new Five-Year-Plan, no new public investment programs were undertaken by the government in the first half of the year.

Figure 8: South Asia experienced portfolio outflows last year but inflows so far this year.

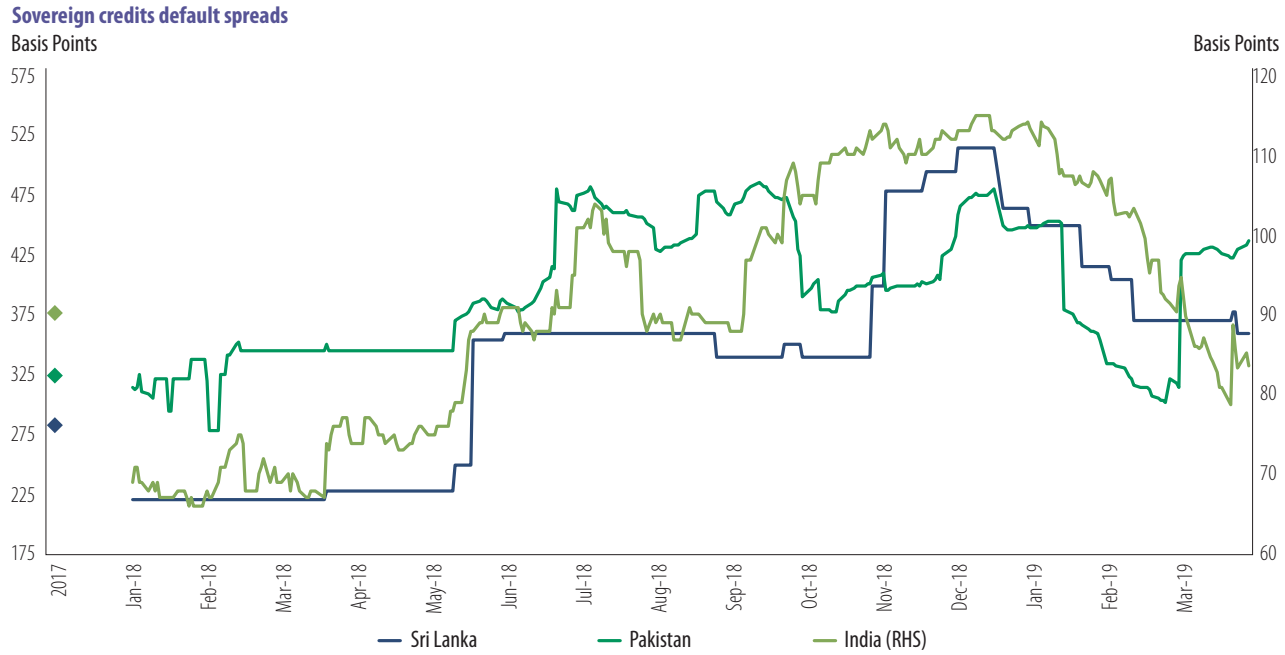
Capital inflows to India and Pakistan were positive in 2017 and at the beginning of last year, but negative in 2018. At the end of the year, capital flows turned positive again. There is a strong correlation with flows to other EMDEs, though EMDEs did not suffer from overall outflows last year.



Note: The year 2017 represents the average of 2017.
Source: International Institute of Finance.

Figure 9: Sovereign credit default swap spreads increased in 2018 but reversed course in 2019.

Sovereign credit default swap spreads measure a country's risk of default and are a useful measure of a country's economic health. These spreads increased in Pakistan, India and Sri Lanka in the second half of last year, but they have declined in 2019 so far.



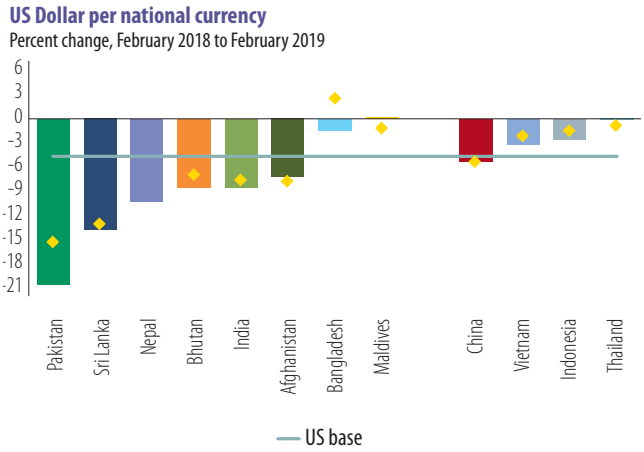
Note: The year 2017 represents the average of 2017.
Sources: Global Economic Prospect 2019 and Haver Analytics.

After capital outflows in 2018, capital is again flowing to India and Pakistan this year (Figure 8). Due to less benign international financing conditions related to increasing U.S. interest rates and high policy uncertainty, capital flows to emerging market and developing economies (EMDEs) slowed in 2018. Flows to India and Pakistan even turned negative the combined outflows amounted to over 12 billion USD over the course of the year. In addition to emerging market wide pressures faced by both countries,

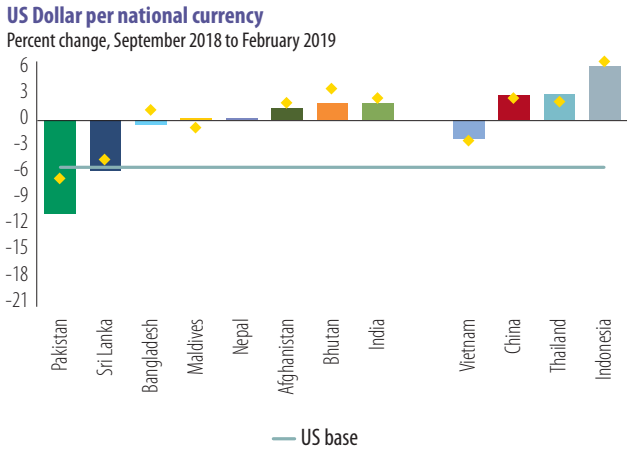
Figure 10: Currencies depreciated against the USD, mostly in the first half of 2018.

Nearly all South Asian currencies depreciated strongly against the USD last year, much more than other currencies. The Nepalese rupee lost over 10 percent, the Sri Lankan rupee over 15 percent, and the Pakistani rupee over 20 percent. Over the last six months, the depreciation trends continued in Sri Lanka and Pakistan but weakened in the other countries.

a) Over the past 12 months



b) Over the past 6 months



Notes: Bars indicate the percent change in nominal exchange rates between February 2018 and February 2019 (September 2018 and February 2019 for the right-hand side graph). Diamonds indicate the percent change in the real exchange rate between February 2018 and February 2019 (September 2018 and February 2019 for the right-hand side graph). The U.S. base shows the appreciation of the USD against all other currencies in the world.
Sources: IMF, World Bank and staff calculations.

outflows in Pakistan were also partly related to domestic imbalances. However, at the end of last year the situation improved and capital flows to EMDEs picked up again. In line, capital flows to India and Pakistan started increasing again and have been positive in 2019 so far.

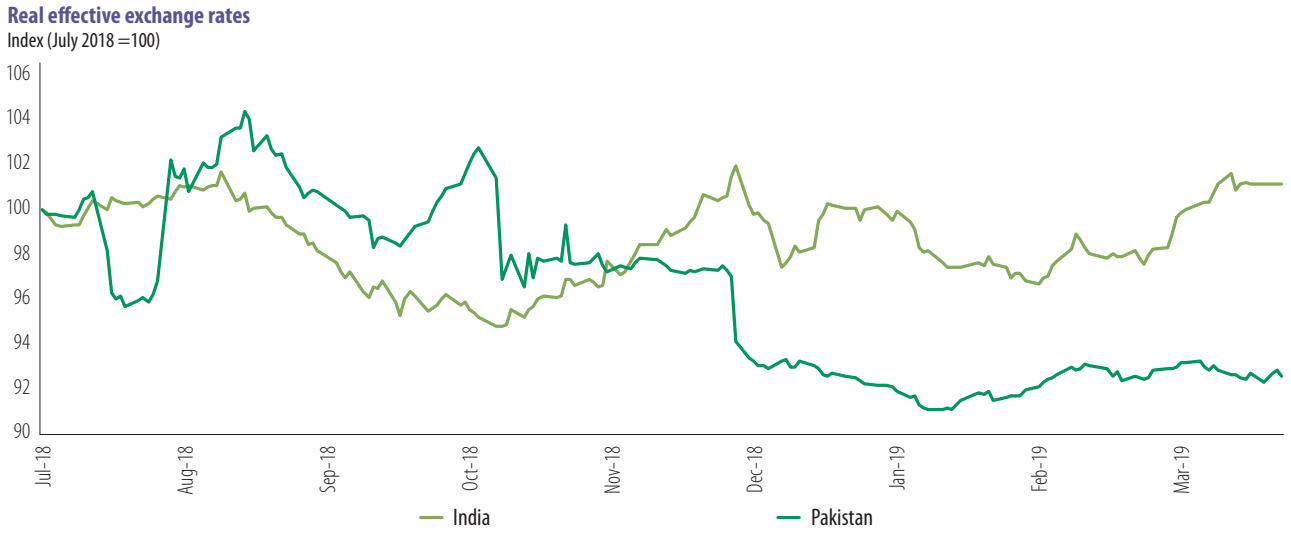
Sovereign credit default swap spreads increased in the second half of last year in India, Pakistan, and Sri Lanka but declined at the beginning of this year (Figure 9). These credit default swaps are an insurance against the debt default of the country and the price hence reflects the market expectations of such a default. They are thus a good measure of a country's risks and the health of an economy, even though these spreads are also affected by risk appetite of international investors and returns in other countries. While these spreads were mostly stable in South Asia at the beginning of last year, they picked up in the second half. From May 2018 to December 2018, they rose from an average of 0.8 percent to 1.1 percentage point in India, from 3.7 percent to 4.6 percentage points in Pakistan, and from 2.8 percent to 4.9 percentage point in Sri Lanka. In the new year, they continued to decline in India and Sri Lanka, where they are now back at the levels of August last year. In Pakistan, they decreased from January to February, but jumped back in March.

South Asian currencies depreciated strongly against the USD over the last twelve months (Figure 10a), but some currencies have appreciated slightly over the last six months (Figure 10b). Apart from the Maldivian rufiyaa (fixed against the USD), all currencies in South Asia depreciated against the USD in 2018. The depreciation was around 8 percent in Afghanistan, Bhutan and India, 10 percent in Nepal, 14 percent in Sri Lanka, and over 20 percent in Pakistan. In 2018, South Asian currencies depreciated against the USD by more than the (unweighted) average of all currencies (labeled 'US base' in Figure 10 and providing a rough approximation of currency movements explained by developments in the United States, for example higher interest rates), while in 2017 South Asian currencies' depreciation against the dollar was less than the average. Over the last six months the depreciation continued in Pakistan and Sri Lanka, but not in the other countries and in Sri Lanka the rupee appreciated from January to March this year. The Indian rupee appreciated 1.9 percent against the USD from September 2018 to February 2019.

Pakistan's currency has continued to depreciate against its trading partners over the last six months, while India's has not (Figure 11). Pakistan's real effective exchange rate, which is the average of its currency in relation to an index of other major cur-

Figure 11: Pakistan's currency has continued to depreciate against its trading partners over the last six months, while India's has not.

Pakistan's real effective exchange rate, which is the average of its currency in relation to an index of other major currencies weighted by their relative trade shares, depreciated by nearly 5.5 percent from October last year to March of this year.



Note: An increase indicates an appreciation of the economy's currency against a broad basket of currencies.
Source: Haver Analytics/JP Morgan.

rencies weighted by their relative trade shares and adjusted for inflation differentials, depreciated by nearly 5.5 percent from October 2018 to March of this year. The depreciation against its trading partners increases the price competitiveness of Pakistan's exports in international markets and makes imports more expensive. Over time, such an adjustment of relative prices is needed if policies are put in place to mprove the trade balance (see Chapter 3). In India, the real effective exchange rate depreciated from July to October 2018 but then appreciated for two months after which it has been hovering around its July 2018 level.

Bucking the trend of the last couple of years, exports grew faster than imports in the third and fourth quarter of last year (Figure 12). In 2017, imports grew faster than exports in all countries, in some cases by a very wide margin, but the situation changed over the course of 2018. In India, the export performance improved, with an acceleration in the growth of exports from 1.5 percent (y-o-y) in the first quarter of last year to 16.6 percent in the fourth. Import growth was a very high 23.2 percent in the third quarter but decreased to 8.0 percent in the fourth. In Pakistan, import growth came down dramatically and exports grew faster than imports in all four quarters of 2018. Regulatory duties imposed on 'luxury items', combined with the imposition of a ban on imports of furnace oil were among the policy responses to curb imports in Pakistan (see Box 1 for an update in recent trade policy developments). However, exports grew below 5 percent in the third quarter and not at all in the fourth. In Bangladesh, both imports and exports grew little in 2017, but strongly at the beginning of the year. Different from before, exports grew stronger than imports in the third quarter of 2018. In Sri Lanka, export growth decreased from 7.5 percent in 2017 to 2.1 percent in the fourth quarter of last year. At the same time, however, import growth came down from nearly 20 percent in 2017 to -5.8 percent in the last quarter of last year. Because of reconstruction efforts and the establishment of local government offices in Nepal, imports grew over 30 percent in fiscal year 2018. In Afghanistan, exports declined in 2018, despite an increase in high-value fruit exports to India via new air corridors. In Maldives goods exports contracted, while goods imports continued to grow fast, by over 16 percent. However, services exports grew by more than 10 percent.

After growing fast in 2017, remittances continued to grow strongly in all countries except Sri Lanka last year (Figure 13). Remittances are an important source of foreign financing and a key contributor to domestic demand and poverty reduction in several South Asian countries. Over the last year, the flow of remittances increased strongly in India, where

Box 1: An update on trade policy changes affecting South Asia

Several trade policy developments have recently impacted South Asia. On the one hand, import restrictions and tariff increases were put in place in some South Asian countries either to reduce current account vulnerabilities, to protect domestic industries, or as retaliatory actions. On the other hand, countries also achieved some success in restructuring and reducing import tariffs.

a) Import tariffs to contain external vulnerabilities or to protect domestic industries

In September 2018, India raised import tariffs on 19 non-essential imports such as jewelry, jet fuel, and communications gear. Sri Lanka has raised import duties on vehicles and imposed a temporary non-tariff measure to raise more revenue and to reduce vehicle imports, which doubled in 2018. The cash margin on Letters of Credit for the import of motor vehicles has been increased and the maximum Loan to Value ratio for hybrid vehicles has been reduced. To protect domestic industries from international competition, the 2019 budget in Bangladesh imposed supplementary duties on energy drinks, toiletries, perfumes, body sprays and similar items. In Pakistan, the Supplementary Finance Act 2018, passed in October last year, adjusted regulatory duties on selected luxury goods to reduce the trade deficit. For example, a flat rate of USD 75 on imported mobile phones valued between USD 350 and USD 500 has been introduced.

b) Trade tensions between India and the United States

India has again postponed retaliatory tariffs on selected U.S. products by a month (such as walnuts, chickpeas, artemia, lentils, and diagnostic reagents), planned as a response to the new U.S. tariffs on steel and aluminum enacted last year. India benefited greatly from the designation as a beneficiary developing country under the Generalized System of Preferences (GSP) that gave 2,000 products duty-free access to the United States. In 2017, the value of Indian exports covered by GSP was USD 5.7 billion, more than for any other country. However, early in 2019 the United States withdrew these export incentives because of compliance issues related to statutory eligibility criteria. The GSP withdrawal may be an indication of the United States following a market access strategy to open India's market for U.S. products, for example soybeans.

c) Trade tensions between India and Pakistan

After the Pulwama incident, India has withdrawn the most favored nation (MFN) status for Pakistan and raised custom duties on all goods imported from Pakistan to 200 percent. This may lead to a significant drop in Pakistani exports to India. However, Pakistan's exports to India are worth only USD 560 million. Pakistan may still impose retaliatory tariffs on Indian goods or expand its negative list prohibiting specific imports from India. Such retaliatory tariffs could jeopardize Indian exports, which are worth USD 1.8 billion. But since the bilateral trade between the two countries barely reaches USD 2.4 billion, the negative effects from an escalation of trade tensions are limited. However, they would prevent the two countries from moving closer to their high trade potential (see Chapter 3).

d) Progressing trade talks between China and the United States

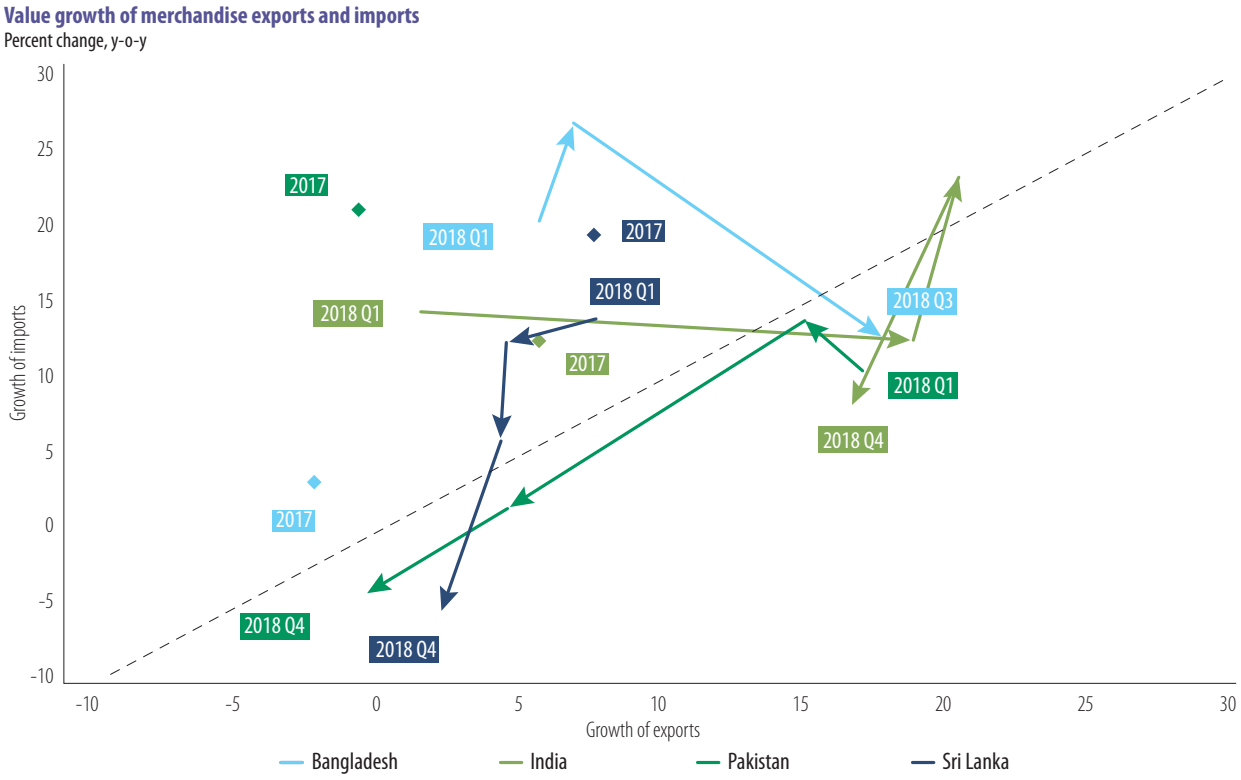
Trade negotiations between the United States and China are progressing. New tariffs introduced since the beginning of last year have affected about 12 percent of overall U.S. goods imports, 6.5 percent of China's total goods imports, and about 2.5 percent of global goods trade. South Asia may have reaped some benefits from trade diversion. In Bangladesh, for example, the tariff escalation has contributed to increased orders from both countries. From July to December 2018, exports to the United States grew by 19 percent and exports to China by 36 percent (see Chapter 4). After the United States government increased duties on textile imports from China, apparel imports from Bangladesh have more than doubled. Despite possibly reduced benefits from trade diversion, however, the weakening tensions between the United States and China are good news for South Asian countries, as they reduce the risk of a global economic slowdown and of a reversal of investor sentiments.

e) Some promising developments

Recently, Pakistan approved a National Tariff Policy (NTP) to ensure transparency and predictability with the aim of institutionalizing the entire tariff structure. However, the NTP is vague in nature and may postpone the reduction of tariffs on intermediates. In Sri Lanka, most imports, except for some basic goods, are subject to a local levy, i.e. para-tariffs, called Export Development Board Levy (or Cess). In the 2019 Budget, the Cess on imports will be subject to a tariff phase out to increase competition and foster participation in value chains. Some items considered sensitive will be excluded from a complete para-tariff phase out. The Ports and Airports Development levy (PAL), another para-tariff in Sri Lanka affecting high-tech machinery, boilers, and electrical items, will be reduced to 2.5 percent to reduce the upfront costs of investments. Bangladesh is seeking tariff benefits on its exports of garments made from U.S. cotton by requesting re-admittance to the United States Generalized System of Preferences (GSP). Bangladesh was suspended from GSP benefits in June 2013, due to issues related to worker rights and safety. Around 7 percent of the cotton that Bangladesh imports from the United States is used to produce garments that are then exported back to the United States. With a tariff of 16 percent, these apparel exports are subject to the highest tariffs among all exporters. However, at the moment there is no indication that the Unites States is going to give back GSP to Bangladesh.

Figure 12: Marking a major shift, exports grew faster than imports in the third quarter of last year in Pakistan and Bangladesh.

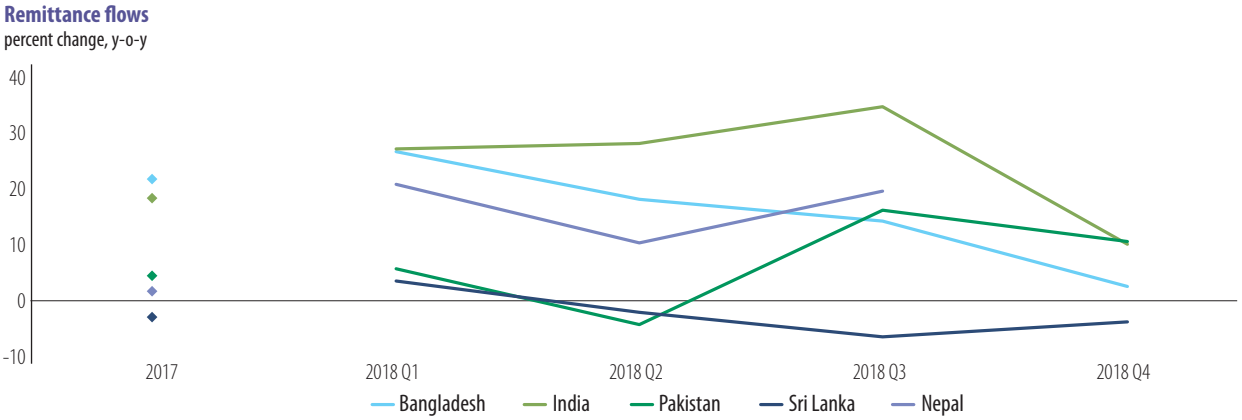
In 2017, imports grew faster than exports in all countries, in some cases by a very wide margin. Over the course of last year, the situation improved and in the third and fourth quarter of last year, exports grew faster than imports.



Note: The year 2017 represents the growth of exports from 2016 to 2017.
Source: World Bank.

Figure 13: Strong remittances growth in most countries provided additional external funding.

Apart from Sri Lanka, remittances increased in 2017 and they kept increasing last year. In India, they increased by over 30 percent (y-o-y) in the third quarter of 2018 compared to a year ago, and in Bangladesh and Pakistan they grew over 10 percent. But remittances growth slowed in the fourth quarter.



Note: The year 2017 represents the percent change between 2016 Q4 and 2017 Q4.
Source: National Authorities / Haver Analytics.

remittances grew 34 percent (y-o-y) in the third quarter. In Pakistan and Bangladesh, they increased by around 13 percent in the third quarter, but growth slowed in the fourth quarter. In Sri Lanka, on the other hand, remittances were almost flat.

Despite mild declines in Bangladesh and India, their reserve coverage remains comfortable, but the level of reserves is more worrisome in the other countries (Table 1). Foreign exchange interventions of the Reserve Bank of India (RBI) have resulted in losses of

Table 1: Foreign exchange reserve coverage declined across South Asia, though by very little in most countries.

Reserve coverage is a little bit lower than a year ago in Bangladesh and India but remains at comfortable levels there. Sri Lanka's reserves cover only 2.8 months of imports, and the country faces large repayments soon. In Pakistan, the reserve coverage deteriorated further.

	Foreign exchange reserves in months of goods imports			
	Bangladesh	India	Pakistan	Sri Lanka
Average in 2017	8.4	10.3	4	3.8
18-Jan	7.1	10	3	4
18-Jul	6.6	9.2	2.8	4.5
18-Dec	7.1	9.6	2.5	4.2
19-Jan	6.9	9.5	2.8	3.9

Source: World Bank

some reserves. However, with 9.5 months of import coverage as of January the level remains comfortable. In Bangladesh, the reserve coverage declined from over 8.4 months of imports in 2017 to 6.9 months of imports in January 2019. In Sri Lanka, the reserve coverage increased from around 2 months of imports in January 2018 to 3.9 months of imports in January 2019. A 1 billion Eurobond matured in January of this year and international repayments will remain high over the coming years. From April of last year to end of January, the reserve coverage declined from USD 9.0 billion to only USD 5.2 billion. In Pakistan, external account pressure reduced international reserves to USD 6.6 billion (1.3 months of goods and services import coverage) by mid-January 2019. With short-term financing from the Kingdom of Saudi Arabia, the United Arab Emirates and China, international reserves increased to USD 10.5 billion (2.0 months of goods and services import coverage) at the end of March. Meanwhile, the government continues to negotiate a support package with the International Monetary Fund.

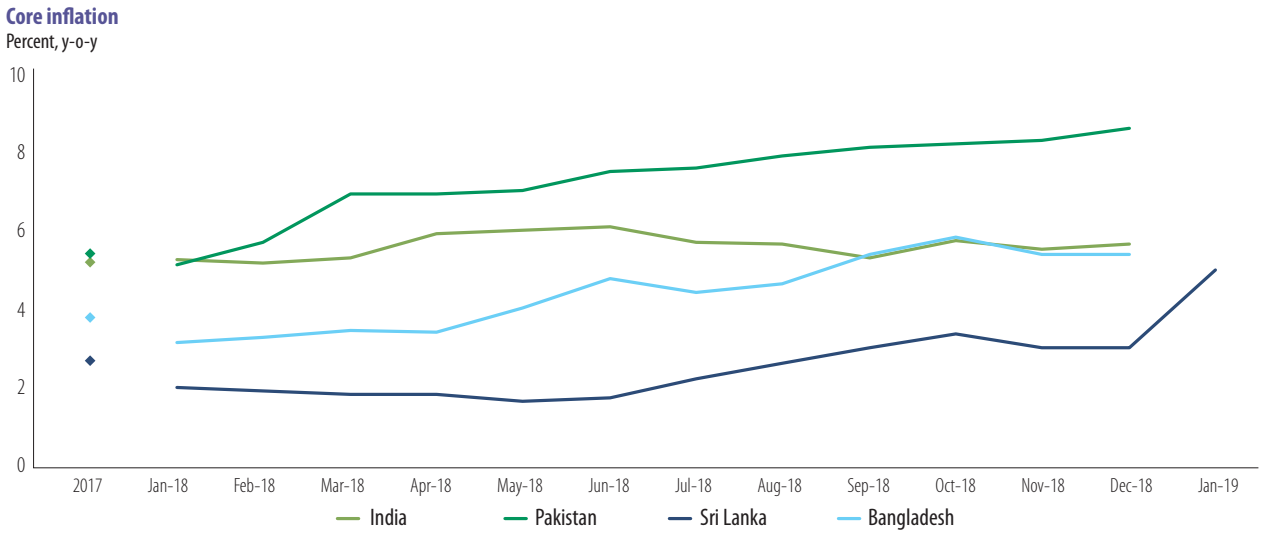
Rising core inflation but low headline inflation

Core inflation is rising fast in Pakistan and Bangladesh and recently picked up in Sri Lanka (Figure 14). Core inflation measures consumer prices excluding food and energy. In Pakistan core inflation steadily rose throughout 2018, mostly due to currency pressures which made imported final and intermediate goods more expensive. It reached 8.3 percent (y-o-y) in December of last year, the highest value since January 2015. In Bangladesh, strong domestic demand and the disappearance of underutilized capacity, as well as higher costs from frequent transport disruptions, increased core inflation from 3.2 percent in January to 5.5 percent in December. In Sri Lanka, core inflation was as low as 2.1 percent at the beginning of the year and even continued to decline slightly until June. However, since then it has increased considerably – partly due to higher prices for housing and exchange rate depreciation – and it jumped to 5.1 percent in January 2019. In India, on the other hand, core inflation is very stable despite high growth, and in 2018 it fluctuated closely around 5.5 percent.

Food price inflation decelerated in nearly all countries in South Asia in 2018 (Figure 15). Global food price growth decelerated as well, but food inflation in South Asia seems driven by idiosyncratic and regional factors and not global trends (see Box 2). Food prices fell in Sri Lanka, Bangladesh, and in India, mainly due to good harvests, and food prices were lower at the end of last year compared to a year before. Prices were stable in Pakistan and Maldives. While average food inflation was still modest at 3.0 percent (y-o-y), Nepal was the only country in which food prices increased faster last year than in 2017, mostly owing to an unfavorable monsoon. Food price inflation in Bangladesh declined, from

Figure 14: Core inflation is rising fast in Pakistan and Bangladesh and recently picked up in Sri Lanka.

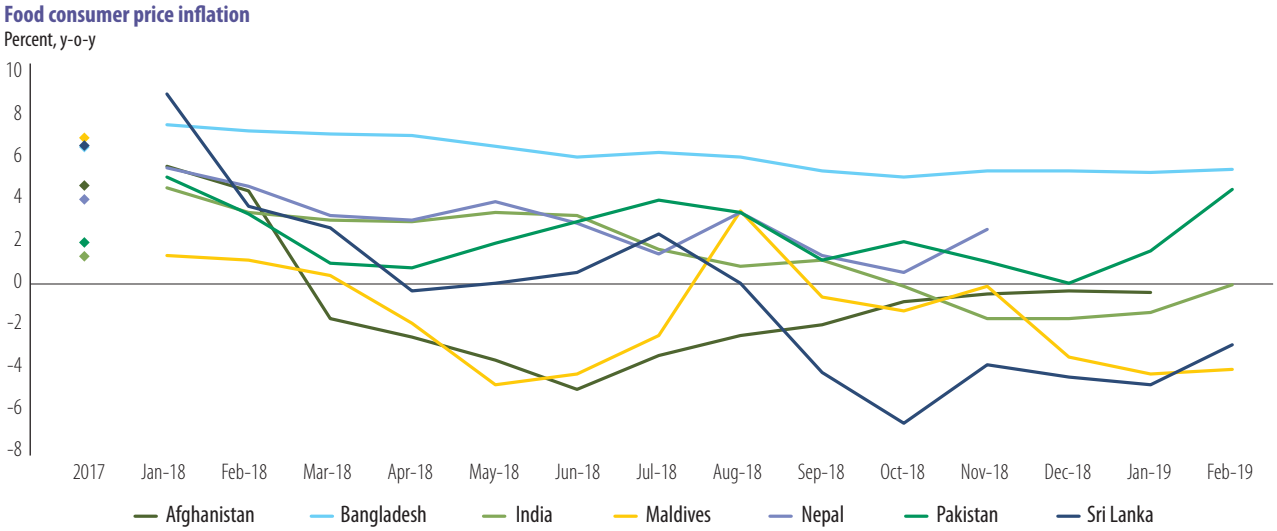
Core inflation, which measures the costs of goods and services excluding food and energy, increased steadily in Pakistan and Bangladesh and picked up recently in Sri Lanka. In India, on the other hand, it is very stable.



Note: The year 2017 represents the percent change between Dec-2016 and Dec-2017.
Sources: Haver Analytics. Sri Lanka data is from Sri Lanka Department of Census and Statistics. Bangladesh data is from the Central Bank of Bangladesh (non-food inflation).

Figure 15: But food price inflation fell, so that …

Food price inflation decelerated over the course of last year in nearly all countries in the region. In India, Maldives, Pakistan and Sri Lanka, food prices remained either constant or even declined compared to a year earlier. On average, they declined by 3.0 percent in these countries.



Note: The year 2017 represents the percent change between Jan-2016 and Jan-2017.
Sources: Afghanistan, Bangladesh, India, Pakistan and Sri Lanka National Authorities. Maldives data series from MMA / Haver Analytics.

7.3 percent in February 2018 to 5.4 percent in February 2019. In South Asia, food constitutes a large part of household expenditure and its budget share exceeds 50 percent in Bangladesh, India, and Nepal. Across South Asia, the share is higher for the rural population and the poor. For example, in Bangladesh the poor in rural areas spend 67 percent of their total spending on food. Lower food prices hence tend to foster shared prosperity and to benefit the poor most. In South Asia, changes in consumer prices can to a large extent be explained by changes in food prices, which tend to be more volatile (see Box 2). In most countries, lower food price inflation led also to lower overall inflation. In Pakistan, on the other hand, consumer prices increased despite a strong decline in food prices.

Table 2: … headline inflation softened in most countries.

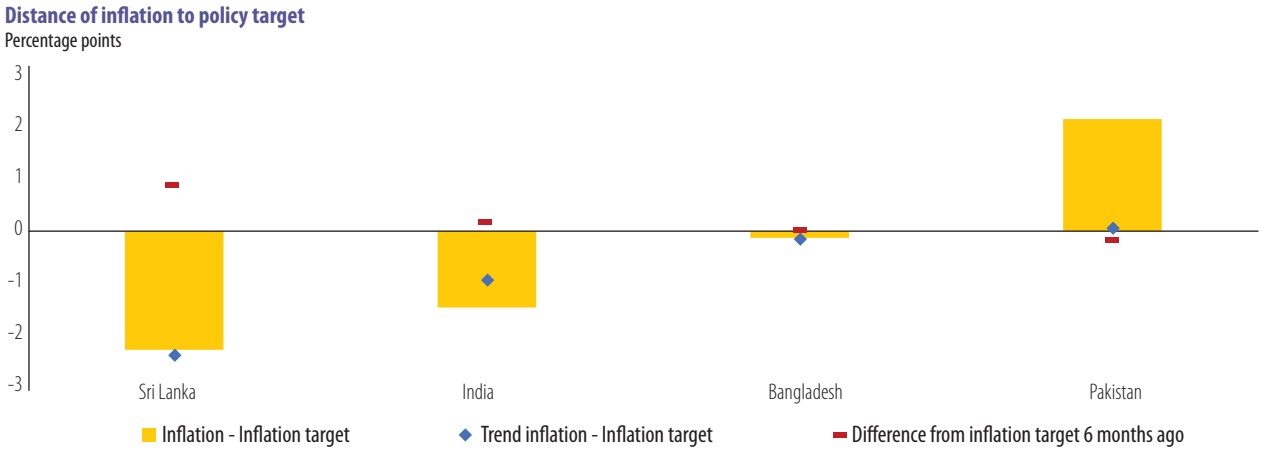
Consumer price inflation is around or below 3 percent in most countries but 5.5 percent in Bangladesh and 8.2 percent in Pakistan. Inflation decreased strongly in India and Sri Lanka and nearly doubled in Pakistan.

	Consumer price inflation in percent (y-o-y)							
	Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
2017	3.0	5.9	0.7	5.2	1.3	4.1	4.6	7.3
Jan-18	4.3	5.9	2.4	5.1	1.1	2.0	4.4	5.4
Jul-18	-0.2	5.6	1.4	4.2	-0.3	4.5	5.9	3.4
Dec-18	0.8	5.4	3.1	2.1	-0.9		6.1	0.4
Last observation	0.4	5.5	3.1	2.6	-1.2	4.2	8.2	2.4

Notes: Data for Afghanistan was completed using national data since September 2018; for Bhutan since December 2017; for India since December 2018; and for Maldives since July 2018. The year 2017 represents the percent change between Dec-2016 and Dec-2017. The last observation for Nepal is October 2018; for Afghanistan and Bhutan is January 2019; and for the rest of the countries it is February 2019.
Sources: World Bank, National Statistics and Information Authority (Afghanistan), National Statistics Bureau (Bhutan), Sri Lanka Department of Census and Statistics (Sri Lanka).

Figure 16: Inflation is below target in Sri Lanka and India but above in Pakistan.

Benchmarking actual inflation against targets reveals how successful central banks are with their stabilization policies and indicates the monetary policy stance. Different from six months ago, inflation is now below target in India and Sri Lanka, and above target in Pakistan.



Notes: Sri Lanka has not yet moved to explicit inflation targeting; the target used is the center point of the Monetary Policy Consultation Clause (MPCC) of 4.7 percent. All countries' reported inflation is from February 2019.
Sources: Inflation target data is from Haver Analytics (National Authorities). Current inflation data is from World Bank. Trend inflation was calculated using the HP filter. SAEF Fall 2018 provides the distance from inflation target 6 months ago. Distance of inflation to target is based on staff calculations.

Headline inflation softened in most countries, and with inflation rates varying from 0 to over 8 percent (y-o-y), strong regional heterogeneity persisted (Table 2). Inflation in Afghanistan picked up during the second half of last year and left deflationary territory. The low inflation in Maldives last year was mainly due to a decrease in the prices of staple food items and electricity brought about by policy changes in food subsidies and electricity charges. In Pakistan, inflation increased owing to exchange rate depreciation, demand side pressures and higher fuel prices. Consumer prices rose by 8.2 percent from February 2018 to February 2019, the highest rate in South Asia. Average inflation reached 7.0 percent in the period between October 2018 and February 2019, compared to 4.1 percent in the same period last year. On the other hand, inflation has been softening in India and Sri Lanka. Inflation came down strongly from 5.2 percent in 2017 to 2.5 percent in February 2019 in India, and from 7.3 percent in 2017 to 2.4 percent in February 2019 in Sri Lanka owing to a sustained decline in food prices since July 2018 (see Figure 15) complemented by softening oil prices in the second half of last year (Figure 2). As in the past, inflation in Bangladesh is very flat but it decreased slightly due to declining rice prices.

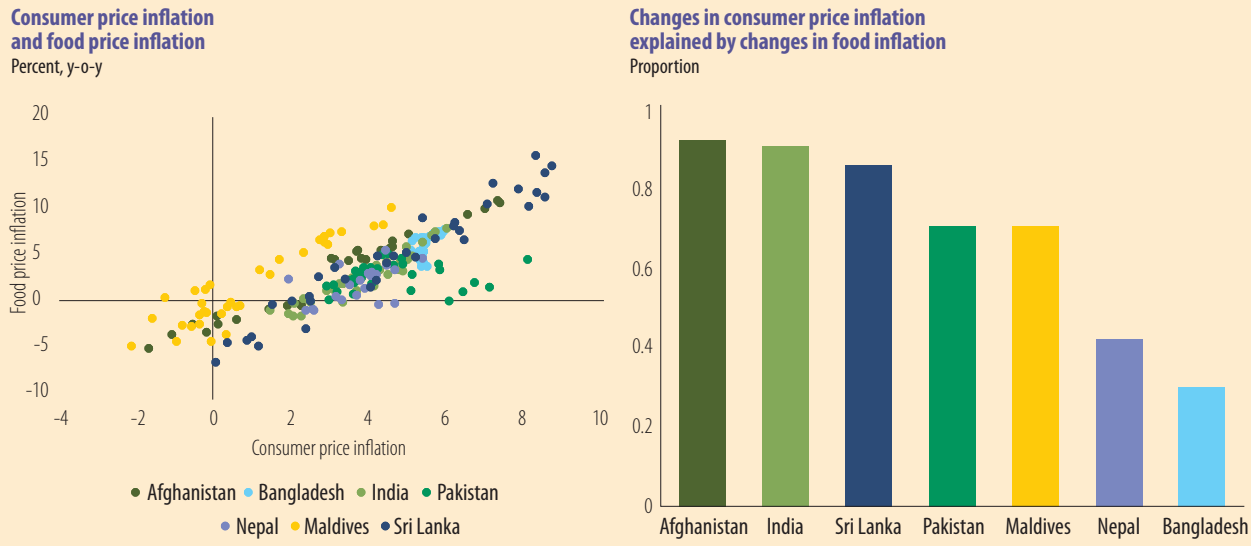
Box 2: Consumer price inflation and food inflation in South Asia

In South Asia, consumer price inflation and food inflation are highly correlated (Figure 17a). Food inflation can raise aggregate inflation substantially when food constitutes a significant share of the consumption basket, as it does in South Asia. In Bangladesh, for example, food has 56 percent weight in the national CPI. Aggregate inflation also increases through knock-on effects on non-food inflation caused by the rise in food inflation. It induces labor to demand higher wages, which raises the cost of production and hence prices of non-food items as well. In addition, an increase in food prices, relative to aggregate prices, raises demand for non-food products via substitution and income effects. In the long-run, however, high food inflation can have a negative impact on non-food inflation when food is a large expenditure item. Persistently high food inflation reduces real income in the long-run, causing proportionately greater decline in consumption of non-food items compared to food and hence negatively impacts on non-food prices. In Afghanistan, India, Maldives, Nepal and Sri Lanka, the correlation between the two from April 2016 to February 2019 was above 0.9. In Bangladesh the correlation was at 0.6 somewhat lower, but still high. In Pakistan, on the other hand, the correlation was very low. One reason is the recent currency devaluation that resulted in increasing consumer prices despite slowing food prices (see Figure 15 and Table 2). To understand what proportion of consumer price changes can be explained by changes in food prices, we regress the former on the latter. There are two possible reasons for why changes in overall consumer prices may be strongly related to changes in food prices. First, food prices are of course part of the prices that make up overall consumer prices and since food prices are often volatile, they may be important drivers of overall price changes. The weight of food and non-alcoholic beverages in the consumption basket used to measure consumer prices varies between 35 percent in Pakistan and 48 percent in Afghanistan. Second, there could be a common factor driving both food prices and other consumer prices. The most obvious candidate is the price of oil, as it may increase both agricultural production costs (e.g. through petrol and fertilizers) and other consumer prices. However, we do not find a strong link between the oil price and food prices in South Asia. There is a statistically significant but weak relationship between changes in oil prices and changes in food prices in Nepal and Bangladesh, but no relationship in the other countries. From early 2016 to February of this year, over 80 percent of the variation in consumer price inflation in Afghanistan, India and Sri Lanka can be explained by changes in food prices (Figure 17b). In Pakistan and Maldives, around 70 percent of consumer price changes can be explained by food price changes. But despite the high correlation, only around a third of the variation in consumer prices is explained by food prices in Bangladesh.

Figure 17: CPI and food inflation are highly correlated in South Asia.

a) Correlation between consumer prices and food prices in South Asia

b) Changes in consumer prices explained by changes in food prices



Notes: Data of CPI and food inflation is from April 2016 to February 2019. Each point represents one month's data.
Sources: World Bank, National Statistics and Information Authority (Afghanistan), National Statistics Bureau (Bhutan), Sri Lanka Department of Census and Statistics (Sri Lanka).

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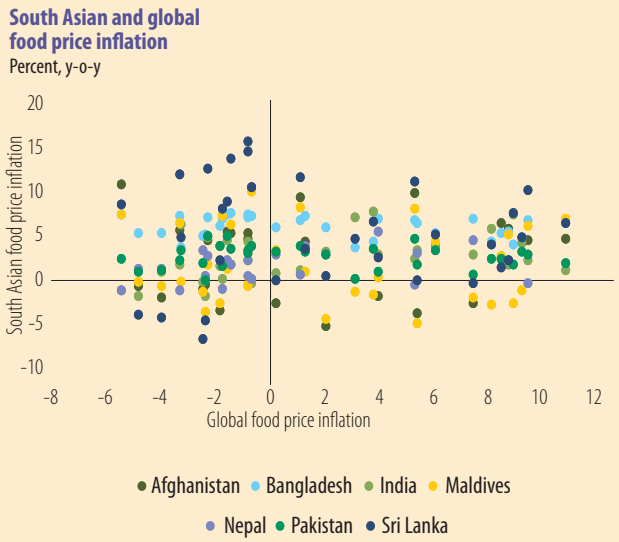
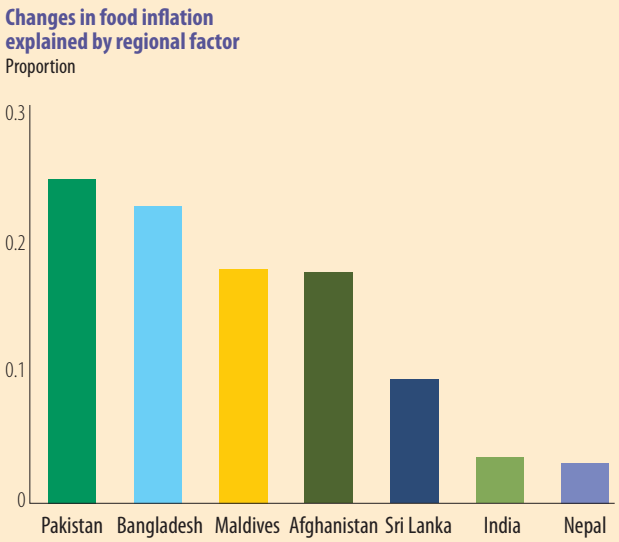
Figure 18: Food inflation in South Asia is not strongly driven by global prices.

a) Food prices are not correlated with global food prices...



b)... but co-move within the region.



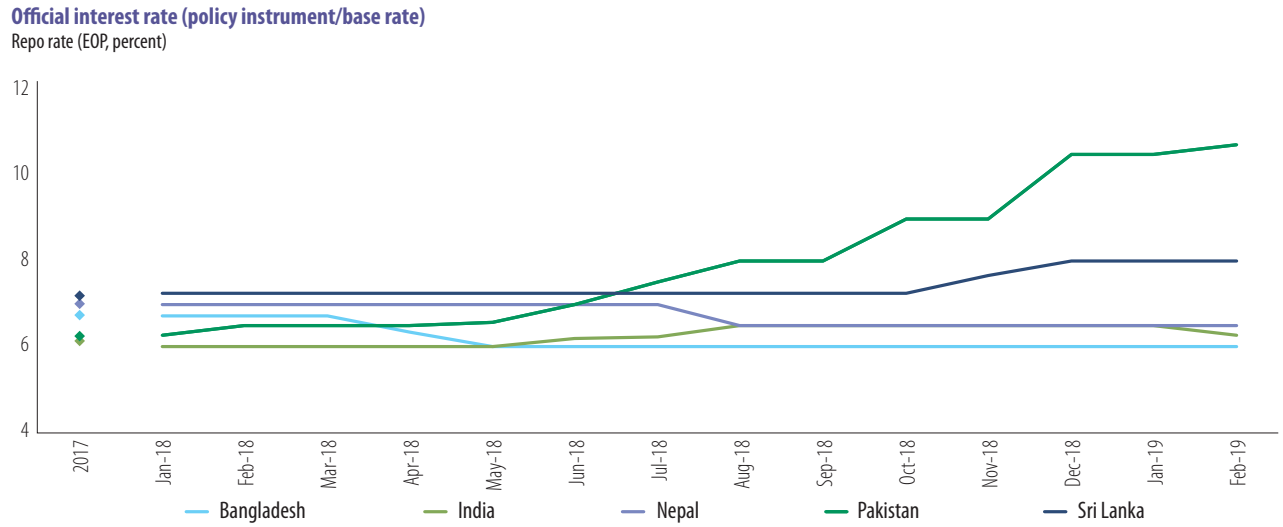
Notes: The regional food inflation factor is derived as the first principal component of food inflation in Bangladesh, India, Maldives, Nepal, Pakistan, and Sri Lanka. The right-hand side graph indicates the percent of variance in food inflation explained by regional factors (squared factor loadings).
Sources: World Bank, National Statistics and Information Authority (Afghanistan), National Statistics Bureau (Bhutan), Sri Lanka Department of Census and Statistics (Sri Lanka).

Global food prices are often cited as an important determinant of food price developments in South Asia. The theoretical reasons for assuming a strong relationship are obvious: first, some food items are imported and hence directly depend on international prices and, second, if international prices drop, domestic suppliers have less incentive to export their produce, which may lower domestic food prices. However, we find no correlation between global food prices and food prices in South Asia (Figure 18a). Instead, food prices in South Asia seem to follow a regional pattern. We compute the first principle components of food prices in South Asia and then check how much variation this regional factor explains in the different countries (Figure 18b). In Pakistan and Bangladesh, far over 20 percent of domestic food price changes can be explained by regional movements. In Maldives and Afghanistan, the proportion is around 20 percent and in Sri Lanka around 10 percent. One reason for the strong regional co-movement could be the monsoon, and weather more generally. Clearly food prices in South Asia depend strongly on the harvests, which in turn depends on the monsoon. In India and Nepal, however, the regional factor does not explain much, which could be due to strong regulation of food prices.

Inflation is now below target in Sri Lanka and India but above target in Pakistan. Comparing actual inflation to targets reveals whether central banks face unexpected developments and how successful they are with their stabilization policies (Figure 16). Inflation rates far above target can signal a need to tighten interest rates and inflation far below can signal monetary policy leeway. Sri Lanka has not yet moved to explicit inflation targeting, but its inflation can be compared against the center point of the Monetary Policy Consultation Clause, which is 4.7 percent. Different from six months ago, consumer price inflation in Sri Lanka was below target in February. With over two percentage points, it was below by quite some margin and looking at trend inflation widens the gap a little further. In India, the difference between consumer price inflation and the target was around 1.5 percentage points in February and around 1 percentage point when looking at trend inflation, which still is within the target band. This gap explains the reduction in interest rates in February and further reduction in early April. In Bangladesh, inflation was nearly at target. The State Bank of Pakistan does not explicitly target inflation, but authorities announce an inflation target with every budget which it uses as an indicative target. Different from six months ago, inflation was with over 2 percentage points considerably above this indicative target.

Figure 19: Interest rates are reacting in most countries, especially in Pakistan.

In Sri Lanka and especially in Pakistan, interest rates were increased last year to contain external pressures. Rates were also raised slightly between May and August in India, but then were reduced in February as inflation was below target.



Note: The year 2017 represents the average of 2017.
Sources: National Central Banks and IMF / Haver Analytics.

In Sri Lanka and especially in Pakistan, interest rates were increased last year to contain external pressures (Figure 19). In Pakistan, policy rates increased from 6.3 percent in January to 10.5 percent in February. These raises were needed to reduce capital outflows, defend the currency and curb domestic demand that resulted in high imports and a large current account deficit. Sri Lanka's interest rate developments are nuanced. The upper band of the policy rates was reduced in April of last year, which ended a tightening cycle. Later in the year, the Statutory Reserve Ratio (SRR) applicable on all rupee deposits of commercial banks was reduced to address a liquidity shortage. To neutralize the impact of this reduction, the Standing Deposit Facility Rate (SDFR) was increased to 8.0 percent and the Standing Lending Facility Rate (SLFR) to 9.0 percent. In India, rates were raised from 6.0 percent to 6.25 percent June, and further to 6.5 percent in August. The underperformance of inflation (see Table 2), resulted in a reduction of interest rates in February and April, to now 6.0 percent. In Nepal, rates were lowered from 7.0 percent to 6.5 percent in May.

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South Asia economic outlook

The growth outlook for South Asia assumes that the recent acceleration of export growth continues and that import growth slows, so that imports and exports grow at similar rates going forward. Under these conditions, GDP growth is expected to accelerate slightly to 7.0 percent this year and to 7.1 percent in 2020 and 2021. GDP growth is forecast to slightly accelerate in Afghanistan, India, and Sri Lanka, but to moderate in Bangladesh, Bhutan, Maldives, Nepal and Pakistan. The further acceleration of export growth will be challenging given global trade weakening. Other downside risks to the forecasts include a re-escalation of political turbulence, fiscal slippages, and deteriorated balance sheets of both banks and corporates. For high GDP growth to be sustained in the long run, the large infrastructure gaps have to be narrowed, and the still weak business climate has to be improved to increase investments from both domestic and foreign sources.

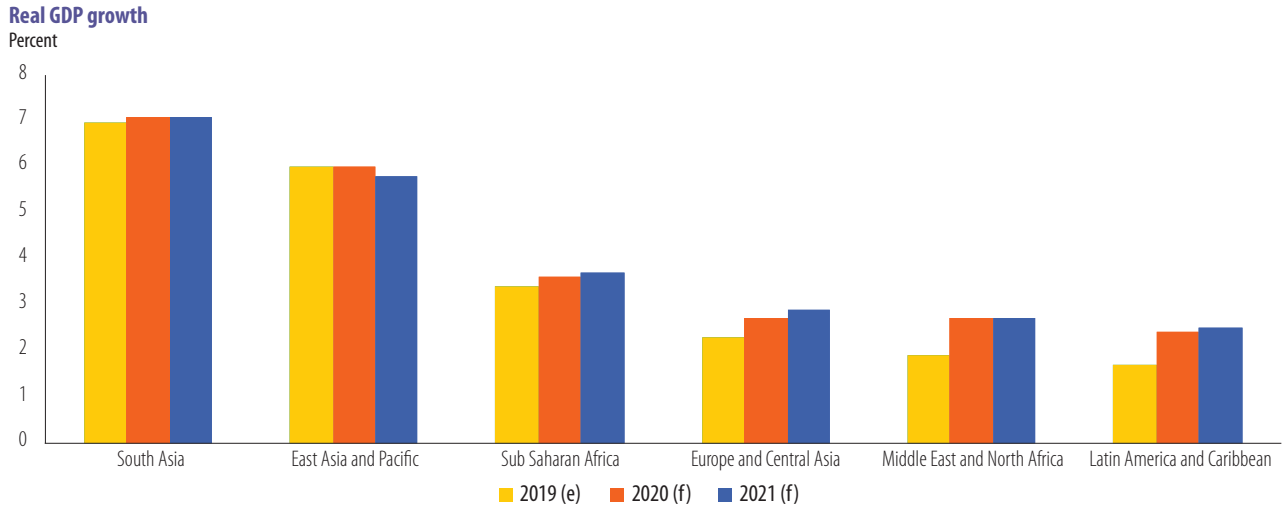
Robust growth forecast

Moderating global activity and heightened risks mean that global economic prospects are less benign than six months ago. International trade and investment have softened, trade tensions remain elevated, and some large emerging market and developing economies (EMDEs) have experienced substantial financial market pressures recently. Downside risks have become more acute and disorderly financial market developments could disrupt activity in the affected economies and lead to contagion effects. Global growth is projected to moderate from 2.9 percent in 2018 to 2.6 percent in 2019 and is expected to stabilize at 2.8 percent the following two years. The softening of global trade and the further tightening of financing conditions is expected to result in a more challenging external environment for EMDEs, whose growth is expected to stall in 2019.

The growth outlook for South Asia has been slightly revised down but remains strong. GDP growth is

Figure 20: Growth in South Asia is expected to remain strong.

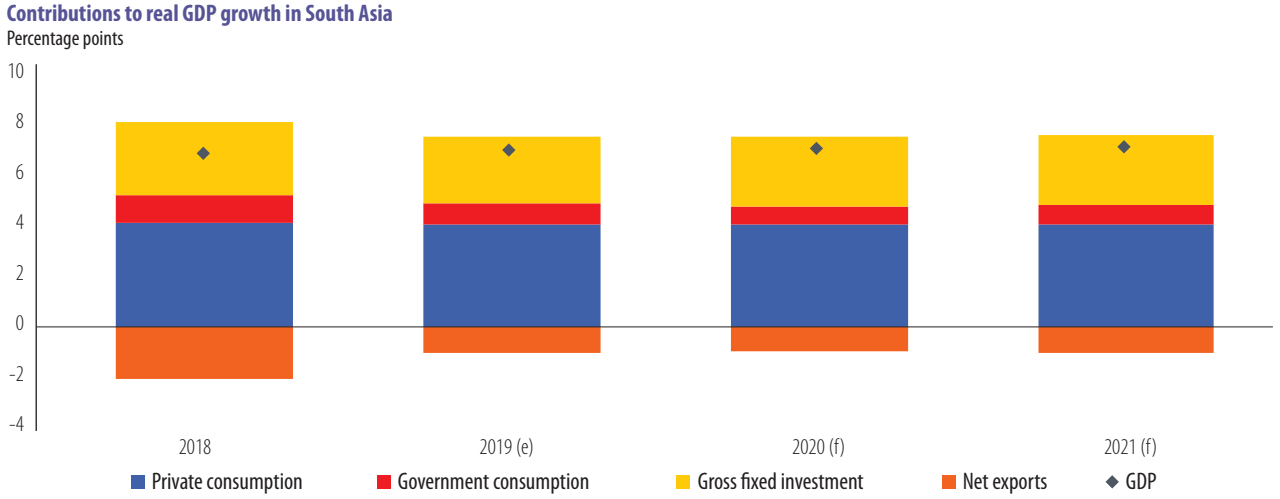
GDP growth in South Asia is estimated to accelerate to 7.0 percent this year and to 7.1 percent in the following two years and South Asia will expand its lead as the fastest growing region in the world.



Note: (e)= estimate; (f)=forecast.
Source: World Bank.

Figure 21: The negative contribution of net exports to growth is expected to shrink.

The contribution of government consumption is expected to decline from 1.1 percentage point last year to 0.8 percentage point this year and the following. The contributions of private consumption and investment are expected to soften very little. The largest change is expected from the net exports, whose contribution is expected to improve to -1.0 percentage point from -2.1 percentage points last year.



Note: (e)= estimate; (f)=forecast.
Source: World Bank.

expected to accelerate slightly to 7.0 percent this year and to increase further to 7.1 percent in 2020 and 2021 (Figure 20). For this year, this is 0.1 percentage point below the expectation in January due to a small downward revision for India and a larger one for Pakistan. For India, growth for fiscal year 2018-19 has been revised downward to 7.2 percent to align it more with the recent downward revision by the Central Statistical Office to 7.0 percent. Growth estimates in India are susceptible to revisions and further revisions are likely upcoming in May. East Asia and Pacific is expected to grow at 6.0 percent this year and next, before it is expected to decelerate to 5.8 percent. South Asia is hence very likely to extend its lead as the fastest growing region in the world. In 2021, South Asia is projected to account for 4.8 percent of the world economy, up from 4.5 percent last year and its contribution to world growth will reach 0.33 percentage points. In 2021, over ten percent of the world's GDP growth is projected to originate in South Asia.

Growth will continue to be driven by domestic demand. Domestic demand is expected to remain strong with support from monetary and fiscal policies. The contribution of government consumption is expected to decline from 1.1 percentage points last year to 0.8 percentage point this year and the following (Figure 21). The contributions of private consumption and investment are expected to soften very little, to 4.0 percentage points and 2.8 percentage points in 2020 respectively. The largest change is expected from net exports. The net contribution of trade is expected to improve from minus 2.1 percentage points last year to minus 1 percentage point this and the following year.

Table 3: Growth is expected to moderate in most countries in the region.

	2018	2019 (e)	2020 (f)	2021 (f)
Afghanistan (CY)	1.0	2.5	3.2	3.5
Bangladesh (FY)	7.9	7.3	7.4	7.3
Bhutan (FY)	5.7	5.4	5.4	5.2
India (FY)	7.2	7.5	7.5	7.5
Maldives (CY)	7.9	5.7	5.2	5.3
Nepal (FY)	6.3	6.0	6.1	6.2
Pakistan (FY, factor prices)	5.8	3.4	2.7	4.0
Sri Lanka (CY)	3.2	3.5	3.6	3.7

Notes: (e) = estimate (f) = forecast, CY = calendar year, FY = fiscal year. In Bangladesh, Bhutan, and Pakistan, FY 2018/19 ends June 30, in Nepal it ends July 15 and in India FY 2018/19 ended March 31.
Source: World Bank.

GDP growth is forecast to moderate in most countries - namely in Bangladesh, Bhutan, Maldives, and Pakistan – but to slightly accelerate in Afghanistan, India, and Sri Lanka (Table 3).

- In Afghanistan, GDP is estimated to recover and converge to 3 percent over the forecast horizon, with the assumption that drought conditions will ease, and political stability will be restored upon presidential elections in September. An improved security situation would support confidence and economic activity.
- In Bangladesh, GDP is projected to average 7.3 percent over the forecast horizon. Activity will be underpinned by strong infrastructure spending and robust investment with expanding credit growth. However, a slowdown in economic activity of trading partners could restrain the contribution of net exports to growth next year.
- In Bhutan, GDP growth is expected to remain solid at 5.4 percent in FY2019/20 and to remain above 5 percent over the forecast horizon, supported by tourism and retail trade.
- In India, GDP is forecast to expand 7.5 percent in FY2019/20. Credit growth will benefit from relatively more accommodative monetary policy amid benign inflationary conditions. Support from delayed fiscal consolidation will partially offset the effects of political uncertainty on economic activity around elections in May.
- In Maldives, economic activity is forecast to expand by 5.7 percent in 2019, and to moderate to 5.3 percent over the medium term, as investment projects converge to historical averages.
- In Nepal, GDP growth is projected to average 6 percent over the medium term. The services sector is forecast to benefit from strong tourism, and manufacturing will be supported by the opening of the Nepal's largest cement factory next year.
- In Pakistan, GDP growth is expected to further slow to 2.7 percent in FY2019/20, as domestic demand remains depressed. Macroeconomic imbalances, reflected in large fiscal and current account deficits, are expected to resolve gradually. Remittances flows are likely to support growth and the current account balance next year. A relatively more stable external environment is seen to help a pickup in economic activity starting from FY2020/21.
- In Sri Lanka, GDP growth is expected to pick up to 3.5 percent in 2019 and to converge towards 4 percent over the forecast horizon. The recovery will be supported by a pickup in services sector and solid infrastructure investment.

Lower import growth and higher export growth

In a major shift from the last years, imports and exports are expected to grow at very similar rates this year and the following (Figure 22). In the last two years, imports grew much stronger than exports. In 2017, exports grew only 4.6 percent whereas imports grew by 14.9 percent. Last year, exports grew by 9.7 percent and imports by 15.6 percent. In both years net exports were negative and hence dragged growth. This year, however, import growth is expected to come down to 11.8 percent and export growth to improve to 11.1 percent. In the following years, both are expected to grow around 11 percent. As a result, the negative net contribution from exports is projected to weaken over time.

The projected decline in regional import growth is consistent with the projected GDP growth composition going forward. To assess whether the projected import growth is consistent with developments in the past, we use three simple error correction models. For the first prediction we regress import growth on the growth rate of the sum of domestic demand (minus imports) and exports. The advantage of this specification is that we need to estimate few coefficients. For the second prediction, we consider exports and the three components of domestic demand (private consumption, government consumption, and investments) separately, and for the third we include oil prices. All models have a reasonably good in sample fit. That said, the models fit the data better the more information we include (Figure 23). Especially the first model but also the second one underpredicts import growth in 2016 and 2017, but the model with oil prices is very close. For last year, imports grew exactly as much as the second and third prediction model suggest. The forecast import

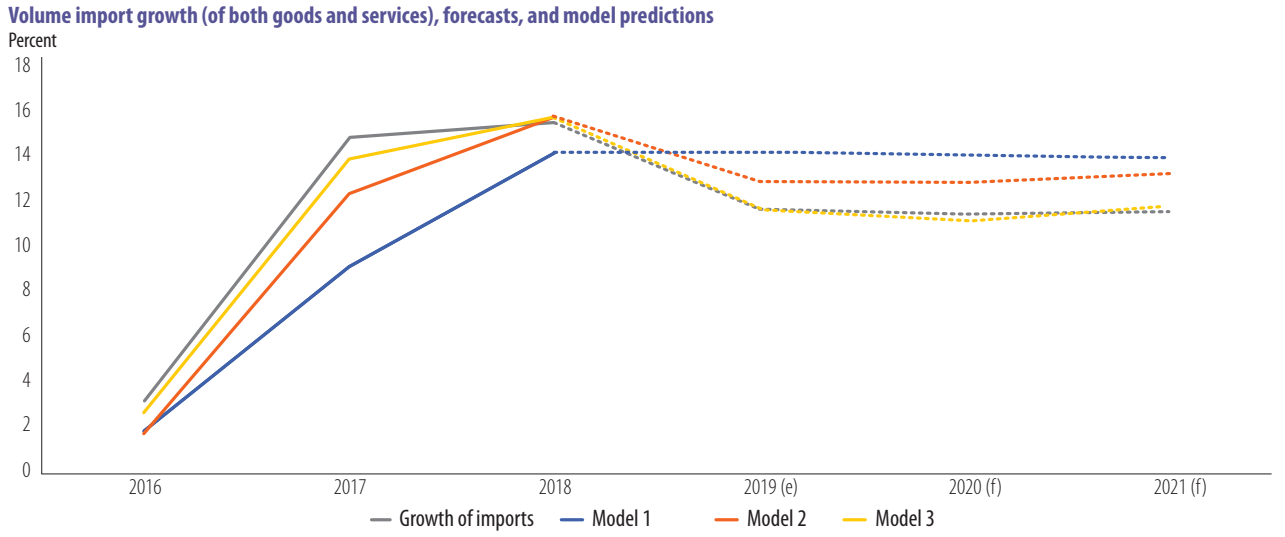
Figure 22: Imports and exports are forecast to grow at similar rates going forward.

In the past years, imports grew much faster than exports in South Asia. This year and the following year, however, imports and exports are forecast to grow at very similar rates.

Note: (e)= estimate; (f)=forecast.
Source: World Bank.

Figure 23: The expected decline in regional import growth is consistent with the forecast GDP growth composition.

The projected decline in imports for this year and the two following is very much consistent with a prediction based on a model considering the projections of the other components of GDP, especially when also taking oil prices into account.



Note: (e) = estimate; (f)=forecast. Predictions are based on error-correction models explaining import growth given the other components of GDP (1 and 2) plus oil prices (3).
Source: World Bank.

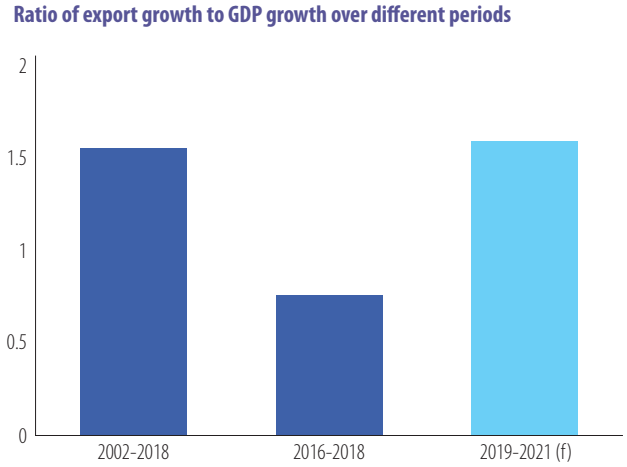
growth rates, done by different teams for different countries, are below the prediction of the first two models, but follow closely the prediction of the third.

But will export growth pick up? For this year and the next two, the projected ratio of export growth to GDP growth is 1.6. While this is very much in line with the long-run average from 2000 to 2018, it is twice as high as the ratio over the last three years, when it only averaged 0.8 (Figure 24a). It is especially high if one considers the fact that global trade growth is projected to slow this year and the following (Figure 24b) and that the export growth in South Asia is strongly correlated with world trade growth (a correlation coefficient of 0.8 since 2000). In Bhutan, exports will increase due to the opera-

Figure 24: Export growth is projected to pick up, despite global trade weakening.

The projected increase in exports means a doubling of the export growth to GDP growth ratio compared to the average over the last three years, but it is consistent with the long-run average. However, global trade is expected to moderate, which will make achieving high export growth more difficult.

a) Ratio of South Asia's export growth to GDP growth



b) Projected global trade growth

Note: (e)= estimate; (f)=forecast.
Source: World Bank.

tionalization of new hydropower plants. Similarly, the Upper Tamakoshi Hydropower Project will increase Nepal's exports. But while the depreciation of South Asian currencies may have a positive impact in the medium run (see Chapter 3), countries may struggle to increase exports further this year and then even more the next two years. It remains to be seen whether they will indeed manage to improve their export performance as much as projected. In the past, our trade projections have been too upbeat and we overpredicted export growth and underpredicted import growth (see last edition of this report). If the net contribution of exports does not shrink but instead stays at last year's level, growth in 2021 would *ceteris paribus* only be 6.0 percent rather than the projected 7.1 percent.

Downside risks to the outlook

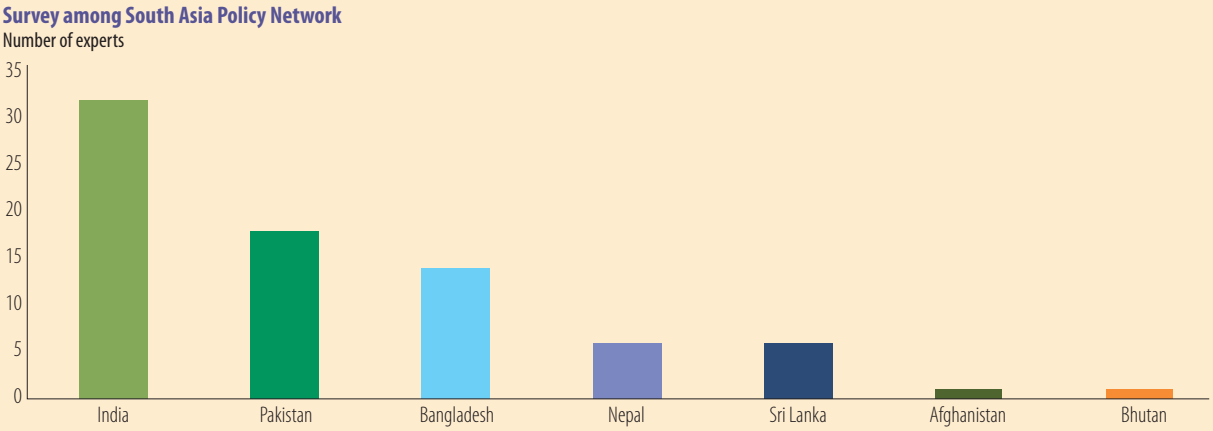
Downside risks to the forecasts are strong. In addition to uncertainty about the projected pick up in export growth, there are additional downside risks to the outlook. The main domestic risks include a re-escalation of political turbulence amid an election cycle in some countries, fiscal slippages with expanding public spending, and a resurgence of non-bank financial sector funding issues. The elevated tension between India and Pakistan in mid-February did not have a major immediate effect on markets, however a re-escalation could deteriorate confidence and weigh on investment in the region. External risks stem from weakening global growth and rising policy uncertainty. A sharper than expected deceleration in major economies or a recurring escalation of trade-related tensions among them could result in unfavorable spillovers to the region. High external debt and low international reserves limit the maneuverability against external shocks in some countries in the region. The new GST regime in India is still stabilizing, though GST tax collection has been improving in February, and fiscal deficits exceed official targets in some countries, posing a risk for the public finance outlook.

And structural bottlenecks persist. Deteriorated balance sheets of banks and corporates, and supply bottlenecks such as infrastructure gaps and relatively weak business climates continue to depress domestic and foreign investment potential in South Asia. A setback in reforms to address these issues could weigh on activity. In addition, South Asia is vulnerable to natural disasters, and the frequent occurrence of these events poses a challenge for its economic development.

Box 3: Views from the South Asia Economic Policy Network

The South Asia Economic Policy Network, launched by the office of the regional Chief Economist for the South Asia region at the World Bank in 2017, represents an attempt to engage more strongly with thinkers and doers across South Asia. The objective is to be more proactive in nurturing the exchange of ideas and to learn more systematically from colleagues and counterparts in the region. The Network currently focuses broadly on macroeconomics and includes over 380 researchers and practitioners from the region. The network includes researchers from seven South Asian countries, selected based on peer recognition, recent conference presentations, and research outputs. Many of them are academics at renowned universities; others are researchers in central banks and think tanks, and some are affiliated with policy-making units.

Figure 25: We asked over 380 economists from seven countries about their views.



Source: World Bank South Asia Economic Policy Network.

As for the last three editions of this report, a short opinion survey was conducted among the group for this edition of South Asia Economic Focus. The objective was to take the pulse of informed and influential experts about economic developments in their countries. By the same token, the survey allowed gathering their views on issues related to external stability and the main obstacles to higher exports in their respective countries.

With 83 filled-in questionnaires from 7 countries the response rate was 22 percent and all South Asian countries apart from Maldives are represented (Figure 25). Nearly all respondents identified themselves as academics and as macroeconomists. Almost one third of the respondents are involved in policy making and over a half in policy advising. Responses regarding the economic situation are sum¬marized here. The views on external vulnerabilities and exports are reported in the third chapter.

The expectations of Network members regarding economic developments over the next six months are summarized in a single number, using so-called diffusion indices. For any indicator, a value above 50 indicates that an increase is expected, whereas a value below 50 corresponds to an expected decrease. The farther away the number is from 50, the greater the consensus among Network members that an important change is under way.

Respondents anticipate GDP growth to develop differently in different countries (Figure 26). In Pakistan and India, a majority expects that the growth rate will come down. In Bangladesh and the other countries, however, the diffusion index signals an acceleration in GDP growth. Network members expect that inflation and interest rates will pick up across all countries, except in India, where interest rates are expected to decrease further. The expected decline in interest rates has already taken shape with the recent reduction in early April. In India, imports are expected to increase, while exports are expected to decrease. In Pakistan, on the other hand, imports are expected to decrease, while exports are expected to increase. In all other countries the volume of imports and exports are both expected to increase. Network members also foresee an increase in the fiscal deficit across all countries, but in Pakistan less strongly than in other countries. Finally, there are very strong views across South Asia that the exchange rate will further depreciate, and that financial sector stress will rise

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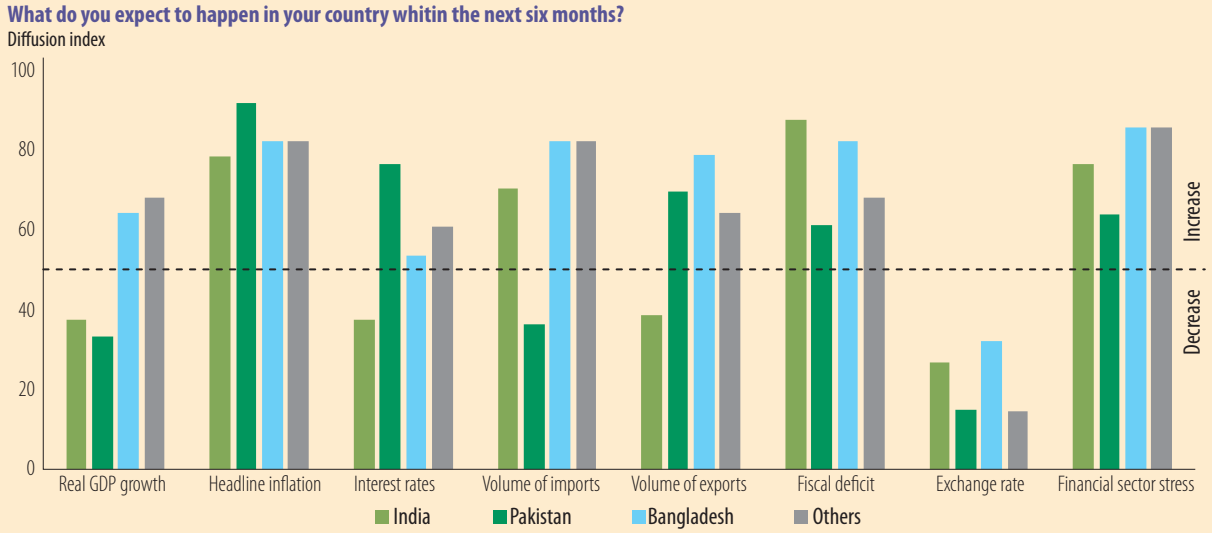
Figure 26: Views on the outlook are mixed.



Notes: The index is calculated as follows: Index=(P1*100) + (P2*50) + (P3*0), where P1 is the proportion of responses that report that the indicator will increase, P2 is the proportion of responses that report that the indicator will stay the same, and P3 is the proportion of responses that report that the indicator will decrease. The data points reflect results from the Fall 2017 survey.
Sources: World Bank South Asia Economic Policy Network and staff calculations.

Different from six months ago, experts expect lower interest rates in India (which has already materialized). But the growth and inflation expectation remain broadly unchanged and so do the expectations about future trade developments as well as the strong views on continued depreciation and rising financial sector stress.

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Exports wanted

External financing conditions became less benign, and especially countries relying on portfolio investment from abroad face rising borrowing costs. This is particularly worrisome, as South Asia's external financing needs have increased. The region's current account deficit has widened from 0.7 percent of GDP two years ago to 2.9 percent last year. This widening deficit reflects accelerating growth in domestic demand, outpacing income growth. The rebound in oil prices was one of the factors driving it. In response to the mounting financing tensions, interest rate spreads have increased, and currencies have depreciated. However, it is unlikely that such price changes will, by themselves, bring current accounts quickly back into balance. If not accompanied by direct measures to reduce domestic demand, depreciations in fact tend to increase South Asia's current account deficits, at least in the short run. Fiscal tightening is the most direct way to reduce domestic demand. And indeed, in South Asia there is a strong link between fiscal deficits and current account deficits. Under current circumstances fiscal tightening is appropriate, not only to make government debt more sustainable, but also to bring the economy back into balance, and thus become less vulnerable to deteriorating conditions in international financial markets. Once the reduction in domestic demand has been achieved, real depreciations can bring imports and exports back in line and replace domestic demand with foreign demand. A complication in the latter adjustment is that South Asia's export volumes are low, so that large real depreciations are needed for a substantial increase in exports. Using a gravity model, we show that South Asian countries export less than a third of their potential. If countries export closer to potential, not only would short-term adjustments be easier, but also the long-term growth potential would be higher. Closing the export gap is an essential step in addressing both short-term and long-term macroeconomic challenges in South Asia.

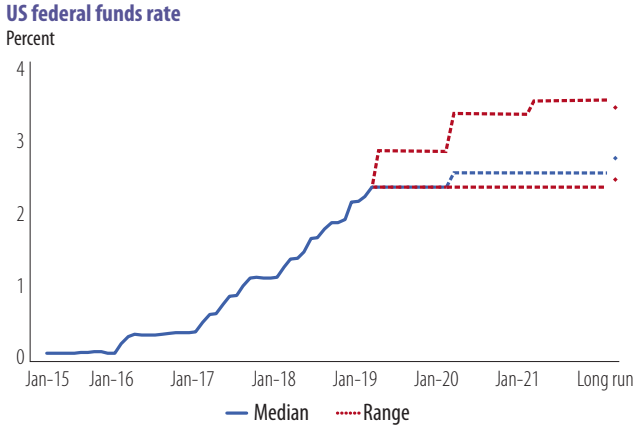
Tighter external financing conditions

As monetary policy tightened in the United States, external financing conditions became less benign in 2018. The rise in U.S. interest rates has led to reduced capital flows to emerging markets and developing economies (EMDEs), making external borrowing more expensive. In South Asia, this was especially true for Sri Lanka, Pakistan, and India. All three faced rises in credit default swap spreads, and the latter two experienced net portfolio outflows. Although the monetary tightening has paused currently, the expectation is that U.S. interest rates have not yet reached their peak (Figure 27), while the quantitative easing by the European Central Bank (ECB) will likely be reversed and European interest rates are expected to increase as well. Even limited further tightening of monetary conditions could become disruptive for borrowers. Back in 2013, the mere announcement by the Federal Reserve Bank (Fed) of its plan to gradually reduce its quantitative easing program led to strong portfolio outflows from EMDEs, currency pressures, and increasing borrowing costs (World Bank 2018a; World Bank 2018b). That fierce market reaction might not repeat itself, but the costs of external financing for EMDEs are very likely to increase further, even if the extent of the increase is unpredictable.

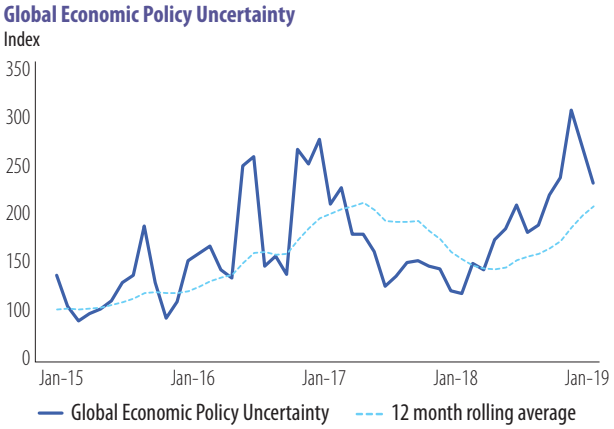
And high economic policy uncertainty adds to the risks for a sudden reversal in investor sentiments (Figure 27). Escalation of trade tensions between the United States and China or the European Union could indirectly affect South Asia in an adverse manner. Even if South Asia benefits from trade diversion caused by the trade tensions, it could be hurt by the accompanying souring of global investor sentiments. Since capital flows to EMDEs are strongly correlated,

Figure 27: External financing conditions are becoming less benign.

Monetary policy in the United States is expected to tighten further, and global economic policy uncertainty is rising, partly due to the unclear future trade relations between major economies.



Note: The projections for the federal funds rate are based on the assement of Federal Open Market Committee (FOMC) members.
Source: Federal Reserve System.



Notes: The solid line shows the GDP weighted global average including 20 countries. Each of the national indeces reflects the relative frequency of newspaper articles that contain a trio of terms economy, policy and uncertainty. For more information refer to www.policyuncertainty.com.
Source: Baker, Bloom and Davis (2016).

a worsening of investor sentiments would also affect South Asian countries, and the impact of changes in the risk appetite of international investors tends to outweigh the direct impact of policy changes on trade flows (Freund et al. 2018). These risks could materialize against the backdrop of a slowing global economy, which in itself may negatively affect investor sentiment (World Bank 2019a). Moreover, geopolitical tensions could put downward pressure on FDI inflows into the region. All these risks would make financing of the region's current account deficits more difficult.

While financing conditions were deteriorating, South Asia's financing needs were surging. The region's current account deficit increased from 0.7 percent of GDP in 2016 to 2.9 percent of GDP in 2018. Except for Afghanistan, all countries in South Asia faced a current account deficit last year. Deficits in India, Pakistan, and Sri Lanka have widened over the last two years, while current account surpluses in Bangladesh and Nepal turned into deficits (Figure 28). The reasons for the deficits vary from country to country. In India, for example, it is mostly driven by oil imports, whereas in Sri Lanka also foreign exchange financing of short- and medium-term debt plays an important role. The current account deficit has been very large for many years in Bhutan and Maldives, due to high investments in hydropower projects in Bhutan and large infrastructure projects in Maldives. In both countries, the current account deficit has started to close somewhat as many of these investment projects are nearing completion.

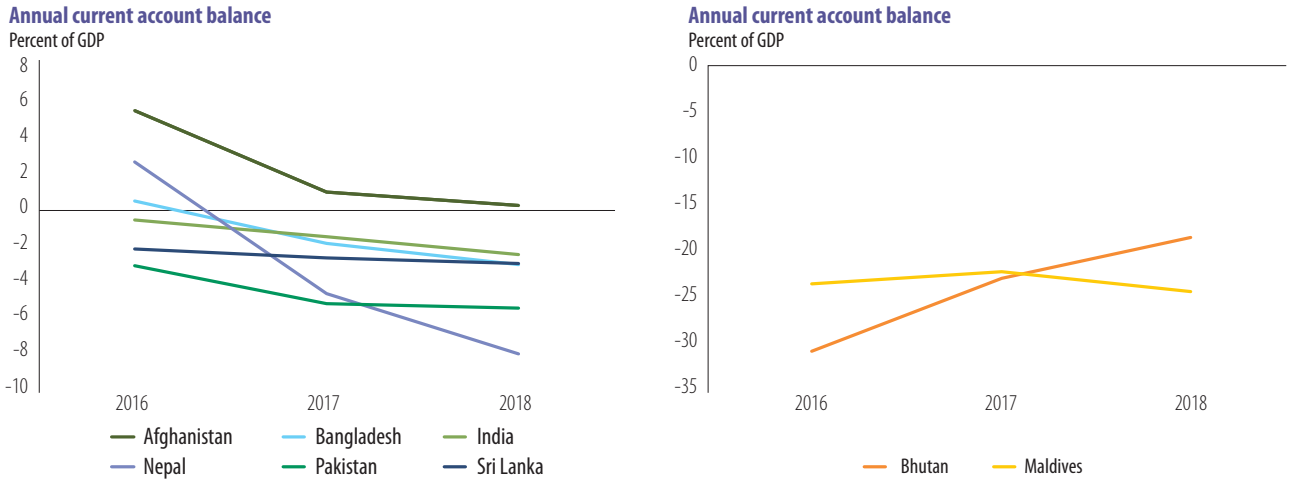
The current account deficit indicates that the region's expenditure exceeds its income. The current account is for a country what the fiscal balance is for a government. Adding private income minus private spending to government spending minus government income gives the current account balance, or:

current account balance =
private saving – private investment + fiscal balance

where private saving is private income minus private consumption. In South Asia the fiscal balance has been structurally in deficit. In 2016 that deficit was largely compensated because private sector savings exceeded private sector investments. But that compensation weakened over the last two years, resulting in a widening of the current account deficit (Figure 29). The balance of private savings and private investments was reduced largely because of a fall in savings. The widening deficits meant that countries had to borrow more from abroad. A current account deficit is not necessarily undesirable, harmful or risky, and the current account may be in deficit for many years. The sustainable equilibrium balance depends on many factors, including demographics, credit cycles, and institutions.

Figure 28: Except for Afghanistan, the current account is in deficit across the region.

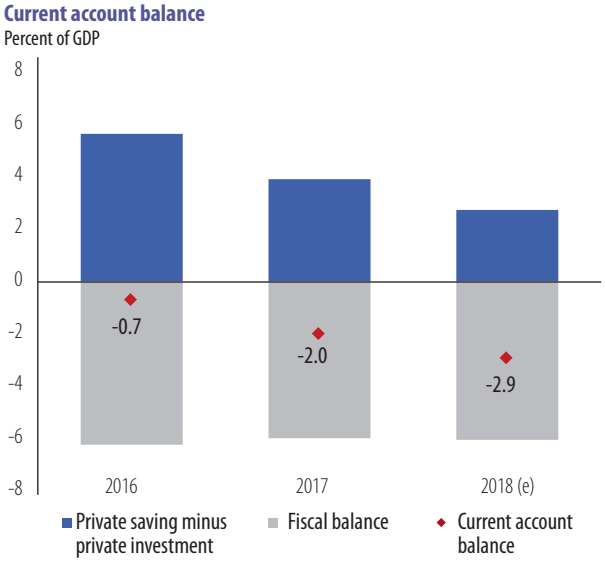
The current account deficit of Bhutan and Maldives has been large for many years due to high investment, but it is narrowing again. In all other countries, the current account balance decreased from 2016 to 2018 and except for Afghanistan it was in deficit last year.



Source: World Bank.

Figure 29: South Asia's external financing needs are increasing.

South Asia's current account deficit rose from 0.7 percent of GDP in 2016 to 2.0 percent of GDP in 2017 and to 2.9 percent of GDP in 2018. Over these years, private saving decreased, and investment increased.



Note: (e) = estimate.
Sources: IMF, World Bank, and staff calculations.

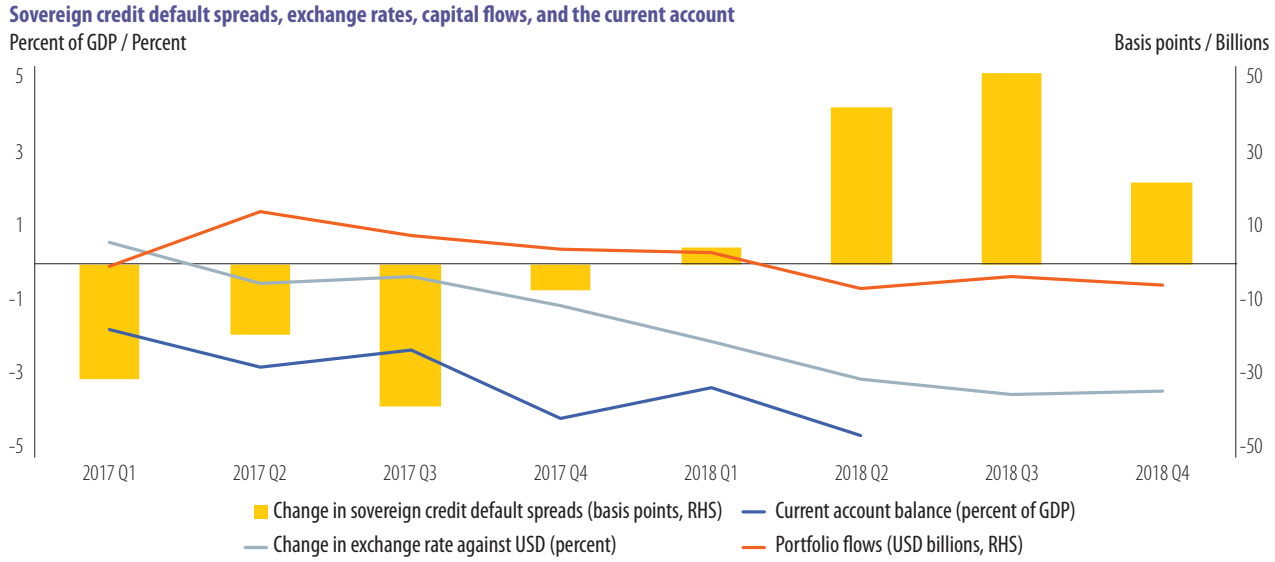
The combination of a less benign external environment and larger external financing needs have increased sovereign credit default spreads, triggered capital outflows, and depreciated the currencies strongly. While portfolio flows to India and Pakistan were positive during the first quarter of 2018, capital started flowing out of South Asia afterwards and overall portfolio flows were negative in 2018 (Figure 30). The interest rate spread is the difference between the interest a government has to pay on a dollar-denominated bond and the interest rate the United States government pays. This spread can be approximated by sovereign credit default spreads. From January 2018 to January 2019, these spreads increased by over 200 basis points in Sri Lanka, by over 70 basis points in Pakistan, and by 40 basis points in India. In addition, all South Asian currencies depreciated against the U.S. dollar and they depreciated more than currencies in the rest of the world (see Chapter 1). The only exception is Maldives, as their currency is pegged against the USD.

A delicate balance

The current account balance is the result of many domestic and international factors. As mentioned above, the current account balance equals domestic income, i.e. domestic production plus remittances and current grants, minus domestic spending. Spending can temporarily deviate from income after short-term shocks to smooth consumption over time. Spending can also deviate structurally from income. For example, fast growing economies can sustain current account deficits. They need high

Figure 30: Higher risks already resulted in increasing sovereign spreads, depreciating currencies and capital outflows.

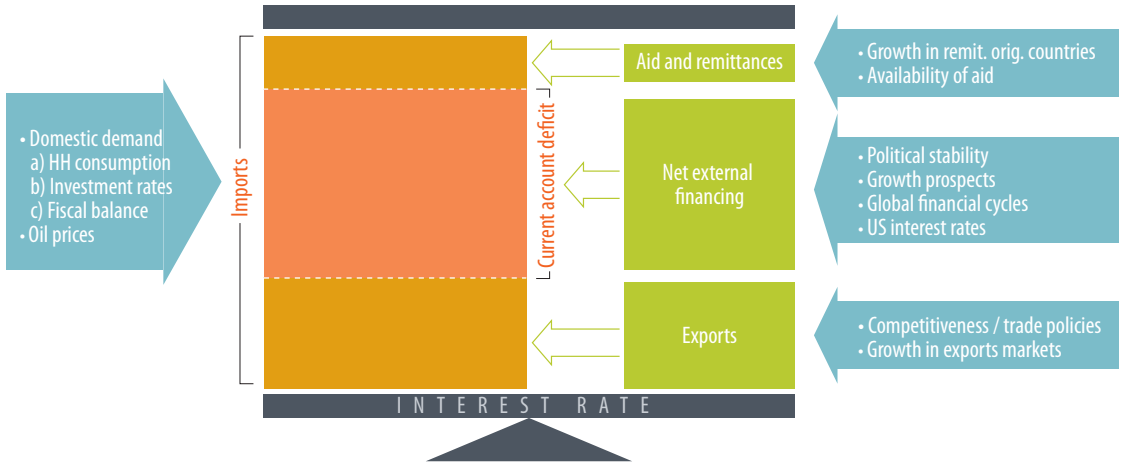
While portfolio flows to India and Pakistan were positive during the first quarter of 2018, capital started flowing out of South Asia afterwards. Sovereign credit default spreads increased in 2018 and South Asian currencies depreciated against the U.S. dollar.



Notes: Sovereign credit default spreads represent the simple average year-on-year change of India, Pakistan and Sri Lanka of their respective five-year U.S. dollar credit default swap (mid-rate). The current account is in percent of GDP and represents the average of Bangladesh, India, Pakistan, and Sri Lanka. Portfolio flows (billions) include India and Pakistan flows in a 3-month rolling average. Official exchange rate USD per LCU represent the average quarterly growth for Bangladesh, India, Pakistan, and Sri Lanka.
Sources: Sovereign credit default spreads are from CMA Datavision (Haver Analytics)/Global Economic Prospects (January 2019). The current account is from Trading Economics. The Official exchange rate is from the International Financial Statistics (IFS) from the IMF. Portfolio flows are from IIF.

Figure 31: The Balance of Payments is driven both by domestic and international factors.

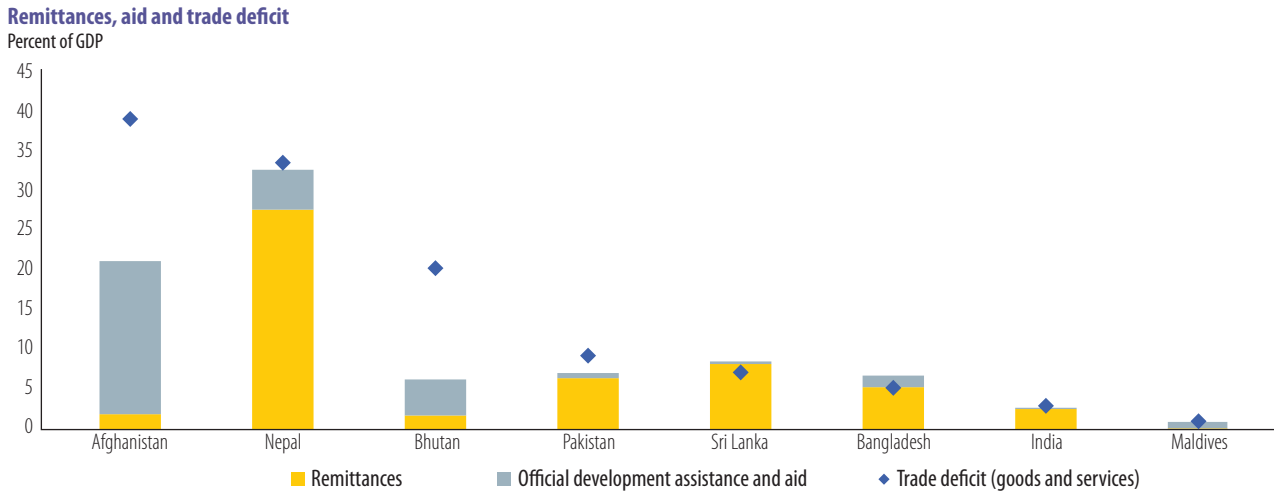
The Balance of Payments records all economic transactions between the residents of a country and the rest of the world. If imports are higher than exports, the trade deficit needs to be financed by aid, remittances, or external borrowing. Relative prices ensure external balance in equilibrium.



investment ratios to support high growth rates and debts can be paid back in the future when the economy is larger. Current account deficits also equal net capital inflows and are thus also dependent on international factors. If foreign investors are not willing to finance deficits, then domestic spending will be forced down. If foreign investors are eager to invest in a country, then domestic spending will be forced up. International financing can be of a cyclical nature, often through portfolio flows, or can be structural, often through FDI. Therefore, the availability of external financing depends on domestic factors like political stability and growth prospects, but also on international factors like global finan-

Figure 32: High remittances and grants are resulting in large trade deficits in some countries.

Some South Asian countries benefit from large grants and remittances inflows. The former is close to 20 percent of GDP in Afghanistan, the latter close to 30 percent of GDP in Nepal. These large external inflows allow for high trade deficits.



Note: Data is for 2017 as data on official development assistance and aid is not yet available for 2018.
Source: World Bank and staff calculations.

cial cycles and US interest rates. Finally, the current account balance also equals the trade balance minus inflows of remittances and official grants. That means that current accounts can be influenced, at least in the short run, by trade shocks, like changes in tariffs or sudden changes in commodity prices. Figure 31 depicts all these influences on the current account.

In South Asia, there is a major difference between trade balances and current account balances. In all countries in the region, imports exceed exports and the trade deficits are partly paid with official grants and remittances inflows. While almost all South Asian countries receive large remittances inflows, Nepal is a clear outlier with officially recorded remittance inflows close to 30 percent of GDP. As remittances are inherently difficult to measure and not all are accounted for in official statistics, actual remittances might even be higher (see Box 4). Most Nepali migrant workers are in India, Malaysia or the Gulf Cooperation Countries. Remittances increase disposable income and thus imports. But they may also reduce exports as a rise in income can reduces international competitiveness if it raises domestic prices. Remittances and aid flows are rather stable sources of external financing. The autocorrelations of both remittances and grants in South Asia are a very high 0.7, and the coefficients of variation are a very low 1.5. Since neither creates a financial obligation, trade deficits in the region directly linked to inflows of remittances and aid could well be sustainable.

There is no single policy measure that can keep current accounts in balance or keep deficits sustainable. Because so many factors determine the ultimate outcome, the balance is delicate and can easily be disturbed. What constitutes disequilibrium is difficult to measure (IMF 2018a) and depends on many factors, some of which a country cannot control itself. But once off balance, it can be challenging to restore equilibrium. Out of equilibrium, pressure builds on interest rates and exchange rates, but changes in these prices do not necessarily restore equilibrium quickly. Before addressing this equilibrium process at the end of this chapter, we first discuss consecutively three components of Figure 31: domestic demand, external financing, and exports.

Accelerated domestic spending

South Asia's domestic demand has recently grown much faster than exports. In the early 2000s, South Asia's export grew three times as fast as domestic demand. But since then, exports growth declined,

Box 4: Measurement and significance of remittances

In South Asia, remittances have been increasing since the 1980s, as more workers started to migrate to other countries, especially within South Asia and to Gulf Cooperation Council Countries. For many South Asian economies, remittances now represent a sizable and stable source of external funds, which in many cases exceeds official aid and foreign direct investment by far. South Asian remittances inflows are among the highest in the world compared to output, with a level close to 30 percent of GDP in Nepal, and above 5 percent of GDP in Pakistan, Sri Lanka and Bangladesh. All four of them are among the top 20 remittances receiving countries in the world. And while remittances inflows are only 2.5 percent of GDP, India receives by far the largest amount of remittances in total value in the world.

Importantly, personal remittances as recorded in the current account comprise both personal transfers and specific kinds of compensation of employees. Personal transfers are current transfers in cash or in kind received by resident households from nonresident households. In addition, the income of workers employed in an economy where they are not residents and of residents employed by nonresident entities are defined as remittances as well (IMF 2014). For most countries in South Asia, officially recorded personal remittances consist nearly completely of personal transfers, but there are two exceptions: for Afghanistan the compensation of employees matters and for Maldives, compensation of employees is by far the most important component of remittances.

Remittances are very difficult to measure precisely and the Balance of Payments (BoP) of course only include officially recorded ones. Any mismeasurement from imperfections in source data and compilation shows up in the errors and omissions of the BoP. In Nepal, for example, the large current account deficits in previous years did not lead to a significant increase in external debt or decline in reserves. This points towards significant positive net errors and omissions related to informal transactions not captured in workers' remittances and compensation of employees (IMF 2018b).

Remittances help finance trade deficits and, at least for the moment, seem resilient across the countries in the region. As remittances support domestic consumption, they contribute to declining poverty, especially in South Asia (Maimbo et al. 2005). Remittances enable better health care, nutrition, housing, and education and can improve economic growth, especially if used for financing education or health expenses of children (Maimbo and Ratha 2005). Remittances have also been shown to promote financial development (Aggarwal et al 2006). Yet, like for other foreign currency inflows, large remittances inflows result in currency appreciation, which affects the competitiveness of exports (Maimbo et al. 2005). In a study on the effect of remittances on current accounts, Lartey (2018) finds a positive effect of remittances contemporaneously, but a negative lagged effect, which indicates the presence of some underlying mechanisms characteristic of the Dutch disease phenomenon.

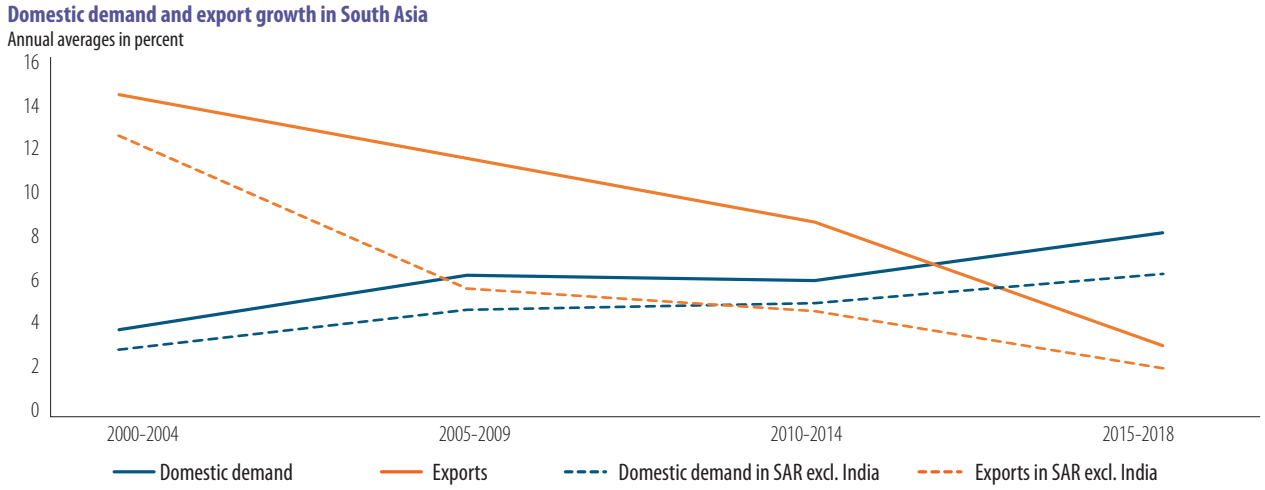
The World Bank regularly reports global trends in remittances flows and highlights developments connected to migration-related Sustainable Development Goal (SDG) indicators for which the World Bank is a custodian: increasing the volume of remittances as a percentage of (GDP), reducing remittance costs, and reducing recruitment costs for migrant workers (World Bank 2018c).

and growth of domestic demand increased (Figure 33). For South Asia including India, exports grew 5.4 percentage points faster than domestic demand between 2005 and 2009 and still 2.6 percentage points faster between 2010 and 2014. For South Asia excluding India, exports and domestic demand grew at similar rates between 2005 and 2014.. Over the last four years, however, domestic demand growth overtook export growth. In South Asia including India, domestic demand grew by 8.4 percent, while exports grew only 3.2 percent. The situation has been similar in the region excluding India, with domestic demand growth of 6.6 percent and export growth of 2.2 percent**.** The recent economic boom was hence not driven by exports, but instead by domestic demand (see Chapter 1 and World Bank 2018a). These dynamics explain the fast growth of imports and the widening current account deficit during the last couple of years. The change in the structure of growth could have made the growth unsustainable. For that we also need to look at the composition of domestic demand growth.

During the last two years, a consumption and investment boom resulted in very strong import growth. In South Asia, the volume growth of consumption and investment was higher over the last two years than between 2000 and 2016. Government consumption grew on average 11.1 percent in the last two years, compared with a long-run average of 5.7 percent. For South Asia excluding India, the growth of private consumption and investment have also

Figure 33: Over the last years, domestic demand grew much faster than exports.

While South Asian exports used to grow faster than domestic demand in the 2000s, the opposite was the case in recent years. Between 2015 and 2018, domestic demand increased on average by 8.4 percent a year, while exports only grew by an average of 3.2 percent.

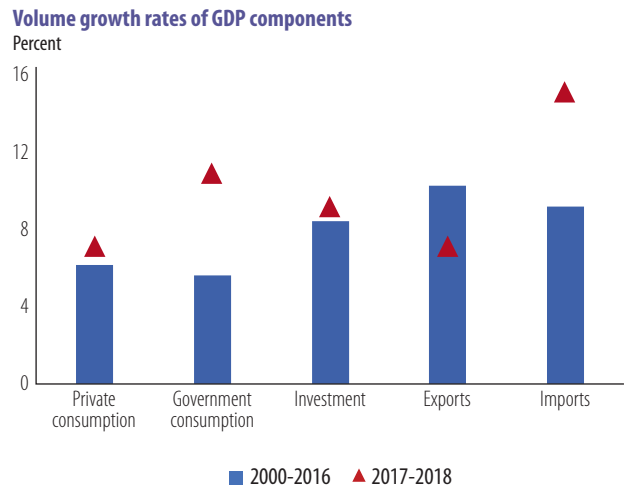


Note: Domestic demand and export growth are annual averages.
Source: World Bank and staff calculations.

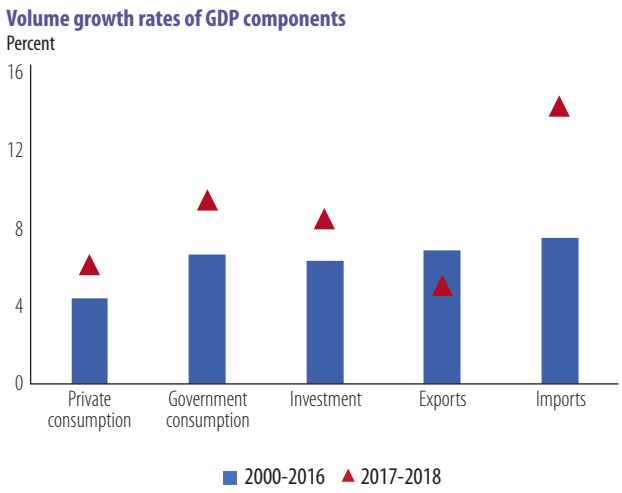
Figure 34: In many countries, domestic factors translate into high import growth.

During the last two years, a consumption and investment boom resulted in very strong import growth. Especially government consumption growth was unusually high. Exports, on the other hand, grew much less than in the past.

a) South Asia



b) South Asia excluding India



Source: World Bank and staff calculations.

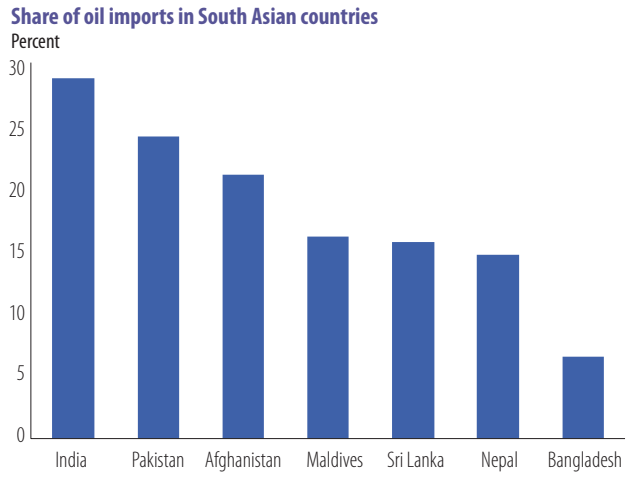
been considerably above the long-run average. Whether India is included in the regional aggregate or not, exports grew much less than in the past and imports much more. South Asia's imports grew 15.3 percent in the last two years compared to an average of 9.3 percent in the long-run (14.4 percent and 7.5 percent if India is excluded). In Bangladesh, imports increased by over 20 percent in 2018, the highest in South Asia. Imports also increased strongly in Pakistan and Nepal. In India imports still grew 9.5 percent. In Sri Lanka, however, they grew by only 3.6 percent due to lower government expenditure and slow household consumption growth. And in Bhutan they even decreased, as investment came down with one hydropower project about to be commissioned and two further projects facing construction delays.

Oil imports are high across countries in South Asia and the rising oil price increased the oil import bills, which in turn worsened trade and current account

Figure 35: South Asian countries are net importer of oil and the rise in oil prices has raised their import bills.

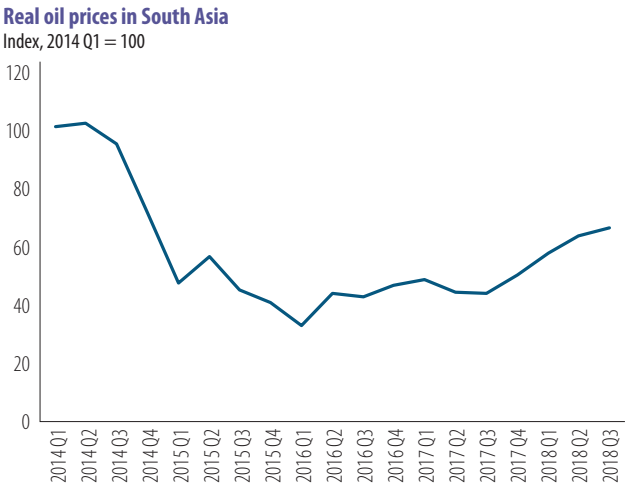
South Asian countries import a lot of oil. After a large drop in 2014, oil prices are increasing again since 2016 and they reached 70 USD per barrel in the last quarter of last year. Rising prices translated into higher oil bills. And the oil trade balance in South Asia is highly correlated with the overall trade balance and the current account balance.

a) South Asian countries import a lot of oil.



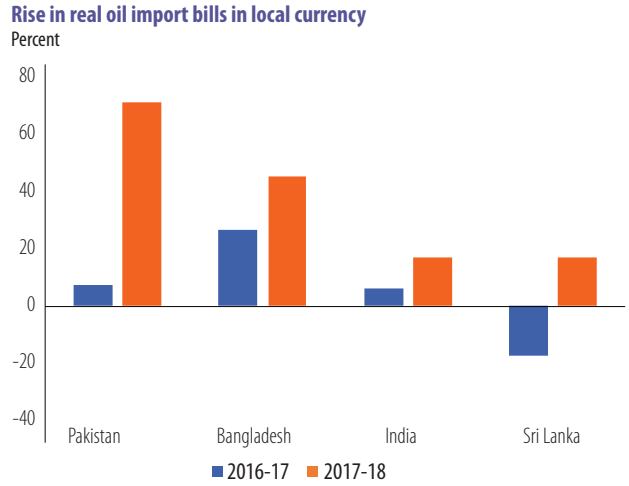
Note: The bars reflect the average share of fuel imports among all imports from 2014 to 2017.
Source: WTO and staff calculations.

b) The price of oil increased over the last years



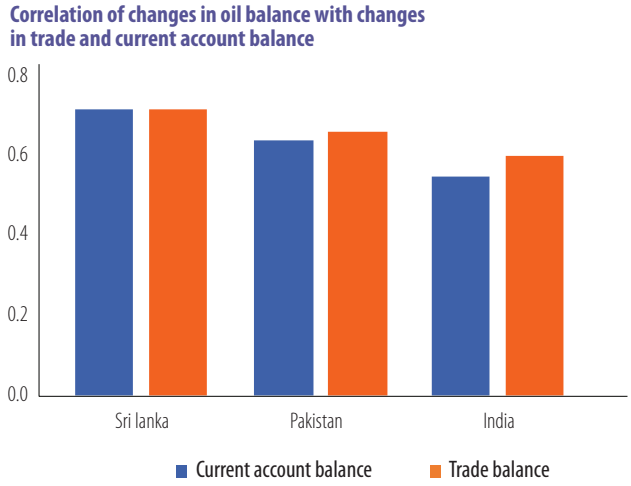
Note: The oil price computed based on BRENT and the price for South Asia is a simple average of all South Asian countries.
Sources: IMF, Federal Reserve Bank of St. Louis, and staff calculations.

c) The oil import bills of South Asian countries increased



Notes: For Sri Lanka, 2016-17 stands for CY 2016; for all other countries we report fiscal years. For all countries we used oil import information as reported by the national statistical offices and petroleum ministries. For Bangladesh we sum the crude oil imports and refined oil imports; for India we use crude oil imports, petroleum product imports and LNG imports; for Sri Lanka we use crude oil imports; and for Pakistan we use petroleum oils import.
Sources: BPC for Bangladesh, PNG for India, PBS for Pakistan, DCS for Sri Lanka, and staff calculations.

d) The oil balance affects the overall trade balance and the current account



Note: The correlations are based on annual data in values from 2000 to 2017.
Sources: Comtrade and IMF.

deficits. Fuel imports between 2014 and 2017 constituted on average around a third of imports in India, a quarter in Pakistan and a fifth in Afghanistan (Figure 35a). In Maldives, Sri Lanka, and Nepal, they constituted around 15 percent of imports, while in Bangladesh they accounted for only 8 percent. After the large drop in 2014, oil prices have risen since 2016. International oil prices dropped strongly from over 100 USD per barrel in the second quarter of 2014 to a low of 34 USD per barrel in the first quarter of 2016. Since then, prices have increased again, and they reached 69 USD per barrel at the end of 2018, more than double the level in the first quarter of 2016. For countries in South Asia, the oil price in local curren-

Box 5: Analyzing the current account balance with Vector Autoregressive (VAR) Models

We employ two different VAR models in this chapter. One estimates the effect of oil shocks on the current account; the other estimates the effect of temporary and permanent shocks on the current account and the exchange rate.

a) Estimating the effect of oil prices on the current account

We estimate the effect of oil price shocks on the current account with a SVAR model with three variables following Qurat-ul-Ain and Tufail (2013): the oil price, the exchange rate and the current account. Shocks to oil prices are identified by assuming that oil prices are independent from exchange rates and current accounts in South Asia in the same period. We hence estimate the following model:

$$\begin{pmatrix} \Delta oil_t \\ \Delta rer_t \\ ca_t \end{pmatrix} = A_1 \begin{pmatrix} \Delta oil_{t-1} \\ \Delta rer_{t-1} \\ ca_{t-1} \end{pmatrix} + \begin{pmatrix} \varepsilon_t^{oil} \\ \varepsilon_t^{rer} \\ \varepsilon_t^{ca} \end{pmatrix} \qquad \text{where} \qquad \begin{pmatrix} 1 & 0 & 0 \\ a_{21} & 1 & 0 \\ a_{31} & a_{32} & 1 \end{pmatrix} \begin{pmatrix} \varepsilon_t^{oil} \\ \varepsilon_t^{rer} \\ \varepsilon_t^{ca} \end{pmatrix} = \begin{pmatrix} u_t^{oil} \\ u_t^{rer} \\ u_t^{ca} \end{pmatrix}$$

and where Δoil_t and Δrer_t are the percentage changes of the oil price and the real exchange rate in each quarter respectively and ca_t is the current account balance over GDP. Data on oil prices, exchange rates and the current account balance is in USD and available quarterly from 1993Q4 to 2017Q4 from the IMF BoP and International Financial Statistics (IFS) databases for Bangladesh, India, Pakistan, Sri Lanka and Nepal. We use the cur rent account balance as percent of GDP and assume constant nominal GDP growth within each year for countries without quarterly GDP data. Since South Asian countries are net importers of oil, we expect higher oil prices to decrease the current account. We use the Schwartz information criterion (SIC) to select a lag length of one for all countries. The longer lag length suggested by the Akaike information criterion resulted in coefficient estimates with lower statistical significance.

b) Estimating the effect of temporary and permanent shocks on the current account

Second, we estimate the effect of temporary and permanent effects on the current account and the exchange rate for Bangladesh, India, Nepal, Pakistan, and Sri Lanka using quarterly data from 1993Q4 to 2017Q4. As for the VAR model described above, we use the current account balance as percent of GDP and assume constant nominal GDP growth within each year for countries without quarterly GDP data. Lee and Chinn (2006) show that for the G7 countries permanent shocks (interpreted as technology innovations) induce a permanent change of the real exchange rate but have no effect on the current account. Temporary shocks (associated with monetary innovations), on the other hand, induce an improvement in the current account that dissipates in the long run. We follow their estimation strategy that uses one key identification assumption consistent with a very broad class of open-macroeconomics models (Obstfeld and Rogoff 1995): temporary shocks have no long-run effect on the real exchange rate. Shocks can hence be identified using long-run restrictions following Blanchard and Quah (1989). Following the SIC criteria, we estimate the model with 1 lag for all countries, except for Pakistan for which we use 2 lags. We estimate the model:

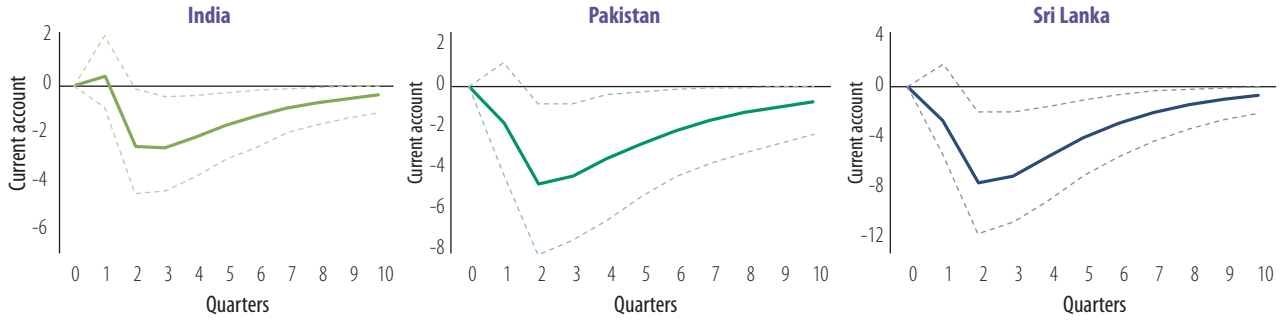
$$B_0 \begin{pmatrix} \Delta rer_t \\ ca_t \end{pmatrix} = B_0 A_1 \begin{pmatrix} \Delta rer_{t-1} \\ ca_{t-1} \end{pmatrix} + B_0 \begin{pmatrix} u_t^{rer} \\ u_t^{ca} \end{pmatrix} \qquad \text{where} \qquad [B_0(I_2 - A_1)]^{-1}_{(1,2)} = 0$$

and where the variables are defined as above. The identification restriction in this model – that temporary shocks have no long-run effect on the real exchange rate – is imposed with the following long-run restriction: , where is the matrix of lagged coefficients and is a 2x2 identity matrix We use the same data as for the model described above.

cies relative to the local CPIs from the first quarter of 2016 to the end of 2018 increased nearly as much. (Figure 35b). This measure of change in relative oil prices is merely an indication of the relative price change that consumers and firms experienced, as domestic prices can deviate from international prices when governments absorb the changes in international prices through changes in taxes and subsidies. In that case, a rise in international oil prices does not affect private savings, but it affects the fiscal deficit. Moreover, some countries may have special deals or long-term contracts at lower rates. India, for example, faces pressures to reduce its oil imports from Iran and Venezuela, which may increase its oil price in the near-term. Because of higher oil prices, the oil import bills in South Asia rose on average by a third in 2017/18 (Figure 35c). The oil balance strongly impacts the overall trade balance. Changes in the oil trade balance are strongly correlated with the changes in the overall trade balance and changes in the current account. The correlation between changes in the oil balance and changes in the cur-

Figure 36: Higher oil prices decrease the current account balance in India, Pakistan, and Sri Lanka.

Employing a vector autoregression (VAR) model, we find a significant effect of oil prices on the current account balance in India, Pakistan, and Sri Lanka. The effect is particularly strong for Sri Lanka and somewhat weaker in India. Across South Asia the effect lasts for around two years.



Notes: All estimations are based on a VAR estimated with one lag as described in Box 2. The dotted lines mark the 95 percent confidence bands.
Sources: IMF, Federal Reserve Bank of St. Louis, and staff calculations.

rent account since 2000 is 0.72 in Sri Lanka, 0.64 in Pakistan, and 0.55 in India (Figure 35d). In a survey conducted for this report (see Box 3 in Chapter 2), over half of the regional experts say that an USD 10 increase of the oil prices affect the current account a lot and another 40 percent say it affects the current account a little.

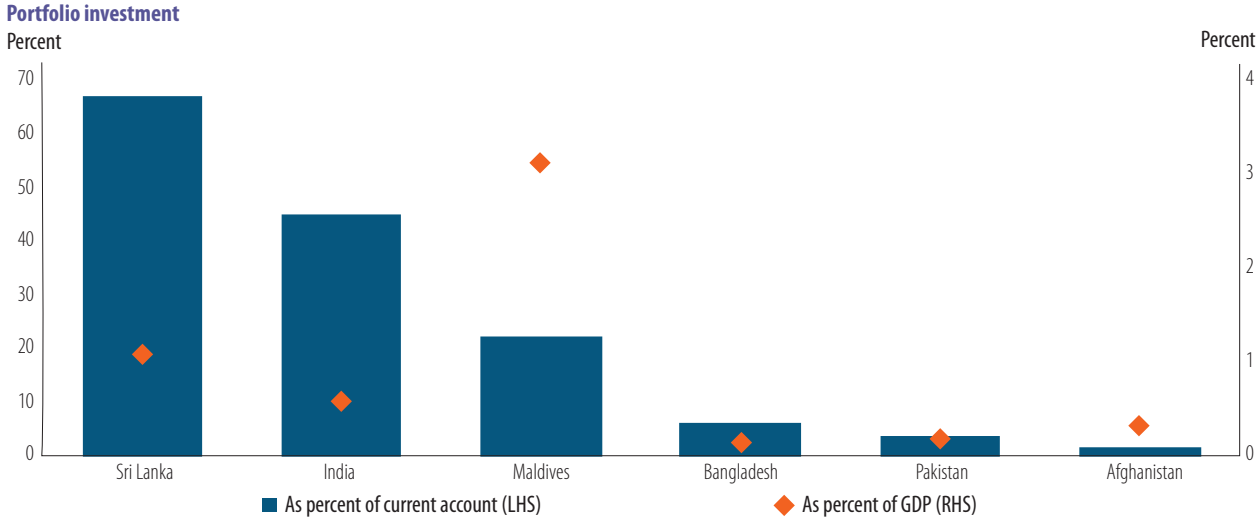
Rising in oil prices indeed increase current account deficits in South Asia, at least in the short run. The reason is that most oil consumption is imported and that it is difficult to substitute away from oil, which explains low short-term price elasticities of oil demand. In addition, the domestic pass through is small when highly administered domestic oil prices are rigid. A rising oil bill does not immediately trigger cuts in non-oil imports, because also these adjustments take time. For South Asian countries, the effect of oil price changes on the current account balance lasts for around two years. The effect is strongest for Sri Lanka, followed by Pakistan and India (Figure 36). For the other countries in South Asia, we did not find evidence for such a relationship. This might be due to the frequency and quality of the data in these countries and does not mean that oil prices are not affecting the current account there. After the first two years the impact vanishes, because in the long run more possibilities exist for substitution away from oil and adjustments in non-oil imports are easier to make. For example, in India, the short-run elasticity of oil demand is between zero and -0.1, but the long-run elasticity is close to -1 (Ashraf et al. 2018). Concluding, higher oil prices in 2017 and 2018 contributed to the high import growth in recent years (Figure 34) and increased external vulnerabilities.

Financing risks vary

Over the last three years, portfolio investment has been substantial relative to the current account deficit and GDP in Sri Lanka, India, and Maldives (Figure 37). All countries in South Asia depend on external financing, but the composition of the Balance of Payments varies considerably across countries. Afghanistan and Bhutan, for example, benefit from a large capital account surplus, while Nepal receives a lot of remittances. Portfolio flows matter most for Sri Lanka, India, and Maldives. Over the last three years, portfolio flows in Sri Lanka have been on average above 60 percent of the current account deficit and close to 20 percent of GDP; in India, they have been above 40 percent of the current account deficit and around 10 percent of GDP; and in Maldives, they have been around 20 percent of the current account deficit and above 50 percent of GDP. FDI, on the other hand, is very low across the region apart from Maldives, where the tourism and construction sector attract substantial amounts. Countries in South Asia use their reserves to a greater or lesser extent as buffers to smooth adjustments and to balance the current accounts.

Figure 37: Portfolio flows are crucial especially in Sri Lanka, India, and Maldives.

Over the last three years, portfolio investment flows have been substantial relative to the current account deficit and GDP in Sri Lanka, India, and Maldives. In the latter, they have been on average above 50 percent of GDP.

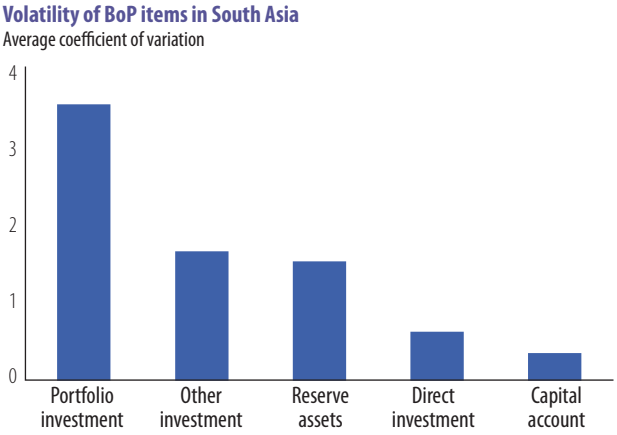


Note: Data is the average from 2016 to 2018.
Source: IMF BoP Statistics and staff calculations.

Portfolio investment is very volatile (Figure 38). Portfolio flows can surge quickly, but they can also dry up quickly. They can even reverse themselves, as investors pull earlier investments out of countries when conditions deteriorate. Moreover, portfolio flows are highly correlated across countries. Thus, a country dependent on portfolio flows to finance the current account is vulnerable to changes in investor confidence. On the other end of the scale, the volatility of inflows on the capital account and of FDI inflows is very low. FDI is thus a relatively stable source of financing. Investors of FDI have long-term commitments and are not inclined to liquidate assets when conditions deteriorate. FDI inflows also bring other advantages, as they often come with technology transfer and increased exposure to foreign competition, while risks are taken by the investor and not the borrower. Nevertheless, there is no certainty that FDI flows will continue completely uninterrupted. Large FDI inflows into small countries are often linked to one-time mega projects, and other FDI flows will likely fall if economic risks increase or investors become risk adverse. Reserve assets are more volatile, showing that countries rely on them to balance their payments and smooth out adjustments. Other investments, which are mainly related to debt instruments of the Central Bank, the general government and financial corporations, are as volatile as reserves. Given the significant role of portfolio flows for the financing of the current account in Sri Lanka, India, and Maldives and their high volatility, these countries are likely to be most affected by changing international financing conditions.

Figure 38: Portfolio investment is very volatile.

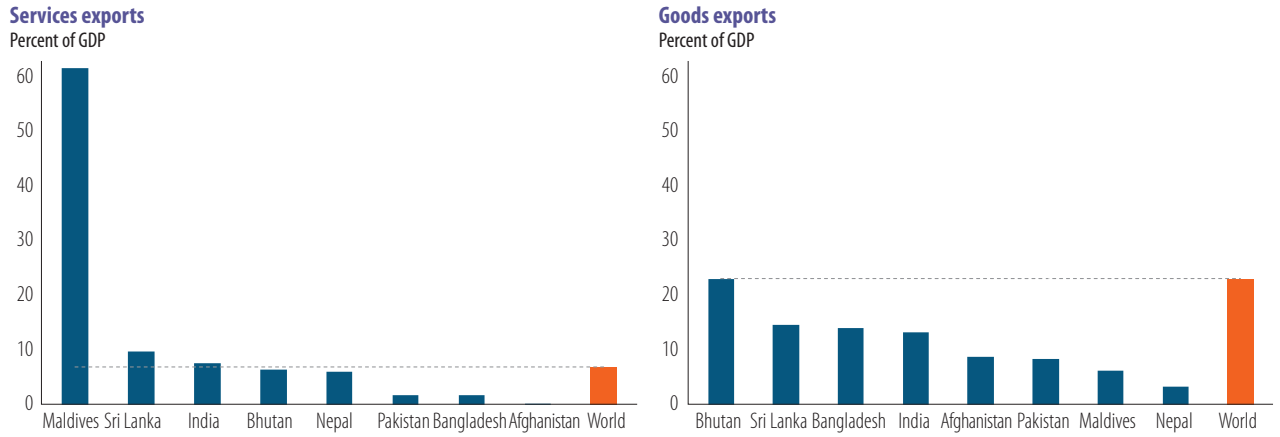
The coefficient of variation measures the variability of the different financing items. While capital account surpluses and FDI are rather stable sources of financing, reserves and other investment show some volatility. Unsurprisingly, portfolio investment flows exhibit the highest volatility.



Notes: The coefficient of variation is the standard deviation divided by the mean. It is estimated from 2000 to 2017, for all countries except for Afghanistan and Bhutan for which the estimation starts in 2006 and 2008 respectively. We show simple averages across countries and exclude observations if their contribution to the overall balance is negligible.
Source: IMF and staff calculations.

Figure 39: Export shares in South Asia are below the world average and especially good exports lag behind in South Asia.

Exports of services are above the world average in Maldives, Sri Lanka, and India and close to it in Bhutan and Nepal. However, apart from Bhutan, goods exports are far below average in all countries. And apart from Maldives and Bhutan, the combined exports of goods and services are lower than the world average.



Note: Data is for 2018.
Sources: IMF, World Bank and staff calculations.

Underperforming exports

Export shares in South Asia are below the world average. Maldives, Sri Lanka and India export more services as percent of GDP than the world average and in both Bhutan and Nepal the services exports are close to it (Figure 39). In many of these countries, tourism contributes substantially to services exports. For goods exports, however, all countries apart from Bhutan (that exports a lot of electricity to India) arebelow the world average. And in many cases, they export less than the world average by a wide margin. While the world average is 22 percent, goods exports are only around 13 percent in Sri Lanka, Bangladesh, and India, around 8 percent in Afghanistan and Pakistan and even lower in Maldives and Nepal. Apart from Maldives and Bhutan, the combined services and goods export are below the world average. However, how much South Asian countries are underperforming in their good exports cannot be accurately derived from just comparing export to GDP ratios with the world average. There is no reason why all countries should have the same export shares. Large countries naturally have a smaller export share, as firms in those countries have relatively more opportunities to sell in the domestic market. Landlocked countries also have naturally a smaller export share, as trading costs are higher. One way to more accurately measure underperformance in goods exports is to compare actual exports with exports predicted by a gravity model (see Box 6).

South Asian countries export only one third of their potential and the gap is widening (Figure 40). The export gap at the start of the estimation period in 1996 was 12 percent of GDP. Together with increasing world trade, however, the export potential of South Asian countries rose over time. However, South Asian countries did not sufficiently take advantage of the benign global environment, and exports remained mostly stable as percent of GDP. Thus, the export gap widened considerably over time. Exports even declined as share of GDP after 2014, reaching only 11 percent in 2017, resulting in an export gap of 23 percent of GDP in 2017. In other words, South Asia's export potential is three times its current level of exports. South Asia also imports less than is expected based on experience in other countries. The import gap is smaller than the export gap, which reflects strong domestic demand, partly fueled by inflows of remittances. Nevertheless, also imports fall short of their potential. If South Asia succeeds in closing the export gap, it will likely also close its import gap. Exports need imported intermediary inputs and exports generate income that will be partly spent on imports. This link between imports and exports is important from a long-term development perspective. The importance of closing the export gap is not that it will improve the current account balance in the long-run.

Box 6: A Gravity model to estimate South Asia's export gaps

To benchmark the exports performance of South Asian countries, it is important to understand their export potential, which of course depends on the characteristics of each country. To estimate export potential, we use a common and intuitive econometric analysis, called the gravity model, which is the workhorse model in international trade for this purpose (Head and Mayer 2014). It determines potential goods exports based on the performance of other countries in the world and their characteristics. More precisely, it measures the trade potential of a given country by predicting trade flows with all other countries based on observable variables. Note that the analysis is restricted to goods but excludes services, as reliable data on bilateral service trade flows across a comprehensive number of countries and over a long period of time does not yet exist.

In our preferred specification (building on Kathuria 2018), the model includes the distance between trading partners ($DIST_{ij}$), whether countries share a common border ($CNTG_{ij}$), a common language ($LANG_{ij}$), or a colonial legacy ($CLYNY_{ij}$), and whether they participate in Regional Free Trade Agreements (RTA), as well as the exporter and importer GDP (GDP_{it}, GDP_{jt}). In addition, we control for multilateral resistances by including a remoteness indicator (REM_{it} and REM_{jt}) and we include year fixed effects to control for international business cycle fluctuations that affect international trade (γt). We estimate the following model for 196 countries from 1996 to 2017:

$$T_{ijt} = \exp[\,\beta_0 + \beta_1 \log DIST_{ij} + \beta_2 CNTG_{ij} + \beta_3 LANG_{ij} + \beta_4 CLNY_{ij} + \beta_5 RTA_{ijt}\,] \times \exp[+\,\beta_6 \log GDP_{it} + \beta_7 \log GDP_{jt} + \beta_8 \log REM_{it} + \beta_9 \log REM_{jt} + \gamma_t + \varepsilon_{ijt}],$$

where stands for the imports of country *i* from country *j* or in other words, for the exports of country *j* from *i*. We use bilateral trade import data from UN Comtrade and variables related to distance, common border, common language, and common colonial history from the CEPII gravity dataset. The remoteness index is defined as the arithmetically weighted average of the distance of exporter and importer countries from all their trading partners, following Wei (1996). We use bilateral trade flows as reported by the importer but in case of missing information rely on the flows reported by the exporter. We apply a Poisson Pseudo Maximum Likelihood (PPML) estimator to be able to include all zero bilateral trade flows, which is not feasible with a simple ordinary-least-squares estimator, and to overcome all the econometric challenges that have been identified in the literature (Silva and Tenreyro, 2006). Our specification delivers a good data fit (the R-squared is 0.71) and the estimation yields the following very intuitive results in line with the literature (Head and Mayer 2014): distance depresses trade (-0.51), while sharing a language (+0.16), a border (+0.52), colonial ties (+0.69) and a regional trade agreement (+0.48) foster trade.

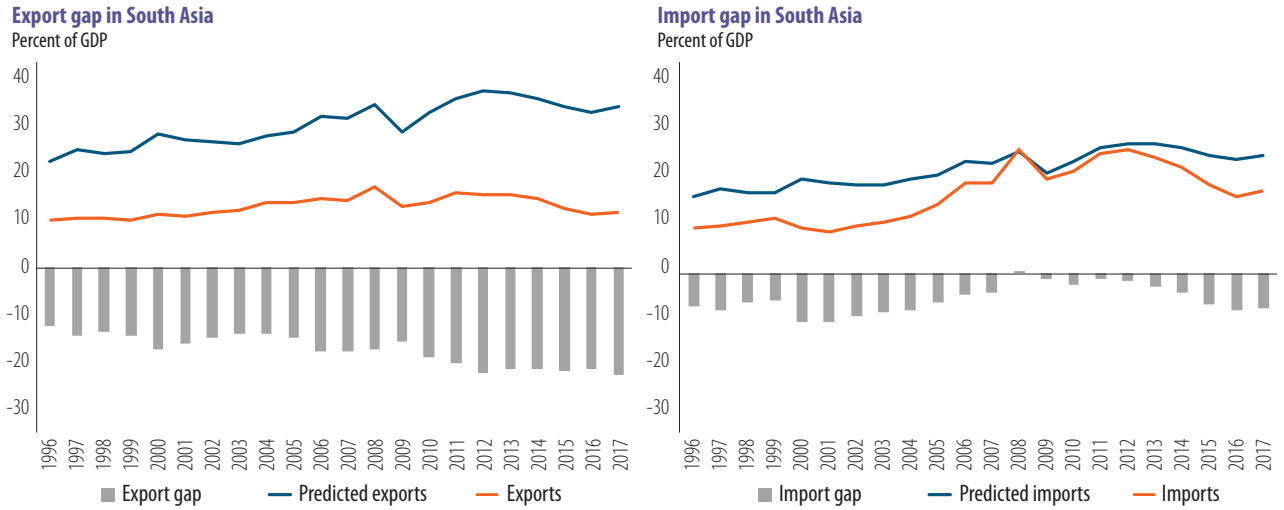
Once bilateral trade is predicted for all country pairs based on these results, we can compare predicted trade to actual trade and compute export and import gaps defined as the difference between the predicted and observed trade flows. We will refer to the predicted exports, which we consider a meaningful benchmark, as potential exports, as the prediction shows the amount of exports you would expect given the above-mentioned characteristics and the experience of 196 countries over 22 years. Our potential exports of course depend strongly on the model specification and abstracts from any factors that are outside the model (and time-varying), such as comparative advantage, economic structure, human capital and many more. But these factors can help explain the observed gaps.

Our attempt is certainly not the first to estimate and assess trade patterns in South Asian countries with a gravity model. Most recently, the World Bank used this approach to highlight that the trade between Pakistan and India is much lower than it could be (Kathuria 2018; World Bank 2019b). In our model the predicted trade between Pakistan and India is even higher, since we take the common colonial history of the two countries into account. It is a common approach in academic publications in South Asia as well. For Pakistan, Butt (2008) and Abbas and Waheed (2015) also find a positive export gap. The latter also show that Pakistan's exports are positively affected by its domestic supply capacity and the demand potential of its partners. Batra (2006) and Kaur and Nanda (2010) show that India's trade potential is high within the South Asia region and especially with Pakistan. Similarly, exports are generally found to be below potential in Nepal (Thapa 2012; Prasai 2014) and Bangladesh as well. For the latter, rising trade transaction costs are argued to be major cause (Rahman and Ara 2010). Overall, research suggests that South Asian countries are yet to achieve the full benefits of trade (Hassan 2001; Kathuria 2018).

The importance is that it exposes a country more to international competition, in international markets, where exporters compete with foreign suppliers, and in domestic markets, where domestic producers compete with foreign suppliers of imported products. The arising international competition is the driving force of productivity increases that can fuel the development process.

Figure 40: South Asia's exports are well below potential, and the gap is increasing.

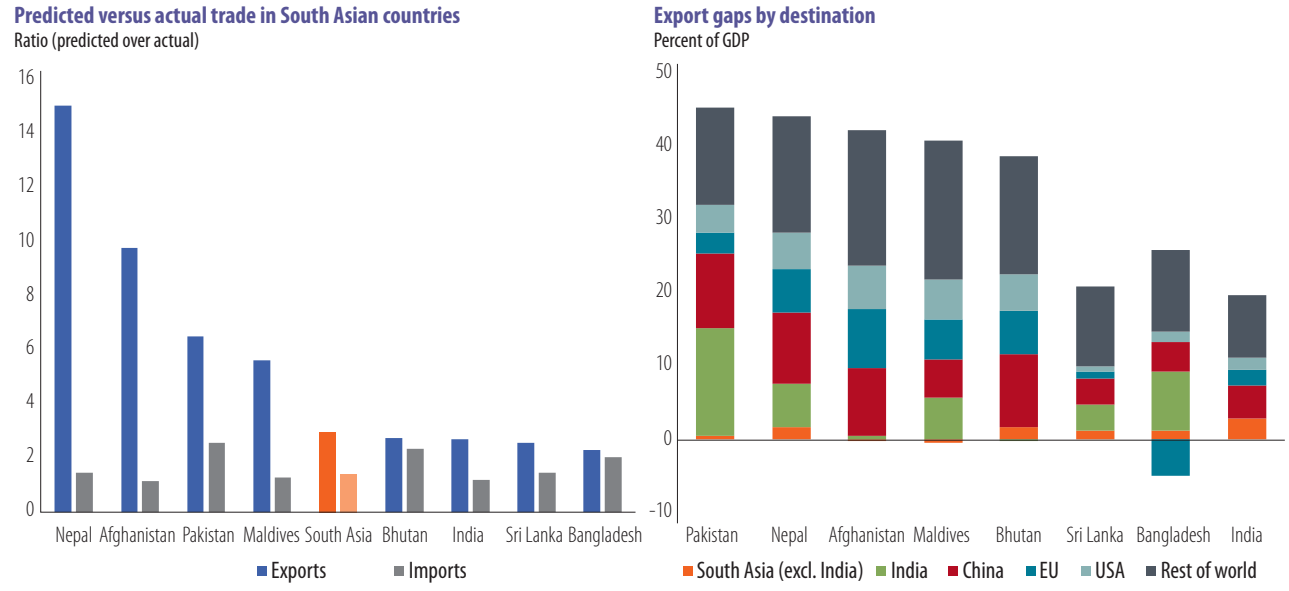
Benchmarking South Asia's export performance against predictions from a gravity model, estimated for 196 countries from 1996 to 2017, unveils a large and increasing export gap. In 2017, the export gap was over 20 percent of GDP. Imports are below the prediction as well, but the gap is much smaller.



Notes: Predicted trade based on gravity regression described in Box 6. Actual exports and imports from UN Comtrade.
Sources: UN Comtrade, WDI, CEPII gravity dataset, and staff calculations.

Figure 41: Export and import gaps vary between countries, but exports are below potential with all major export destinations.

The export gaps are especially large in Pakistan, Nepal, Afghanistan, and Maldives, but export gaps are substantial in all South Asian countries; apart from Bangladesh's exports to the EU, exports from all countries to all major destinations are below potential.

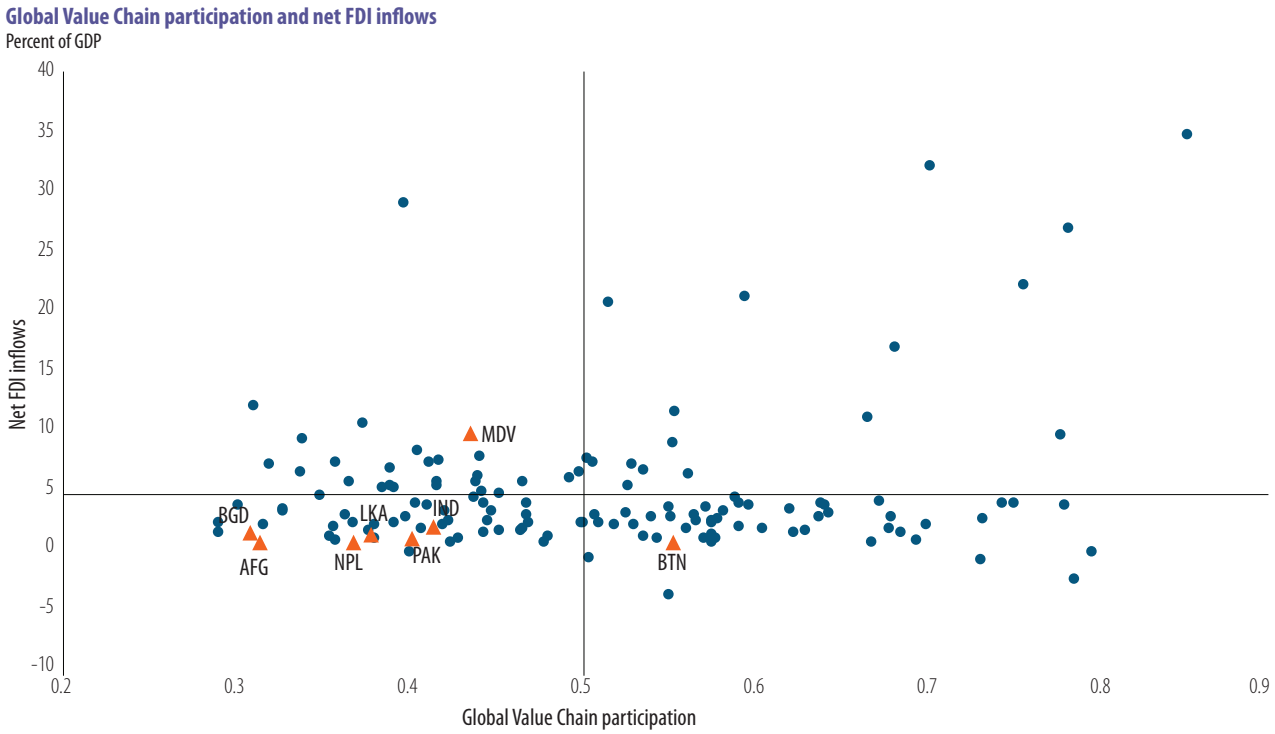


Notes: Predicted trade based on gravity regression described before. Actual exports and imports from UN Comtrade.
Sources: UN Comtrade, WDI, CEPII gravity dataset, and staff calculations.

For all countries in South Asia, goods exports are below potential, but there are strong differences between countries. One way to compare predicted trade is to contrast it with actual trade (Figure 41). In Nepal, predicted goods exports are 15 times larger than actual exports, whereas predicted imports – due to large remittances inflows – are only 1.5 times larger than actual imports. In Afghanistan, predicted exports are 9.8 times larger than actual, in Pakistan 6.5 times and in Maldives 5.6 times. In all three countries, the predicted imports are much closer to actual. In Bhutan, India, Sri Lanka, and

Figure 42: South Asian countries are not integrated into Global Value Chains and attract little FDI.

South Asian countries are not well integrated into GVCs and apart from Maldives attract low FDI inflows. Most countries in South Asia are below average in both.



Notes: Data is an average from 2013 to 2017. The cross marks the average GVC participation and the average FDI inflow.
Sources: WDI, UNCTAD-Eora, and staff calculations.

Bangladesh, the predicted exports are between 2.7 times and 2.3 times larger than the actual. In contrast to other countries, the import gaps are nearly as large as the export gaps in Bhutan and Bangladesh. Another way to look at the trade gaps in percent of GDP (Figure 41). Using this measure, Pakistan has the largest export and import gap. Its exports are below potential for all major destinations, especially for India (in line with Kathuria 2018 and World Bank 2019b) as well as China (see Box 7 for constraints to export competitiveness in Pakistan). Nepal, Afghanistan, Maldives and Bhutan have large export gaps in percent of GDP as well. Both Nepal and Bhutan border two large economies (China and India) and – based on the experience of other small countries – the model suggests that they should be trading a lot with these countries. There are mainly two reasons for their low exports: first, both countries are mountainous and, second, they opened their economies very late. When including being landlocked in the model, the gaps for both countries decline somewhat (9 percentage points in Nepal and 8 percentage points in Bhutan). The breakdown of the export gaps by destination confirms that a considerable proportion of the two countries' gaps is explained by low exports to China. Both countries have only a small gap with the other South Asian countries, due to considerable exports to India, but considerable gaps with all other major export destinations. Maldives and Afghanistan both have an export gap of around 40 percent of GDP. The model's prediction for Maldives may be too high, given its particular characteristics, like being an atoll, that are difficult to incorporate in a model estimated for the world. And for Afghanistan the gap is no surprise, given the difficult economic and political situation. Both have much smaller import gaps, since Maldives needs to import goods for its tourism and construction sector (e.g. oil and food) and Afghanistan receives large aid flows. The export gaps are smaller but with around 20 percent of GDP still substantial in Sri Lanka, Bangladesh, and India. The EU is the most important export destination for Bangladesh, due to essentially tariff-free access, and

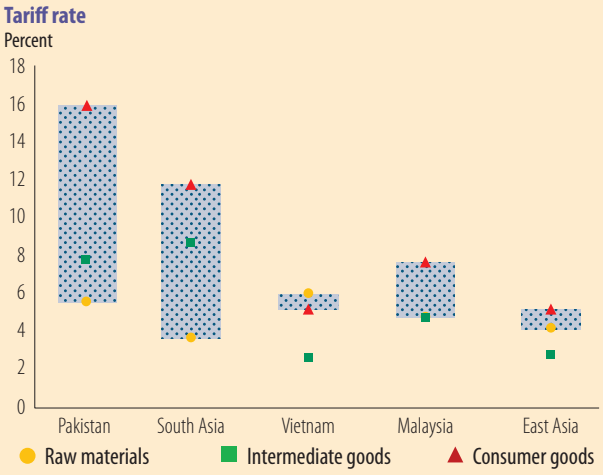
Box 7: Constraints to export competitiveness in Pakistan

The last fiscal year showed a record-high trade deficit in Pakistan, at USD 31.1 billion, contributing to a current account deficit of 6.1 percent of GDP. The observed trade deficit resulted from the combination of consumption-led growth, that fueled demand for imports, and mounting constraints to export competitiveness. Between 2005 and 2018, Pakistan's merchandise exports rose from USD 16 billion to USD 23 billion, an increase of only 47 percent compared to an increase of 286 percent in Bangladesh, 563 percent in Vietnam or 193 percent in India. Its exports have been concentrated in a few products with little sophistication like textiles, apparel and rice. Its exporting firms remain small, when compared to those in peer countries, and there is little entry into and exit out of export activities. This box elaborates on the constraints to export competitiveness.

Many factors affect competitiveness in Pakistan. These include, among others, high costs of doing business, electricity availability at affordable costs, or access to finance. However, there are three constraints that directly affect exporters. These are the anti-export bias of its trade policy, the inadequate export promotion infrastructure, and an ambiguous regulatory framework around FDI.

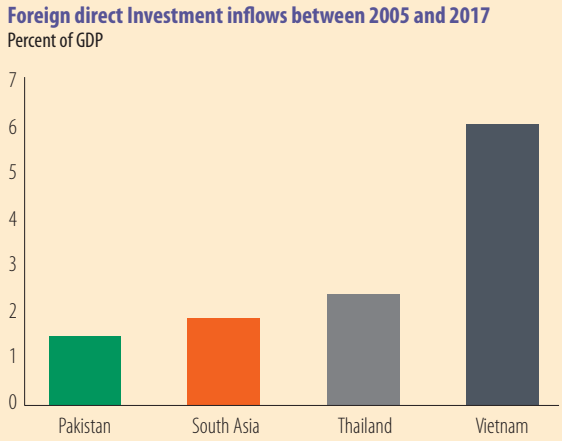
First, high duties on imports create an anti-export bias, considerably reducing the ability of Pakistan's firms to integrate into global markets. The structure of Pakistan's taxes on imports displays two features that prevent firms from leveraging regional and Global Value Chains (GVCs) to sell Pakistan's goods and services to the world, to increase productivity, and to create more and better jobs. First, Pakistan's import duties are high – with a marked escalation: the average difference between tariffs on final goods and raw materials was 10.4 percentage points in 2016, and between intermediate goods and for raw material it was of 2.2 percentage points (Figure 43). This creates an incentive for firms to focus on the local market, in which they enjoy higher profit margins due to the tariffs on the final goods, rather than innovating and venturing into competitive global markets. In fact, the policy response to the increasing trade deficit has been to increase import duties, which further increases the anti-export bias. Second, duty suspension schemes for exporters that source intermediates from abroad work imperfectly. It takes 60 days to get the scheme approved – double the time stipulated by law and clearing customs under the scheme takes between 5 to 10 days. In addition, the complexity of securing the scheme approval is such that only 3 percent of textile and apparel exporters use it. Duty rebate schemes, instead, are more widely used – about 50 percent of textiles and apparel exporters use them, although more than half of the firms claim a waiting time of 250 days and more to receive the rebate.

Figure 43: Pakistan's tariffs are higher than in the region, with escalation showing an anti-export bias



Note: Average tariff by type of good in 2016.
Sources: FBR and UN TRAINS.

Figure 44: Foreign Direct Investment inflows have been low



Source: UNCTAD.

Second, export promotion infrastructure is not aligned with international good practices. Evidence collected through private sector consultations in Punjab, Sindh, Islamabad and Khyber Pakhtunkhwa also revealed that exporters lack support in terms of provision of export intelligence, which in other countries has effectively reduced the information frictions that new and small exporters face and that substantially increase their trade costs. This has been validated by a recent assessment of

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the main export promotion agency in Pakistan, the Trade Development Authority (TDAP), conducted by the International Trade Center (ITC). ITC assesses the performance of TDAP at 'below average' in its latest benchmarking exercise of 2017, pointing to several challenges, including lack of support to value chain development, lack of client datasets, and client management systems, as well as lack of monitoring and evaluation frameworks for its interventions. Indeed, the existing support focuses on participation in trade fairs for well-established export sectors (textiles and apparel), rather than focusing on connecting new or potential exporters with global buyers, that tend to have been more impactful, according to international evidence. Inadequate export promotion interventions underlie the little diversification of Pakistan's export bundle as well as the low entry rates into exporting observed in the data.

Third, the policy regime towards foreign direct investment increases the risks perceived by foreign firms. With global trade being structured around Global Value Chains, a country's success in boosting exports is inextricably linked with its ability in attracting FDI. Pakistan's record in FDI inflows is lackluster, with inflows averaging 1.5 percent of GDP between 2005 and 2017, compared to 6.1 percent of GDP in Vietnam over the same period (Figure 44). Part of the difficulties lie with the perception of security challenges in Pakistan, which discourages FDI inflows into the economy – indeed, an important challenge has been attracting clients or senior management from abroad to visit premises of multinationals in Pakistan. However, policies have not helped either. The investment regulatory framework shows inconsistencies between the Investment Law of 1976, which is relatively protectionist, and the Investment Policy of 2013, which is relatively more market friendly, although without the rank of a 'law'. These inconsistencies create uncertainty among foreign investors, reducing their incentives to incur substantial largely irreversible investments, and further constraining the realization of export potentials in Pakistan.

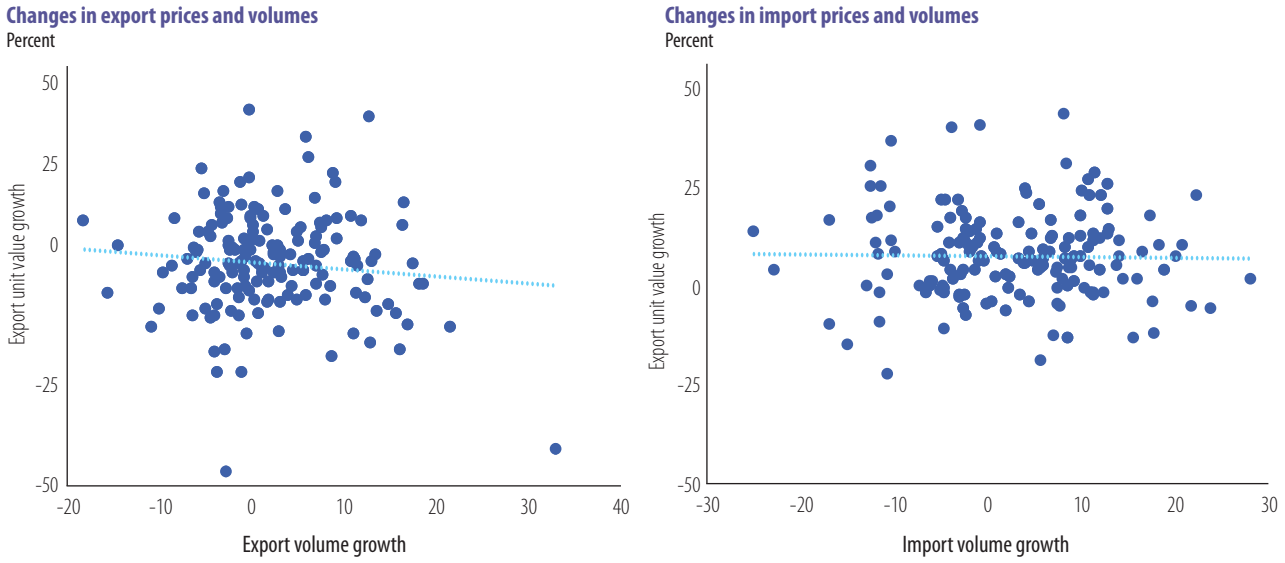
receives around 60 percent of its garment exports. Interestingly, this trade relationship is the only one that the model predicts to be lower than it is, confirming a very close trade relationship between Bangladesh and the EU. In addition, this result may imply that the estimated export potentials can be reached and are not unrealistic. Bangladesh, Sri Lanka and India are nearly at potential regarding their exports to the United States and the EU but have considerable gaps with China and the rest of the world. Due to the large size of India, the benefits from closing exports gaps within South Asia are somewhat asymmetric. Most countries would naturally benefit more from closing the export gap with India than India would from closing its export gap with them. Finally, the exports gaps have been rather stable over time in Bangladesh and India, but they increased a lot in Nepal, Pakistan, and Sri Lanka.

South Asian countries are not well integrated into Global Value Chains (GVC) and apart from Maldives with its strong tourism sector receive small amounts of FDI (Figure 42). The GVC measure takes both backward participation (the use of imported intermediary products) and forward participation (the export of intermediary products) into account. Therefore, weak GVC participation can explain both underperforming imports and underperforming exports. To move towards a more export driven growth model, it will hence be necessary to open further for imported intermediate inputs. Consequently, closing the export gap may automatically result in a closing of the import gap. Closing the trade gaps by integrating more into global markets could also result in larger FDI inflows. Like GVC participation tends to come with knowledge transfers, FDI often comes with technology transfers that improve productivity. These knowledge and technology transfers are the main reason why integration into global markets is necessary for sustained strong growth of the South Asian economies.

The underperformance in exports poses challenges, both in the short and in the long run. In the short run, low levels of exports make adjusting to shocks more difficult. After a rise in oil prices, a fall in remittances, or a reversal in capital flows, exports should increase, through real depreciation or otherwise increased competitiveness, to restore equilibrium. However, if exports start from a low level, the price adjustment needs to be much larger to achieve the same increase in exports. In the long run, insufficient export performance is even more problematic. Through integrating into global markets, countries gain knowledge and competitive pressures force efficiency improvements. This leads to higher growth potential that subsequently extends to the non-tradable sector (Gould 2018). Such an export-led growth process also leads to higher quality and better paying jobs (Artuc et al. 2019). It is virtually impossible to sustain high growth rates over a long period by merely growing the non-tradable sector.

Figure 45: Low price elasticities of imports and exports result in slow adjustments.

With changes of import and export prices, volumes will adjust. However, the contemporaneous relationship is very weak in South Asia. Export volumes respond only very little to changing export price in the same year and import volumes do not respond to changing import prices at all.



Note: Data is for all South Asian countries from 1991 to 2017 or as long as available.
Source: WDI and staff calculations.

Restoring equilibrium

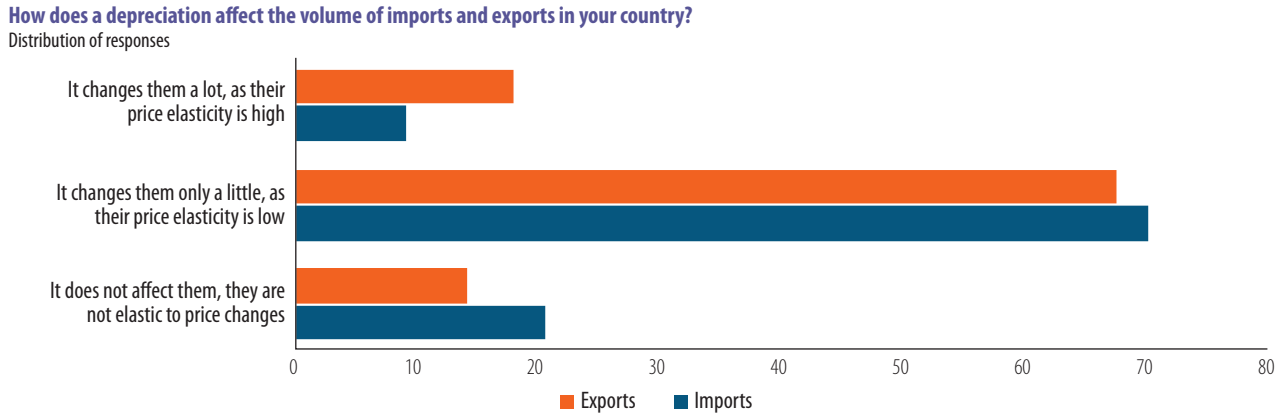
Disequilibrium puts pressure on interest rates and exchange rates, but this can put the balance of payments even further out of equilibrium. If financing of the current account becomes more difficult, after a widening of the current account deficit or a reversal of capital inflows, pressure mounts for currencies to depreciate and interest rates to increase. And this indeed happened during 2018 throughout the region. Investors demanded higher returns, and increased demand for foreign currencies eroded the value of the local currency. However, these price changes will not necessarily restore equilibrium quickly. Depreciation and rising interest rate spreads may generate expectations for further depreciations and interest rate increases in the future, discouraging investors even more. Depreciations tend to increase the value of imports as share of GDP, widening the current account deficit even more. And if the growing current account deficit reflects an overheated domestic economy, then a depreciation can put fuel on the fire, as it further boosts demand for domestically produced goods.

In response to a depreciation, trade deficits in South Asia initially increase, moving current accounts further out of equilibrium. If the price elasticity of imports is below one, meaning that an increase of import prices is not offset by a one-to-one reduction of import volumes, the total value of imports increases immediately after a depreciation. Since exports are unlikely to adjust enough to offset the higher imports bill initially, a depreciation first decreases the trade balance. This is especially true if a large component of imports is oil, which tends not to be very price elastic in the short-run (Ashraf et al. 2018). Over time, both consumers and producers will switch away from some imported goods to domestic ones. In addition, exports will increase, as they are now more price competitive. In the empirical economics literature, this phenomenon has been labeled the J-curve effect and it has been confirmed for numerous countries (see Box 8).

In South Asia, the price elasticities of imports and exports are low, resulting in slow adjustments to relative price changes. Lower export prices have only a small effect on export volumes in the same year (Figure 45). For South Asia, a ten percent reduction of the exports price only results in one percent more exports in the same year. For imports the relationship is even weaker, and the volume of imports does not respond at all in the year of import price changes. In

Figure 46: Views from the region: the price elasticity of exports and imports.

60 percent of experts from South Asia responding to a survey conducted for this report (see Chapter 1) agree that a depreciation affects imports and exports only a little, as their price elasticities are low. Nearly a quarter think that exports react strongly to relative price changes and imports not at all.



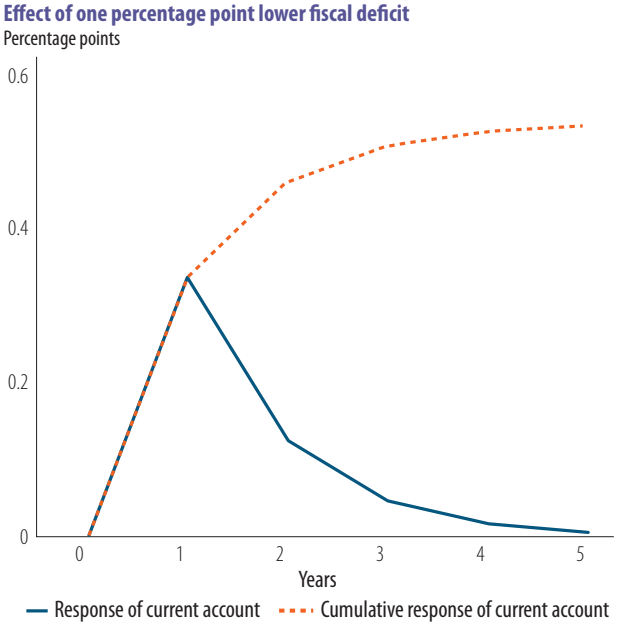
Note: Survey results based on 83 responses from seven South Asian countries (see Box 3 in Chapter 2).
Source: South Asia Economic Policy Network.

Figure 47: A smaller fiscal deficit results in a smaller current account deficit.

There is a statistically significant relationship between the fiscal deficit and the current account deficit in South Asian countries. In a panel estimation, a one percentage point lower fiscal deficit reduces the current account deficit by 0.34 percentage points in the same year and by 0.37 percentage points in the long run.

The current account deficit depends on the fiscal stance			
	(1)	(2)	(3)
Lagged current account	0.65*** (0.06)	0.37*** (0.05)	0.37*** (0.07)
Fiscal balance	0.22 (0.13)	0.24** (0.08)	0.34*** (0.08)
Country fixed effects	No	Yes	Yes
Year fixed effects	No	No	Yes
Observations	151	151	151
R-squared	0.61	0.69	0.78
Number of countries	6	6	6

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1



Notes: Data is from 1990 to 2017 for all South Asian countries excluding Bhutan and Afghanistan. We estimate the following model: $ca_{it}=a_i + \beta ca_{it}+\delta fb_{it}+\varepsilon_{it}$ The specification of the regression is inspired by Bluedorn and Leigh (2011) but differs in two important points: first, since we are not interested in effect of deliberate policy decisions but the fiscal deficits in general, we can use the fiscal balance rather than a measure of discretionary changes in fiscal policy. Second, we estimate the model only with one lag due to the smaller sample.
Source: World Bank and staff calculations.

the second year, on the other hand, there is a larger effect on import volumes than on exports. For a price change of 10 percent, the former decrease by 1.6 percent, while for the latter the effect is negligible. In the third year, imports decrease by 0.4 percent and exports increase by 0.4 percent. Around 70 percent of experts from South Asia responding to a survey conducted for this report (see Box 3 in Chapter 2) agree that a depreciation affects imports and exports only a little, as their price elasticities are low. A fifth thinks that exports react strongly to relative price changes and imports not at all (Figure 46).

Box 8: Research on oil prices, J-curves, and twin deficits in South Asia

a) Oil prices and current accounts

For oil importers, higher oil prices translate into higher oil bills if the price elasticity is below one. If other imports do not decrease or exports pick up at the same time, the higher oil price increases the current account deficit (or decreases the current account balance). Empirical studies of the relationship between oil prices and current account deficits seem surprisingly rare, especially for oil importers. The effect of oil shocks on the trade balance and the current account depends very much on the nature of the shock, its magnitude, and how the nonoil trade balance responds (Marion 1984; Kilian, Rebucci and Spatafora 2009).

In Bangladesh, evidence shows that the trade balance deteriorated because of the oil price boom in the early 2000s (Sánchez 2011). Aside from raising import bills, higher oil prices increased the production costs of the export sector. In Pakistan, an increase in global oil prices has a negative effect on the current account and a negative impact on exports (Mohammad 2010). Similarly, in India, oil prices are a leading indicator for the trade balance with an inverse relationship between the two variables: a temporary increase in oil prices negatively affects the trade balance and the current account (Arouri, Tiwari and Teulon 2014; Bhanmurthy, Das and Bose 2012).

b) The J Curve

The J curve, first identified by Magee (1973), describes the typical pattern of the trade balance in response to exchange rate movements. Currency devaluations initially tend to result in worsening trade deficits before improving them, resulting in a pattern that resembles the letter J, giving the phenomenon its name (Magee 1973; Backus, Kehoe and Kydland 1992; Bahmani-Oskooee and Ratha 2009). Bahmani-Oskooee and Kutan (2004) provide a good review of the empirical literature.

Several studies test the J-curve for South Asian countries. There is mixed evidence for the presence of the phenomenon in India and Pakistan. For India, some studies argue that devaluations have no significant long run effect on the trade balance (Buluswar, Thompson and Upadhyaya 1996; Singh 2004; Bahmani-Oskooee and Mitra 2009). However, using disaggregated bilateral data, Arora et al. (2003) find that a rupee depreciation against the currencies of Australia, Germany, Italy and Japan has a positive impact on India's trade balance with these countries in the long-run. Similarly, Dash (2013) finds a J-curve effect in India's bilateral trade with Japan and Germany using a different methodology (Dash 2013). For Pakistan, most studies have dismissed the presence of the J-curve effect (Aftab and Khan 2008; Hameed and Kanwal 2009; Atiq-ur-Rehman and Anis 2012). On the other hand, Rehman and Afzal (2003) find some evidence for it. There is also some evidence for the J-curve phenomenon in Nepal and Bangladesh (Chaulagai 2015; Khatoon and Rahman 2009; Rahman and Islam 2006).

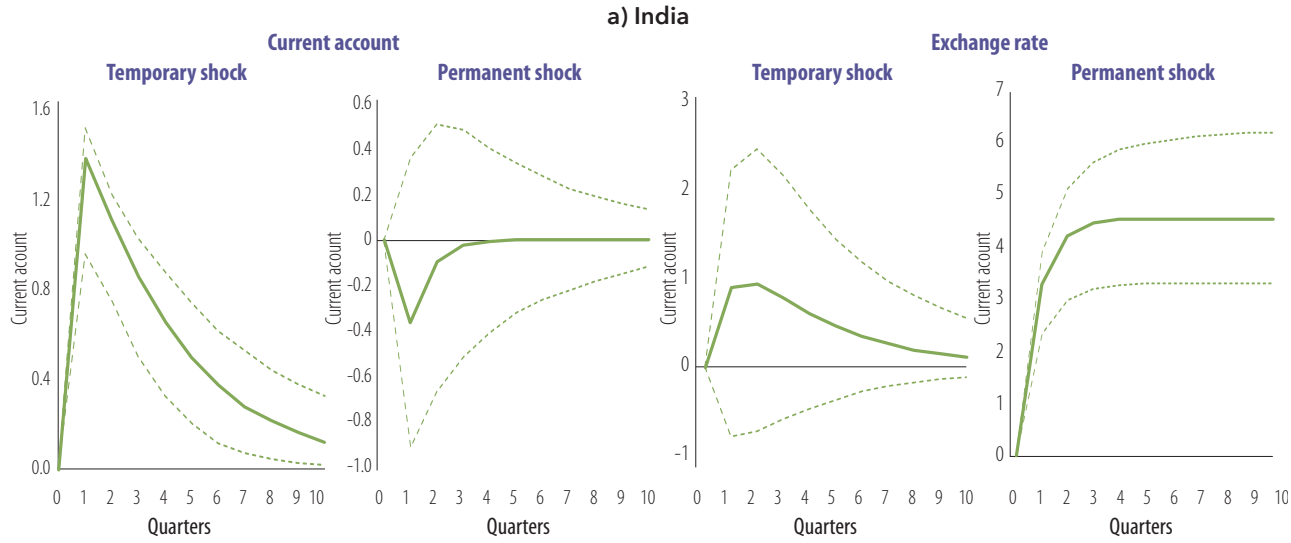
c) Twin Deficits

The evolution of record fiscal and current account deficits in the United States during the 1980s drew increasing attention to what has become popularly known as the "twin deficit" problem. According to the twin-deficit hypothesis, budget deficits increase domestic demand, cause imports to expand, and hence worsen the trade deficit (Ratha 2012). In addition, they cause higher interest rates and domestic currency appreciation, which worsens the trade deficit further (Bartolini and Lahiri 2006; Kulkarni and Erickson 2001; Ratha 2012). Empirical evidence of twin deficits has not been observed as commonly as the identity of total expenditure and total income would suggest. One explanation may be related to the Ricardian Equivalence Hypothesis (REH): since households optimize their consumption inter-temporally and rising budget deficits necessarily imply higher future tax liabilities, they may offset higher government spending by higher savings. In a theoretical model, the inter-temporal shift between taxes and budget deficits has hence no impact on real interest rates or trade deficits (Ratha 2012). Additionally, the causality of the relationship is not always observed in a specific direction. The issue of whether the twin-deficits phenomenon holds is very much an empirical question, and it may hold in some countries and not in others. When the volumes of these deficits are large, the probability that a relationship between them exists increases significantly (Ratha 2012).

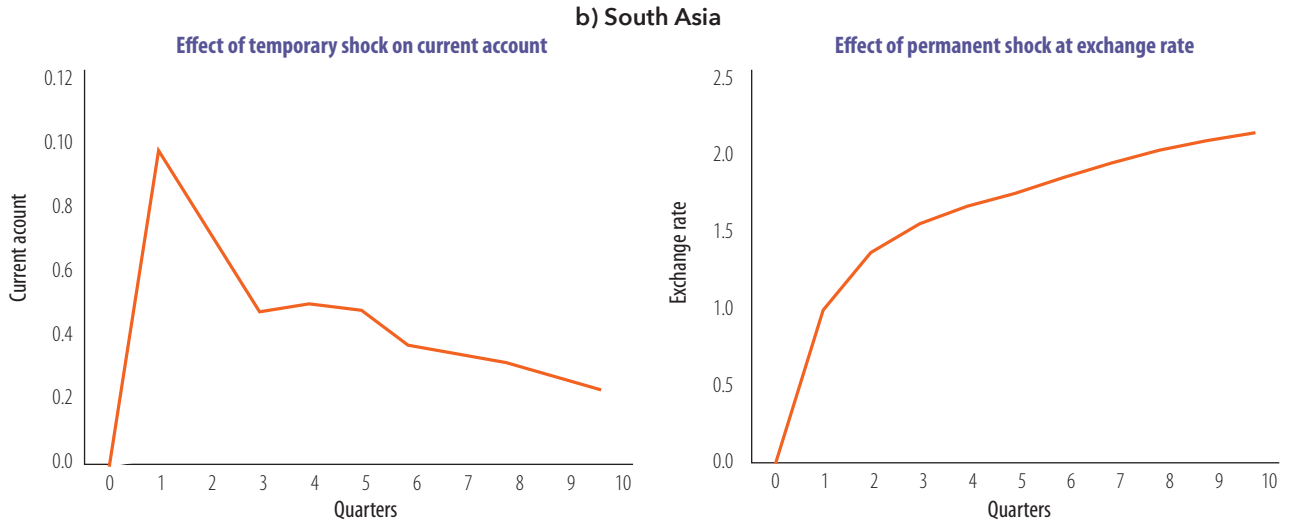
Several studies analyze the link between trade and budget deficits in South Asia. While certain studies provide strong evidence for twin deficits in India (Kulkarni and Erickson 2001; Ratha 2012), some show that budget deficits create trade deficits in the short run, but not in the long run (Ratha 2012; Suresh and Gautam 2012). Others, on the other hand, find no evidence for such a phenomenon in India at all (Ravinthirakumaran, Selvanathan, and Selvanathan 2016; Basu and Dutta 2005). In Pakistan, while twin deficits exist, there seems to be a bi-directional causality between the two variables (Mukhtar, Zakaria and Ahmed 2007) and there may even be evidence for a stronger causality in the opposite direction (Aqeel, Nishat and Qayyum 2000; Kulkarni and Erickson 2001; Mukhtar, Zakaria and Ahmed 2007; Ravinthirakumaran, Selvanathan, and Selvanathan 2016). In Sri Lanka, empirical analyses support the conventional view of a long run relationship between current account imbalances and budget deficits (Saleh, Nair and Agalewatte 2005; Ravinthirakumaran, Selvanathan, and Selvanathan, 2016).

Figure 48: Temporary shocks affect the current account, permanent the exchange rate.

Using a VAR model with long-run restrictions, we confirm that in South Asia temporary shocks affect the current account but not the exchange rate and permanent shocks affect the exchange rate but not the current account.



Notes: The model is estimated using quarterly data for India from 1990Q1 to 2017Q4 and is estimated with one lag. The dotted lines mark the 95 percent confidence interval.
Source: IMF and staff calculations.



Notes: The impulse response functions are an unweighted average of Bangladesh, India, Sri Lanka, Nepal and Pakistan, and the shock size has been standardized to one. All individual country responses are statistically significant at the 5 percent level.
Source: IMF and staff calculations.

In South Asia, there is a strong relationship between fiscal deficits and current account deficits. An additional percentage point of fiscal deficit does not affect the current account deficit one-to-one, because government spending tends to crowd out private spending. Nevertheless, the link between the two deficits is significant in South Asia. For every percentage point decline in the fiscal deficit, the current account deficit decreases by a third of a percentage point in the same year (Figure 47). Over time, the effect accumulates to over half of a percentage point. The effect is much smaller than one-to-one confirming that private saving and consumption react to higher government consumption. The causal relationship between the fiscal deficit and a current account deficit is often referred to as the "twin deficit phenomenon". There is overwhelming evidence that South Asian countries are indeed "twin deficit" countries (see Box 8). This empirical evidence is important for the policy discussion above. If a sudden increase in current account deficits, caused by increased domestic spending, has to be reversed, fiscal adjustment is an effective tool. Not all public spending affecting the current account is accounted for in budgets. In some cases, state-owned enterprises are responsible for large infrastructure projects

that worsen the trade balance and can deteriorate the current account.

Once domestic demand has adjusted, relative prices also must adjust to restore equilibrium in all markets. More specifically, after fiscal adjustment also a real depreciation is needed to ensure that not only the current account becomes sustainable, but also the domestic economy can continue to function at full capacity. These relative price adjustments are especially important, and ultimately unavoidable, after a structural shock. Short-term shocks can often be absorbed through buffer mechanisms and do not require major realignments of relative prices. A temporary hike of the oil price can be offset by running down reserves until the oil price is back at the old level. For permanent shocks, however, running down reserves can sustain the old equilibrium only for some time, but eventually relative prices must adjust to reach a new sustainable external balance. Empirical evidence confirms that temporary shocks affect the current account and permanent shocks the real exchange rate. Employing a well-established estimation method (see Box 5), we find strong empirical evidence that it is indeed the case in South Asia that after permanent shocks relative prices change, while temporary shocks can be absorbed through fluctuations in current accounts (Figure 48). We find these effects for Bangladesh, India, Nepal, Pakistan, and Sri Lanka.

Active policies are needed

Policy makers should play an active role to sustain or restore equilibrium on the balance of payments. Often good things come in threes, and that is probably true also for a successful policy approach in this case:

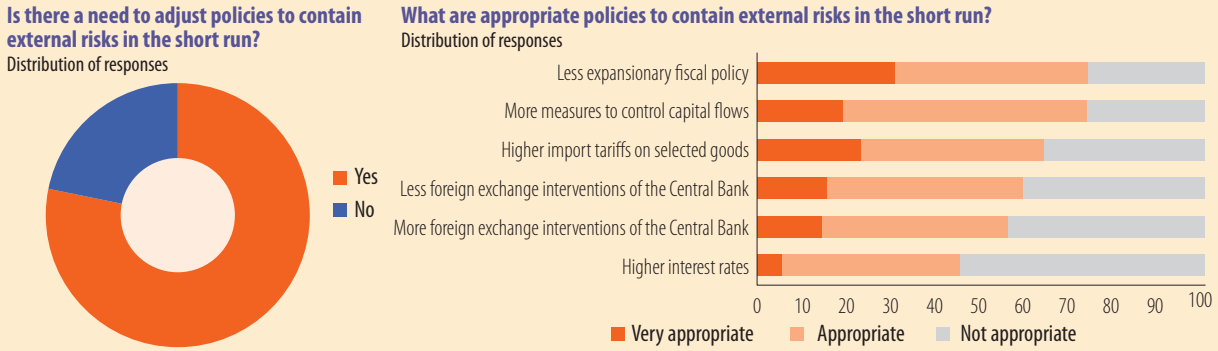
- **It is crucial that central banks build up or preserve sufficient foreign exchange reserves.** That prevents self-fulfilling expectations of further depreciations and further increases in interest rates. It also can serve as a buffer to absorb small, temporary shocks. Also, fiscal buffers, and in general sound macroeconomic policies, can prevent balance of payments to spiral further out of equilibrium. That means that in periods of large capital inflows or large inflows of remittances reserves can be accumulated and governments could run fiscal surpluses. Both measures not only build buffers, they also prevent a loss in competitiveness. In case of negative external shocks, central banks should be cautious in defending the currency through selling of reserves, especially if the shock is not of a short-term, temporary nature. If current accounts are in deficit and international financing conditions have deteriorated, it is obviously difficult to build up reserves, unless an IMF program or other support can provide the required buffers.
- **The root cause of the disequilibrium must be addressed as soon as possible.** If, for example, tensions on the balance of payments are caused by excessive domestic spending, then policies should focus on reducing that spending. Fiscal measures are likely most effective to achieve this. In most South Asian countries, increases in the tax base are more urgent than reductions in government spending.
- **Once spending is adjusted in response to a permanent shock, then relative prices should be allowed to adjust accordingly.** For example, after a moderation of domestic demand to restore equilibrium, a real depreciation is needed to bring all markets in equilibrium again. The smoothest way to achieve this relative price change is through flexible nominal exchange rates. However, the advantages of flexible exchange rates apply especially to the larger economies. For Bhutan and Nepal, which trade mainly with India, the peg to the Indian rupee may serve as an important inflation anchor.

An even more important challenge for policy makers than these three steps to restore equilibrium on the balance of payments is the need to increase exports, bringing them much closer to their potential. A range of reforms are needed to unleash the export potentials in the region. Trade liberalization, reducing both tariff and non-tariff barriers, is a first step. That should include the reduction of import barriers. Tariffs on intermediary inputs directly increase the costs of exports, and therefore reduce export competitiveness. But more generally, larger imports tend to trigger also larger exports. When import prices fall, after a reduction in import tariffs, domestic prices will follow, making a country more competitive and increasing export opportunities.

Box 9: Policy views among economists in the region

Figure 49: Regional economists see a need for short-term measures but are split over which.

In a survey conducted for this report, more than three quarters of respondents see a need to adjust policies to contain external risks in the short-run. Many consider a less expansionary fiscal policy appropriate. There is no agreement whether monetary authorities should intervene more or less in foreign exchange markets and regional economists are skeptical about higher interest rates.

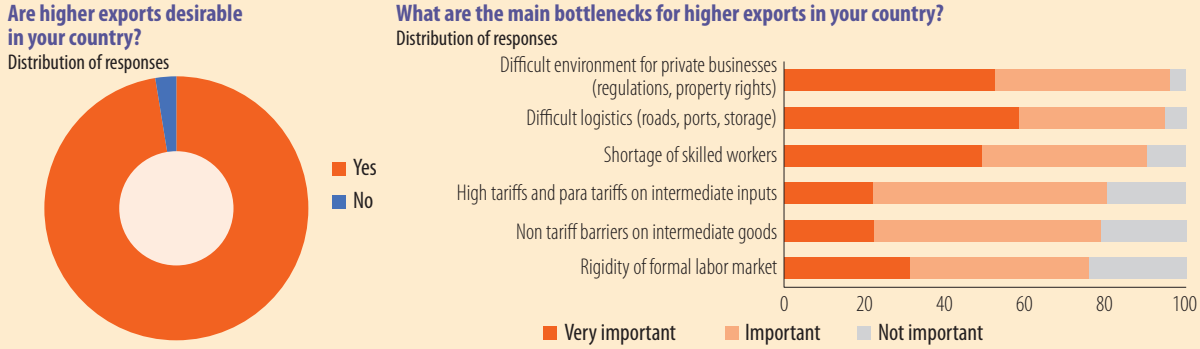


Note: Survey results based on 83 responses from seven South Asian countries (see Box 3 in Chapter 2).
Source: South Asia Economic Policy Network.

Regional economists also see a need to adjust policies to contain external risks in the short-run. Over three quarters of respondents agree that adjusting policies is necessary. However, there is much less clarity on the appropriate measures. In line with our assessment, around 70 percent of the respondents consider a less expansionary fiscal policy very appropriate or appropriate. However, nearly as many are in favor of more measures to control capital flows. This chapter has not addressed this issue. Even if such measures would be desirable to limit capital outflows, an open question is how effective the measures could be and what their long-run implication would be. Over 60 percent say that higher import tariffs on selected goods would be appropriate or very appropriate. That seems at odds with what this chapter suggests. In South Asia more and not less trade is needed. Curbing imports would very likely also lead to a reduction in exports, which is the opposite of what this chapter recommends. More generally, reducing imports will lead to more demand for domestic products. If the current account deficit was caused by too much domestic demand and an overheating economy, import tariffs would reinforce the root cause of the problem. In addition, the frequent use of import tariff measures increases the uncertainty of investments. Close to 60 percent think that less intervention in foreign exchange markets is very appropriate or appropriate. At the same time, however, nearly as many experts call for more interventions. Interestingly, there is no clear pattern regarding where the experts are coming from. The split in views on exchange rate management has hence nothing to do with specific country circumstances. Perhaps the views on intervention differ because there is no unanimity on the questions whether South Asian countries currently face temporary or more structural shocks. Somewhat surprisingly, less than half consider higher interest rates necessary, while that could be one way to reduce domestic demand.

Figure 50: Regional economists desire higher exports and consider the business environment, logistics and a shortage of skilled labor as main bottlenecks.

In a survey conducted for this report, almost all regional experts desire higher exports. They consider a difficult environment for private businesses, difficult logistics and a shortage of skilled workers the most important bottlenecks. Still around 80 percent also see a role of tariffs and nontariff measures, but few think they are very important. And three quarter think the rigidity of the formal labor markets matters, and a third considers it very important.



Note: Survey results based on 83 responses from seven South Asian countries (see Box 3 in Chapter 2).
Source: South Asia Economic Policy Network.

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Regional experts desire higher exports, but they see a lot of bottlenecks. First and foremost, they consider a difficult environment for private businesses related to regulations and property rights an obstacle to a better export performance. Nearly as many name difficult logistics related to roads, ports, and storage, as well as a shortage of skilled labor as major bottlenecks. And still over 80 percent see an obstructing role of tariffs and nontariff measures, even though few consider them very important. Interestingly, half of the respondents who name import tariffs on selected goods an appropriate or very appropriate measure to contain risks in the short-run also consider tariffs a bottleneck for the export performance in the long run. Finally, three quarters perceive the rigidity of the formal labor market as an issue, and a third of the respondents consider this very important. These views outline the right policy agenda. Implementing this agenda is far from easy, but it should nevertheless be relentlessly pursued. The huge underperformance in trade could very well become one of the main bottlenecks in achieving sustained high growth.

A popular view in South Asia is that trade deficits can be reduced by raising import tariffs (see Box 9). However, the trade deficit is ultimately determined by domestic spending in excess of domestic production, not necessarily by relative trade prices. An increase in import tariffs would likely lead to a decline in both imports and exports. Apart from trade liberalization, more flexibility in domestic labor and capital markets is needed to support export growth. If labor or capital is stuck in non-tradable sectors, then it will be difficult to build up a vibrant export sector, even if trade barriers have been removed. Finally, the challenge to increase exports also involves the skills agenda. Specific skills are needed to compete in international markets and the right incentives should exist to develop and use these skills.

Box 10: Views from the region on external vulnerabilities in South Asia

In preparation for this report and as part of our engagement with the South Asia Economic Policy Network, we co-organized a regional conference on "External Vulnerabilities in South Asia" with the Central Bank of Sri Lanka (CBSL), the Institute of Policy Studies (IPS), and the University of Colombo. The event was held on February 28 and March 1 at the Central Bank in Colombo, Sri Lanka. During the two-day conference, both scholars and practitioners from six South Asian countries came together to discuss macroeconomic issues and external risks faced by their countries, to understand the sources and to think about solutions in a challenging global environment. The conference featured both more academically-oriented and more policy-oriented sessions.

In the academic sessions, 16 papers selected through a highly competitive selection procedure and preliminary findings of this report were presented. Some of the papers focused on the drivers of the current account in the region. Narayan Pradhan and Rajat Malik (both from the Reserve Bank of India) focused on real exchange rate but also discussed growth spillover from advance economies, fiscal policy, and private credit growth. Anita Poudel (Nepal Administrative Staff College) described the situation in Nepal and discussed domestic supply side constraints. Muhammad Ibrahim Shah (University of Dhaka) examined the determinants of current account deficits across South Asian countries and contrary to most of the literature, his findings suggest that an appreciation of the real effective exchange rate leads to a reduction in current account deficit in the long-run. In addition, he argued that financial development, trade openness and population growth widen current account deficits.

Muhammad Omer (State Bank of Pakistan) concluded that a depreciation of the real exchange rate decreases imports twice as much as it increases exports and showed that remittances play an important role in the buildup of Pakistan's foreign exchange reserves. Erandi Liyanage (CBSL) revisited the relationship between exchange rate fluctuations and the trade balance in Sri Lanka for different trade partners and presented a significant negative impact for appreciations, but no significant impact of depreciations. Fayyaz Hussain (State Bank of Pakistan), using data for 40 middle income countries, finds that an exchange rate undervaluation has a positive impact on growth through the trade channel. However, this impact is more than offset by the tightening of the credit supply due to the reduced net worth of the firms. In line, he argued against currency undervaluation as well as against currency overvaluation. Ujjal Protim Dutta (National Institute of Technology, India) assessed the impact of remittances on the real effective exchange rate in a panel for Bangladesh, India, Nepal, Sri Lanka and Pakistan and concluded that remittances put upward pressure on real effective exchange rate, raising similar implications to those of the Dutch Disease.

Other papers focused on South Asia's export performance and monetary policy issues. Pavel Chakraborty (Lancaster University, UK) studied the effect of expansive monetary policy on firm-level performance in India after the global financial crisis. Using a matched firm-bank dataset, he showed that manufacturing firms that borrowed from public banks did not see a drop in their exports because of constrained credit supply, as opposed to firms borrowing from private banks. Public banks have likely benefited from implicit government guarantees. While the presence of public banks hence supported the growth momentum during this period, the long-run implications are less clear. Syed Yusuf Saadat (Centre for Policy Dialogue, Bangladesh) concluded that Bangladesh's trade integration into the global economy has been driving its economic growth and showed that the minimum wage of readymade garment workers, manufacturing costs, utilities costs, crude oil prices, the exchange rate, foreign exchange reserves, as well as the budget balance all impact the volatility of trade. Tapas Kumar Parida (State Bank of India) estimated the cost of India's foreign exchange market interventions and concluded that sterilization has overall been successful. Yet, he still sees some operational challenges that could be improved with better communication between the Reserve Bank of India and market participants. Sumila Tharanga Wanaguru and Anil Perera (both CBSL) concluded that monetary policy significantly influences movements of the exchange rate in Sri Lanka, with volatility being persistent and particularly high following negative shocks.

With several South Asian countries now running both fiscal and current account deficits, the so-called twin deficit discussion picked up again. John V Guria (RBI) investigated the contribution of fiscal deficits to external vulnerabilities and concluded that the twin deficits phenomenon is indeed present in South Asia. He identified US monetary policy tightening as a factor exacerbating external vulnerabilities and argued that the accumulation of foreign exchange reserves can provide insurance and liquidity buffers. In line, Utsav Kumar (Asian Development Bank) documented that the twin deficits generated volatility in the balance of payments in Sri Lanka and argued that efforts toward a revenue-based fiscal consolidation should be complemented with building a buffer stock of foreign exchange reserves. Santosh Kumar PK (Cochin University of Science and Technology, India) used an Error Correction Mechanism with data from 1970 and 2017 and confirmed that there is a positive relationship between trade deficit and budget deficit in India, validating the twin deficits hypothesis both in the short and long run. Conversely, Prasant Kumar Panda (Central University of Tamil Nadu, India), using data for the period from 1970 to 2012 and vector autoregressive and autoregressive distributive lag models, did not find evidence of the twin deficit hypothesis in India. He concluded that addressing structural issues and fostering initiatives for export promotion will help reduce the

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current account deficit in India. Muntasir Murshed (Bangladesh Institute of Development Studies) did not find evidence of the twin deficit hypothesis in Bangladesh and attributed this result to the lack of capital mobility.

There were three more policy-oriented sessions. In their opening remarks, Yuthika Indraratna (Director of Economic Research, CBSL), Hans Timmer (South Asia Chief Economist at the World Bank), and Dushni Weerakoon (Executive Director, IPS) highlighted increased external vulnerabilities – such as widening current account deficits and high foreign debt – as risks for South Asia's long-term growth prospects. They all called for solid financial and fiscal management, while emphasizing country specificities. One session focused specifically on the lessons learned from the experiences in Sri Lanka and Pakistan. The speakers, Nandalal Weerasinghe (Senior Deputy Governor, CBSL), Fernando Im (Senior Economist at the World Bank), Rashid Amjad (Lahore School of Economics), and Sakib Sherani (former PMs Economic Council), very much agreed on the important role of fiscal policy in both countries.

A policy expert panel debated the causes, consequences and remedies for the external vulnerabilities in South Asia more broadly. Indrajit Coomaraswamy (Governor, Central Bank of Sri Lanka) pointed to excess demand conditions, fueled by fiscal deficits, as one of the drivers of the current account deficit and generator of external vulnerabilities. He described Sri Lanka as a twin deficit country, financed through concessional terms-loans, that aims at re-entering international capital markets. He emphasized that Sri Lanka needs to identify and address systemic risks like the high level of external commercial borrowing, to commit more firmly to fiscal rules, and to continue the slow process of improving tax administration. Dushni Weerakoon (called the attention to the risks posed by the repayments of maturing short-term debt and worried about the low public support for reforms. She also emphasized the need for higher productivity and higher export competitiveness as part of a comprehensive resilience and growth framework. Hans Timmer underlined that the benefits of foreign exchange reserve buffers are usually underestimated, that public expenditure should follow clear rules to become more predictable to economic agents, and that export competitiveness will require a more dynamic and flexible private sector.

Papers presented

- Anita Poudel (Nepal Administrative Staff College): *Drivers of Nepal's Current Account Deficit and its Policy Remedies.*
- Fayyaz Hussain (State Bank of Pakistan), Muhammad Ishtiaq (State Bank of Pakistan) and M. Ali Choudhary (State Bank of Pakistan): *Exchange Rate Undervaluation and Economic Growth: The Trade- versus the Financial Risk Channel.*
- Hemantha Ekanayake (CBSL, Sri Lanka), Erandi Liyanage (CBSL, Sri Lanka): *Revisiting the Effect of Exchange Rate Fluctuations on the Trade Balance: Evidence from Sri Lanka.*
- John V Guria (RBI, India): *Fiscal Deficit and External Debt Driven External Vulnerabilities in South Asia: A Panel Data Analysis.*
- Muhammad Ibrahim Shah (University of Dhaka): *Assessing the Determinants of the Current Account Deficit: Evidence from South Asia.*
- Muhammad Omer (State Bank of Pakistan) and Junaid Kamal (State Bank of Pakistan): *Does Exchange Rate Depreciation improve the Balance of Trade? A Pakistan's Perspective.*
- Muntasir Murshed (Bangladesh Institute of Development Studies): *The Twin Deficits Hypothesis, Ricardian Equivalence and Feldstein-Horioka Puzzle: An Empirical Evidence from Bangladesh.*
- Pavel Chakraborty (Lancaster University, UK): *Financial Crisis, Monetary Policy and Exports: Evidence from a Matched Firm-Bank Dataset.*
- Rajib Das (RBI, India), Narayan Pradhan (RBI, India) and Rajat Malik (RBI, India): *Determinants of Current Account Balance in South Asian Economies – An Empirical Analysis.*
- Santosh Kumar PK (Cochin University of Science and Technology): *Twin Deficit Hypothesis: Empirical Evidence from India.*
- Soumya K Ghosh (State Bank of India), Debashis Padhi (State Bank of India) and Tapas Kumar Parida (State Bank of India): *Foreign Exchange Market Intervention and Liquidity Management in India: Some Empirical Investigations.*
- Sumila Tharanga Wanaguru (Central Bank of Sri Lanka) and Anil Perera (Central Bank of Sri Lanka): *Implications of Exchange Rate Volatility on the Monetary Policy Conduct: An Emerging Market Perspective.*
- Suraj Badaik (Central University of Tamil Nadu) and Prasant Kumar Panda (Central University of Tamil Nadu): *Ricardian Equivalence, Feldstein-Horioka Puzzle and Twin Deficit Hypothesis in Indian Context: An Empirical Study.*
- Syed Yusuf Saadat (Centre for Policy Dialogue, Bangladesh): *Trade Vulnerability of Bangladesh: An Exploratory Analysis.*
- Ujjal Protim Dutta (National Institute of Technology, India), Partha Pratim Sengupta (National Institute of Technology, India): *Do Remittances have a Flip Side? A Panel Cointegration Analysis of Remittances and Real Effective Exchange Rate in South Asian Countries.*
- Utsav Kumar (ADB), Dushni Weerakoon (IPS), Roselle Dime (ADB): *Sri Lanka's Macroeconomic Challenges: A Tale of Two Deficits.*

All papers and presentations can be downloaded from the conference webpage:
www.cbsl.gov.lk/en/regional-workshop-on-external-vulnerabilities-in-south-asia-2019

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South Asia country briefs

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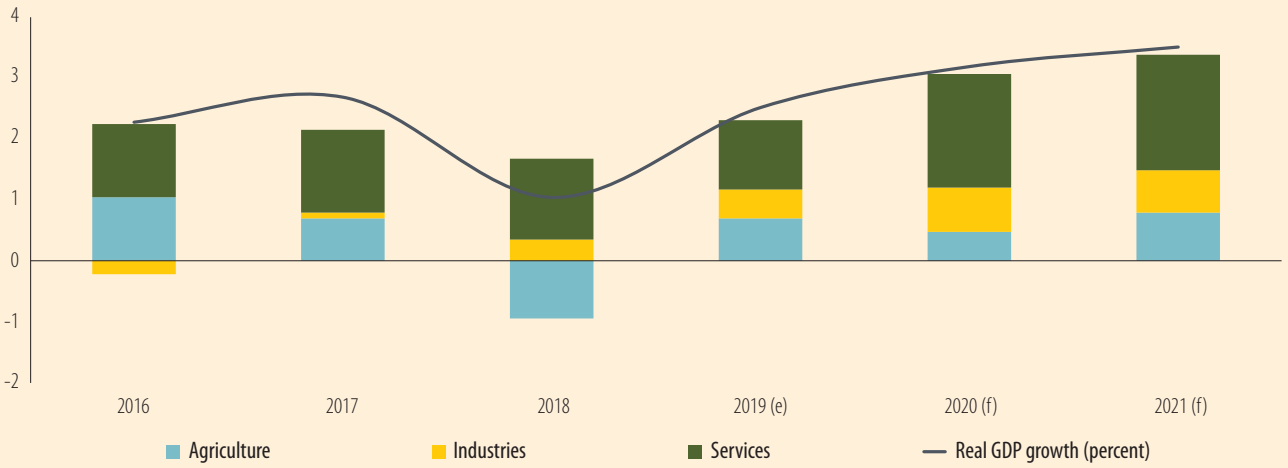
Afghanistan

Severe drought and political uncertainty have dampened growth in 2018. While it is expected to moderately recover in 2019, with improving farming conditions, Afghanistan faces downside risks from political instability and violence, especially ahead of the upcoming presidential elections. Ongoing peace talks, however, could boost investment. Over the medium-term, growth and development prospects will depend on mobilizing new sources of economic dynamism, in the context of declining aid and high poverty.

	2018
Population, million	36.4
GDP, current USD billion	18.2
GDP per capita, current USD	502

Source: World Bank.

Contributions to real GDP growth
Percent, percentage points



Notes: (e) = estimate; (f) = forecast. Afghanistan's fiscal year is the calendar year.
Source: World Bank.

Recent economic developments

Output growth has slowed to an estimated 1.0 percent in 2018, down from 2.7 percent in the previous year. The decline was on account of: a severe drought that affected wheat production and livestock pasture and, heightened political uncertainty and election-related violence, which dampened business confidence. Despite the lower agriculture output, inflation remained moderate at 0.6 percent on average in 2018, due to lower food prices.

The trade deficit is expected to have widened slightly to 35.9 percent of GDP in 2018, from 33.6 percent of GDP in 2017. Exports declined 4 percent (y-o-y) in 2018, despite an increase in high-value fruit exports to India via new air corridors. Imports increased only moderately, by 1 percent y-o-y in 2018. Exports remain limited at only around 4 percent of GDP, while import volumes are ten times larger. With aid inflows almost entirely financing the trade deficit, the current account is expected to have recorded a small surplus in 2018. The Afghani depreciated by 9 percent against the USD in 2018, largely reflecting the strengthening of the USD. On a real effective exchange rate basis, the Afghani appreciated against major trading partners. Despite increased USD sales by Da Afghanistan Bank to smooth exchange rate volatility, gross international reserves increased slightly to USD 8.3 billion by the end of 2018, a level equivalent to over 13 months of merchandise imports.

Fiscal performance improved in 2018, albeit thanks to one-off revenue gains. Domestic revenue collection increased by 12 percent, reaching a record of

13.6 percent of GDP (thanks to tax administration reforms, large one-time payments of SOE dividends, and clearance of tax arrears). Donor grants also increased, reaching 14.8 percent of GDP (up from 13 percent in the previous year). Meanwhile expenditure increased to 27.7 percent of GDP (from 26 percent of GDP in 2017), on the backdrop of record-high budget execution (92 percent). The overall fiscal balance improved to a 0.7 percent surplus (up from a 0.6 percent deficit in 2017). However, Afghanistan continued to rely heavily on donor grants, as domestic revenues covered only 49 percent of total expenditures.

Outlook

Growth is expected to remain modest in 2019, recovering only slightly. Improved precipitation in the 2018-19 winter should be favorable for agriculture. However, its translation to welfare and growth remains uncertain, as the 2018 drought led to population displacements away from rural areas and has likely led to reduced or sub-optimally timed planting. In addition, with limited instruments to manage the flow of snowmelt into rivers and irrigation channels, flood risks and unpredictable access to water for cultivation may threaten farm production and rural welfare. Over the medium-term, growth is expected to gradually accelerate to around 3 percent in 2021, assuming a stable political transition in the aftermath of the presidential election. The outcome of on-going peace talks will also affect medium-term prospects, with a significant upside potential for improvement in the business environment.

The current account is expected to remain close to balance, despite a large trade deficit, thanks to continued aid financing, with international reserves staying at comfortable levels. Fiscal space will be under pressures, with limited room for development expenditures, as revenue collection is expected to remain flat (after significant one-off revenues were mobilized in 2018) and aid flows are expected to decline somewhat.

Risks and challenges

Afghanistan's economy will remain significantly vulnerable to political and security risks. In the near term, these risks will increase in the context of upcoming presidential elections and uncertainty over the outcomes of peace talks. The experience of the 2014 elections also suggests there could be significant revenue losses and weaker expenditure discipline. The humanitarian crisis will remain unabated, with large internal displacements from drought and conflicts, further compounded by growing food insecurity due to the recent drought. Over the medium-term, a decline in foreign aid would pose significant challenges to pursuing growth and development with severely limited fiscal space, warranting a balanced growth strategy to support the sectors with good potential to generate growth, jobs, exports and revenue.

Afghanistan macroeconomic outlook	2016	2017	2018 (e)	2019 (e)	2020 (f)	2021 (f)
Real GDP growth, at constant market prices	2.4	2.7	1.0	2.5	3.2	3.5
Real GDP growth, at constant factor prices	2.1	2.2	0.8	2.4	3.2	3.6
Agriculture	6.0	3.8	-5.0	4.0	2.7	4.5
Industry	-0.8	0.4	1.5	2.0	3.0	3.0
Services	2.2	2.5	2.5	2.0	3.5	3.5
Inflation (consumer price index)	4.3	4.7	0.6	3.1	5.0	5.0
Current account balance (percent of GDP)	5.6	1.0	0.3	-1.4	-2.5	-3.8
Net foreign direct investment (percent of GDP)	-0.1	-0.1	0.1	0.1	0.1	0.1
Fiscal balance (percent of GDP)	0.1	-0.5	0.7	-0.7	-0.7	-0.5
Debt (percent of GDP)	6.1	5.9	6.9	7.0	7.0	7.3
Primary balance (percent of GDP)	0.2	-0.4	0.8	-0.6	-0.5	-0.3

Note: (e) = estimate, (f)= forecast.
Source: World Bank.

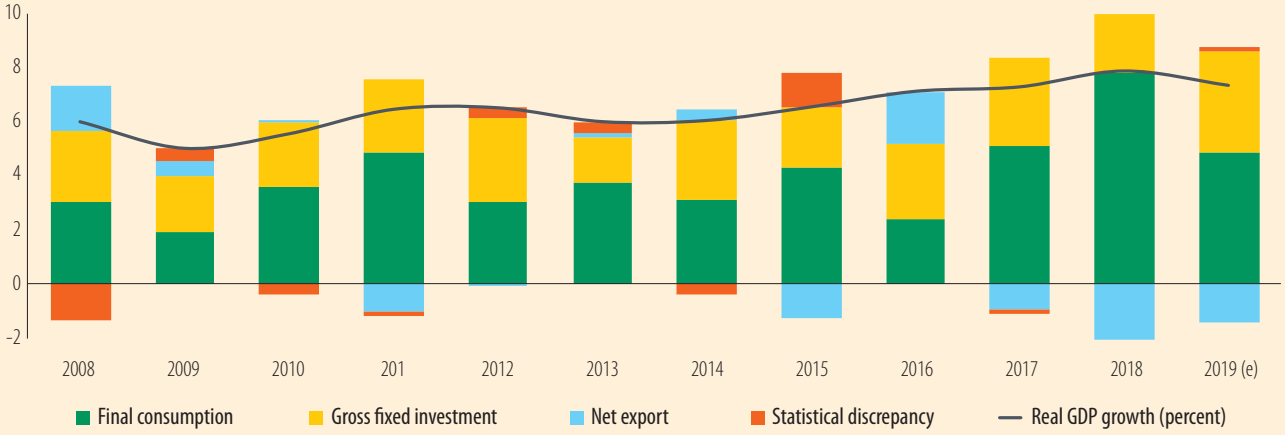
Bangladesh

Economic growth was robust in the first half of FY19, thanks to strong exports and consumption-driven domestic demand. As a result, core inflation increased. While the current account deficit has narrowed, the overall Balance of Payments deteriorated. The fiscal deficit widened due to weak revenue mobilization. Going forward, both growth and poverty reduction are expected to continue at a healthy pace. Risks to the outlook stem mainly from financial sector weaknesses and adverse private investment dynamics.

	2018
Population, million	166.9
GDP, current USD billion	274.1
GDP per capita, current USD	1642

Source: World Bank.

Contributions to real GDP growth
Percent, percentage points



Notes: (e)= estimate. Bangladesh's fiscal year runs from July 1st to June 30th.
Sources: Bangladesh Bureau of Statistics and staff calculations.

Recent economic developments

Economic expansion is continuing. Growth in FY19 benefited from an acceleration in exports, and a boost in domestic consumption thanks to a rise in remittances and bumper agricultural production. Exports grew by 14.4 percent in the first 6 months of FY19, driven by readymade garments. Tariff escalation between the United States and China has led to increased orders from both countries. Exports to the United States grew by 19 percent and to China by 35.8 percent. However, private investment growth remained confined within already established activities, such as garments and pharmaceuticals. Letter-of-Credit settlements for the import of capital machinery declined by 27.5 percent in July-November 2018 relative to the same period last year, and growth in the stock of private sector credit decelerated to 13.3 percent (y-o-y) through December 2018.

Core inflation is rising. Inflation decelerated to 5.3 percent (y-o-y) in December 2018, due to the decline in the price of rice. However, core inflation increased to 5.4 percent, compared with 3.8 percent a year ago. Cost pushes from frequent transport disruptions, exchange rate depreciation and the expanding output gap were the main contributors to the rise. Growth (y-o-y) in the stock of broad money through December 2018 has been weak at 9.4 percent, driven by a decline in net foreign assets and slower private credit growth.

Rising non-performing loans (NPLs) have constrained financing for private investment. NPLs rose to 11.5 percent of total loans at end-September 2018, up from 10.4 percent at the end of June 2018, despite significantly increased rescheduling of toxic loans.

Efforts to improve the NPL recovery rate are constrained by lengthy legal processes and the inability to take action against large defaulters. This increased risk aversion among lenders and led to downward rigidity in lending rates, which declined only 40 basis points since April 2018 when both the Cash Reserve Ratio and the repo rate were reduced. Access to finance continued to feature among the top four constraints on private investment in the World Economic Forum 2018 business perception survey.

The current account deficit is narrowing. Accelerated export growth and slower imports reduced the current account deficit significantly. Still, the deficit in the overall balance of payments widened to USD 513 million from USD 354 million during the same period last year due to a decline in the financial account surplus. The Central Bank sold USD 1.5 billion in the foreign exchange market in the first half of FY19, underpinning taka-dollar rate stability, but the taka-euro and the taka-pound rates appreciated 3.9 percent and 5.3 percent respectively by the end of December 2018 relative to their levels at the end of June. Gross foreign exchange reserves declined from USD 32.9 billion at the end of June 2018 to USD 31.9 billion in mid-February 2019, equivalent to about 5.2 months of imports.

The fiscal deficit is widening. The overall fiscal deficit remained below 4 percent of GDP in FY18, despite a large shortfall in revenues. Weak tax revenue collection continued in FY19, with only 6.4 percent growth in the first half of the fiscal year, well below nominal GDP growth. The government has started borrowing from the banking system, a significant departure from the recent trend of relying exclusively on non-bank borrowing.

Outlook

Bangladesh's growth outlook remains strong due to sound macroeconomic fundamentals and resilient domestic demand. Output growth is projected at 7.3 percent for FY19, driven by industry and services on the supply side, and private consumption and exports on the demand side. The dissipation of political uncertainties should unlock private investment, and accelerated implementation of mega public projects will boost public investment, leading to sustained 7 percent plus growth in the medium-term. Increased investment will also re-energize job creation.

Inflation is likely to remain high in the 6.0 to 6.5 percent range due to increased global inflation, a widening output gap and expansionary fiscal policy. Restrained monetary expansion, announced in January, will help contain excess demand. The current account deficit is projected to narrow moderately with expected declines in food and capital machinery imports.

A large shortfall in government revenue is expected due to reductions in several taxes in the absence of administrative measures to enhance collection. Additional pressure on expenditures are likely, due to expanded export subsidies, inadequate provisions for bank recapitalizations, and spending associated with the Rohingyas. Together, these may widen the budget deficit to 4.2 percent in FY19.

Emerging spatial inequalities warrant greater attention. As poverty continues to decline across the board, poverty rates between east and west are diverging. Faster progress in educational attainment, reduction of fertility rates, and structural transformation creates much more rapid poverty reduction in the east than in the (north) west of the country.

Risks and challenges

Downside external risks deepened, while domestic risks are balanced. Expansion in major export markets may slow. The conclusion of the national elections dissipated political uncertainty. Increasing NPLs could limit banks' ability to finance growth and undermine fiscal discipline. Recent stress in the foreign exchange market highlights the need to strengthen buffers against unfavorable external trade and financial conditions. Donor fatigue in responding to the Rohingya crisis could add to fiscal pressures.

Moving forward, the challenge is to ensure macroeconomic stability, accelerate structural reforms and address partial inequalities. Deepening fiscal reforms, resolving fragile banks, and addressing balance of payments challenges are immediate priorities. In the longer term, steps to enhance human capital, improve urban management, raise rural productivity and lower barriers to investment would boost potential growth and help tackle informality challenges in employment. Infrastructure construction activity is set to rise, but structural challenges need to be addressed.

Bangladesh macroeconomic outlook	2016	2017	2018 (e)	2019 (e)	2020 (f)	2021 (f)
Real GDP growth, at constant market prices	7.1	7.3	7.9	7.3	7.4	7.3
Private consumption	3.0	7.4	11.0	6.8	6.9	6.9
Government consumption	8.4	7.8	15.4	8.0	9.5	10.7
Gross fixed capital investment	8.9	10.1	10.5	11.2	11.2	10.3
Exports, goods and services	2.2	-2.3	8.1	5.2	5.4	4.8
Imports, goods and services	-7.1	2.9	27.0	10.5	11.1	10.4
Real GDP growth, at constant factor prices	7.2	7.2	7.9	7.3	7.4	7.3
Agriculture	2.8	3.0	4.2	4.1	3.5	3.1
Industry	11.1	10.2	12.1	9.9	10.0	9.9
Services	6.2	6.7	6.4	6.6	6.7	6.5
Inflation (consumer price index)	5.9	5.4	5.8	6.0	6.3	6.1
Current account balance (percent of GDP)	1.9	-0.5	-3.5	-3.2	-2.8	-2.9
Net foreign direct investment (percent of GDP)	0.6	0.7	0.6	0.6	0.5	0.5
Fiscal balance (percent of GDP)	-3.7	-3.4	-3.9	-4.2	-4.4	-4.6
Debt (percent of GDP)	31.5	31.0	31.1	32.8	34.7	35.1
Primary balance (percent of GDP)	-1.8	-1.6	-2.1	-2.2	-2.2	-2.3

Note: (e) = estimate, (f) = forecast.
Source: World Bank.

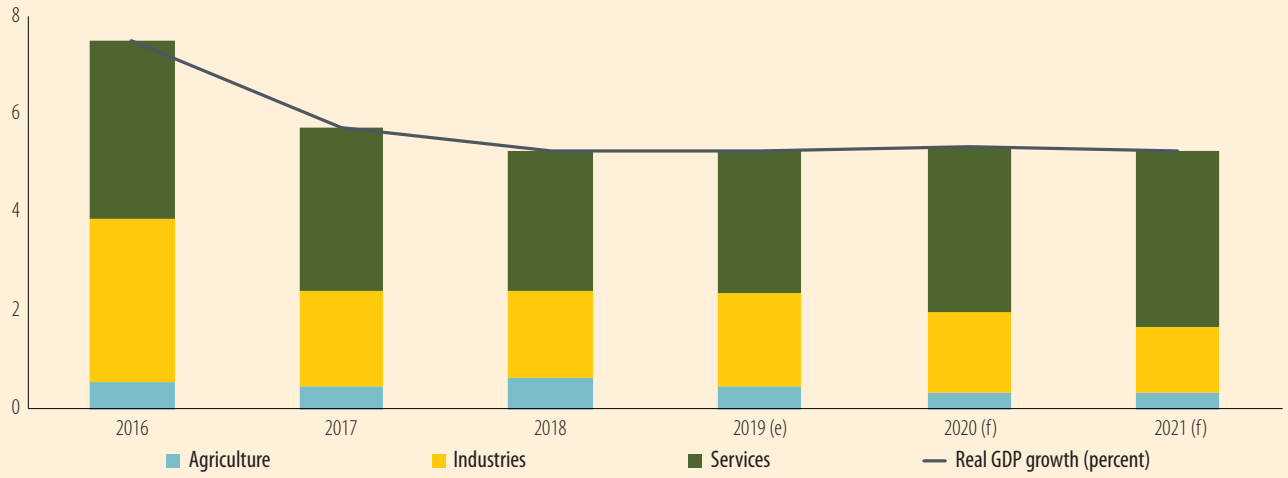
Bhutan

Growth is projected to moderate to 5.4 percent in 2018/19, primarily because of lower investment. Going forward, Bhutan's economy is expected to grow by 5 to 6 percent per annum, supported by a robust services sector and higher net exports. Risks stem mostly from delays in the completion of two major hydropower projects.

	2018
Population, million	0.8
GDP, current USD billion	2.7
GDP per capita, current USD	3321

Source: World Bank.

Contributions to real GDP growth
Percent, percentage points



Note: (e)= estimate, (f)= forecast.
Sources: National Statistics Bureau, Royal Monetary Authority, Ministry of Finance, World Bank, and staff calculations.

Recent economic developments

GDP growth in 2018/19 is expected to decelerate slightly to 5.4 percent compared to 5.8 percent in the previous year. On the supply side, growth will be driven by the services sector, especially hotels and restaurants, retail trade and transportation. On the demand side, the main contribution will come from the pickup in net exports, as the Mangdechhu hydropower plant begins production (720 MW). At the same time, imports are likely to decline because of weaker construction activity associated with further delays in PunatsangchhuI and II. The contribution of net exports to growth will be partly offset by lower investment. Inflation slowed to about 3 percent in the first half of 2018/19, mainly due to stable non-food prices. The Ngultrum depreciated slightly against the USD. It is fully pegged to the Indian rupee and trade with India accounts for more than 80 percent of Bhutan's international trade. As the inflation rates between the countries are strongly correlated, the real effective exchange rate remained stable. In the financial sector, gross non-performing loans at 12.4 percent of total loans warrants continued attention, despite high capital adequacy and sufficient provisioning.

The import of capital goods for hydropower construction declined so far this year because of the completion of the Mangdechhu project and delays in the construction of the other two mega hydropower projects owing to unexpected geological challenges. In addition, no new public investment programs were initiated by the government in the first half of the year, also reducing imports. With continued export growth, the current account deficit is likely to narrow to 17.2 percent of GDP in 2018/19. As of November 2018, gross international reserves stood at

USD 1 billion, equivalent to 11 months of imports of goods and services. In the first half of 2018/19, capital spending fell, as no new capital projects were implemented due to the elections. In addition, higher revenues from royalties and corporate income taxes are expected to contribute to a narrowing of the fiscal deficit to 0.7 percent of GDP in 2018/19. Public debt as a share of GDP is broadly unchanged at about 107.5 percent of GDP in 2018/19.

Outlook

Economic growth may average 5 to 6 percent per annum over the medium term, supported by the services sector and higher net exports. In the services sector, the key drivers are likely to be hotels and restaurants, retail trade and transportation, underpinned by tourism. With the operationalization of the Mangdechhu hydropower project in 2019, exports are projected to increase strongly, while imports are projected to moderate due to further delays in the construction of Punatsangchhu I and II. As a result, the current account deficit may narrow further, and help reduce external debt as a share of GDP. The fiscal deficit is projected to be around 3 percent of GDP over the medium term. Revenue growth will be supported by royalties from Mangdechhu, corporate income taxes, and the introduction of GST in 2020/21. Spending is also likely to increase over the medium term as the government undertakes new public investment programs in line with the Twelfth Five Year Plan. Current expenditures are projected to increase with higher spending on the maintenance of hydropower plants and a possible increase in public sector wages. In spite of the continuing fiscal deficit, public debt as a share of GDP is projected to decline. This is because large amortization payments associated with hydropower investments begin with the operationalization of the plants and are the main determinants of the debt trajectory. The transition out of agricultural jobs will continue to be slow, due to challenges in accelerating private sector development. The tourism sector has expanded significantly in recent years, with the number of visitor arrivals increasing by 21.5 percent between 2016 and 2017. Utilizing the growth potential of the tourism sector could help accelerate poverty reduction, as tourism-related jobs tend to have low entry barriers and require low skills. Improving internal connectivity and further investing in tourism promotion and development could help create jobs and increase earnings in the sector.

Risks and challenges

Risks to the outlook stem mainly from: further delays in hydropower project implementation/completion, which would also delay the large expected export and revenue payoffs; managing financing of the budget at higher costs in a context of under-developed domestic debt markets, which could constrain public investment and; natural calamities, which could lower electricity generation from existing hydropower plants and reduce agriculture output. A short-term challenge will be to ensure prudent fiscal management, including in years when there are jumps in hydropower revenues. Longer-term challenges include the need for diversification of the country's asset base through investments in physical capital, human capital and institutions. This would help lower the barriers for investment and facilitate private sector development.

Bhutan macroeconomic outlook	2016	2017	2018 (e)	2019 (e)	2020 (f)	2021 (f)
Real GDP growth, at constant market prices	7.4	6.3	5.7	5.4	5.4	5.2
Private consumption	3.0	-0.4	1.0	7.0	5.0	4.4
Government consumption	7.3	4.3	6.0	6.0	6.0	5.0
Gross fixed capital investment	14.1	5.6	2.5	-2.0	-7.0	1.1
Exports, goods and services	-6.3	0.8	-2.1	7.6	9.3	0.5
Imports, goods and services	0.8	-4.9	-7.2	0.0	-6.9	-4.4
Real GDP growth, at constant factor prices	7.8	6.0	5.5	5.5	5.6	5.4
Agriculture	4.4	3.6	5.2	4.0	3.0	3.0
Industry	7.6	4.6	4.2	4.5	3.9	3.3
Services	9.2	8.2	7.0	7.0	8.0	8.2
Inflation (consumer price index)	4.4	4.1	3.9	5.0	5.0	5.0
Current account balance (percent of GDP)	-30.5	-22.8	-18.4	-17.2	-12.4	-9.1
Net foreign direct investment (percent of GDP)	0.7	-0.5	0.4	0.9	0.7	0.4
Fiscal balance (percent of GDP)	-1.3	-4.6	-2.4	-0.7	-2.7	-3.2
Debt (percent of GDP)	114.2	108.5	106.8	107.5	105.9	99.4
Primary balance (percent of GDP)	0.2	-3.4	-1.2	0.0	-0.9	-1.6

Note: (e) = estimate, (f) = forecast.
Source: World Bank.

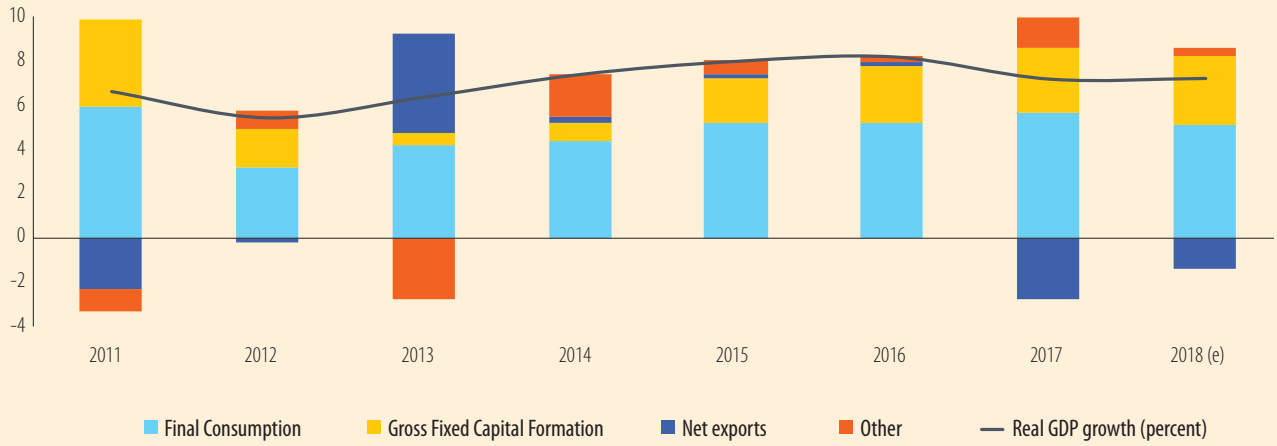
India

India continued to enjoy robust growth in FY18/19, with indications of a revival in investment and exports. Going forward, growth should stabilize around the potential level of 7.5 percent. Main risks to the outlook include possible exogenous shocks and fiscal slippages. However, declining wages of rural construction workers, divergent trends in food and core inflation, and an increased compliance burden on informal sector firms, may have moderated the pace of poverty reduction.

	2018
Population, million	1356.6
GDP, current USD billion	2723.9
GDP per capita, current USD	2008

Source: World Bank.

Contributions to real GDP growth
Percent, percentage points



Notes: (e) = estimate. India's fiscal year runs from April 1st to March 31st.
Sources: Indian Central Statistics office and staff calculations.

Recent economic developments

Real GDP growth is expected to remain at 7.2 percent in FY18/19, unchanged from the (revised) figure for the previous year. Data for the first three quarters suggest that growth has been broad-based. Industrial growth accelerated to 7.9 percent, making up for a deceleration in services. Meanwhile, agriculture growth was robust at 4 percent. On the demand side, domestic consumption remained the primary growth driver, but gross fixed capital formation and exports both made growing contributions. Over the last quarter, growth is expected to remain balanced across sectors.

Inflation dynamics have been subdued over most of FY18/19. A sustained decline in food prices since July 2018, subsequently complemented by the softening of oil prices and concomitant appreciation of the rupee, has led to a steady decline in inflation. Headline inflation stood at 2.6 percent in February 2019, and the average for FY18/19 so far at 3.5 percent, well below the RBI's target-midpoint of 4 percent. As a result, the RBI reduced the policy rate by 25 basis points (to 6.25 percent) in February 2019.

The current account deficit widened in FY18/19. India's external position worsened significantly in the first half of FY18/19, as large portfolio outflows were triggered by US monetary policy and fears of contagion from stress in some emerging market economies. The nominal exchange rate depreciated, and foreign reserves declined by over 8 percent over January to October 2018. However, since then, the decline in oil

prices and the United States Fed signaling a slower pace of normalization than initially anticipated led to a partial reversal. Portfolio outflows have reversed, and the rupee has appreciated by about 4 percent vis-à-vis the USD since October 2018. For the full fiscal year, the current account deficit is expected to reach 2.6 percent of GDP (from 1.8 percent of GDP the previous year). Foreign reserves stood at USD 401.8 billion in early March 2019 (equivalent to over 9 months of imports).

Fiscal consolidation was put on hold. The fiscal deficit of the central government was revised at 3.4 percent of GDP, 0.1 percentage point above the initial budget target, on account of a new income transfer scheme for farmers. With the aggregate gross fiscal deficit of states believed to be in the range of 2.9 percent of GDP, the deficit of the general government is expected to be 6.3 percent, and public debt to remain stable at 67.2 percent of GDP (a level that remains manageable since debt is mostly domestic and long-term).

Outlook

The economic outlook is strong, with growth expected to converge to potential in coming years. GDP growth is expected to accelerate moderately to 7.5 percent in FY19/20, driven by continued investment strengthening—particularly private— improved export performance, and resilient consumption. With robust growth, and food prices poised to recover, inflation is expected to converge toward 4 percent.

Both the current account and the fiscal deficit are expected to narrow. On the external front, improvements in India's export performance and low oil prices should bring about a reduction in the current account deficit to 1.9 percent of GDP. On the internal front, the consolidated fiscal deficit is projected to decline, albeit slowly (to 6.2 and 6.0 percent of GDP in FY19/20 and FY20/21 respectively). As the center's deficit is budgeted to remain unchanged at 3.4 percent of GDP in FY19/20, the burden of adjustment will rest on the states.

The divergent trend between falling food-inflation and rising core inflation has reduced the real purchasing power for agricultural households. Sharply rising inflation in the rural health and education may also result in greater out-of-pocket expenditure and vulnerability for extremely poor households. For non-agricultural households, a muted growth in real rural wages in construction, since 2015, may have moderated the pace of poverty reduction as the sector employs most of the poor and vulnerable. For the urban poor, there may be second-round poverty effects of GST, due to the increased burden of compliance on small and informal firms.

Risks and challenges

External risks have moderated significantly. With the pause in US monetary policy normalization, risks to the growth outlook have declined relative to the first half of the year. Nonetheless, India remains vulnerable to changes in international financing conditions and to increases in oil prices.

However, the outlook on public finances remains challenging. The GST regime is still stabilizing and remaining below expectations on the revenue side, while pre-electoral promises, in addition to commitments already made in the Budget for FY19/20, may translate in significant expenditure outlays at the center and state levels going forward. This implies that meeting budget targets will require significant effort and discipline, including on maximizing revenue potential from the GST.

Important structural challenges remain, particularly to investment. These structural challenges include the "twin balance sheet" problem (impaired balance sheets of public sector banks and corporates) and supply bottlenecks, which preclude the significant increase in credit and investment that would be required to put the economy on a higher growth trajectory. Broad-based poverty reduction remains a big challenge. India must accelerate the responsiveness of poverty reduction to growth, including for presently excluded groups, and extend gains to a broader range of human development outcomes related to health, nutrition, education and gender, where it ranks poorly. The persistent negative impact of uneven monsoons on agriculture, amplified by low uptake of crop insurance, underlines the medium-term risk of climate change for the rural poor. Furthermore, outdated information on indicators of poverty and employment pose serious challenges in reliably correlating growth forecasts with projected rates of poverty.

India macroeconomic outlook	2016	2017	2018	2019 (e)	2020 (f)	2021 (f)
Real GDP growth, at constant market prices	8.2	7.2	7.2	7.5	7.5	7.5
Private consumption	8.2	7.4	7.5	7.9	7.6	7.9
Government consumption	5.8	15.0	8.6	7.8	7.5	7.5
Gross fixed capital investment	8.3	9.3	9.9	8.1	8.7	7.7
Exports, goods and services	5.1	4.7	12.5	12.3	12.5	13.2
Imports, goods and services	4.4	17.6	16.8	13.2	13.5	14.5
Real GDP growth, at constant factor prices	7.9	6.9	7.1	7.4	7.5	7.5
Agriculture	6.3	5.0	3.5	3.6	3.8	3.8
Industry	7.7	5.9	7.6	7.8	7.9	7.9
Services	8.4	8.1	7.7	8.2	8.3	8.2
Inflation (consumer price index)	4.5	3.6	3.7	4.0	4.0	4.0
Current account balance (percent of GDP)	-0.6	-1.8	-2.6	-1.9	-1.7	-1.2
Net foreign direct investment (percent of GDP)	1.6	1.1	1.2	1.4	1.6	1.6
Fiscal balance (percent of GDP)	-6.9	-6.4	-6.3	-6.2	-6.0	-5.8
Debt (percent of GDP)	67.7	67.6	67.2	66.1	65.2	64.1
Primary balance (percent of GDP)	-2.2	-1.6	-1.4	-1.3	-1.1	-0.9

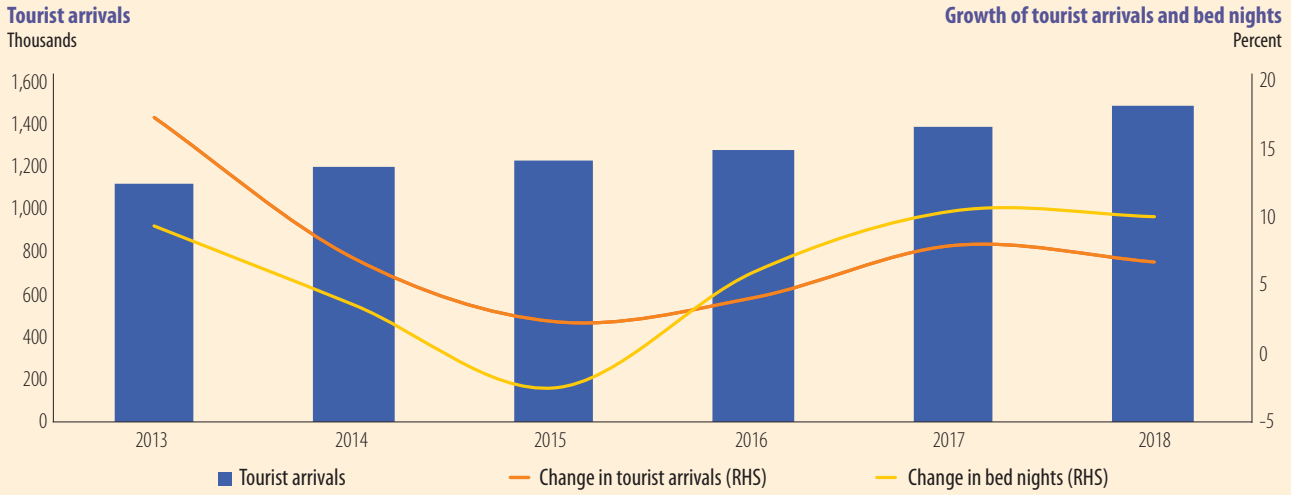
Note: (e) = estimate, (f) = forecast.
Source: World Bank.

Maldives

Real GDP growth is expected to reach 7.9 percent in 2018, driven by construction and tourism, supported by recent infrastructure investment and expansion in the guest houses' sector. It is projected to gradually decline to 5.3 percent over the forecast period. Efforts to rationalize recurrent spending are needed, especially related to subsidies and health spending. Poverty is low, but labor market challenges for the youth persist. Public debt is projected to rise further, and international reserves are low.

	2018
Population, million	0.4
GDP, current USD billion	5.4
GDP per capita, current USD	12108

Source: World Bank.



Note: Maldives fiscal year is the calendar year.
Source: National Bureau of Statistics.

Recent economic developments

Real GDP growth is expected at 7.9 percent for 2018, on the back of strong performance of tourism and construction, as well as trade. Preliminary estimates indicate that growth accelerated to 9.1 percent y-o-y over the first three quarters of 2018, compared to 6.6 percent over the same period in 2017. Tourism contributed 2.1 percentage points, followed by wholesale and retail trade (1.8pp) and construction (1.3pp). Tourist arrivals and bed nights increased by 6.8 percent and 10.2 percent respectively (y-o-y), supported by infrastructure investments on the international airport, the opening of new resorts, and expansion in the guest houses' sector. However, the tourism and construction sectors are not generating employment opportunities that Maldivians are able or willing to take up.

The overall consumer price index marginally declined by 0.1 percent in 2018, compared to an increase of 2.8 percent in 2017. This was driven mainly by a decrease in prices of staple food items and electricity, due to policy changes in food subsidies and electricity charges. The decline in prices was more pronounced in the atolls, averaging -1.4 percent for the year. Two major contributors were food and non-alcoholic beverages (-0.9 percent) and housing and utilities (-9.4 percent).

The current account deficit is estimated to have widened to 24.2 percent for 2018, up from 22 percent in 2017. The trade deficit increased on the backdrop of subdued performance of goods exports (a contraction of 1.6 percent) and rapid growth of goods imports (16.1 percent) linked to investment projects. On the services side, exports performed strongly (10.7 percent) thanks to strong tourism receipts. The

current account deficit was financed mainly through debt flows and direct investment. Gross official reserves increased to USD 758 million in December 2018, up from USD 586 million a year before (USD 281 million after netting out short-term foreign currency liabilities to domestic banks, representing 1.3 months of goods imports).

Preliminary fiscal outcomes suggest a deterioration in 2018. The fiscal deficit is expected to have widened to 4.9 percent of GDP in 2018, from 3.0 percent in 2017. Total spending grew by 13.3 percent between 2017 and 2018, whereas revenues and grants increased by only 6.9 percent. Increases in expenditures were driven by spending on subsidies (3.6pp of total spending), the health program Aasandha (2.5pp), allowances to employees (1.9pp), and interest costs (1.5pp), and training expenses (1.2pp). On the revenue side, the full-year collection of the airport development fee helped increase receipts. Strong growth contributed positively to debt dynamics. Public debt is estimated to have reached 57 percent of GDP in 2018.

There is no strong link between employment and poverty status, and there is a general lack of productive employment opportunities for Maldivians. Youth unemployment is high at 15.3 percent, with young males being 1.5 times more likely to be unemployed than young females, and 6 times more likely to be unemployed than their adult counterparts. Almost one in four Maldivian youth were not in education, employment or training.

Outlook

Real GDP growth is expected to decline gradually to 5.2 percent by 2020, as tourism sector activity converges back to historical levels, and capital investment projects gradually taper-off. Tourism is expected to continue to be the main driver of growth, with recent infrastructure investment helping relieve supply bottlenecks in the sector. The current account deficit is projected to narrow over the forecast period, as investment-related imports gradually subside.

The outlook assumes an increase in recurrent spending related to the new administration's campaign pledges, including an extension of Aasandha coverage for Maldivians living in Sri Lanka, Malaysia and India, additional subsidies, and an expansion of the university scholarship program. Interest costs are also expected to gradually rise over the medium-term, reflecting the country's increased uptake of non-concessional borrowing. The overall fiscal deficit is projected to increase initially, before stabilizing over the forecast period. Public debt is projected to rise over the forecast period and peak soon after.

Risks and challenges

Risks to the outlook are tilted to the downside. A downturn in the global economy could impact Maldives' tourism industry. Increase in oil prices could affect the external account, given the country's heavy reliance on diesel imports. Legislative elections due in April could result in additional fiscal slippages and delay of key reforms.

One key challenge for Maldives is to strike an appropriate balance between making large investments needed to close existing infrastructure gaps – potentially allowing to boost tourism, increase resilience to climate change and ease constraints in service delivery — and managing the rapid accumulation of public debt. Containing recurrent spending and improving the efficiency of social spending are key areas that require attention. The overall level of indebtedness is high and reserves coverage is low. Large volume of external loans and guarantees on non-concessional terms to finance infrastructure projects represent significant risks.

Public sector jobs account for 40 percent of total employment. Large wage premiums and other benefits associated with public employment disincentivize young jobseekers from taking up private sector opportunities. Still the projected expansion in the young labor force means that private sector alternatives will be required.

Maldives macroeconomic outlook	2016	2017	2018 (e)	2019 (e)	2020 (f)	2021 (f)
Real GDP growth, at constant market prices	7.3	6.9	7.9	5.7	5.2	5.3
Real GDP growth, at constant factor prices	7.0	6.0	7.9	5.7	5.2	5.3
Agriculture	1.5	8.3	7.8	5.9	3.4	3.1
Industry	12.3	10.9	13.4	10.2	9.9	8.1
Services	6.7	5.2	7.1	4.9	4.6	5.0
Inflation (consumer price index)	0.5	2.8	-0.1	1.2	1.5	2.0
Current account balance (percent of GDP)	-23.4	-22.0	-24.2	-22.1	-17.2	-14.8
Fiscal balance (percent of GDP)	-9.9	-3.0	-4.9	-5.2	-4.8	-4.5
Debt (percent of GDP)	56.3	58.6	57.2	60.5	62.0	63.1
Primary balance (percent of GDP)	-8.1	-1.5	-3.2	-3.5	-3.0	-2.7

Note: (e) = estimate, (f) = forecast.
Source: World Bank.

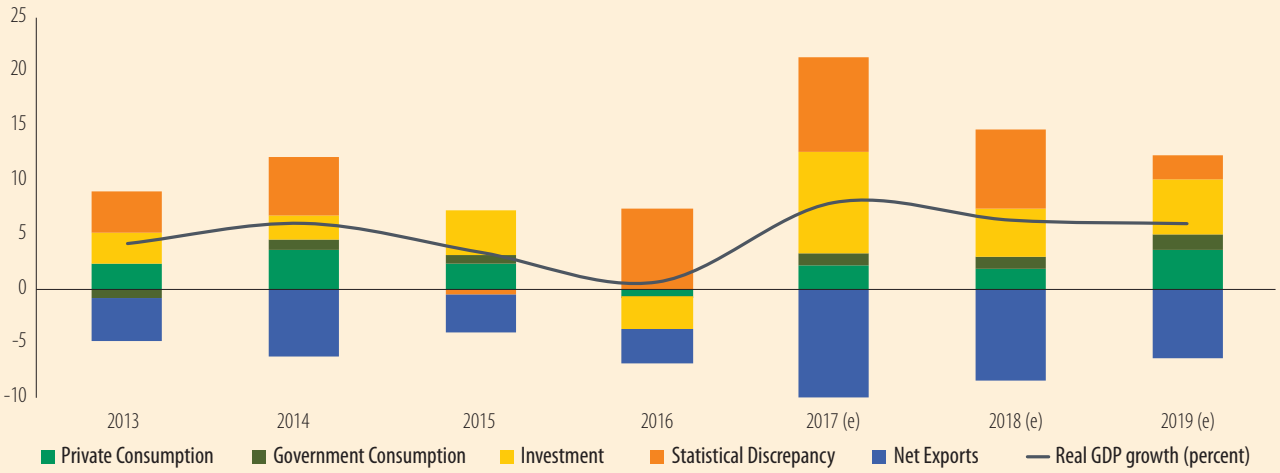
Nepal

Growth reached 6.3 percent in FY2018, driven by investment. The current account and fiscal deficits widened sharply, calling for improved spending efficiency related to the implementation of federalism, strengthened revenue efforts, and enhanced medium-term planning at the subnational level. Over the medium-term, growth is expected to remain strong at around 6 percent and to continue to drive significant poverty reduction. Risks to the outlook arise from reform implementation constraints and vulnerability to natural disasters.

	2018
Population, million	29.6
GDP, current USD billion	28.8
GDP per capita, current USD	973

Source: World Bank.

Contributions to real GDP growth
Percent, percentage points



Note: Nepal's fiscal year runs from July 16th to July 15th.
Sources: Central Bureau of Statistics and staff calculations.

Recent economic developments

GDP grew robustly at 6.3 percent in FY2018, despite less favorable monsoons. On the supply side, growth in services contributed 3.6 percentage points to GDP growth due to record tourist inflows, and the industrial sector contributed an additional 1.4 percentage points, due to expanded capacity supported by improved access to electricity. On the demand side, investment was the main driver, contributing 4.4 percentage points to growth.

As of January 2019, the inflation rate stood at 4.6 percent (y-o-y), driven by increases in non-food prices. Credit growth reached 23.9 percent, exceeding deposit growth of 21.0 percent, and leading to a tightening of liquidity, increase in interest rates, and a rise in the banking sector's credit-to-core capital plus deposits (CCD) ratio.

The current account deficit rose sharply to 8.2 percent of GDP in FY2018 (from 0.4 percent of GDP in FY2017), due to increased imports for establishing local government offices, reconstruction activities, and intermediate goods for the industrial sector. The depreciation of the Nepali Rupee against the USD, and the increased use of formal channels for remittances contributed to an increase in officially recorded remittance inflows in the first six months of FY2019 (30.2 percent). With imports growing by 30.6 percent and a persistently low export-import ratio of only 6.3 percent, even buoyant remittances growth was insufficient to offset a widening trade

deficit, leading to an increase in the current account deficit. A part of this deficit was financed through international reserves which declined to USD 9.4 billion (7.8 months of imports).

The fiscal deficit (including grants) increased over FY2018 (driven by federalism-related expenses) to reach 5.7 percent of GDP, up from 3.1 percent of GDP in FY2017. Federal revenue targets were achieved in FY2018; but spending rose by 29 percent, despite budget execution of just 82.4 percent. Debt to GDP remained close to 30.5 percent in FY2018, a level at which risk of debt distress remains low.

Outlook

Growth is projected to average 6 percent over the medium term. On the supply side, it will be driven by strong growth in paddy production (estimated to reach 10 percent in FY2019), services stemming from higher international tourist arrivals, and manufacturing as the largest cement factory in Nepal comes into operation. On the demand side, the main driver will be gross investment as ongoing reforms to crowd-in the private sector and maximize finance begin to pay-off. Inflation is expected to remain below 5 percent, assuming stable oil prices, and strong agricultural production. With prudent macroeconomic management, the current account deficit is expected to peak over the next year or two, before improving gradually, as imports associated with establishing local government offices slow down, and investments and reforms to stimulate exports, particularly in the energy sector, begin to take effect. Further improvements in access to electricity (possibly through the Upper Tamakoshi Hydropower Project) should help expand industrial capacity and exports.

Consolidated government spending could reach 35 percent of GDP by FY2021 up from 31 percent of GDP in FY2018, with fiscal transfers (to both local and provincial governments) projected to reach 12 percent of GDP. Federal spending is projected to be around 23 percent of GDP by FY2021, as service delivery is devolved to provincial and local governments. Meanwhile revenues are expected to reach 30 percent of GDP over the medium term, from increased taxes on luxury items and incomes of wealthy households. Also, VAT exemptions have been abolished, leaving allowance only for standard VAT refunds. An integrated customs system has also been rolled out to reduce underreporting of taxes. The fiscal deficit is expected to moderate as reforms are implemented to raise revenues at the federal and subnational levels, spending levels stabilize and expenditure efficiency increases. Over the medium term, the debt to GDP ratio is projected to reach around 36 percent.

Risks and challenges

The capacity to sustain service delivery and establish fiscal discipline, particularly at the local levels, remains a challenge. The transfer of financial management staff over a year ago made it possible for local governments to prepare budgets and receive fiscal transfers of 8 percent of GDP in FY2018. However, underspending of the budget persists. Although the 2018 Civil Service Readjustment Act governs the transfer of federal staff to the local levels, there remains uncertainty about staff already recruited by local governments. The latter do not have authority to determine which federal staff are assigned to them. In addition, capacity building and systems strengthening are needed to improve the planning and budget preparation and execution process, and track resources and results.

Key risks to the outlook include (i) slow implementation of reforms to increase private investment, especially foreign investment; (ii) limited resources and capacity to support federalism and local service delivery; (iii) constraints on credit as banks limit lending to meet the CCD ratio regulatory limit; (iv) adverse effects of natural disasters; and (v) shocks to remittance inflow. The poverty outlook is especially sensitive to remittance inflows, natural disasters and local level implementation capacity constraints that may hamper service delivery.

Nepal macroeconomic outlook	2016	2017 (e)	2018 (e)	2019 (e)	2020 (f)	2021 (f)
Real GDP growth, at constant market prices	0.6	7.9	6.3	6.0	6.1	6.2
Private consumption	-0.7	2.6	2.5	4.8	4.8	4.8
Government consumption	-0.4	10.4	9.4	13.0	11.9	14.9
Gross fixed capital investment	-12.3	44.2	15.7	16.5	15.9	14.6
Exports, goods and services	-13.7	13.7	4.4	9.5	11.0	11.0
Imports, goods and services	2.8	30.3	14.8	11.6	11.5	11.5
Real GDP growth, at constant factor prices	0.2	7.4	5.9	6.0	6.1	6.2
Agriculture	0.2	5.2	2.8	4.2	4.5	4.5
Industry	-6.4	12.4	8.8	8.6	8.8	8.8
Services	2.3	7.4	7.1	6.3	6.3	6.4
Inflation (consumer price index)	9.9	4.4	4.0	4.7	4.7	5.0
Current account balance (percent of GDP)	6.2	-0.4	-8.2	-7.8	-6.8	-5.4
Fiscal balance (percent of GDP)	1.4	-3.1	-5.7	-5.7	-5.5	-5.4
Debt (percent of GDP)	27.9	26.6	30.5	32.5	35.1	36.4
Primary balance (percent of GDP)	1.8	-2.8	-4.8	-4.7	-4.7	-4.6

Note: (e) = estimate, (f) = forecast.
Source: World Bank.

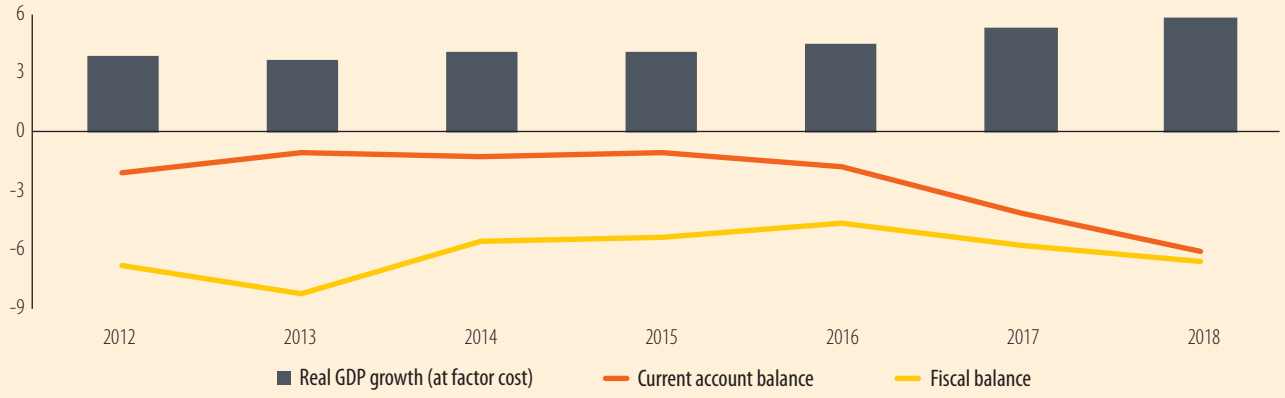
Pakistan

After peaking at 5.8 percent in FY18, growth is expected to slow over the next two years as measures are taken to correct macroeconomic imbalances. Tighter monetary and fiscal policies are expected to curb domestic demand. Large external financing requirements and an elevated public debt to GDP ratio are sources of risk requiring remedial action. In this context poverty reduction is expected to continue but at a slower pace.

	2018
Population, million	200.4
GDP, current USD billion	312.6
GDP per capita, current USD	1560

Source: World Bank.

Real GDP growth and twin deficits
Percent of GDP



Note: Pakistan's fiscal year runs from July 1st to June 30th.
Sources: Ministry of Finance and State Bank of Pakistan

Recent economic developments

While growth reached 5.8 percent in FY18—the highest in 11 years—twin deficits widened. The current account and the fiscal deficits rose to 6.1 and 6.5 (including grants) percent respectively. The new government took steps to address these imbalances, but outcomes by mid-year suggest that further adjustments will be necessary. Leading indicators for real sector activity suggest a contraction in demand. Large scale manufacturing, which accounts for 65 percent of overall industrial output, contracted by 2.3 percent between July and January FY19. In agriculture, four of the five major crops have witnessed a y-o-y decline in production, due to water shortages and a decline in production area. The exchange rate has continued to depreciate, with a cumulative depreciation of 12 percent between July 2018 and February 2019. As a result of exchange rate depreciation, demand side pressures and higher fuel prices, inflationary pressures have increased and average headline inflation reached 6.5 percent in the period between July 2018 and February 2019 (as compared to 3.9 percent in the same period last year). The real effective exchange rate depreciated by 12.6 percent during July and January FY19 compared to a 2.5 percent depreciation in the same period last year. In response to higher inflationary pressures, the State Bank of Pakistan has increased the policy rate by a cumulative 375 bps to 10.25 percent since July 2018. On the external front, the current account deficit reached USD 8.8 billion (3.3 percent of GDP) at end February 2019, compared to USD 11.4 billion (3.7 percent of GDP) the year before. Overall imports contracted by 1.6 percent (y-o-y) but exports also declined by 0.1 percent (y-o-y) in spite of the exchange rate depreciation. Over the same period, remittances experienced healthy growth, but foreign direct investment declined. By mid-January inter-

national reserves had fallen to US$6.6 billion (or 1.3 months of imports). With short term financing from the Kingdom of Saudi Arabia and the United Arab Emirates reserves increased to USD 8.1 billion (or 1.6 months of imports) by March 8th, 2019, and further financing from these countries is expected. Meanwhile, the government continues to negotiate a support package with the International Monetary Fund.

The fiscal deficit reached 2.7 percent of GDP in the first half of FY19 (compared to 2.2 percent in the first half of FY18). Efforts to curb development spending were insufficient to offset the limited growth in revenues and large increases in debt servicing and defense expenditures. Pakistan's public debt reached 73.2 of GDP by the end of December 2018.

Outlook

Growth is projected to decelerate to 3.4 percent in FY19 and to 2.7 percent in FY20, as the government tightens fiscal and monetary policies. While domestic demand growth will slow down immediately, net exports will only increase gradually. As macroeconomic conditions improve, and a package of structural reforms in fiscal management and competitiveness is implemented, growth is expected to recover to 4.0 percent in FY21. This baseline scenario assumes stable international oil prices and reduced political and security risks. Inflation is expected to rise to 7.1 percent (average) in FY19 and projected to reach 13.5 percent in FY20 as a result of further exchange rate depreciation pass-through. The trade deficit is projected to remain elevated during FY19, but to narrow in FY20 and FY21 as the impacts of currency depreciation, domestic demand compression, and other regulatory measures to curb imports set in. Remittances are projected to finance over 70 percent of the trade deficit. FDI, multilateral and bilateral debt-creating flows as well as financing from international markets are expected to be the main financing sources of the current account in the near to medium term. The fiscal deficit is projected to increase to 6.9 percent in FY19 and to remain high during FY20-21, a result of large interest payments and a slow increase in domestic revenues. Public debt to GDP is expected to cross 80 percent in FY19 and to remain elevated in the next two years, increasing Pakistan's exposure to debt-related shocks. The pace of poverty reduction is expected to continue to slow-down in FY19 and FY20, following the projected growth deceleration and higher inflation rates.

Risks and challenges

Together with the macroeconomic adjustment expected over the next two years, there is an urgent need to implement structural reforms to support the growth rebound from FY21 onwards. Economic uncertainty has increased due to protracted negotiations with the IMF. In addition, recent regional tensions have had an impact on risk perceptions. The low reserves position and high debt-ratios limit the buffers that Pakistan could use to absorb external shocks (such as an increase in US interest rates) and may negatively impact the government's ability to access international markets. Reforms to put the country on a stable growth path include increased exchange rate flexibility, improved competitiveness and lower cost of doing business. On the revenue front, reforms to improve tax administration, widen the tax base and facilitate tax compliance are critical. Higher inflation rates may jeopardize recent gains in poverty reduction, since poor households in urban areas are particularly affected by increases in prices, as shown by the most recent inflation hike during the 2007-08 food price crisis.

Pakistan macroeconomic outlook	2016	2017	2018 (e)	2019 (e)	2020 (f)	2021 (f)
Real GDP growth, at constant market prices	5.5	5.7	5.4	3.4	2.7	4.0
Private consumption	7.6	8.7	6.3	2.9	1.8	3.1
Government consumption	8.2	5.3	14.2	10.0	-0.7	1.8
Gross fixed capital investment	7.5	10.0	5.7	-4.1	2.7	6.0
Exports, goods and services	-1.6	-0.8	9.9	5.4	7.0	7.0
Imports, goods and services	16.0	21.0	17.5	1.0	-1.0	2.0
Real GDP growth, at constant factor prices	4.6	5.4	5.8	3.4	2.7	4.0
Agriculture	0.2	2.1	3.8	1.4	1.6	2.3
Industry	5.7	5.4	5.8	2.3	1.3	4.3
Services	5.7	6.5	6.4	4.4	3.5	4.5
Inflation (consumer price index)	2.9	4.2	3.9	7.1	13.5	11.0
Current account balance (percent of GDP)	-1.7	-4.1	-6.1	-5.6	-2.9	-2.4
Net foreign direct investment (percent of GDP)	0.8	0.9	1.0	0.9	1.2	1.3
Fiscal balance (percent of GDP)	-4.5	-5.8	-6.5	-6.9	-6.3	-5.3
Debt (percent of GDP)	68.7	67.9	73.5	82.3	79.3	75.7
Primary balance (percent of GDP)	-0.2	-1.5	-2.1	-1.6	-0.3	0.4

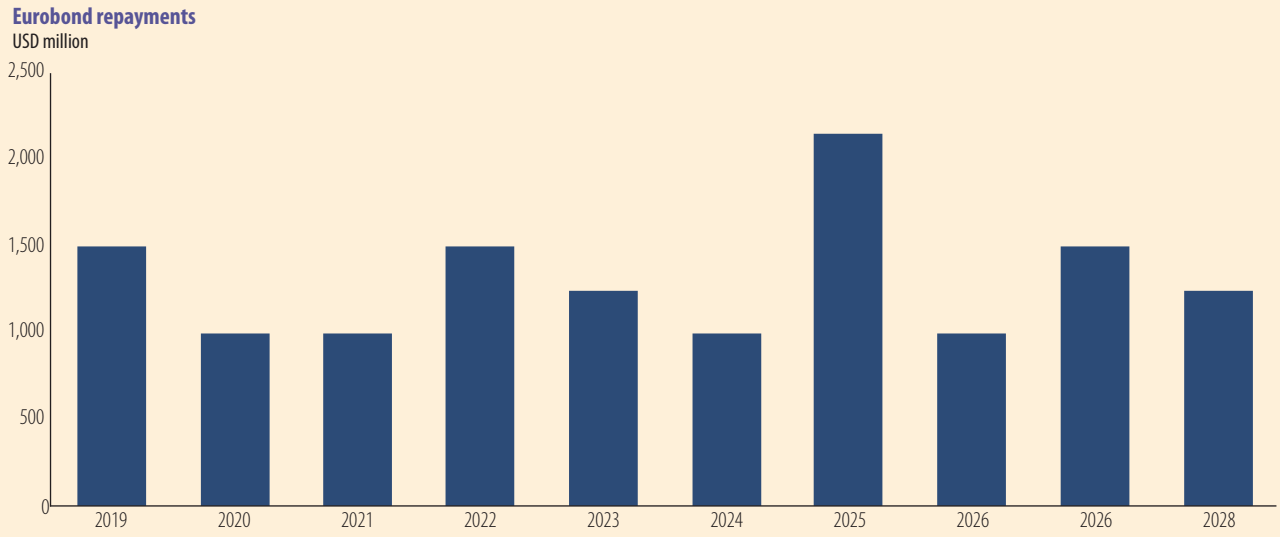
Note: (e) = estimate, (f) = forecast.
Source: World Bank.

Sri Lanka

Sri Lanka is facing a challenging macroeconomic situation. Growth declined to 3.2 percent in 2018, and the fiscal deficit was 5.2 percent of GDP. External sector performance remained weak with a widened current account deficit and low reserves. Going forward, growth is expected to converge towards 4 percent. Large refinancing requirements make the country vulnerable to global financing conditions. Poverty has remained on a downward trajectory, with the headcount ratio estimated at 8.7 percent in 2018.

	2018
Population, million	21.5
GDP, current USD billion	86.3
GDP per capita, current USD	4007

Source: World Bank.



Note: Sri Lanka's fiscal year is the calendar year.
Sources: Department of Census and Statistics and, staff calculations.

Recent economic developments

Growth is expected to have declined to 3.2 percent in 2018, down from 3.3 percent in 2017. While agriculture made a positive contribution, thanks to clement weather, a deceleration in construction depressed the contribution from industry, and services expanded at a modest rate. Inflation declined to 4.3 percent by end 2018, with the moderation brought about by lower food prices, despite currency depreciation and high oil prices in the first half of the year. Monetary policy, which remained broadly tight in response to external pressures, also helped maintain inflation low.

External sector performance was mixed. The trade deficit widened. While earnings from tourism continued to grow fast, high oil prices in the first half of 2018 and increased imports of vehicles drove overall import growth. Meanwhile, worker remittances remained almost flat, and increased dividend and interest outflows exerted pressure on the current account deficit, which is expected to have widened to 3.0 percent of GDP in 2018 (from 2.6 in 2017). Debt-creating flows dominated the financial account with issuance of Eurobonds, project loans and term-financing. Nevertheless, FDI is expected to have reached an all-time high at around USD 2.0 billion in 2018, thanks to the long-term leasing of the Hambantota port.

A political controversy in the fourth quarter affected external sector performance. Fitch, S&P and Moody's cut Sri Lanka's sovereign credit rating by one notch,

and currency pressures were elevated amid capital outflows. Keeping up with debt repayment, capital outflows, and market intervention by the Central Bank, gross official reserves decreased to USD 6.9 billion in December (from an all-time-high of USD 9.9 billion in April 2018). Thus, reserve adequacy metrics remained weak, with foreign exchange obligations for 2019 estimated at USD 5.9 billion. The Government announced plans to issue Eurobonds, and to borrow from Chinese banks, while entering into SWAP arrangements. The IMF reached a staff-level agreement on the fifth review of Sri Lanka's Extended Fund Facility program in February 2019, which was delayed earlier due to the political controversy. After the announcement of the staff-level agreement with IMF, the Government raised USD 2.4 billion in Eurobonds.

Fiscal policy remained conservative. A primary surplus of 0.5 percent of GDP is expected to have been realized in 2018, thanks to a combination of increased tax revenues and tight control over expenditures. However, a sharp increase in interest expenditure is expected to have overshadowed these improvements and contributed to keep the overall deficit at 5.2 percent of GDP (only marginally down from 5.5 percent in 2017). Central government debt is estimated to have reached 83 percent of GDP, more than half of which is denominated in foreign currency. Recent commercial borrowings have increased the cost and risk of the portfolio. While the implementation of cost-reflective pricing of fuel is an important step, further reforms are needed to reduce fiscal risks of SOEs.

A rebound in the agricultural sector and modest inflation helped incomes of the rural poor. The political turmoil, however, put a temporary brake on the rapid growth in tourism towards the end of the year, on the eve of the peak holiday season. A rebound in this sector could help move labor out of agriculture and improve the earnings of the poor.

Outlook

The economy is expected to rebound, and growth to converge gradually toward 4 percent in the medium term, driven by domestic demand. Inflation is projected to stabilize around 5 percent. Continued fiscal consolidation, albeit slow, should bring the overall fiscal deficit and public debt on a downward path. The current account deficit is projected to remain at around 2.4 percent of GDP between 2019-2021, as tourism receipts help counterbalance the effect of sluggish remittance flows and high external interest payments. Foreign capital inflows to government securities and FDI should help meet external financing requirements. The recovery of domestic demand and improvements in the labor market, aided by low inflation, should boost real incomes and lead to a further reduction in poverty. Sri Lanka is a fast-growing tourist destination and the tourism sector could help accelerate poverty reduction as it is labor-intensive, requires relatively low investment, and thus holds great potential to create jobs for youth and women. More generally, the recovery of domestic demand and improvements in the labor market, aided by low inflation, should boost real incomes and lead to a further reduction in poverty.

Risks and challenges

The challenging political environment remains a key source of risk. Given recent developments, and the impending election cycle, the window for reforms is narrowing. On fiscal and debt management fronts, risks include a delay or reversals in efforts to strengthen revenue collection, improve tax administration, and implement liability management operations. On the external front, tighter than expected global financial conditions would increase the cost of debt and complicate endeavors to roll-over maturing Eurobonds. The increasing occurrence and impact of natural disasters could also have an adverse impact on growth and poverty reduction.

Priority reforms to sustain economic growth, create more and better jobs, and reduce poverty include: (a) fiscal consolidation to make space for investments in health, education, social protection and public infrastructure; (b) improving competitiveness and promoting trade and FDI to facilitate a shift in the growth model driven more by private investment and exports; (c) mainstreaming governance reforms, particularly with respect to public finance management (PFM) and state owned enterprise (SOE) reforms; and (d) reducing vulnerability stemming from refinancing risks and natural disasters risks.

Sri Lanka macroeconomic update	2016	2017	2018 (e)	2019 (e)	2020 (f)	2021 (f)
Real GDP growth, at constant market prices	4.5	3.3	3.2	3.5	3.6	3.7
Private consumption	-3.9	1.3	3.2	3.5	3.6	3.8
Government consumption	2.3	-5.2	3.3	3.6	3.6	3.6
Gross fixed capital investment	7.8	5.0	5.8	5.5	5.5	5.4
Exports, goods and services	-0.7	7.5	3.6	3.4	3.4	3.3
Imports, goods and services	7.9	19.3	3.8	3.0	3.0	3.0
Real GDP growth, at constant factor prices	4.3	3.3	3.6	3.5	3.6	3.7
Agriculture	-3.8	-0.8	4.8	3.4	3.4	3.4
Industry	5.8	4.6	0.9	4.0	4.1	4.2
Services	4.7	3.2	4.7	3.3	3.4	3.5
Inflation (consumer price index)	4.0	6.6	4.3	5.0	5.0	5.0
Current account balance (percent of GDP)	-2.1	-2.6	-3.0	-2.4	-2.4	-2.5
Net foreign direct investment (percent of GDP)	0.8	1.5	2.2	1.4	1.1	1.1
Fiscal balance (percent of GDP)	-5.4	-5.5	-5.2	-4.8	-4.8	-4.7
Debt (percent of GDP)	78.8	77.4	83.0	81.4	80.2	79.2
Primary balance (percent of GDP)	-0.3	0.0	0.5	1.0	1.1	1.3

Note: (e) = estimate, (f) = forecast.
Source: World Bank.

South Asia at a glance

			Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka	South Asia (CY)
OUTPUT and PRICES	Real GDP growth	2015	1.3	6.8	6.2	7.8	2.9	2.0	5.1	5.0	7.4
		2016	2.4	7.1	7.4	8.2	7.3	0.6	5.5	4.5	7.7
		2017	2.7	7.3	6.3	7.2	6.9	7.9	5.7	3.3	7.2
		2018 (e)	1.0	7.9	5.7	7.2	7.9	6.3	5.4	3.2	6.9
		2018 Q3 (CY)	..	..	..	6.9	..	..	..	3.4	..
		2018 Q4 (CY)	..	..	..	6.5	..	..	..	1.7	..
	Inflation (Consumer Price Index)	2015	4.6	6.4	6.3	4.9	0.9	7.2	4.5	0.9	2.8
		2016	4.3	5.9	4.4	4.5	0.5	9.9	2.9	4.0	4.3
		2017	4.7	5.4	4.1	3.6	2.8	4.4	4.2	6.6	5.1
		2018 (e)	0.6	5.8	3.9	3.7	-0.1	4.0	3.9	4.3	4.0
		2019 January	1.9	5.4	3.1	2.0	0.0	..	7.2	1.2	..
		2019 February	..	5.5	..	2.5	..	..	8.2	2.4	..
	REER (CY)	2015	..	..	..	103.7	..	..	110.3	..	104.3
		2016	..	..	..	105.0	..	..	109.6	..	105.4
		2017	..	..	..	109.7	..	..	106.4	..	109.4
		2018 (e)	..	..	..	104.8	..	..	102.4	..	104.6
		2019 January	..	..	..	103.5	..	..	101.9	..	103.3
		2019 February	..	..	..	102.2	..	..	101.3	..	102.1
BALANCE of PAYMENTS	Current account balance (percent of GDP)	2015	12.6	1.5	-27.4	-1.0	-7.3	5.1	-1.0	-2.4	-0.8
		2016	5.6	1.9	-30.5	-0.6	-23.4	6.2	-1.7	-2.1	-0.7
		2017	1.0	-0.5	-22.8	-1.8	-22.0	-0.4	-4.1	-2.6	-2.0
		2018 (e)	0.3	-3.5	-18.4	-2.6	-24.2	-8.2	-6.1	-3.0	-2.9
	Trade balance (percent of GDP)	2015	-21.6	-6.5	-24.3	-1.0	9.1	-33.1	-5.3	-10.9	-5.4
		2016	-29.2	-4.1	-24.9	-0.8	-1.1	-35.6	-7.5	-12.8	-5.0
		2017	-30.8	-4.8	-20.8	-3.2	-1.1	-44.4	-10.6	-16.8	-6.9
		2018 (e)	-31.5	-8.3	-17.0	-4.2	..	-49.0	-12.4	-17.0	-8.9
	Import growth (percent, y-o-y)	2015	4.6	3.2	6.3	-5.9	..	9.6	-1.6	10.6	-2.3
		2016	25.8	-7.1	0.8	4.4	..	2.8	16.0	7.9	3.2
		2017	8.0	2.9	-4.9	17.6	..	30.3	21.0	19.3	14.9
		2018 (e)	1.2	27.0	-7.2	16.8	..	14.8	17.5	3.8	15.6
	Export growth (percent, y-o-y)	2015	2.4	-2.8	-4.7	-5.6	..	6.8	-6.3	4.7	-3.3
		2016	-0.3	2.2	-6.3	5.1	..	-13.7	-1.6	-0.7	1.8
		2017	7.0	-2.3	0.8	4.7	..	13.7	-0.8	7.5	4.7
		2018 (e)	-4.0	8.1	-2.1	12.5	..	4.4	9.9	3.6	9.7

			Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka	South Asia (CY)
BALANCE of PAYMENTS	Foreign reserves (months of goods import cover, CY)	2015	..	7.6	..	10.7	4.1	..	4.6	4.5	9.8
		2016	..	8.8	..	12.1	3.4	..	5.4	3.8	11.0
		2017	..	8.4	..	10.4	2.8	..	4.0	3.8	9.5
		2018 (e)	..	7.1	..	9.5	3.2	..	2.8	4.4	8.7
		2019 January	..	..	..	9.5	..	..	2.8	3.9	8.7
		2019 February	..	..	..	10.2	..	..	..	..	9.3
	Personal remittances received (USD million, CY)	2015	341	15,296	20	68,910	3.6	6,730	19,306	7,000	117,606
		2016	368	13,544	34	62,744	3.8	6,612	19,808	7,262	110,376
		2017	378	13,498	43	68,967	4.0	6,928	19,689	7,190	116,698
		2018 (e)	..	15,545	..	47,321	..	..	20,909	7,015	..
		2018 Q3	..	3,869	..	13,477	..	..	5,558	1,652	..
		2018 Q4	..	3,626	..	11,602	..	..	5,473	1,739	..
GOVERNMENT FINANCES	Fiscal balance (percent of GDP)	2015	-0.8	-3.7	-1.1	-6.9	-6.4	1.0	-5.2	-7.7	-6.4
		2016	0.1	-3.7	-1.3	-6.9	-9.9	1.4	-4.5	-5.4	-6.4
		2017	-0.5	-3.4	-4.6	-6.4	-3.0	-3.1	-5.8	-5.5	-6.2
		2018 (e)	0.7	-3.9	-2.4	-6.3	-4.9	-5.7	-6.5	-5.2	-6.2
		2019 (e)	-0.7	-4.2	-0.7	-6.2	-5.2	-5.7	-6.9	-4.8	-6.1
	Public debt (percent of GDP)	2015	6.8	31.8	95.9	68.5	52.8	25.6	64.3	78.5	..
		2016	6.1	31.5	114.2	67.7	56.3	27.9	68.7	78.8	..
		2017	5.9	31.0	108.5	67.6	58.6	26.6	67.9	77.4	..
		2018 (e)	6.9	31.1	106.8	67.2	57.2	30.5	73.5	83.0	..
		2019 (e)	7.0	32.8	107.5	66.1	60.5	32.5	82.3	81.4	..
CONSUMPTION and INVESTMENT	Private consumption growth (percent, y-o-y)	2015	6.8	5.8	2.8	7.9	..	2.9	2.9	7.5	6.9
		2016	-0.2	3.0	3.0	8.2	..	-0.7	7.6	-3.9	7.4
		2017	4.3	7.4	-0.4	7.4	..	2.6	8.7	1.3	7.5
		2018 (e)	0.5	11.0	1.0	7.5	..	2.5	6.3	3.2	7.0
		2019 (e)	1.3	6.8	7.0	7.9	..	4.8	2.9	3.5	6.9
	Gross fixed capital investment growth (percent, y-o-y)	2015	4.8	7.1	20.0	6.5	..	19.6	15.8	2.5	5.8
		2016	-6.0	8.9	14.1	8.3	..	-12.3	7.5	7.8	8.0
		2017	6.4	10.1	5.6	9.3	..	44.2	10.0	5.0	9.2
		2018 (e)	3.1	10.5	2.5	9.9	..	15.7	5.7	5.8	9.4
		2019 (e)	5.1	11.2	-2.0	8.1	..	16.5	-4.1	5.5	8.4
	Net foreign direct investment (percent of GDP)	2015	0.0	0.9	0.4	1.7	7.4	0.2	0.3	0.8	..
		2016	-0.1	0.6	0.7	1.6	10.3	0.5	0.8	0.8	..
		2017	-0.1	0.7	-0.5	1.1	10.6	0.8	0.9	1.5	..
		2018 (e)	0.1	0.6	0.4	1.2	..	..	1.0	2.2	..
		2019 (e)	0.1	0.6	0.9	1.4	..	..	0.9	1.4	..
	Net foreign portfolio investment (USD million, CY)	2015	82	-203	..	-9,487	-123	..	-916	-686	..
		2016	99	-42	..	4,725	132	..	-153	-993	..
		2017	-29	367	..	-30,638	-279	..	-1,200	-1,772	..
		2018 (e)	..	..	..	..	..	..	291	..	..
		2018 Q2	..	372	..	8,145	..	..	-1	..	..
		2018 Q3	..	89	..	1,618	..	..	140	..	..

Notes

(e)	Estimate
CY	Series for calendar year
FY	Series for fiscal year
	Afghanistan's fiscal year is the calendar year.
	Bangladesh's fiscal year runs from July 1st to June 30th.
	Bhutan's fiscal year runs from July 1st to June 30th.
	India's fiscal year runs from April 1st to March 31st.
	Maldives's fiscal year is the calendar year.
	Nepal's fiscal year runs from July 16th to July 15th.
	Pakistan's fiscal year runs from July 1st to June 30th.
	Sri Lanka's fiscal year is the calendar year.
Real GDP growth	Note: Real GDP growth rates (percent change, y-o-y) at Market Prices; Pakistan is in factor costs. Sources: Central Statistics Office of India, Department of Census and Statistics - Sri Lanka, World Bank and World Bank MTI.
Inflation (Consumer Price Index)	Note: Period average percent change in CPI inflation. Sources: National Statistics and Information Authority (Afghanistan), National Statistics Bureau (Bhutan), Sri Lanka Department of Census and Statistics (Sri Lanka), World Bank DEC GEM, and World Bank MTI.
REER (CY)	Note: Real effective exchange rate is the nominal effective exchange rate (a measure of the value of a currency against a weighted average of several foreign currencies) divided by a price deflator or index of costs. An increase in REER implies that exports become more expensive and imports become cheaper. Source: World Bank DEC GEM.
Current account balance (percent of GDP)	Note: Does not include grants unless otherwise stated. Source: World Bank MTI.
Trade balance (percent of GDP)	Note: Trade balance in goods and services is derived by offsetting imports of goods and services against exports of goods and services as ratio to GDP. Sources: World Bank MTI for all countries except Maldives, World Bank WDI for Maldives, and staff calculations.
Import growth (percent, y-o-y)	Notes: For each country, annual trade change is in fiscal year and covers goods and services imports in volume. Sources: World Bank MTI and staff calculations.

Export growth (percent, y-o-y)	Notes: For each country, annual trade change is in fiscal year and covers goods and services exports in volume. Sources: World Bank MTI and staff calculations.
Foreign reserves, months of import cover (CY)	Source: World Bank DEC GEM.
Remittances (USD million, CY)	Note: Personal remittances including personal transfers and compensation of employees in current USD. Sources: Haver Analytics, World Bank WDI, and staff calculations.
Fiscal balance (percent of GDP)	Notes: Does not include grants unless otherwise stated. Source: World Bank MTI.
Public debt (percent of GDP)	Note: Gross public debt stock including domestic and foreign liabilities, end of Period. Source: World Bank MTI.
Private consumption growth (percent, y-o-y)	Notes: Annual (respective) fiscal year percent change in gross real consumption expenditure. Source: World Bank MTI.
Gross fixed capital investment growth (percent, y-o-y)	Notes: Annual (respective) fiscal year percent change in gross real fixed capital expenditure. Source: World Bank MTI.
Net foreign direct investment (percent of GDP)	Note: Net balance of Foreign Direct Investment assets and liabilities as ratio to GDP. Sources: World Bank for all countries except Maldives and Nepal and World Bank WDI for Maldives and Nepal.
Portfolio investment (USD million)	Notes: Portfolio investment covers transactions in equity securities and debt securities. Balances are calculated as net assets minus net liabilities. Data is in current USD. Sources: Haver Analytics, IMF Balance of Payments Statistics, and staff calculations.

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