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South Asia Economic Focus Spring 2015

# Making the most of cheap oil



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South Asia Economic  
Focus Spring 2015

# Making the most of cheap oil







*This report is a joint product of the Office of the Chief Economist for the South Asia Region and the Macro and Fiscal Management Global Practice. Its preparation was led by Markus Kitzmuller (Economist) under the oversight of Martin Rama (Chief Economist, South Asia Region) in close collaboration with Shubham Chaudhuri (Practice Manager, Macro and Fiscal Management). Substantive contributions to the focus section were made by Vincent A. Floreani, Markus Kitzmuller, Gladys Lopez Acevedo, Muthukumara S. Mani, Martin Melecky, Dhushyanth Raju and Fan Zhang. The report greatly benefitted from inputs by Tehmina Khan and colleagues in the Development Economics Prospects Group (DECPG) under the supervision of Ayhan Kose (Director DECPG). Colleagues providing information for country briefs include Kishan Abeygunawardana, Genevieve Boyreau, Roshan Darshan, Zabid Hussain, Omar Joya, Faruk Khan, Aurelien Kruse, Jose Lopez Calix, Poonam Gupta, Jaba Misra, Claudia Nassif, Frederico Gil Sander, Saurav Shamsher Rana, Saadia Refaat, Nadeem Rizwan, Smriti Seth, Saurabh Shome, Ralph Van Doorn and Salman Zaidi. The team is grateful for comments, suggestions and background information provided by Gabi Afram, Mehwish Ashraf, Miklos Bankuti and Sebnem Sahin. and Frederico Gil Sander. Gabriela Aguilar signed responsible for the layout, design and typesetting, Alexander Ferguson (Senior Manager SAREC) coordinated the dissemination, and Neelam Chowdhry provided valuable administrative support.*

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

*The cutoff date for this report was April 12, 2015.*

# Table of Contents

<b>Recent economic developments</b>	<b>9</b>
Growth remains subdued in advanced economies	9
South Asia's external balances are on a solid footing	10
While external balances are strong, export performance is weak	13
More upbeat output growth expectations amidst blurred signals	15
Inflationary pressures have eased significantly	17
The main risks and vulnerabilities remain domestic in nature	18
<b>Outlook and policy</b>	<b>23</b>
South Asia is set to become the fastest growing region, driven by a strong India	23
<b>Is South Asia making the most of cheap oil?</b>	<b>27</b>
A diverse pass-through of international oil prices to domestic prices	28
The impact of oil prices is mediated by the structure of the economy	30
The balance of payments and the budget are key transmission channels	32
Households will unambiguously gain but richer households will gain more	35
Macroeconomic tailwinds provide a unique opportunity to rationalize energy prices	37
<b>South Asia country briefs</b>	<b>42</b>
<b>Afghanistan</b>	<b>44</b>
Recent developments	44
Outlook	45
Challenges	46
<b>Bangladesh</b>	<b>47</b>
Recent Developments	47
Outlook	48
Challenges	49



<b>Bhutan</b>	<b>50</b>
Recent Developments	50
Outlook	51
Challenges	51
<b>India</b>	<b>52</b>
Recent Developments	52
Outlook	53
Challenges	53
<b>Maldives</b>	<b>54</b>
Recent economic developments	54
Outlook	55
Challenges	55
<b>Nepal</b>	<b>56</b>
Recent Developments	56
Outlook	57
Challenges	58
<b>Pakistan</b>	<b>59</b>
Recent Development:	59
Outlook:	59
Challenges:	60
<b>Sri Lanka</b>	<b>61</b>
Recent developments	61
Outlook and risks	62
Challenges	62
<b>South Asia at a glance</b>	<b>64</b>
<b>Notes:</b>	<b>66</b>



पुत्री सड़क  
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कमल फोखरी  
KAMAL FOKHARI  
कालिका स्थान  
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# Recent economic developments

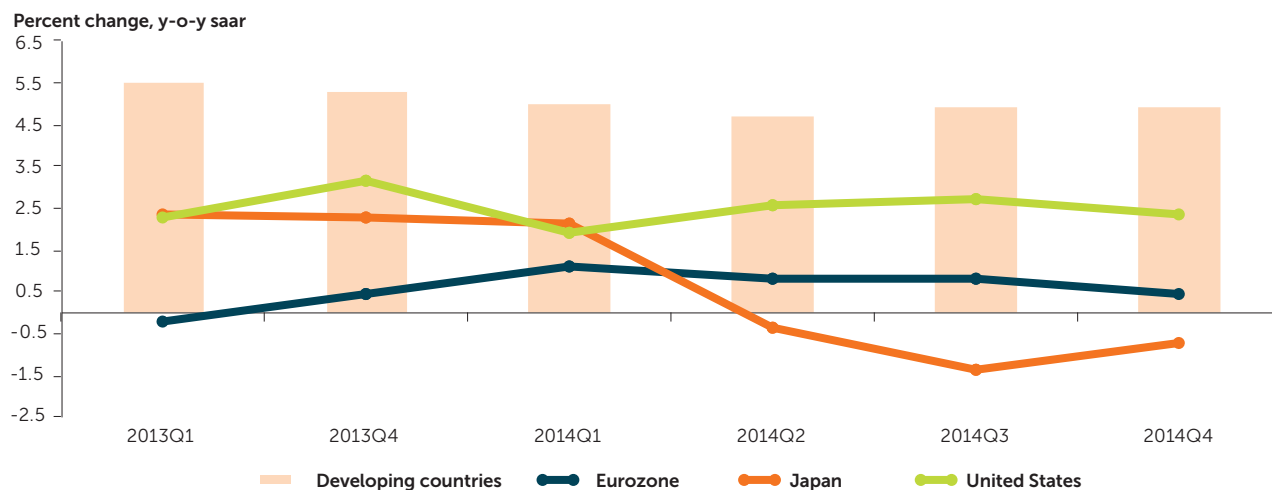
**A**n uneven recovery and diverging monetary policy across major developed countries remain a challenge for developing and emerging market economies. But plunging oil prices bring in real income shifts and a distinct set of opportunities for oil importers. In South Asia cheaper oil imports are reducing subsidy bills and easing inflationary pressures. Supported by this benign external environment and on the back of robust consumption growth in India, South Asia has overtaken East Asia and become the fastest growing region in the world. However, the biggest oil price dividend comes in the form of an opportunity to rationalize energy prices and more permanently decouple fiscal balances from international oil price movements. In many countries this dividend remains to be paid out.

## Growth remains subdued in advanced economies

**The US is the only major advanced economy exhibiting signs of sustained recovery.** Although improvement in US labor markets slowed a little in March 2015, and severe weather has dampened activity in 2015Q1, the Federal Reserve Bank is still expected to start increasing interest rates in 2015Q3 on the back of solid real GDP growth. This will start a tightening cycle to last until 2018. Meanwhile the Eurozone continues on a soft trajectory in spite of unexpectedly positive signs that quantitative easing may finally start to bite, following recent jitters around Greece and divergent views on how to conduct fiscal policy across member states. Japan's central bank has announced another round of monetary stimulus in October 2014. However, inflation is not expected to pick up to the targeted 2 percent before FY2016/17, with negative real interest rates set to persist. Ultimately, the growth outlook for Japan remains severely constrained by unfavorable demographics (a shrinking population and workforce) and related upward pressures on public debt.

**Meanwhile, South Asia has become the fastest growing region in the world over the course of 2014H2.** Helped by the benign external environment and a first

**Figure 1: Real GDP growth is weak in Japan and the Eurozone while the US shows signs of sustained acceleration**



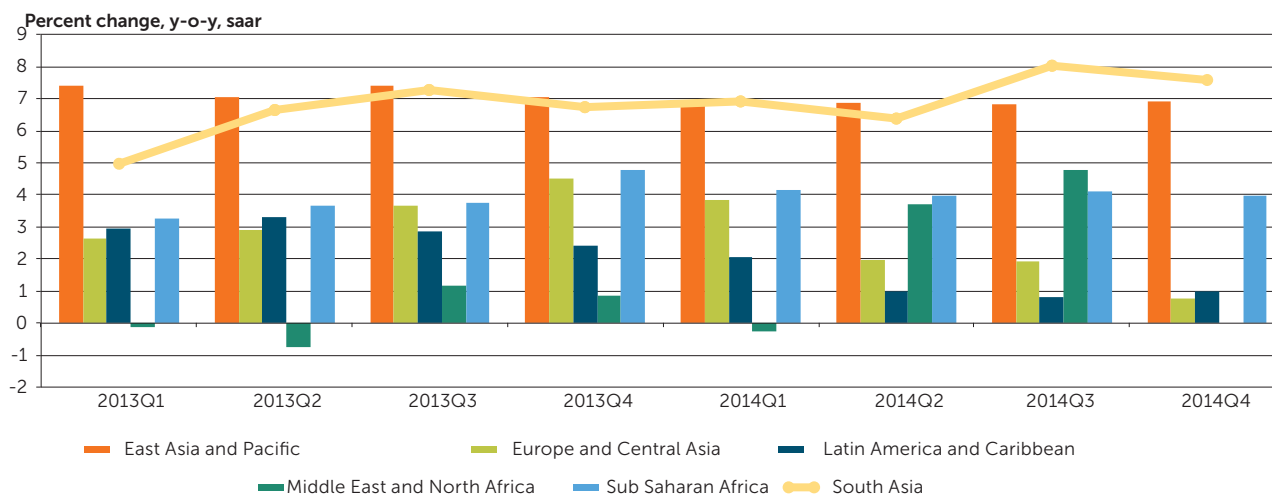
Source: World Bank DECPG

round of direct effects from the drop in international crude oil prices, almost all South Asian economies saw improvements on their macroeconomic and fiscal balances as well as in terms of growth. An important factor in South Asia's current growth equation is the significantly lower inflation rate and its contribution to anchoring expectations. Given its share in regional GDP, India's growth performance has set the pace for the region backed mainly by strong contributions from domestic consumption on the demand side as well as services growth on the supply side. Investment performance has been subdued except for Bhutan and Sri Lanka, while export growth has broadly disappointed, though masked by strong remittance flows and weaker import growth.

## South Asia's external balances are on a solid footing

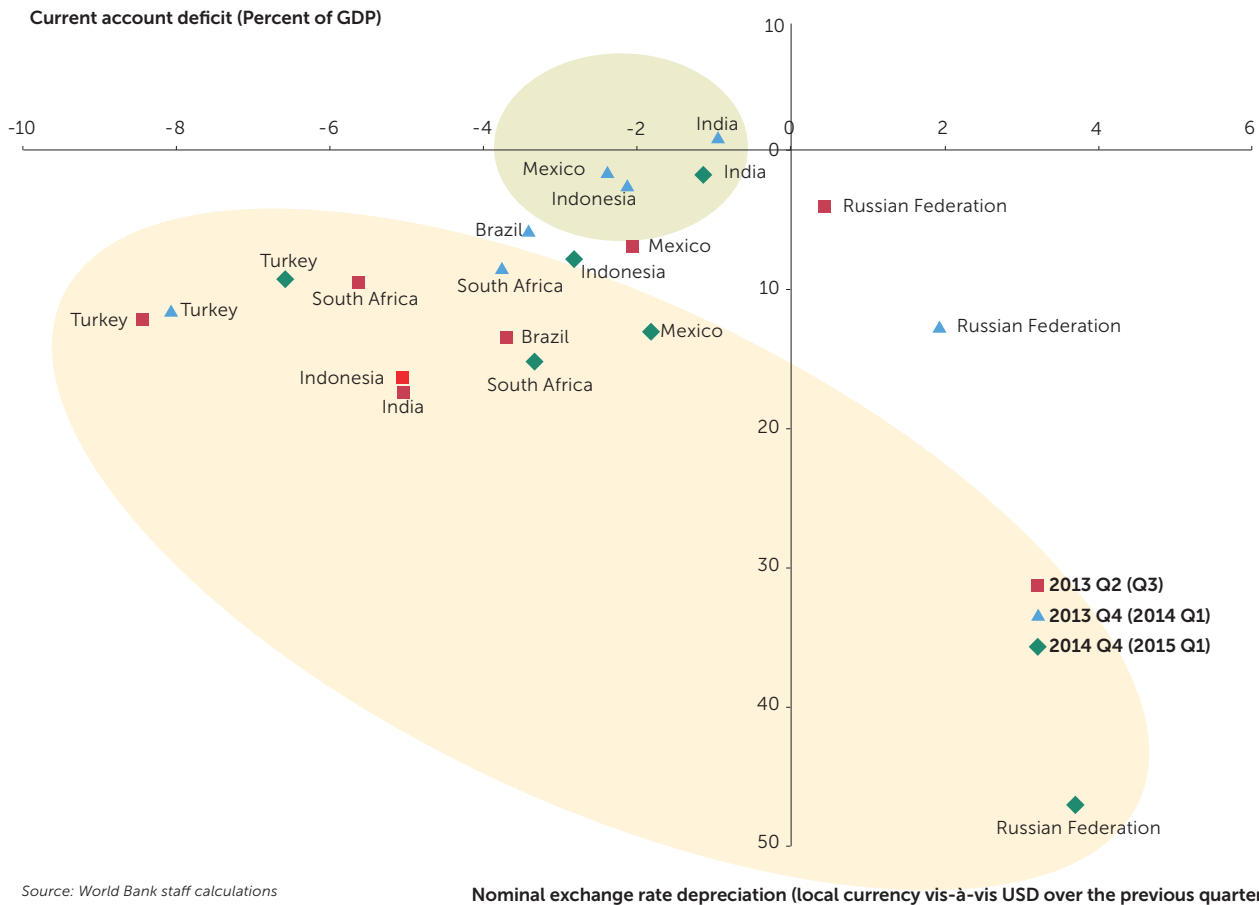
**Current account balances remain strong across the region.** In continuation of improving external positions in 2014H1, current account balances across South Asia remain manageable and well financed. Solid remittances and (for some countries) tourism flows offset often large and widening trade deficits – in spite of lower oil prices. In Bangladesh a current account deficit emerged to the tune of USD 1.3 billion between July and January of FY2014/15, compared with a USD 2.5 billion surplus over the same period of FY2013/14. The deficit reflected weak export growth (2.1 percent) and a surge in imports (16.4 percent). Nepal, on the other

**Figure 2: South Asia became the fastest growing region**



Source: World Bank DECPG

**Figure 4: Unlike other emerging economies India substantially improved its external position**

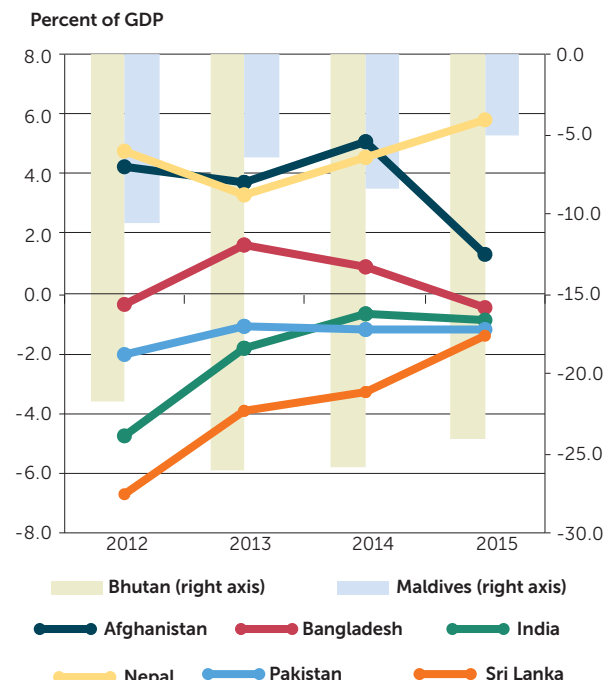


Source: World Bank staff calculations

hand, continues to enjoy a substantial current account surplus on account of strong remittance growth more than offsetting the country's still widening trade deficit. Similarly, resilient remittance flows and low oil prices kept the current account deficit at a modest 1.1 percent of GDP in Pakistan, despite a chronically negative trade balance. In Sri Lanka, the current account deficit narrowed to an estimated 3.3 percent of GDP in 2014 on account of strong tourism and remittance flows at an estimated 12.4 percent of GDP offsetting a very large trade deficit at 11.2 percent of GDP in 2014 (down from 11.3 percent in 2013).

**Maldives and Bhutan remain the region's current account outliers.** Bhutan runs a large current account deficit (estimated at about 25 percent of GDP in FY2014/15), to which the hydropower sector contributes a third. The deficit is essentially financed by donor resources, with India providing the lion's share through loans and grants to finance hydropower development. In Maldives, higher tourism exports and subdued global food and fuel prices helped reduce the current account deficit to around 8.4 percent of GDP in 2014. The current account is expected to narrow over the medium

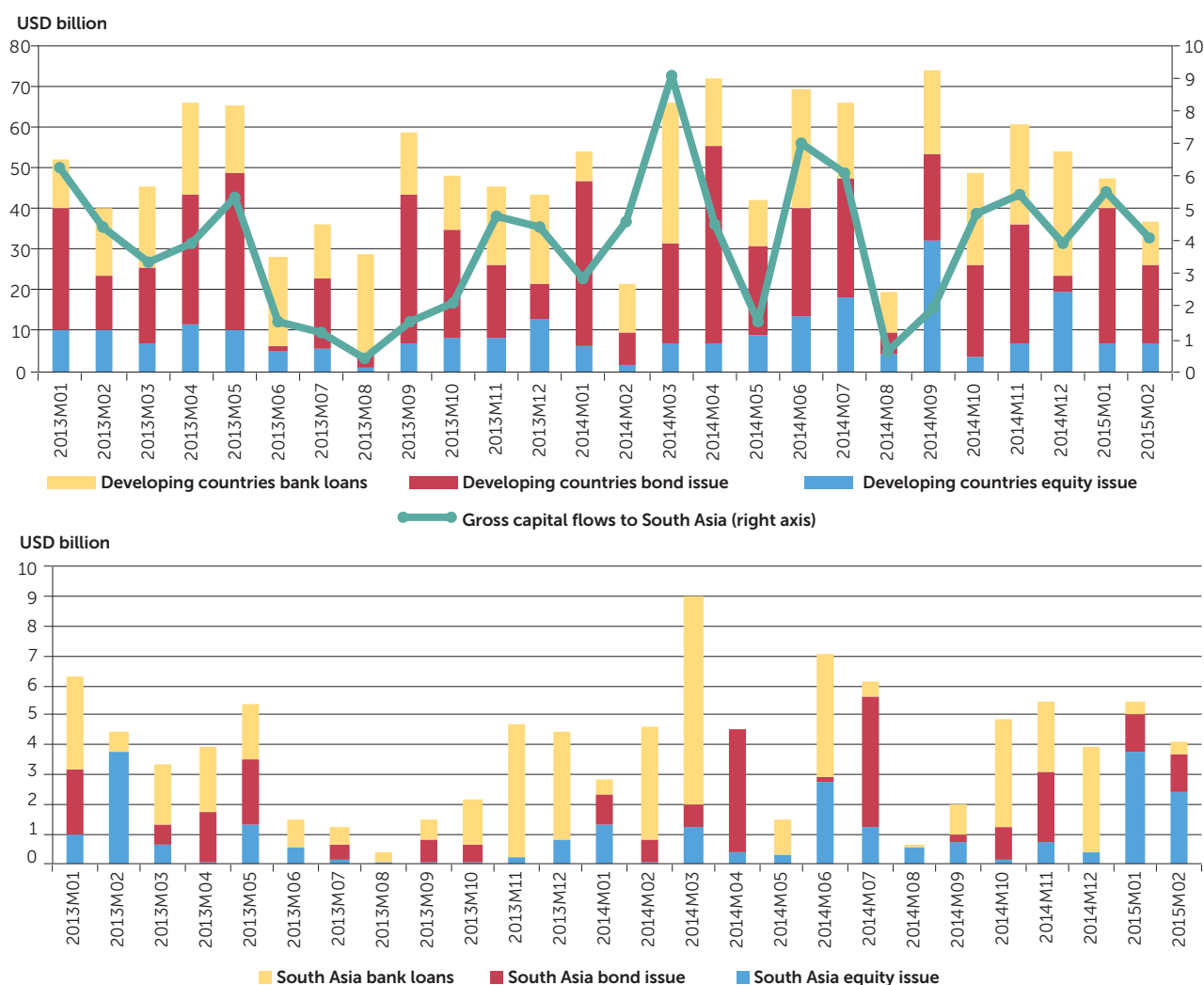
**Figure 3: Current account balances across most of South Asia are either positive or improving**



Source: World Bank and national authorities



**Figure 5: Capital flows to South Asia have become less volatile but their composition continues to show significant fluctuations**



Source: World Bank DECPG

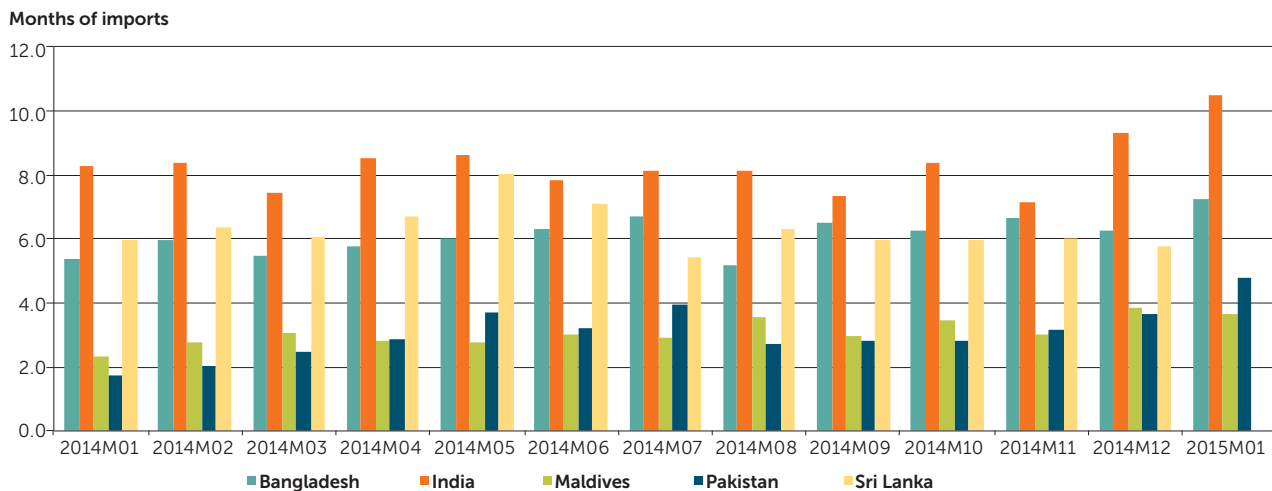
term to around 4.7 percent of GDP by 2019 as fiscal restraint and lower oil prices help constrain imports.

**Less than two years after the rupee depreciation episode, India has a resilient external position.** The steady stream of remittances and services exports helped to bring the current account deficit to USD 26 billion in the first three quarters of FY2014/15, compared to USD 32 billion over the corresponding period in the previous fiscal year. The sharp decline in the price of oil helped take off pressure from India's merchandise trade deficit, while gold imports were well contained. Overall, the current account deficit is projected to remain well below 2 percent of GDP over the medium term. At the same time, the real effective exchange rate appreciated over the course of CY2014, thereby leaving India in a position of manageable external vulnerability, particularly when compared

to its emerging market peers. Along those lines and analyzing the global portfolio rebalancing of 2013, recent research<sup>1</sup> suggests that a global surprise factor, more than domestic vulnerabilities, was the main driver of the large rupee depreciation in summer 2013. With the surprise factor gone, further normalization of U.S. monetary policy is less likely to have significant effects on the rupee exchange rate going forward.

**Many South Asian economies saw positive developments on their capital accounts.** In India, Foreign Direct Investment (FDI) and portfolio flows regained momentum reaching 3.4 percent of GDP during FY2015Q1-3, up from 1.4 percent during FY2013/14.

1 "Advanced-Country policies and Emerging-Market Currencies: the Impact of US tapering on India's Rupee" by Y. Ikeda, D. Medvedev, and M. Rama. Policy Research Working Paper 7219. World Bank, March 2015.

**Figure 6: Foreign exchange reserves are broadly improving across the region**

However, the balance shifted again towards more volatile portfolio flows, which totaled about USD 28 billion in the first three quarters of FY2014/15, compared to FDI flows at nearly USD 24 billion. In Pakistan the capital account balance nearly doubled during July 2014 to February 2015, compared to the same period in the previous year. Underlying this improvement were the receipts from the issuance of international Sukuks as well as large disbursements from International Financial Institutions. Bangladesh's financial account recorded a USD 3.3 billion surplus between July and January of FY2014/15, compared with a surplus of just USD 424 million during the same period the previous year. The move into positive territory reflected a turnaround in "other investment (net)" from USD 722 million of outflows to nearly USD 2 billion of inflows. Gross aid disbursements increased by 11.7 percent while outflows on account of trade credit reversed from USD 550 million of outflows to USD 905 million of inflows during July-January of FY2014/15. Finally, Sri Lanka saw a period of strong capital inflows. FDI reached 1.9 percent of GDP in 2014; together with remittances and tourism flows in the magnitude of 12.4 percent of GDP, it strongly supported the balance of payments overall.

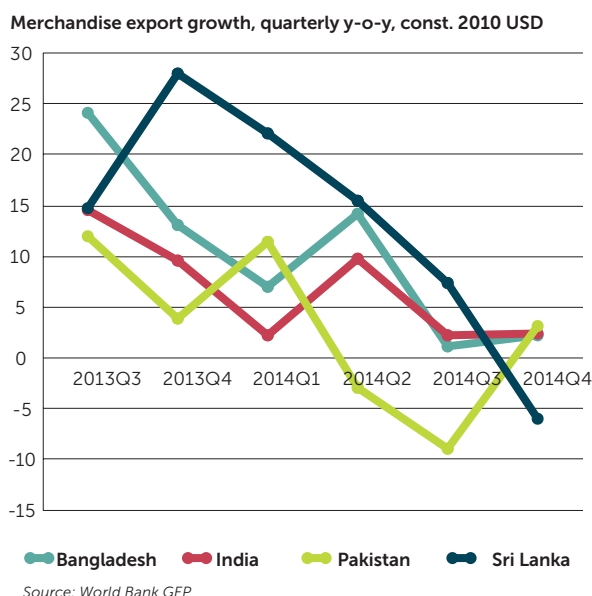
**Robust capital flows financed current accounts across South Asia and even helped building reserve buffers.** Most notably, the Reserve Bank of India (RBI) refurbished its international reserves beyond an impressive 10 months of import coverage (USD338 billion) as of February 27, 2015. But India was not alone. In Pakistan, reserves reached 2.5 months of imports in December 2014, taking the country out of the danger zone. Official reserves increased to USD 10.6 billion by

end CY2014 compared to USD 9.2 billion at end of FY2013/14. In Bangladesh, there has been a sustained surplus in the balance of payments, and reserves have remained at a comfortable level at over 6 months of imports. Nepal is in a similarly strong position, as foreign exchange reserves should continue to rise to over USD 7 billion, equivalent to 8.8 months of imports. Sri Lanka saw its gross official reserves strengthening to USD 8.2 billion, equivalent to 5.1 months of imports. Bhutan's international reserves had built up to roughly USD 1.1 billion by November 2014, reflecting prudent management, while Maldives experienced an increased supply of dollars in the official market and a related rise in gross official reserves to USD 614 million or 2.8 months of imports.

### While external balances are strong, export performance is weak

**After an encouraging rebound, India's exports seem to have lost momentum.** In FY2014/15 growth in India was largely driven by consumption, with only modest contributions coming from investment and exports. Even more so, export growth has been worryingly negative in FY2014/15Q2 and Q3, averaging at only 0.5 percent over the past three quarters. This was largely on account of a decline in petroleum exports, an important merchandise export item for India (accounting together with gems and jewelry for a third of the total export basket) and fairly sensitive to movements in international crude oil prices. From a sectorial point of view, services exports remain the bright spot, somewhat offsetting the blow from oil exports and continuing to increase steadily.

**Figure 7: Export growth has been disappointing across South Asia**



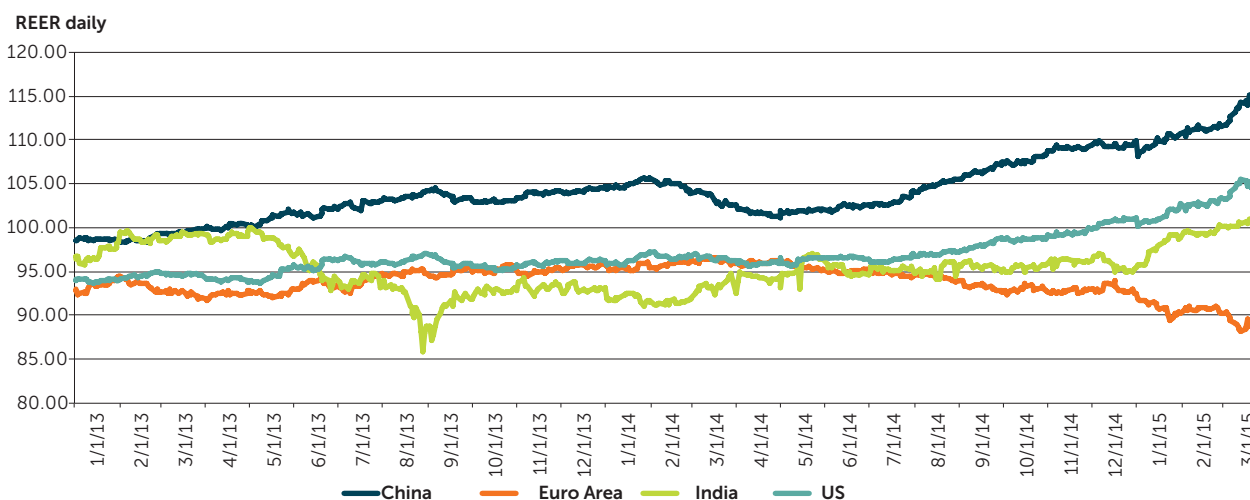
But overall India's share in world exports has stagnated recently, reflecting subdued global import demand and signaling the need to address supply-side constraints to competitiveness. Furthermore, the lack of momentum of growth in India's major export destinations, together with a possible deterioration in demand from oil exporting countries, may provide further headwinds for India's exports to kick start soon.

**Across the region, export growth is slowing down.** In Bangladesh, exports lost momentum because of weak global demand and a transition in the garment industry

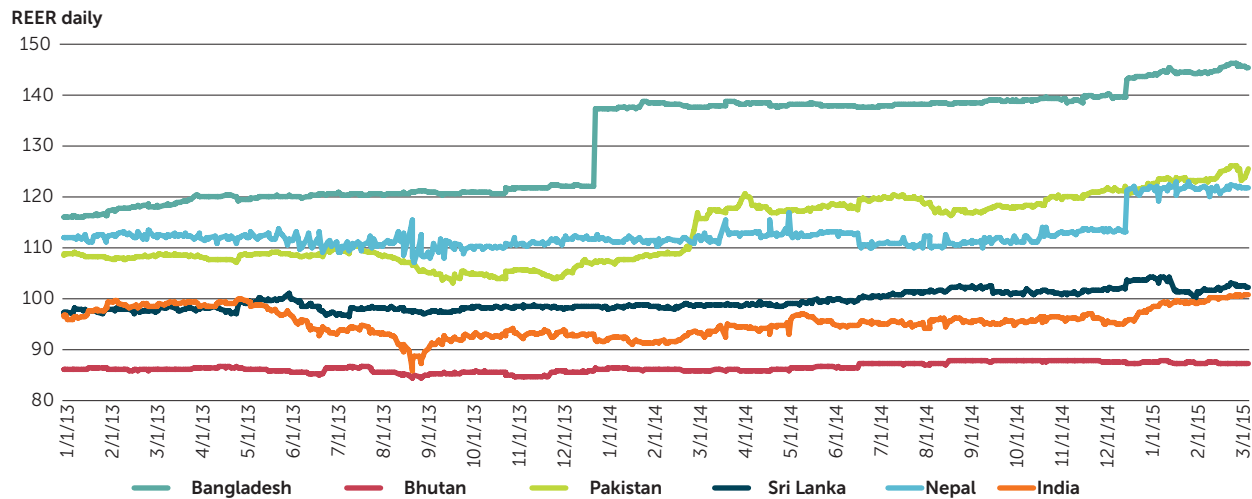
involving a significant number of factory closures. The oil windfall on the import side will only gradually materialize because oil imports are contracted forward and non-oil imports have been strong. Pakistan has mildly started to benefit from low oil prices reflected by its import bill contained at USD 626 million per month as of February 2015, but this effect continues to be offset by the fall in the export values of agriculture commodities and lower trade related revenues. Negative export growth was mainly driven by deteriorated exports of textile, food items (wheat and tobacco), petroleum products, as well as chemical and pharmaceutical goods. Also in Nepal, export value growth is expected to decelerate from a modest 5.4 percent in 2014 to 4.5 percent this year. However, import value growth is projected to moderate considerably, given the large share of petroleum products in total imports.

**Going forward, many South Asian economies will be facing weak demand in Europe as well as real effective exchange rate appreciation.** In Bangladesh, the competitiveness of exports is eroding due to growing strength of the USD vis-à-vis other major currencies. The Taka has appreciated by 17.6 percent against the euro so far in FY2014/15. India's real effective exchange rate (REER) appreciated despite decreasing inflation in light of relatively stable nominal exchange rates. Pakistan also saw pressures on its rupee ease, with the real effective exchange rate appreciating over 2014H2, helped by solid capital inflows and decreasing inflation.

**Figure 8: India lost some of the competitiveness it had gained during the rupee depreciation episode.**



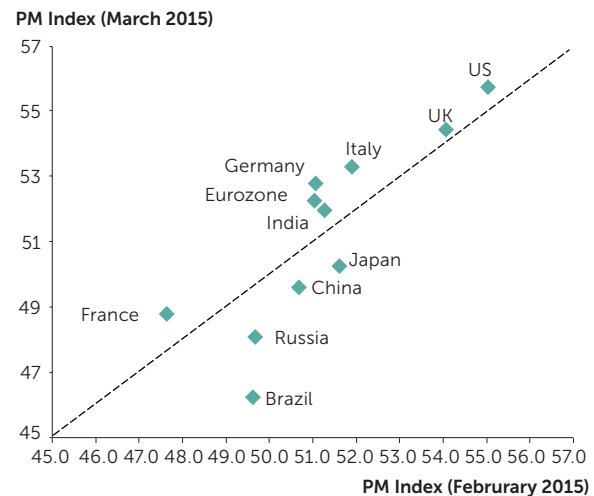


**Figure 9:** Across the region, competitiveness has remained stable or faltered

## More upbeat output growth expectations amidst blurred signals

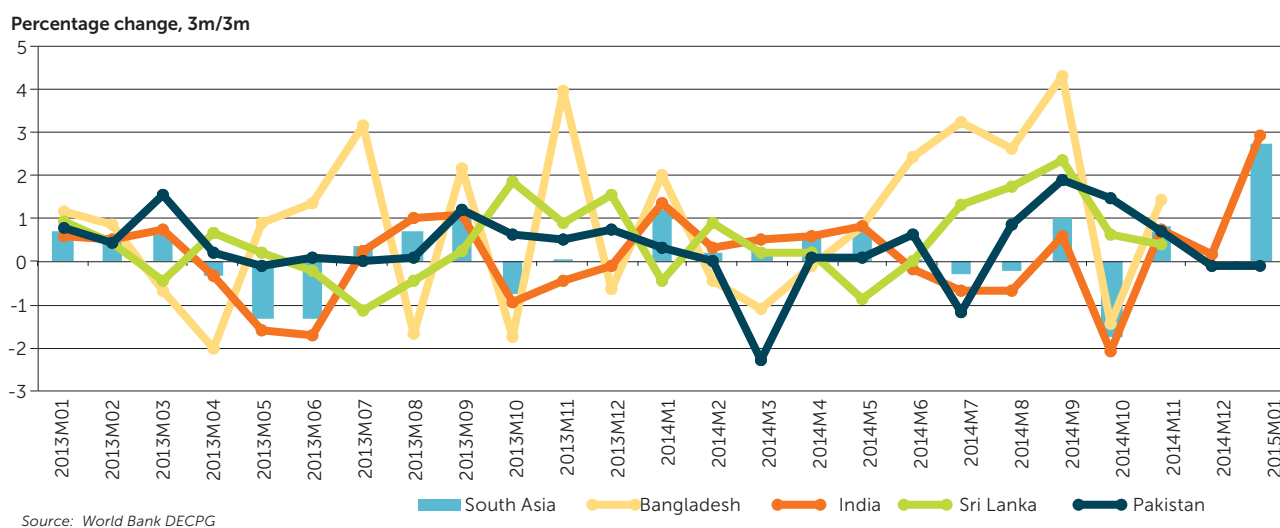
**Regional industrial production growth continues to be volatile, with India surprising on the upside.** India's improving Purchasing Managers Index (consistently above 50) gives hope for an acceleration of growth in the near term. Industrial output, which accounts for nearly one-third of India's GDP, accelerated to 5.3 percent during the first three quarters of FY2014/15, compared to 4.6 percent last year, and 2.7 percent in the year before. The manufacturing sector grew at a steady 5.4 percent in the first three quarters of the fiscal year. This upward trend was also reflected in high frequency indicators of industrial production—the Index of Industrial Production, grew by 2.1 percent year-on-year between April and December 2014, as compared to stagnant output in the previous year. While utilities grew at a robust 9.6 percent, construction growth slowed in the FY2014/15Q3.

**From a sectorial point of view, agriculture and services have driven the growth performance across South Asia.** In Pakistan, these two sectors have offset weaker than expected performance in manufacturing. Afghanistan experienced a strong agricultural harvest in 2014, for the third year in a row, whereas growth in manufacturing, construction, and services is estimated to have fallen further in 2014. Conversely, inclement weather during the peak planting season and limited investments in irrigation resulted in lower agricultural growth in Nepal, triggering an overall growth deceleration. Construction and tourism played a key role in the smaller countries

**Figure 10:** Purchasing managers in manufacturing have become more optimistic about India

in the region. In Bhutan, hydropower construction got back on track after delays due to geological disruptions and the five-year plan implementation now in full swing. The country also benefited from a record level of tourists following a special offer to Thailand over the low season of June to August. Maldives saw tourists returning, with a rapid expansion from Asian markets overdoing a tepid recovery from Europe. Sri Lanka saw a continuation of its growth momentum based upon robust growth in construction, which pushed growth by the industrial sector up to 11.4 percent year-on-year in 2014. Business fluctuations in Bangladesh were driven by politics rather than by the weather: while growth was gaining momentum in the first half of FY2014/15,

**Figure 11: Growth in industrial production remains volatile across South Asian but is showing momentum in India**

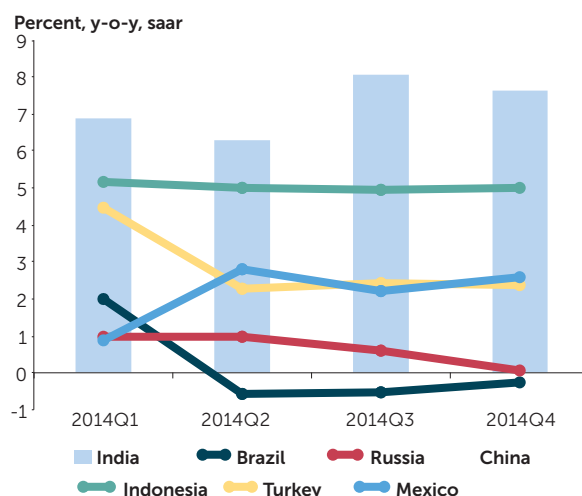


direct production losses inflicted by recent turmoil could amount to around 1 percent of GDP

**On the expenditure side, consumption has been the major contributor to regional growth while investment remains subdued, except in Bhutan.** In India, private final consumption expenditure (which accounts for close to 60 percent of total demand for output) grew at an average of 6.5 percent year-on-year during FY2014/15Q1 and Q2, but decelerated to 3.5 percent in Q3. This deceleration was countered by a 32 percent spike in public consumption expenditure in Q3. On the other hand, investment, after growing rapidly in the first quarter at 7.7 percent, lost momentum subsequently, growing at an average 2.2 percent over Q2 and Q3. In Afghanistan the protracted political process in 2014, combined with uncertainties associated with the security transition, dealt a further blow to investor and consumer confidence. Nepal's growth continues to be based on remittance driven consumption, while investment growth continues as constrained by project implementation bottlenecks as well political and policy uncertainty, especially in the hydropower sector. In Pakistan, growth is picking up on the back of slightly better energy availability, a continuous revival of credit and (to a lesser extent) growing investor confidence. Only in Nepal is investment performance substantive, with the new dynamism in hydropower construction pushing its growth up to 22.4 percent. Private consumption, supported by an increase in wages, is estimated to have grown by 6.6 percent.

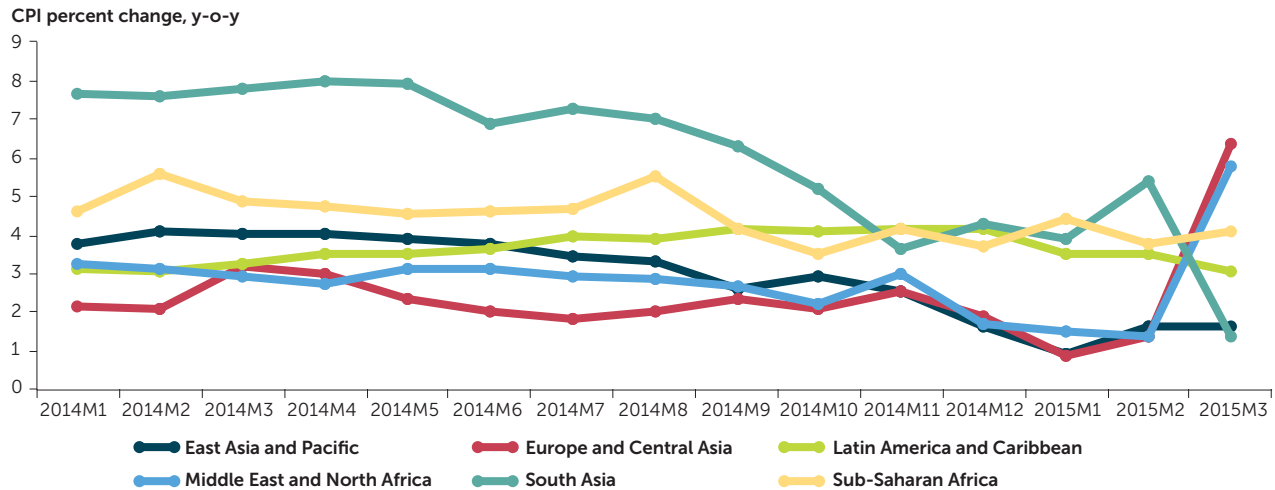
**India's growth performance vis-à-vis its emerging market peers remains strong.** On the production

**Figure 12: India has by now the strongest growth performance among emerging markets**



side, its strong growth performance is clearly driven by the services sector, which continues to outperform manufacturing. Within services, growth was driven by a sharp acceleration in public administration and defense, which expanded at 20 percent year-on-year in FY2014/15Q3, compared to an average growth of 4 percent during the first two quarters. Growth in services was also supported by continued buoyancy in financial services and real estate services, which grew by 13.7 percent year-on-year in the first three quarters of FY2014/15. On the other hand, agricultural output growth continued to decelerate (turning negative in FY2014/15Q3, y-o-y) due to deficient rainfall.

**Figure 13:** South Asia's inflation rate dropped from highest to lowest among all regions in less than one year



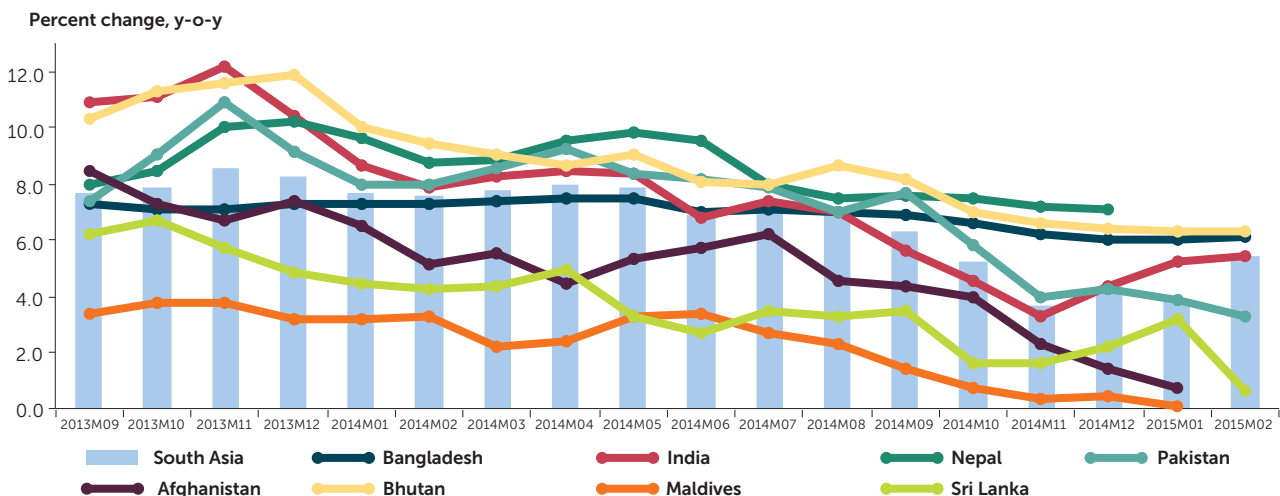
## Inflationary pressures have eased significantly

Helped by easing pressures on commodity prices, tight monetary policy stances, and relatively stable currencies, South Asia ceded its long-held top spot as the region with the highest inflation rate. The Consumer Price Index (CPI) increased by 3.2 percent year-on-year in February 2015, below its regional counterparts for Latin America and Caribbean and for Sub-Saharan Africa, at 3.5 and 3.8 percent respectively. March 2015 saw a further pronounced decrease for South Asia. Besides commodity prices, another crucial component of consumer prices in South Asia, food

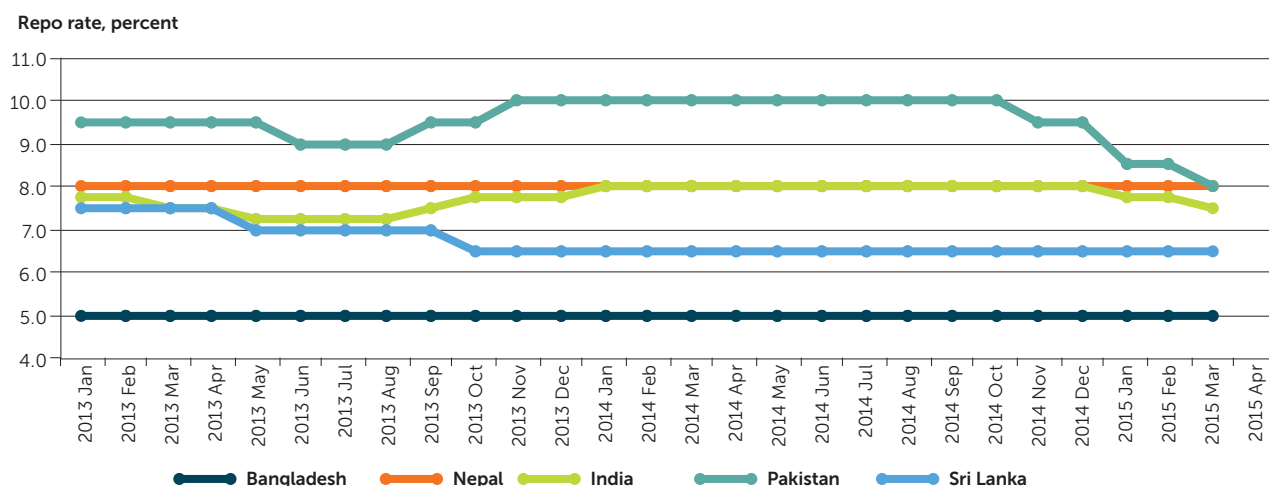
price inflation, has also contributed to the decrease in CPI inflation, except for an uptick in India since the start of 2015. The drop in food price inflation is partly attributable to robust food harvests across the region.

**Inflationary pressures have consistently eased across all South Asian economies.** In Afghanistan, consumer price inflation dropped from 7.7 percent in 2013 to 4.4 percent in 2014 as both food and non-food price increases slowed down. Bangladesh's inflation appears contained showing decreasing momentum with the twelve-month moving average decelerating to 6.8 percent in February 2015, compared with 7.6 percent in February 2014. Headline inflation (year-on-year)

**Figure 14:** All countries in South Asia experienced a deceleration in inflation





**Figure 15: Monetary policy has recently started to soften in Pakistan and India**

Source: National central banks

declined to 6.1 percent in February 2015, compared with 7.4 percent in February 2014. Given their currency peg to the Indian rupee, both Bhutan and Nepal both saw consumer price inflation slowing down in line with trends in India. There, inflation declined to 5.1 percent (or to 4.3 according to the new CPI series) during October 2014-January 2015, from an average 7.7 percent (or 7.3 percent according to the new CPI series) in FY2014/15H1. Similarly, in Pakistan inflation rates reached a 13-year low of 2.5 percent at the end of March 2015, down from a peak of 10.9 percent in November 2013. In Maldives, inflation is forecasted to be just 0.3 percent in 2015 but to pick up with the increase in import duties, to settle at around 4 percent in the medium term. Last but not least, Sri Lanka saw its annual average inflation, as measured by the Colombo Consumer Price index (CCPI-2006/07), decline for 19 consecutive months. On a year-on-year basis, inflation hit its lowest point in March 2015, at just 0.1 percent.

**The deceleration of inflation has already triggered monetary policy responses.** Lower inflation rates and well-anchored inflationary expectations led the Reserve Bank of India (RBI) and the State Bank of Pakistan (SBP) to lower their interest rates in a move to support credit growth. RBI has adopted a framework based on flexible inflation target, and the recent decline in inflation and fiscal restraint generated some room for monetary accommodation, making it possible to lower the policy rate twice in the recent past (while keeping it constant at the latest meeting). The SBP lowered the policy rate (called SBP reverse repo rate) from 10 percent to 9.5 percent on November 17th 2014 and further to 8.5 percent on January 26th 2015. It further

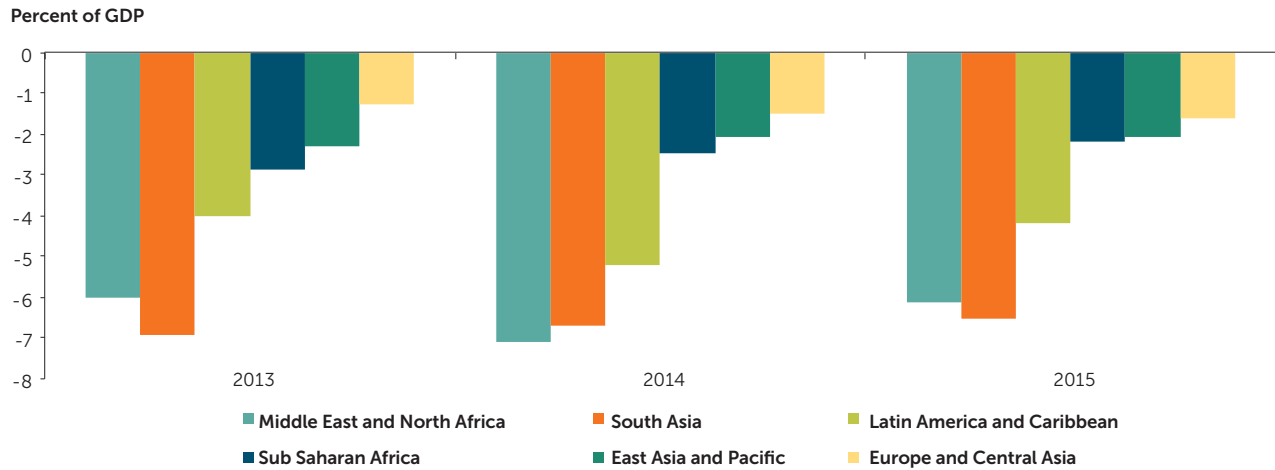
lowered the rate by another 50 basis points on March 24th 2015.

### The main risks and vulnerabilities remain domestic in nature

**Fiscal improvements due to lower subsidy bills and expenditure compression mask the real sources of fiscal risk going forward: weak revenue generation and continued exposure to international oil prices.** In light of strong and well cushioned external positions and favorable tailwinds from low oil prices expected to continue in the short term, major downside risks remain domestic in nature. Continued revenue weakness across the region as well as policy reform complacency in light of favorable economic development pose important fiscal risks. Political uncertainty and potential turmoil continue to be risk factors in Afghanistan, Bangladesh, Pakistan and Sri Lanka.

**Many South Asian governments were able to consolidate their fiscal balance from the expenditure side.** A mixture of slow project implementation, active spending compression and lower energy subsidy bills due to low oil prices has resulted in some fiscal moderation. Total public expenditure in Bangladesh increased by 4.5 percent in the first four months of FY2014/15 relative to the same period the previous year, compared with the 31 percent annual growth target. Development expenditure increased by a meager 1.3 percent, a consequence of resource constraints, overly optimistic planning, and procedural lapses from initiation to completion of a project life cycle. Slow execution of the

**Figure 16: Fiscal deficits in the region fell slightly due to lower energy subsidy bills but remain high due to weak revenue generation**

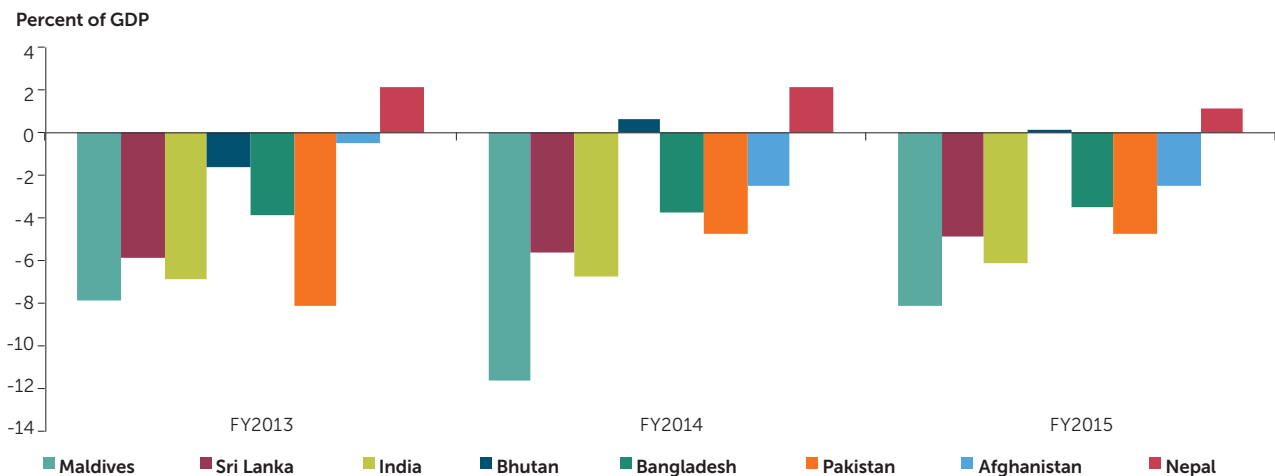


Source: The World Bank DECPG

planned capital budget has also been pervasive in Nepal. In Bhutan, civil service wages and allowances were increased by 19 and 23 percent respectively, but the impact on spending is expected to be offset by a reduction in other current and capital expenditures. In India, the subsidy bill (at 2.1 percent of GDP) was larger than budgeted (2 percent) because of higher food subsidies. Declining global crude prices and a phased increase in retail diesel prices allowed for a complete deregulation of this market segment in October 2014. As a result, petroleum subsidies declined from 0.8 percent of GDP in FY2013/14 to 0.5 percent in FY2014/15. But food subsidy expenditure during the same period increased from 0.8 percent of GDP to 1.1 percent of

GDP, offsetting the decline in petroleum subsidies. In Pakistan, recurrent expenditures of the federal government increased by 4.8 percent in FY2014/15, because of additional defense-related expenditures and federal grants to state-owned enterprises. Development spending of the consolidated government registered a marginal increase of 1.5 percent only. However, fiscal space was created as subsidies registered a decline for the third consecutive year, from 0.7 percent of GDP in H1-FY 2014 to 0.4 percent of GDP during H1-FY 2015. Maldives stands out as an outlier, as a sharp rise in recurrent expenditures (pensions, and wages) is likely to have widened the fiscal deficit to 11.6 percent of GDP in 2014.

**Figure 17: Overall fiscal deficits remain sizeable in many South Asian countries**



Source: The World Bank, IMF and national authorities

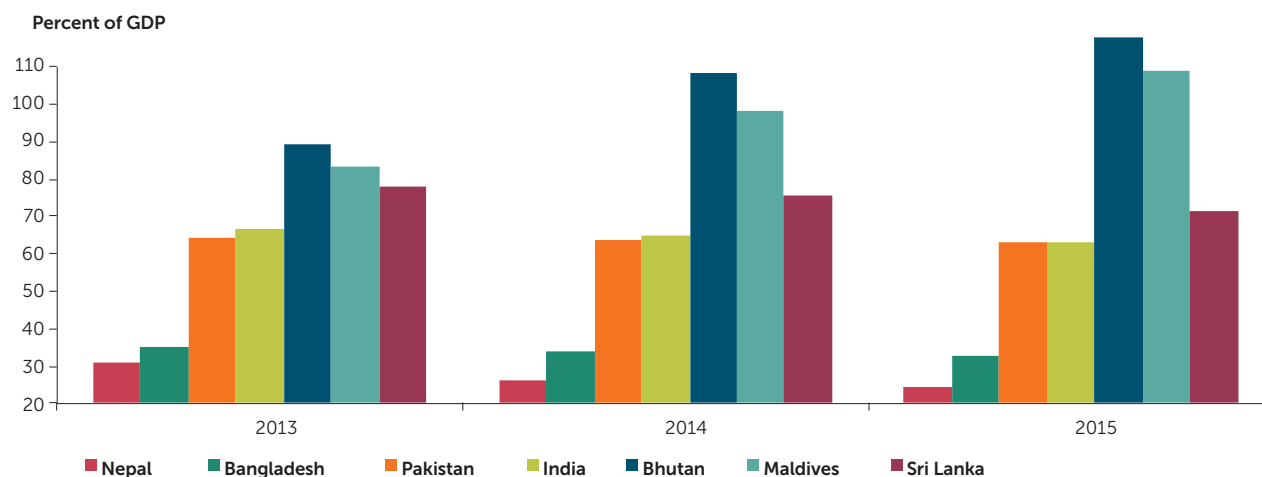
**Revenue generation and collection remain the key fiscal challenge across most of the region.** With the exception of Nepal, which sustained high revenue growth, government revenues either stagnated or fell, and broadly registered below target. In Bangladesh, disruptions related to the political turmoil led to a shortfall in tax revenue collection relative to the FY2014/15 target (5.9 percent growth, instead of 20.9 percent). The tax revenue shortfall was compounded by a large drop in non-tax revenues, driven mainly by lower dividends from the Bangladesh Bank (BB). Total revenue collection in the first four months of FY2014/15 was 3.2 percent lower than in the corresponding period of FY2013/14, due entirely to a 36.5 percent decline in non-tax revenue collection. Bhutan's domestic revenues measured as a share of GDP have declined over the last three years, from 22 percent to an estimated 18.9 percent. Grants, mainly from India, finance about 27 percent of total spending. In India, revenue collection was weak as indirect tax collection and disinvestment proceeds were smaller than anticipated. While almost all tax collection targets slipped, the lower outturn was predominantly due to underperformance in service tax collection, which reached 1.3 percent of GDP, instead of the 1.7 percent target. Tax collection improved in Pakistan, but it remained slightly below target due to legal challenges and lower-than-expected revenues from taxes on oil imports. The budget envisaged a 24 percent growth in its tax collection over last year, however, floods and major political turbulence during the first half of FY2014/15 created significant headwinds and FBR's tax collection during FY 2014/15 H1 grew only by 13.6 percent. Non-tax revenues during FY2014/15

H1 stood at PKR 388 billion compared to PKR 493 billion during same period last year. As a note of caution, collection last year however was abnormally high due to one-off inflows, i.e. universal service fund and the mark-up received from SOEs against the circular debt settlement. In Sri Lanka, in 2014, tax revenue is estimated to have remained unchanged at 11.6 percent of GDP.

**Afghanistan is faced with the risk of a fiscal crisis due to a large and persistent finance gap.** Domestic revenues fell from a peak of 11.6 percent of GDP in 2011 to 8.4 percent in 2014, because of the economic slowdown and weaknesses in tax and customs enforcement. The decline in revenue collection took place across all sources, including tax revenues, customs duties, and non-tax revenues. In spite of measures to restrain expenditures, the authorities faced a financing shortfall of about USD 500 million in 2014. The authorities managed the shortfall by drawing down cash reserves, accumulating arrears, and relying on exceptional donor assistance. They also curtailed civilian operations and maintenance (O&M) and discretionary development expenditures, which ended up being lower in nominal terms in 2014 compared to 2013. However, overall expenditures increased because of higher security and mandated social benefit spending.

**Public debt remains broadly sustainable but continues to resist swift reduction.** In Bangladesh the ratio of central government debt to GDP is projected to remain on a gradual downward path with the country remaining at low risk of debt distress. Pakistan is also

**Figure 18: Government debt is high across most countries in the region, and especially in Bhutan and Maldives**



Source: The World Bank, IMF and national authorities



likely to see decreasing public debt ratios in the medium term. In Sri Lanka, on the other hand, a slowdown in GDP growth might reverse the decline in the public debt-to-GDP ratio observed in recent years.

**Public debt levels are similarly high in Bhutan and Maldives, but the two countries differ in their debt sustainability.** Bhutan's public and publicly guaranteed external debt stood at 95 percent of GDP by end-2014, compared to 5 percent of GDP in domestic debt. But the risk of debt distress continues to be moderate, as two thirds of the external debt are from commercially profitable hydropower projects. The risk-sharing agreement with India for hydropower loans, Bhutan's strong track record in project implementation, rapid growth in energy demand from India, committed donor support, and the country's high level of international reserves, imply that its high public debt is not much of a concern. Maldives, on the other hand, remains at moderate risk of external debt distress. Persistent fiscal deficits have led to high and increasing public debt levels, projected to continue its upward path from 61.7 percent of GDP at end 2013, towards 75 percent in 2014. The current account deficit meanwhile has entailed increasing shares of external debt. All of this makes Maldives highly dependent on the performance of its tourism-related revenue.



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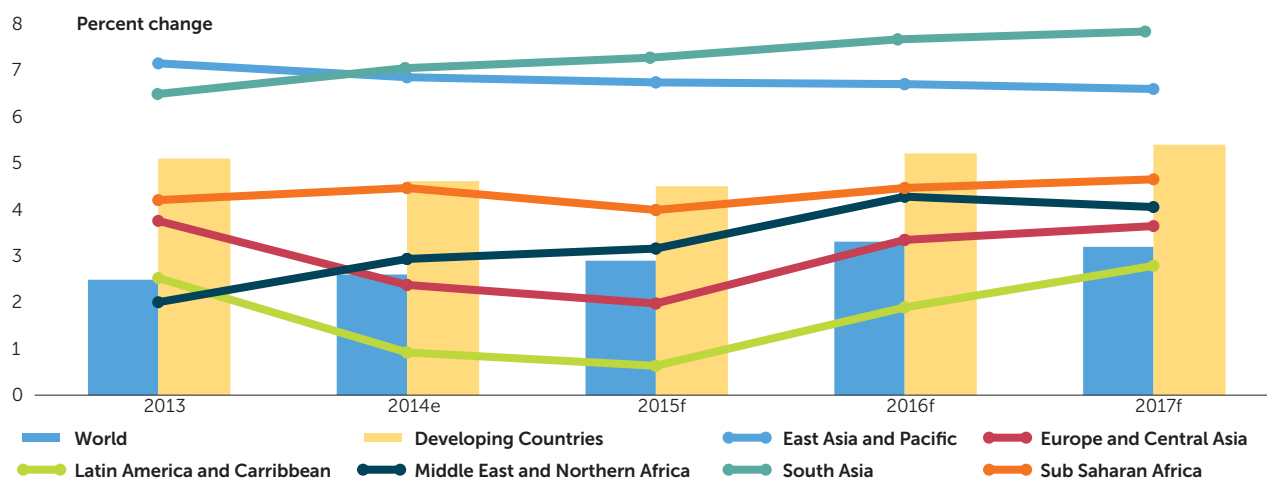
# Outlook and policy

**T**he short- and medium-term outlook for South Asia points towards continued macroeconomic stability and relatively strong growth, with potential downside risks concentrated on the fiscal side. Future growth dynamics will strongly hinge on higher investment rates as well as improved export performance. A key factor for South Asia's success going forward will be the ability of its policy makers to seize the decline in global oil prices to address the inefficiencies and the fiscal burden from the inadequate pricing of energy in the region.

## South Asia is set to become the fastest growing region, driven by a strong India

South Asia is expected to take the global lead in economic growth region in 2015. While Asia as a whole remains the hot spot of the world economy, dynamism within the continent is shifting from East to South. The two major economies in the region tell the tale. As China appears to be gradually landing into growth rates around 7 percent between 2015 and 2017, India is expected to accelerate continuously towards 8 percent real GDP growth by FY2017/18. While China is trying to transition from an investment- and export-led growth model to one based a consumption, India is confronted with accomplishing the opposite. Cementing South

**Figure 19: South Asia's GDP growth will continue to outperform that of other regions**



Source: World Bank DECPG

Note: based on constant GDP in 2010 USD at market prices, calendar years



**Table 1: South Asia's strong growth performance is expected to be driven by investment over the coming years**

	2013	2014	2015	2016	2017
<b>South Asia real GDP (at market prices, calendar years)</b>	6.3	6.8	7.0	7.4	7.6
<i>Percent change</i>					
Private Consumption	5.6	5.9	6.6	7.4	7.9
Government Consumption	6.6	8.2	7.9	7.5	7.1
Gross Fixed Investment	2.6	5.7	8.1	10.6	11.5
Exports, GNFS	6.5	2.0	4.4	6.8	7.8
Imports, GNFS	-2.9	-0.6	6.3	10.3	12.2
Statistical Discrepancy	-0.2	-0.5	-0.1	0.0	0.1
Change in inventories	0.0	0.1	0.0	0.0	0.0
<b>SAR Current account balance</b>	-2.1	-0.8	-0.8	-1.5	-2.3
<i>(Percent of GDP, calendar year)</i>					

Asia's leadership in global growth will indeed require that India switches from the largely consumption-driven growth performance of FY2014/15 towards the ignition of investment and the reinvigoration of exports as the main drivers of its economic dynamism.

**Regional growth in South Asia is projected to continue its upward trajectory over the next years.** The main pillars of this regional growth forecast remain strength in consumption and most importantly a pronounced pick-up in gross fixed investment. Given India's weight in regional GDP, these projections reflect to a large extent an expected investment boom driven by broad macroeconomic stability and improved business sentiment. South Asia is expected to grow at 7 percent in 2015, picking up pace to 7.6 percent by 2017 as more productive capital is brought on stream. Exports dynamism is expected to remain lackluster and will only gradually increase its contribution to Indian and regional growth as demand in developed economies recovers.

**There is potential for sustaining or even improving growth across many South Asian countries.** In India, GDP growth is expected to increase to 7.5 percent in FY2015/16 and reach 8.0 percent two years later, on the back of an acceleration of investment growth to 12 percent during FY2016-FY2018. Consumption is expected to remain an important contributor to growth in the near term with government consumption expenditure receiving a push in FY2015/16 on account of the anticipated revision in public salaries under the ambit of the 7th Pay Commission. In the medium term, low crude prices, improved production capacity, and flexible inflation targeting are likely to keep inflationary pressures under check and prevent

**Table 2: In the medium term growth performance will improve across all countries in the region**

<b>Real GDP growth (at market prices, by fiscal year)</b>	2013	2014	2015	2016
Afghanistan	3.7	2.0	2.5	5.0
Bangladesh	6.0	6.1	5.6	6.3
Bhutan	2.0	5.2	6.7	5.9
India	6.9	7.2	7.5	7.9
Maldives	4.7	5.0	5.0	-
Nepal	3.9	5.5	5.0	5.0
Pakistan	3.7	4.1	4.4	4.6
Sri Lanka	7.3	7.4	6.9	6.6

Note: Estimates and projections are based on GDP at market prices per respective country fiscal year, except for Pakistan where factor costs were used.  
Source: World Bank MFM Global Practice

overheating. In Pakistan, a gradual recovery to around 4.6 percent growth by end of FY2015/16 will be aided by low inflation, fiscal consolidation and the rebuilding of the external position. But its success will remain contingent on tackling key growth constraints: power load-shedding, a cumbersome business environment, and low access to finance. Economic activity in Bhutan is expected to gain momentum with real GDP growing at 6.7 percent in 2015, driven by new hydropower construction and innovative tourism measures. However, this boost could risk a resumption of overheating and macroeconomic imbalances.

**In the short term Bangladesh, Nepal and Sri Lanka may face a more sluggish economic activity.** In Bangladesh, potential GDP growth is on a declining path due to slower labor force growth as well as stagnant productivity growth and capital accumulation. Actual



growth is projected to slow down in FY2015/16 because of repercussions from political turmoil. However, a medium-term recovery seems possible if stability prevails, on the back of a strong domestic demand base, a gradually improving investment climate, and moderate inflation. Nepal's outlook is largely framed by supply-side constraints, with growth remaining in the 4.5 to 5 percent range. The fact that consumption remains the country's main driver of growth makes its prospects vulnerable to a slowdown in remittances and highlights the need to kick-start investment and domestic production. In Sri Lanka, growth is expected to decelerate to 6.9 percent year-on-year in 2015 due to slowing construction activity, as the new government reassesses the country's growth model.

**Afghanistan remains as a special case where the post-transition outlook remains highly contingent on a relatively stable political and security environment, as well as a successful management of the fiscal situation.** Agriculture and services are likely to be the key drivers of economic growth. But extractive industries may play an increasing role in the medium term. In

light of the large financing gap, restoring fiscal stability will require accelerating revenue enhancing reforms, additional discretionary assistance, and the prioritization of expenditures. Beyond restoring confidence, the new government must address formidable medium term development challenges. Ultimately, jobs for 400,000 new entrants into the labor force will need to be created each year in spite of declining international assistance.

**Political developments in South Asia remain a two-sided risk factor.** On the upside they may be able to ignite reform, and boost investor confidence; on the downside, they may inject uncertainty or even cause economic disruption. In Bangladesh, the biggest challenge going forward will indeed be ensuring durable political stability, a precondition for accelerated, inclusive, and sustainable growth. In Pakistan, a key risk is the repetition of the political events of the first half of FY2014/15, which could keep FDI flows and private investment low, affect foreign reserves, slow down the government's privatization program and ultimately undermine growth prospects.

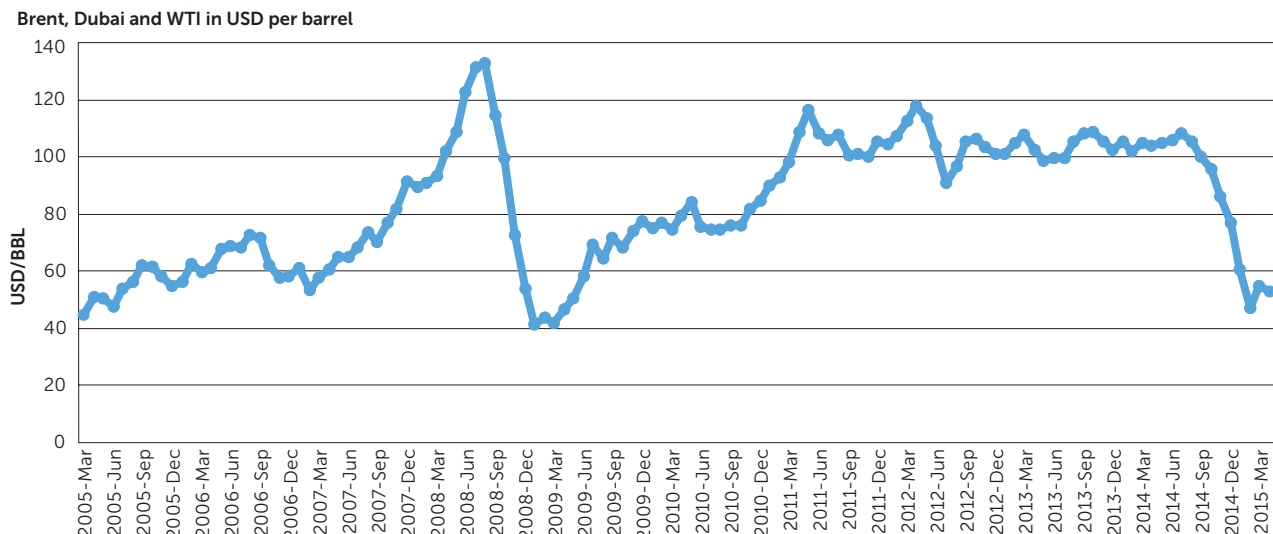


# Is South Asia making the most of cheap oil?

**T**he biggest oil price dividend to be cashed in by South Asia is one yet to be earned, but it is not one that will automatically transit through government or consumer accounts. The current constellation of macroeconomic tailwinds provides a unique opportunity for policy makers to rationalize energy prices and to improve fiscal policy. Decoupling external oil prices from fiscal deficits may decrease vulnerability to future oil price hikes – something that may very well happen in the medium term. Furthermore, cheap oil offers a great opportunity to introduce carbon taxation and address the negative externalities from the use of fossil fuels.

South Asia is a major beneficiary of the recent fall in international oil prices, as all countries in it are net oil importers. Cheaper imports should boost their trade and current account balances. But also fiscal balances should see relief, as fuel subsidies have been significant expenditure items across South Asian budgets. From a microeconomic perspective, oil-intensive sectors such as energy or transport should see lower costs translate into lower market prices, in turn putting significant downward pressure on consumer price inflation. Ultimately, from a social welfare perspective, consumers and households should experience positive income effects – both directly through lower consumer prices and indirectly through faster economic growth.

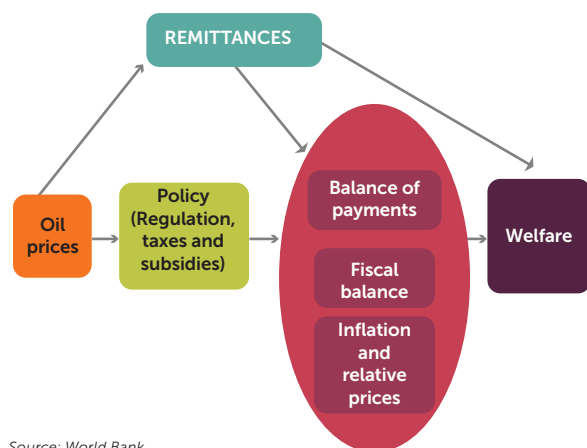
**Figure 20:** Average spot prices of crude oil have dropped significantly since mid-2014



Source: World Bank



**Figure 21: The impact of oil prices on welfare is mediated by multiple mechanisms**



Source: World Bank

**The impact of international oil prices on the domestic economy is calibrated by government policies that vary substantially across countries.** South Asian countries are not only net importers of oil: they are characterized by prevalence of fuel subsidies. Impacts also depend on the extent to which different fuel types are consumed by households, or used for production and for the generation of electricity. For instance, poorer households spend relatively less on gasoline and diesel and relatively more on kerosene when compared to richer households. There are also differences in the energy mix across countries. In South Asia, Bangladesh relies relatively more on coal for electricity generation, whereas fuel plays a more important role in Pakistan. The decline in oil prices may also have indirect effects, through the remittances sent by workers who migrated from the region to oil-rich countries. If economic growth declined in these countries, South Asian households could be affected.

### A diverse pass-through of international oil prices to domestic prices

**The domestic prices of oil products follow international prices to very different extents across the three largest economies in the region.** This is despite the fact that all three economies have historically regulated the price of oil products at the retail level. The administered prices were at times set below import costs and were not adjusted regularly, resulting in large losses (under-recoveries) to public sector oil-marketing companies (OMCs). For example, the Bangladesh Petroleum Corporation (BPC), the

country's main distributor of oil products, incurred losses in every fiscal year between 1990 and 2013. In the fiscal year of 2012, this policy resulted in US\$ 890 million of subsidies for oil products.<sup>1</sup> The prices of oil products were increased by up to 11 percent in January 2013. But even after that, diesel and kerosene products still suffered from under-recoveries of about Tk 12 per liter. The price of LPG in 12.5-kg cylinders sold by BPC has not changed since 2009.

### India completely deregulated gasoline prices in June 2010 and diesel prices in November 2014.

However, household kerosene is still subsidized indirectly, through OMC under-recoveries and cross-subsidies from industrial customers. Household LPG is largely supplied in 14.2 kg cylinders, and is sold at both subsidized and commercial rates. The subsidized prices of kerosene and LPG have remained unchanged since October 2012 and November 2014, respectively.<sup>2</sup> But in recent months the excise duty on diesel and gasoline has been increased periodically to match the decline in international oil prices. Pakistan has deregulated the price of diesel since June 2002 and the price of gasoline since June 2011. The ceiling for the price of kerosene is set based on an import-parity formula. For LPG, the government sets ceilings for the prices for domestic production but not for imports. Fuel prices are subsidized through a petroleum levy.<sup>3</sup>

**Because of these different interventions by governments, the extent of pass-through from international to domestic prices of oil products is substantially different by country and by oil product.** The pass-through rate is defined as the ratio of the change in domestic prices to the change in international crude price over a certain period. In what follows, the period from the beginning of 2014 to February 2015 is considered. Since international crude oil prices are denominated in US dollars, the pass-through to domestic prices is also affected by the movement in exchange rate between the US dollar and the local currency. Using this approach, no price pass-through took place in Bangladesh. In India, the pass-through rates of diesel and gasoline are 33 percent and 20 percent, respectively. There was no price adjustment in the case of subsidized kerosene. It is in

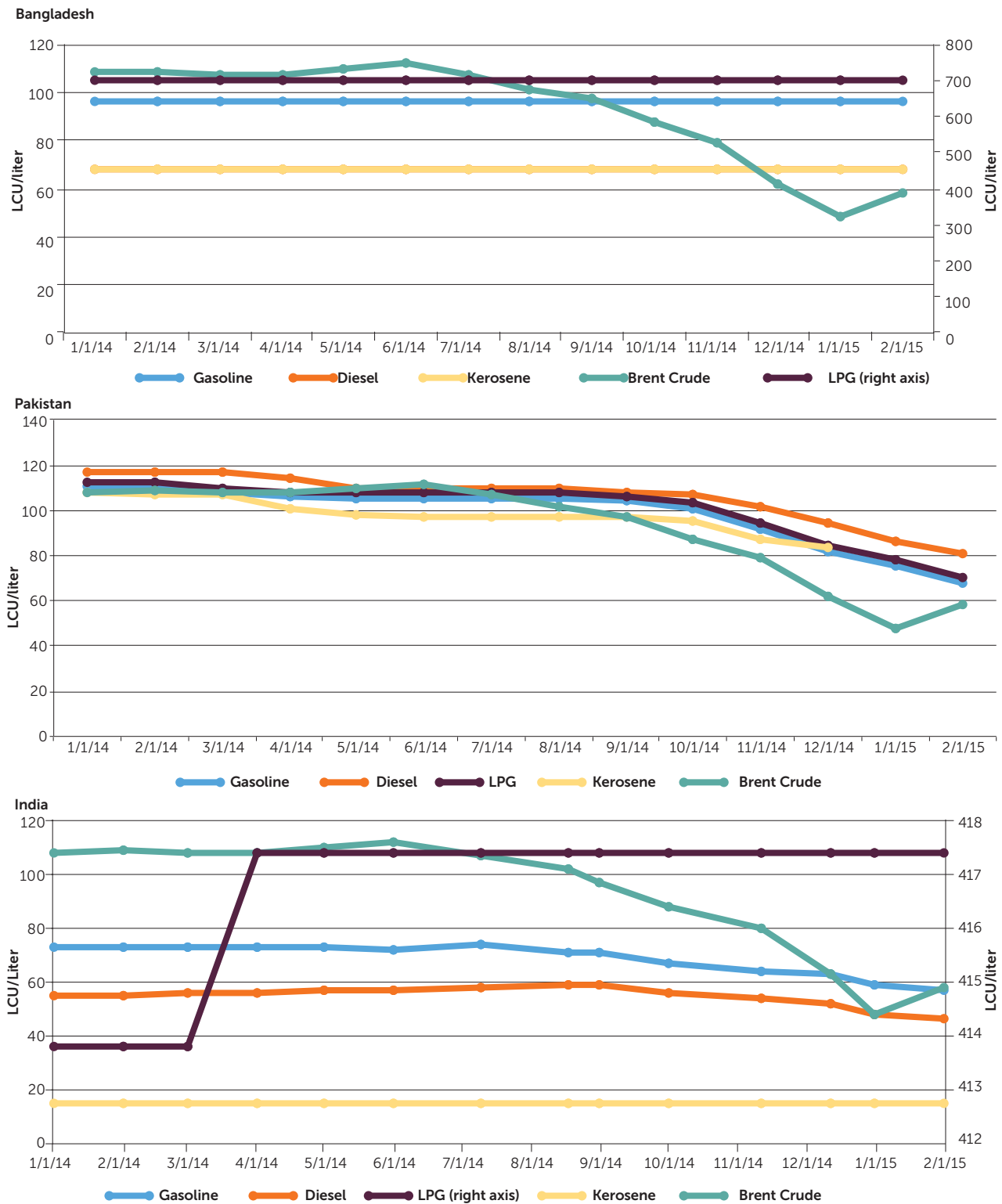
1 Mujeri et al. "Energy Sector in Bangladesh: An Agenda for Reforms." International Institute for Sustainable Development. March 2014.

2 Subsidies to Liquefied Petroleum Gas in India: An overview of recent reforms. International Institute for Sustainable Development. March 2014.

3 Kojima, M. "Petroleum Product Pricing and Complementary Policies: Experience of 65 Developing Countries since 2009." Policy Research Working Paper 6396. Washington DC: the World Bank. April 2013.

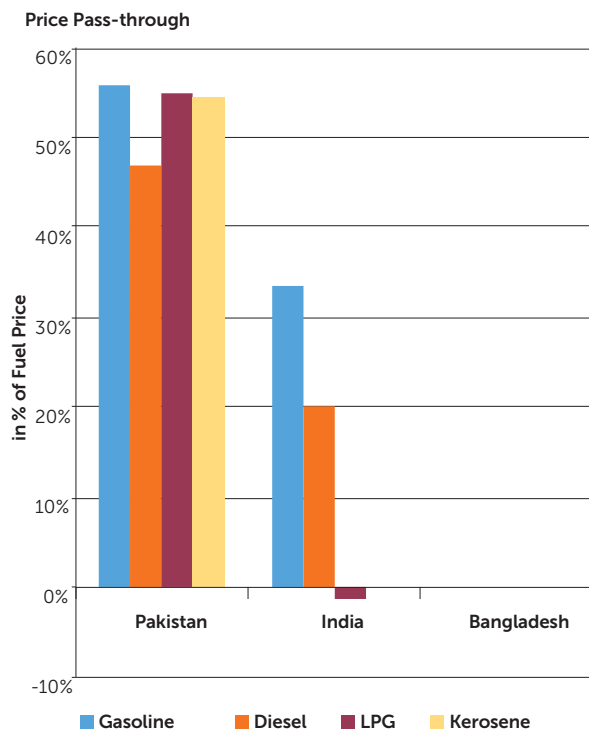


**Figure 22: Domestic prices of oil products have not always followed international prices**



Sources: Bangladesh Petroleum Corporation, India Petroleum Planning & Analysis Cell, Pakistan State Oil, Thomson Reuters

**Figure 23: The decline in oil prices was passed on to domestic prices to a very large extent in Pakistan**



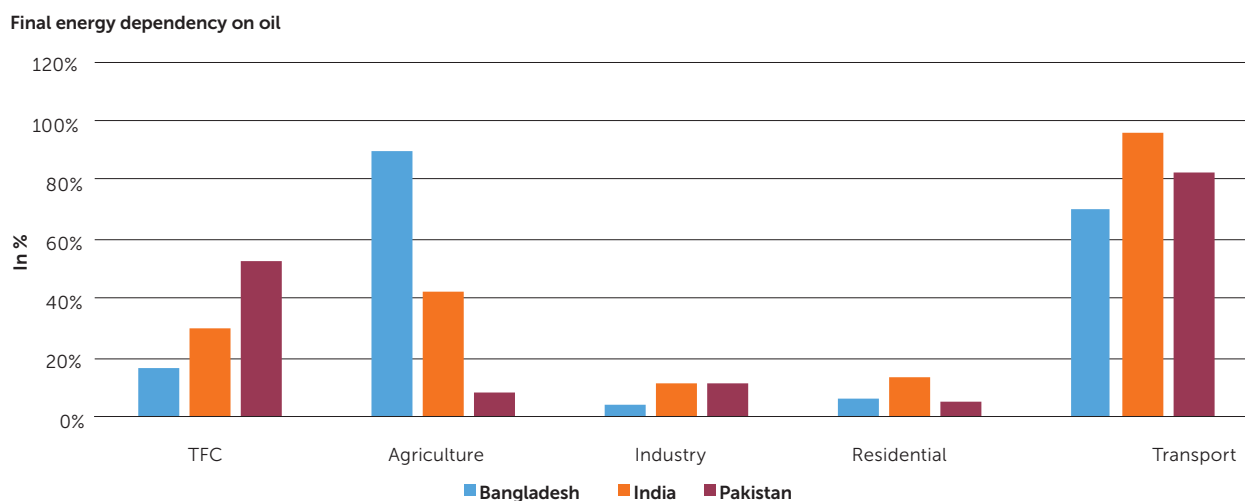
Pakistan that domestic prices were most responsive to the changes in international prices. The pass-through was around 54 percent in case of LPG and kerosene, and 56 percent and 47 percent in case of gasoline and diesel respectively.

## The impact of oil prices is mediated by the structure of the economy

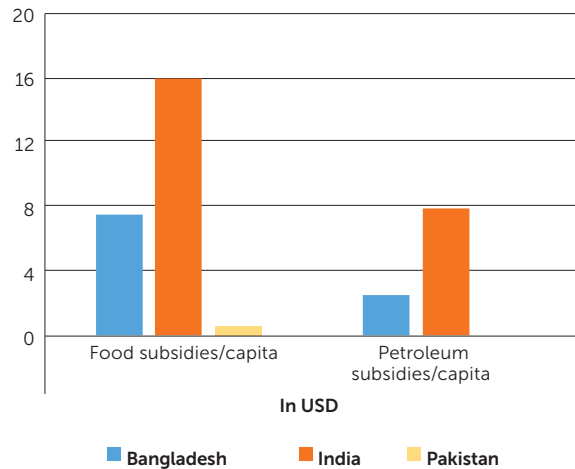
**Transportation is the sector that relies on oil products the most, followed by agriculture.** In India, gasoline and diesel account for 96 percent of the fuel used for transportation. The share is relatively lower in Bangladesh and Pakistan (it reaches 70 and 83 percent of the total, respectively) due to the promotion of compressed natural gas in the two countries. In agriculture, almost 90 percent of the energy inputs to the sector in Bangladesh come from oil products. By contrast, only 12 percent of energy consumption by the industry sector comes from oil in India and Pakistan. Residential sectors in all three countries have a low dependency on oil and oil products, reflecting the region's low access to modern energy in the household sector.

**Fertilizers and transportation costs make agriculture a highly energy-intensive sector, and as a result of it lower domestic prices for oil products may also translate into lower food prices.** As the agricultural production costs recede, and getting the produce from farm to market becomes cheaper, a deceleration of food inflation can be expected. This effect is independent from food price fluctuations in international markets, from which many South Asian economies are partially isolated. Moreover, the high energy-intensity of the agricultural sector implies that energy subsidies and food subsidies are potentially correlated. Put differently, if energy prices are lower than in other countries, food prices should be

**Figure 24: Dependence on the consumption of oil products varies widely across sectors**



**Figure 25: Energy subsidies are correlated with food subsidies**

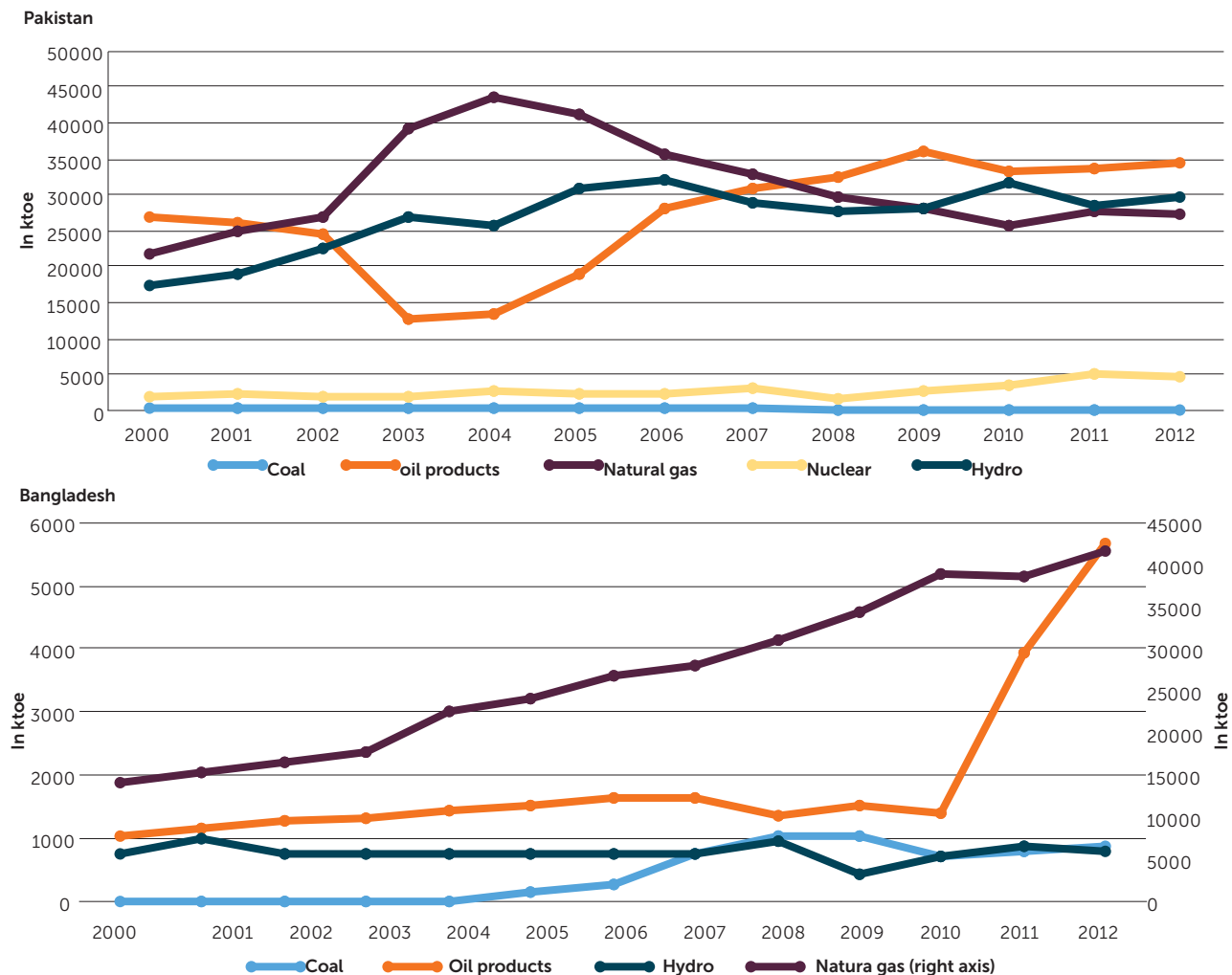


Source: World Bank staff calculations and national authorities

lower as well. This seems to be the case in South Asia. If the decline in oil prices makes it possible to reduce energy subsidies, it could also result in lower food subsidies.

**Oil prices also affect the cost of generating energy, but they do so differently across countries depending on their energy mix.** For instance, Pakistan produces more than one third of its electricity through fuel-oil powered thermal plants. In fact, imported heavy fuel oil has become the single largest fuel source for Pakistan's power generation in recent years. In Bangladesh, on the other hand, fuel oil only accounts for 10 percent of electricity generation. But its contribution has increased rapidly in recent years. Oil is not important in India's case, where its share in the energy mix has fallen from 5 to 2 percent between 2000 and 2012. However, prices of Liquefied Natural Gas (LNG) tend to follow crude oil prices with a time lag. If so, the cost of energy could

**Figure 26: Pakistan is highly dependent on oil for electricity generation and Bangladesh increasingly so**



Source: International Energy Agency Energy Balance and Statistics.

decline further, especially in Bangladesh and Pakistan. Even India would benefit, as LNG and oil together account for 9.5 percent of its electricity generation.

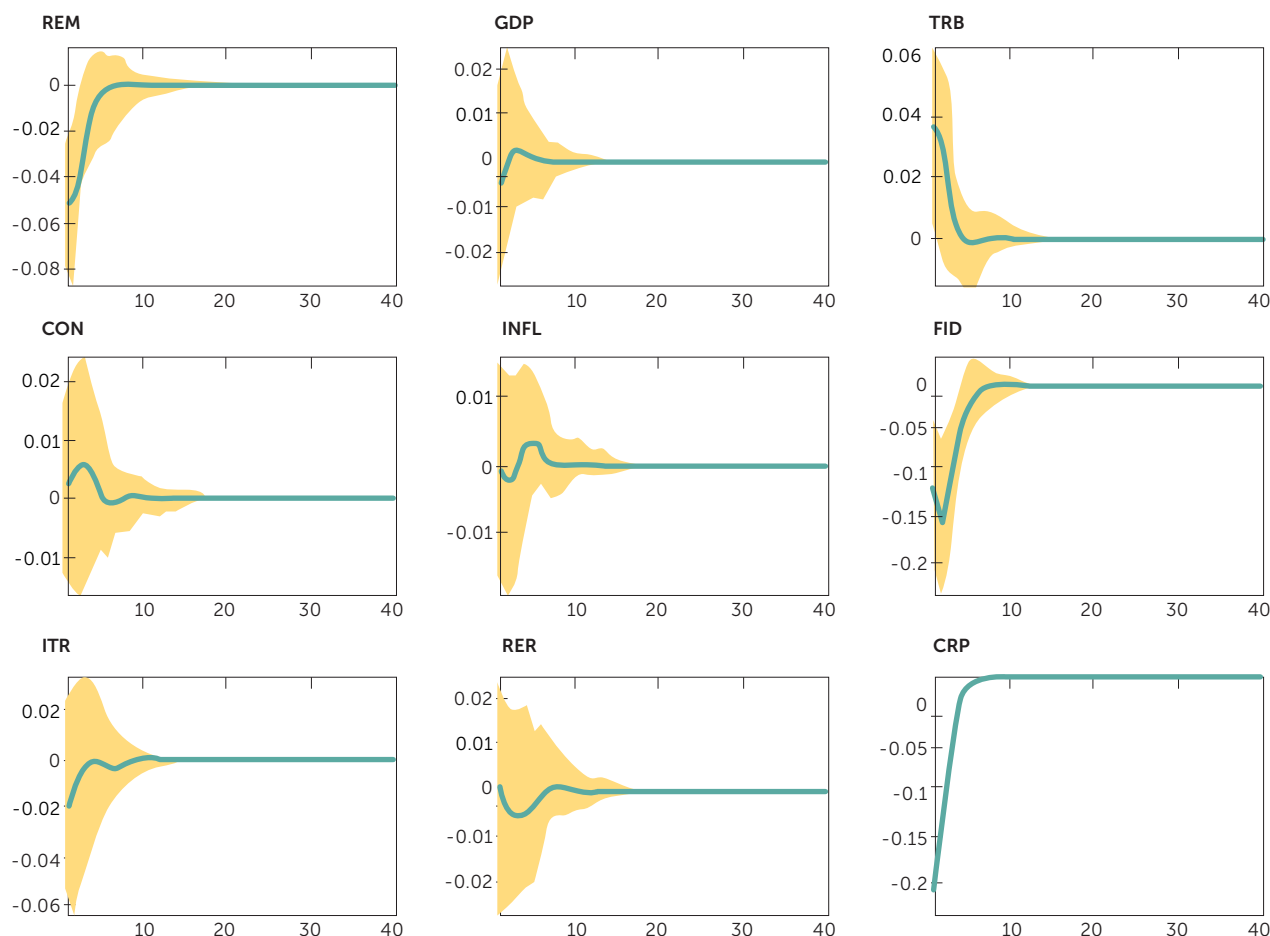
## The balance of payments and the budget are key transmission channels

Based on India's experience over the last decade, oil price shocks affect the economy mainly through current account balances and fiscal accounts. Using an empirical approach to identify the key transmission mechanisms is justified in light of the varying degree of price pass-through across countries, as well as their different dependence on oil across sectors. In these circumstances, attempting to predict the impact of cheaper oil on the basis of conceptual arguments could be misleading. An arguably more reliable picture is provided by

the predictions (or impulse responses) from a Structural Vector Auto Regression (SVAR) estimated with Indian data for the years 1995-2014. The impulse responses to an oil price decrease of 20 percent suggest a relatively pronounced effect on the trade and budget deficits. The former increases while the latter decreases in response to lower oil prices. Furthermore, remittances seem to be negatively affected while GDP, inflation, interest rates and the real effective exchange rate show minor responses.

Whether there will be a negative impact of the oil price shock on remittances to South Asia will to a large extent depend on the policy response of Gulf countries. Based on the empirical exercise above, a 20 percent decline in the world price of oil leads in the medium-term to a 5 percent decline in remittances. Traditionally, the GDP of oil exporting countries and the volume of remittances from migrant workers in those countries have been highly correlated. However,

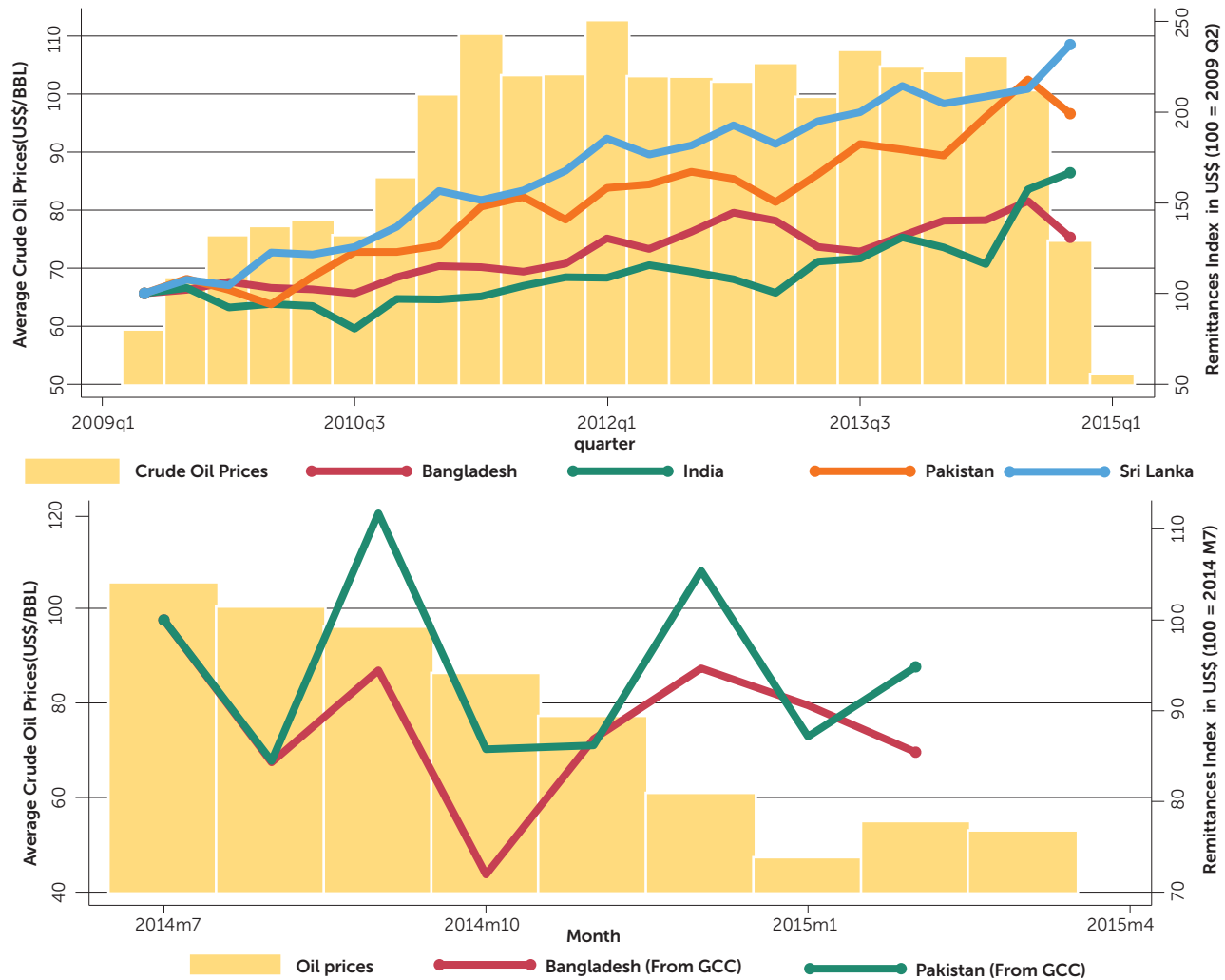
**Figure 27: Simulated impulse responses to a 20 percent decline in crude oil prices based on historic data from India**



Source: World Bank staff calculations using quarterly data from World Bank, IMF, RBI, MoF, and JPM.



**Figure 28:** There has been no noticeable slowdown in remittances to South Asia, except for Bangladesh and Pakistan



Source: World Bank, national central banks and World Bank staff calculations

oil exporting countries have substantial international reserves and can afford prolonged budget deficits in order to support their domestic economic activity. Recent research has found that the elasticity of remittances to international oil prices is positive but small.<sup>4</sup> So far, there seems to be a decline in remittances only in the cases of Bangladesh and Pakistan, and it is marginal.

**The impact of cheaper oil on the trade balance depends on the oil component of both imports and exports, as well as on indirect effects from the change in economic activity.** Because all countries in the region are net importers of oil products a positive impact on the trade balance can be expected in all cases. But there

can be tradeoffs in the short term, especially in India's case, where diesel and other petroleum products also account for a significant share of exports. The quantities of oil products imported and exported are not equally sensitive to changes in prices. The number of vehicles in circulation in a country is given in the short term, implying that there is little room of maneuver to reduce oil imports in volume. The response is even more muted when there is limited pass-through of cheaper oil prices globally onto cheaper domestic prices for oil products. In that case, domestic consumers may not "notice" the oil price shock immediately, and therefore may not adjust their demand for oil products. But at a time of global surpluses in oil, sales abroad may decline in volume. Hence the difference in the elasticity of the value of imports and exports to changes in oil prices. Using quarterly data from South Asia during the years 1995 to 2014, it appears that exports are indeed more sensitive to oil prices than imports in India, implying a relatively

<sup>4</sup> This research is summarized in the blogpost <http://blogs.worldbank.org/peoplemove/will-falling-oil-prices-lead-decline-outward-remittances-gcc-countries>.

### Box 1. Structural Vector Auto Regression: methodology and data

An SVAR links a series of economic variables through a dynamic structure implying that changes in the level of one of them are transmitted to all the others through multiple channels over time. The amplitude and speed of these mutual impacts can be estimated using historic data on the variables considered. Once the impact coefficients have been estimated, it is possible to simulate impulse responses to a shock across all the variables in the SVAR.

The SVAR model used here contains ten variables: crude-oil prices, global GDP growth, remittances, CPI inflation, domestic GDP growth, the trade balance, private consumption, the fiscal deficit, the monetary policy rate, and the real effective exchange rate. The lag length of the dynamic system is determined using the BIC and HQC information criteria, which are well suited for small samples. The lag was set to one quarter, but first-order autocorrelation in residuals was allowed, which effectively sets the lag order to two.

The system contains two blocks. One of them, representing the domestic economy, includes all domestic variables. The other, for the world economy, includes crude oil prices and global GDP growth. The latter block assumes that crude oil prices affect global GDP contemporaneously and with a lag, while oil prices are only affected by global GDP with a lag. The latter restriction identifies the oil price shock. Both oil prices and global GDP affect the domestic economy contemporaneously and with one period lag.

For the domestic economy, remittances are only affected by other domestic variables with one period lag. GDP growth is affected contemporaneously only by remittances and with a lag by all domestic variables. The trade balance and private consumption are affected contemporaneously only by remittances and GDP growth, and with lag by all other variables. Remittances and GDP (including the trade balance and private consumption as its sub-components), affect inflation contemporaneously. Impacts on the fiscal deficit come afterwards. Monetary policy takes into account inflation and the budget situation. The exchange rate comes last in the chain, because the foreign currency markets is considered to be the most efficient, reflecting information on all variables at once.

In practice this amounts to ranking the SVAR variables from most exogenous to most endogenous. The assumed ordering for the variables in the domestic block is as follows: remittances, GDP, trade balance, consumption, inflation, fiscal balance, interest rate, and exchange rate. This ordering is consistent with the recent SVAR literature on the impacts of lower oil prices on the economy.

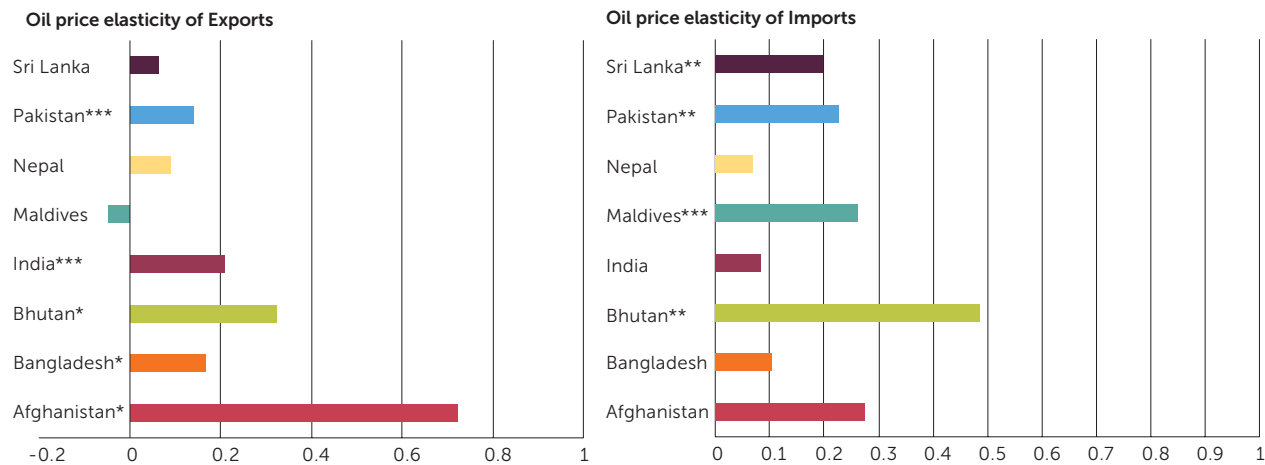
For estimation purposes, all variables are measured in log differences, quarterly, year-on-year, demeaned and de-trended. The average of three crude oil prices (UK Brt Lt, Dubai Med and Alaska NS heavy) is used as the impulse variable. The estimation relies on Bayesian methods combining classical full information likelihood with prior information. We impose very mild priors on all unrestricted coefficients using wide-spread Normal distribution centered on zero, with the exception of autoregressive coefficient for which we assume Beta (0.2, 0.1) distribution. Standard errors are assumed to have inverse Gamma (0.4, 0.2) distribution. For all coefficients, the posterior distribution heavily dominates the priors. We use Bayesian confidence intervals of 90 percent to draw inference on the generated impulse responses.

stronger adjustment of exports than imports with less positive effects on the trade balance in the short term. The opposite is true mostly everywhere else in the region. Based on these estimates, Bhutan, Maldives and Sri Lanka should see the biggest improvements in their trade balance as a result of the oil shock.

**In the presence of limited pass-through of the decline in oil prices to domestic prices, most of the impact is bound to be felt on the fiscal balance.** Based on India's

experience during 1995-2014, a 20 percent decline in international oil prices should lead to a 10-to-15 percent decline in the budget deficit. This is mainly the result of lower spending on energy subsidies. But the policy cushioning of the impact also results in more modest impacts on inflation and on economic activity. Overall, the empirical exercise conducted for India suggests that a 20 percent decline in oil prices leads to an increase in GDP by roughly 0.5 percentage points over four quarters.

**Figure 29:** Except possibly for India, most countries in the region can expect an improvement in their trade balance.



## Households will unambiguously gain but richer households will gain more

The decline in oil price affects household welfare directly through the resulting change in the domestic price of oil products, and indirectly through its overall impact on economic activity. Both effects are likely to be positive. Cheaper oil products result in greater purchasing power for the same income. More buoyant economic activity implies more household income for the same level of prices. But not all households will benefit to the same extent. Some consume more oil products than others; similarly, some may see their income growing faster than others. While there is limited information to infer how the oil price will affect the incomes of different population groups, household surveys allow to estimate what share of consumption expenditures goes into oil products. The direct welfare effect is defined as the percent of total consumption expenditure “freed up” from the household having to pay less for oil products for a given income. The indirect welfare effect is the percent change in income from more buoyant economic activity, for a given price of oil products. The sum of the direct and indirect effects provides a crude measure of the gain experienced by a household, expressed as a percentage of household consumption.

**Welfare effects in Bangladesh, India and Pakistan are positive and not negligible, but they are skewed towards richer households.** These effects are quantified

here using household survey data from Bangladesh, India and Pakistan.<sup>5</sup> Key inputs are the estimation of the pass-through effect in each of the three countries, and the expected increase in GDP following the oil shock. The share of oil products in total consumption expenditure is generally low for poorer households. Many among the poor are farmers, who do not rely on transportation much. As for the urban poor, they commute to work by foot, bicycle or public transportation much more frequently than in their own vehicles. Only drops in kerosene prices benefit the poor more than the rich. Moreover, the pass-through of international oil prices to the domestic prices of oil products is partial at most. As discussed above, there is no pass-through in the case of Bangladesh, and the extent of pass-through is limited in India’s case. Only in Pakistan is the decline in domestic oil prices substantial. Indirect effects are estimated in two ways. One of them applies to household expenditures the cumulative impact from a 20 percent drop in oil prices on GDP based on the SVAR analysis above. The other relies on the differences in growth forecasts between October 2014 and April 2015 over a one-year horizon. Overall effects range from a gain of 2 percent for households in the poorest decile to a gain of 4 to 5 percent for those in the richest decile.

5 The sources used are 2010 Household Income and Expenditure Survey for Bangladesh, the 2011–12 National Sample Survey (68th round) for India, and the 2010–11 Household Integrated Economic Survey for Pakistan. All of them are representative, at the minimum, at the urban/rural level.

## Box 2. The fuel consumption patterns of households in Bangladesh, India, and Pakistan

Using recent household survey data with consumption expenditure information, fuel consumption rates and mean fuel expenditure shares for households are estimated. The estimates are disaggregated by location (urban versus rural) and by product (for example, petrol, diesel, liquid petroleum gas, kerosene).

*Bangladesh:* The oil products examined were liquid petroleum gas (LPG), kerosene, petrol, diesel, and compressed natural gas (CNG). In rural areas, 87 percent of the bottom 40 percent of the population consume kerosene. But their consumption of other oil products is negligible. In urban areas, 23 percent and 55 percent of the bottom 40 percent consume LPG and kerosene, respectively. The consumption of other fuel types is negligible as well.

Except for kerosene, the mean expenditure share for each of the fuel types is lower for the bottom 40 percent of the population than for the top 60 percent in both urban and rural areas. For kerosene, the mean expenditure share in rural areas is 1.1 percent for the bottom 40 percent versus 0.7 percent for the top 60 percent. The corresponding shares in urban areas are 0.6 percent and 0.2 percent respectively. Pooling fuel types, the mean expenditure share in rural areas is 1.2 percent for the bottom 40 percent and 1 percent for the top 60 percent. The corresponding figures for urban areas 1.2 percent and 1.6 percent.

*India:* The analysis considered kerosene, LPG, petrol, and diesel. The household survey captures information on kerosene separately by whether the kerosene was obtained through the Public Distribution System (PDS) or other sources. In rural areas, 92 percent of the bottom 40 percent of the population consume kerosene, followed by 13 percent for LPG, and single-digit rates for petrol and diesel. Similarly, in urban areas, 55 percent of the bottom 40 percent consume kerosene, followed by 36 percent for LPG, and single-digit rates for petrol and diesel. In both urban and rural areas, the bottom 40 percent is more likely to directly consume kerosene than the top 60 percent. For all other fuel types, the top 60 percent has higher consumption rates than the bottom 40 percent in both urban and rural areas. The bottom 40 percent is more likely to directly consume kerosene obtained from the PDS than the top 60 percent but the difference is not large.

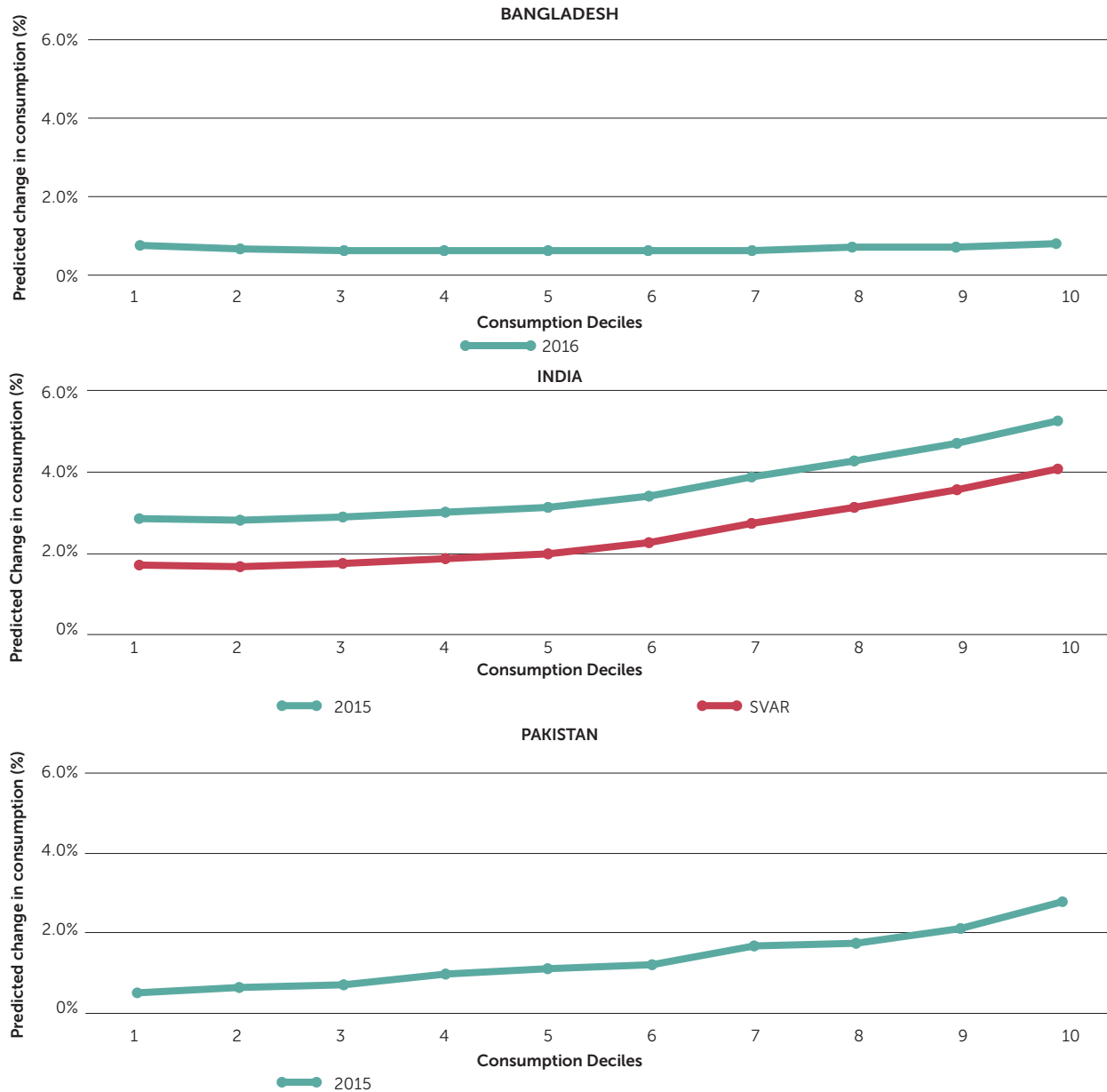
Apart from kerosene, the mean expenditure share for each of other oil products is lower for the bottom 40 percent than for the top 60 percent. For kerosene, the mean expenditure share for the bottom 40 percent is 1.5 percent in both rural and urban areas. The shares are 0.7 percent and 0.5 percent for the top 60 percent of the population in rural and urban areas, respectively. Pooling fuel types, the mean expenditure share is 2.1 percent for the bottom 40 percent of the population and 3.7 percent for the top 60 percent in rural areas. The corresponding shares in urban areas are 4.1 percent for the bottom 40 percent and 6.5 percent for the top 60 percent.

*Pakistan:* The analysis covered kerosene, LPG, and petrol/diesel. In rural areas, 19 percent of the bottom 40 percent directly consumes kerosene, 11 percent LPG, and 15 percent diesel/petrol. In urban areas, 3 percent of the bottom 40 percent consumes kerosene, 69 percent LPG, and 17 percent petrol/diesel. Apart from kerosene, the bottom 40 percent is less likely to directly consume each of the fuel types than the top 60 percent. This is so in both urban and rural areas.

Except for kerosene in rural areas, the bottom 40 percent of the population has an equal or lower expenditure share for each of the fuel types than the top 60 percent. For kerosene, the mean expenditure share is 0.2 percent for the rural bottom 40 percent versus 0.1 percent for the rural top 60 percent. Pooling fuel types, the mean expenditure share is 1.1 percent for the bottom 40 percent versus 2.7 percent for the top 60 percent in rural areas and 2.4 percent for the bottom 40 percent versus 4.7 percent for top 60 percent in urban areas.



**Figure 30: As richer households spend more on oil products they tend to benefit more from cheap oil prices**

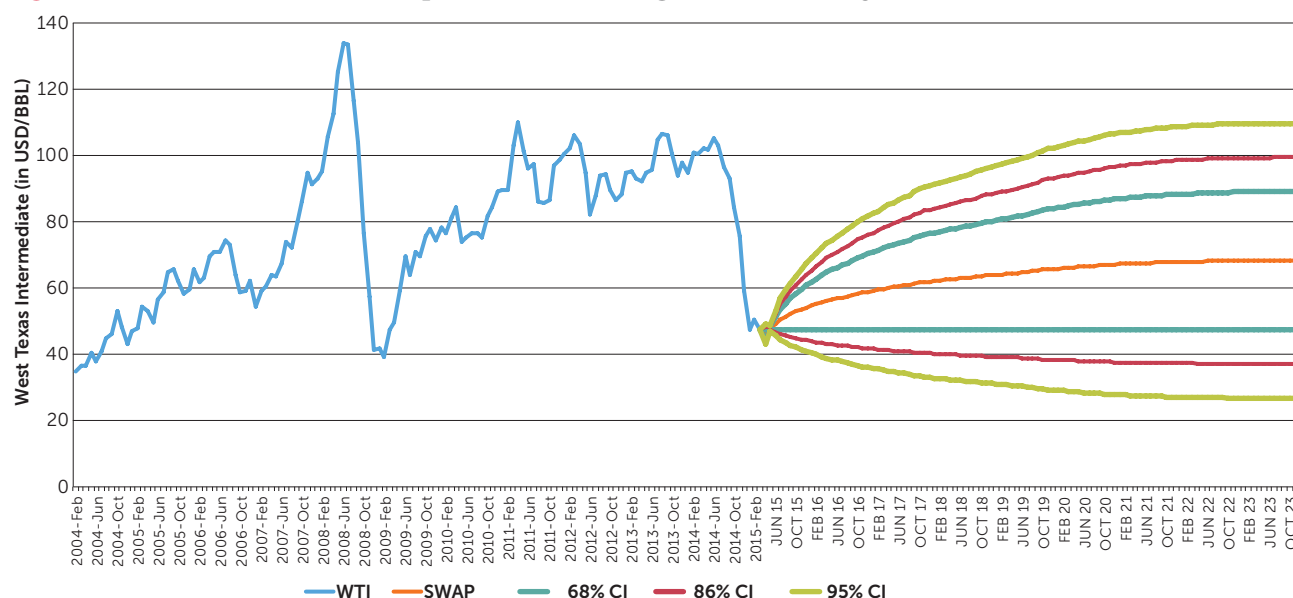


Source: World Bank.

## Macroeconomic tailwinds provide a unique opportunity to rationalize energy prices

**Future development in oil prices is surrounded by great uncertainty.** The current market sentiment suggests that the sharp decline in oil prices could be more sustained compared with the transitory, V-shaped decline of oil prices in 2008-2009. While many could agree that the V-shape pattern may be put to rest this time around, the market sentiment provides a little insight into whether the future dynamics in oil prices will

resemble an L-shape rather than a U-shape pattern. The market forecast and swap curves for oil prices suggest slow convergence of WTI oil prices to USD 60 per barrel by April, 2017. However, this market consensus forecast is surrounded by large uncertainty. While in 68 percent of the time the price is predicted to stay in the range of USD 44.8 to USD 75.2 per barrel by April 2017, a 95 percent confidence requires this interval to widen to USD 29.6-90.4 per barrel. Ultimately, many patterns of future price development are probable, including significant further decline in oil prices. Low oil prices may thus very well be transitory and a fast

**Figure 31: Forecasts for crude oil prices suffer from great uncertainty**

Source: World Bank staff estimates

increase could quickly put back pressure on fiscal balance sheets. Therefore, the time to strategically choose government exposure, pass through mechanisms as well as social welfare and growth implications related to international oil price movements is now.

**In principle, hedging options are available to help governments and larger businesses mitigate this uncertainty. But there are also important risks associated with hedging.** Government and businesses can choose to live with the uncertainty or try to reduce it through self-insurance or hedging. The self-insurance mechanism could work through buying oil in times when prices are deemed low and using the accumulated stock when prices rise again. This approach has been applied by India recently. Alternatively, governments and firms can use long-term hedges to lock in prices that they see as fair and variable for their future business and focus on better investment planning. Some of the available hedging options, their markets of origin, quoted prices, and term structure are presented in the table below. They indicate some possibilities to lock in the price of oil even 7-8 years ahead—that is the time needed for most medium term investment projects to start generating returns. However, to use those markets effectively and transparently, solid governance frameworks need to be implemented, especially by governments both at the central level and at the level of the SOEs, and sub nationals. The fundamental steps supporting commodity risk management are well established in the commercial world, and apply to any interested organization, whether public or private. At

**Table 3: Selected global hedging options with over-the-counter derivatives**

PERIOD	WTI*	BRNT*	NYULSD*	NYRB*
Dec-15	54.11	60.85	182.49	151.97
Dec-16	58.90	66.41	194.34	161.85
Dec-17	61.93	69.60	200.65	168.95
Dec-18	63.82	72.07	201.50	173.24
Dec-19	65.77	74.17	na	177.64
Dec-20	67.18	76.04	na	180.84
Dec-21	67.89	77.78	na	182.65
Dec-22	68.22	Na	na	183.56
Dec-23	68.24	Na	na	183.71

WTI – NYMEX Crude Monthly Average, OTC Swap in USD/bbl;  
 BRNT – ICE Brent Crude Monthly Average, OTC Swap in USD/bbl;  
 NY ULSD – NYMEX Heating Oil Monthly Average, OTC Swap in USD/gal  
 NYRB – NYMEX RBOB Gasoline Monthly Average, OTC swap in USD/gal

a high level, the framework for implementing a commodity hedging strategy should always cover the points outlined in the Box below.

**A more workable option to reduce fiscal vulnerability in face of large international commodity price swings is to take advantage of cheap oil to cut energy subsidies.** The subsidy channel, though muted in face of low oil prices at the moment, remains an important potential driver of fiscal deficits in South Asia. Furthermore, current tailwinds for fiscal balances may send the wrong signal to fiscal policy makers and take off pressure from

### Box 3. A high-level framework for implementing a commodity hedging strategy

Governments should not embark in hedging without previously considering the following:

- ◆ Formulating the hedging-strategy objectives.
- ◆ Assessing the impacts of short-term price volatility and carefully quantifies price exposure.
- ◆ Documenting the reasons for selecting a specific hedging product, including details on terms of coverage.
- ◆ Verifying adequate legal and regulatory infrastructure to support the use of commodity derivatives.
- ◆ Describing operational arrangements, including roles and responsibilities of actors and agencies and mechanisms for cost accounting and managing potential payouts associated with the hedging instruments.
- ◆ Establishing procedures for those authorized to (i) negotiate, (ii) approve, (iii) execute, and (iv) audit transactions and reports; these authorizations should include the limits act.
- ◆ Review of accounting policies and tax regulations related to the management of hedging instruments.
- ◆ Establishing procedures to select counterparties and brokers; this could involve establishing requests for proposals (RFPs) to help guide choice and evaluation of counterparties.
- ◆ Setting clear limits for acceptable market and counterparty risks.
- ◆ Establishing back-office and control procedures for monitoring and managing the hedge position, including the process for valuing transactions;
- ◆ Developing procedures for oversight and supervision of and reporting on risk management operations.

Source: World Bank

addressing structural weaknesses in revenue generation. These arguments constitute a solid case for taking the opportunity to replace risky subsidies with other support measures and transfer schemes able to better target those in need while allowing fiscal balances to be permanently decoupled from uncertain and volatile international oil price movements. This also is an opportunity to reform poor performing electric utilities and state owned refineries that are often highly subsidized.

#### **Running in parallel with the decline in petroleum fuel prices but conceived and initiated well before, reforms in subsidy programs to reduce inefficiencies and distortions can yield additional dividends.**

Under the Direct Benefit Transfer (DBT) scheme, the Indian government has started to directly deposit entitled subsidies into the bank accounts of consumers for the purchase of market-priced LPG cylinders. Government reports indicate that the majority of intended households are now covered under the DBT scheme, which stems leakage from the diversion of LPG from household to other uses that occurred under the previous arrangement of at-purchase subsidies. The government also reports that large numbers of (well-off) households appear to have opted out of the DBT scheme, which has generated significant savings. The price of kerosene sold outside the PDS has been deregulated, leaving subsidized kerosene under PDS which is intended for poorer households. These steps in reforming subsidies are progressive in nature. The government is also considering ways to eventually

terminate price subsidies for kerosene under PDS given the expansion of electrification and the current low use of kerosene primarily for lighting purposes among poorer households in rural areas.

**India has already started to take advantage of the opportunity to rationalize energy prices by getting rid of subsidies whilst shifting taxes towards negative externalities of energy use.** India began by deregulating diesel prices while at the same time increasing excise duty on petroleum and diesel. As shown below, under-recoveries to diesel have been eliminated and in a series of actions since October 2014, excise duties on diesel and petro have been gradually increased. The Economic Survey of India suggests that using low oil prices, subsidies for both LPG and kerosene will be reformed as well. The new government budget for the fiscal year 2015/16 has slashed the petroleum subsidy estimate by 50 percent to INR 30,000 crore (USD 4.9 billion), from the FY2014/15 budget estimate of INR 60,000 crore. The government has also decided that most welfare schemes including subsidies for food, fuel and fertilizer will be delivered through cash transfer.

**India is bound to reap significant environmental benefits from these measures.** Calculating the CO<sub>2</sub> emission reduction from the measures taken for petrol and diesel suggests that there will be a net reduction of 11 million tons of CO<sub>2</sub> emissions in less than a year, more than the entire CO<sub>2</sub> emissions of Luxembourg in 2012, compared to the baseline or 0.6 percent India's

**Figure 32: India has eliminated under-recoveries for diesel products and raised excise duties on both diesel and petrol**



Source: Economic Survey of India, 2015.

annual emissions. In addition to serving as a carbon tax, an excise on petrol and diesel may, of course, also price other externalities associated with burning petrol or diesel. This includes congestion costs (from using vehicles), noise and local air pollution (of various forms) which can be deeply damaging for health.

**However, countries highly and increasingly dependent on oil for power generation, have not yet taken action.** No pricing reform has taken place in Bangladesh and Pakistan so far. Although at current international prices, there would be no need for subsidizing fuel sales, both countries remain vulnerable to volatility of international oil prices. This is particularly the case in Pakistan due to its high reliance on oil for electricity generation. Electricity tariffs are heavily subsidized in Pakistan, accounting for 1.2 percent of GDP in the fiscal year of 2013/14. Falling oil prices have reduced

input costs for electricity generation enabling tariffs to be adjusted downwards. However, a gap of about PKR 2/kWh remains and the sector continues to suffer acute liquidity shortages. As a result, accumulated arrears of payment by the public electricity distribution companies to their suppliers, commonly known as the circular debt, has started to re-emerge and currently stands at an estimated PKR 245 billion, or one percent of FY2013/14 GDP. Without the proper payment (from consumers or covered by subsidies from the government), the power producers have been unable to buy and/or produce adequate fuel to generate electricity that causes up to 5,000 MW of capacity to lie idle and contributed to several power shortage. Amid lower oil prices, electricity pricing reform has regained momentum. The government intends to adjust electricity tariffs and bring subsidies for electricity down to 0.7 percent of GDP in FY2014-2015.



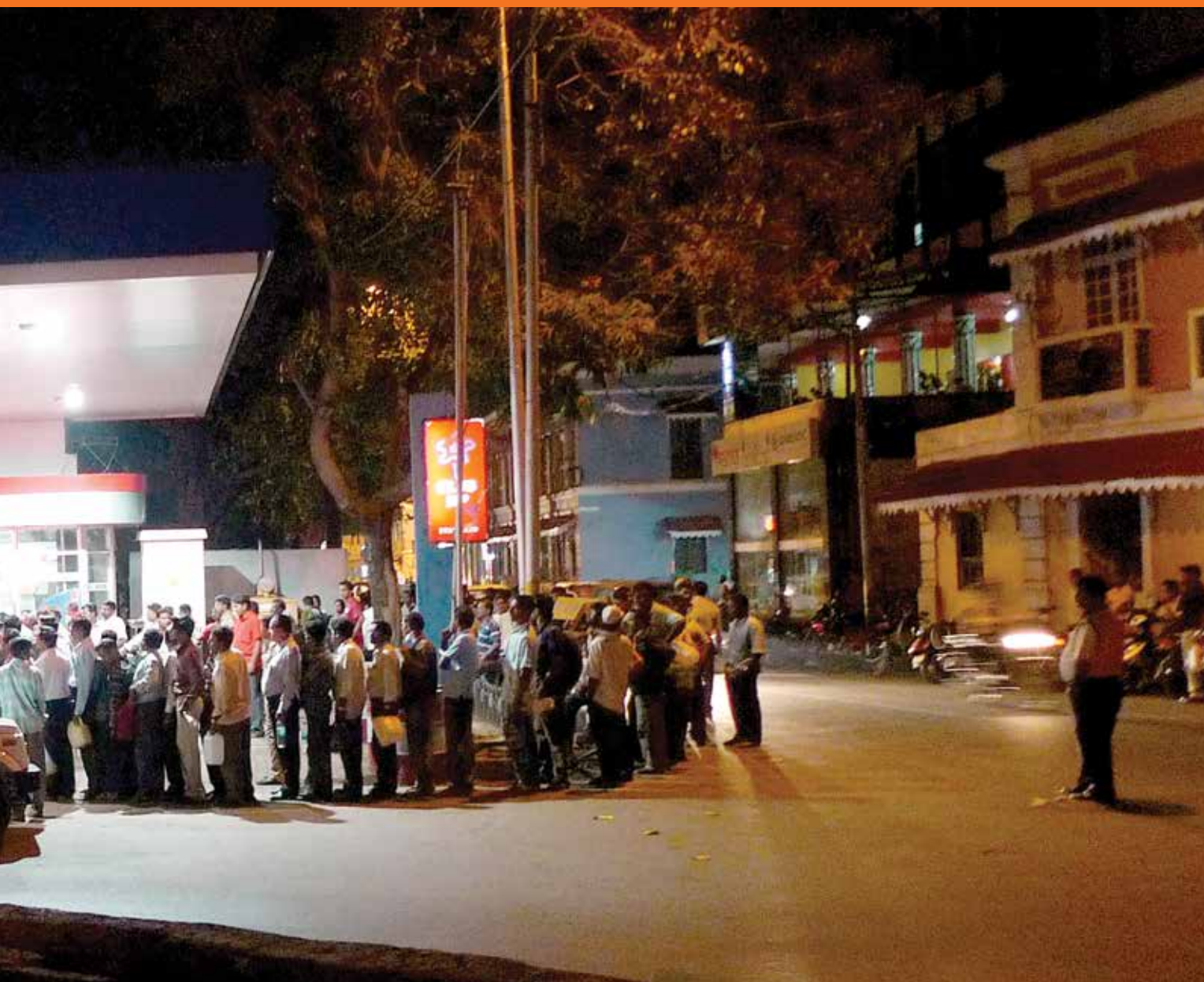




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# South Asia country briefs





In alphabetical order

Afghanistan

Bangladesh

Bhutan

India

Maldives

Nepal

Pakistan

Sri Lanka

# Afghanistan

*Economic growth has fallen sharply in Afghanistan from uncertainty surrounding the political and security transition in 2013–14. A fiscal crisis is underway with declining revenues leading to accumulating arrears and exceptional financing needs. Progress on key reforms and a stable political and security outlook are critical to improving a weak growth outlook and restoring fiscal stability. Poverty remains high and persistent and is likely to have worsened since 2011, although an improved outlook for growth and stability should lead to modest progress on poverty in the medium term.*

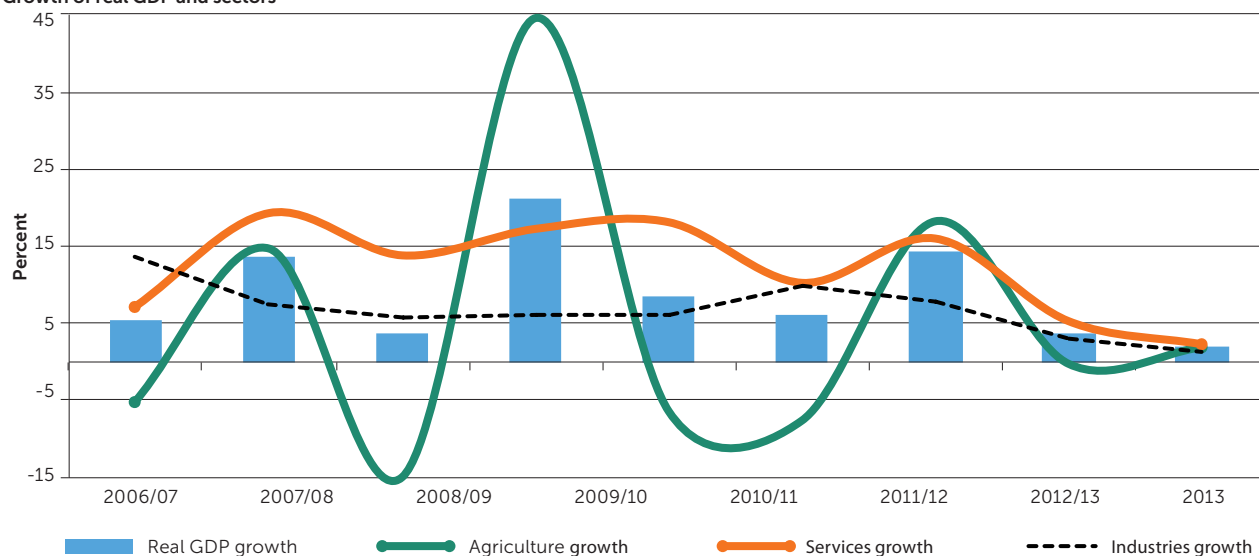
## Recent developments

**The political and security transition continues to take a heavy toll on Afghanistan's economy.** Economic growth is estimated to have fallen further to 2 percent in 2014 from 3.7 percent in 2013 and an average of 9 percent during 2003–12. The protracted political process in 2014 combined with weak reform progress dealt a further blow to investor and consumer confidence, which were already in a slump from uncertainty building since 2013. The economy also faces headwinds from the drawdown in aid. As a result, growth in the non-agricultural sectors (manufacturing, construction, and services) is estimated to have fallen further in 2014. New firm registrations, which is a proxy for investor confidence, dropped further to 2,470 in 2014 from 3,370 in 2013 and 5,300 in 2012, with this sharp drop occurring across all sectors.

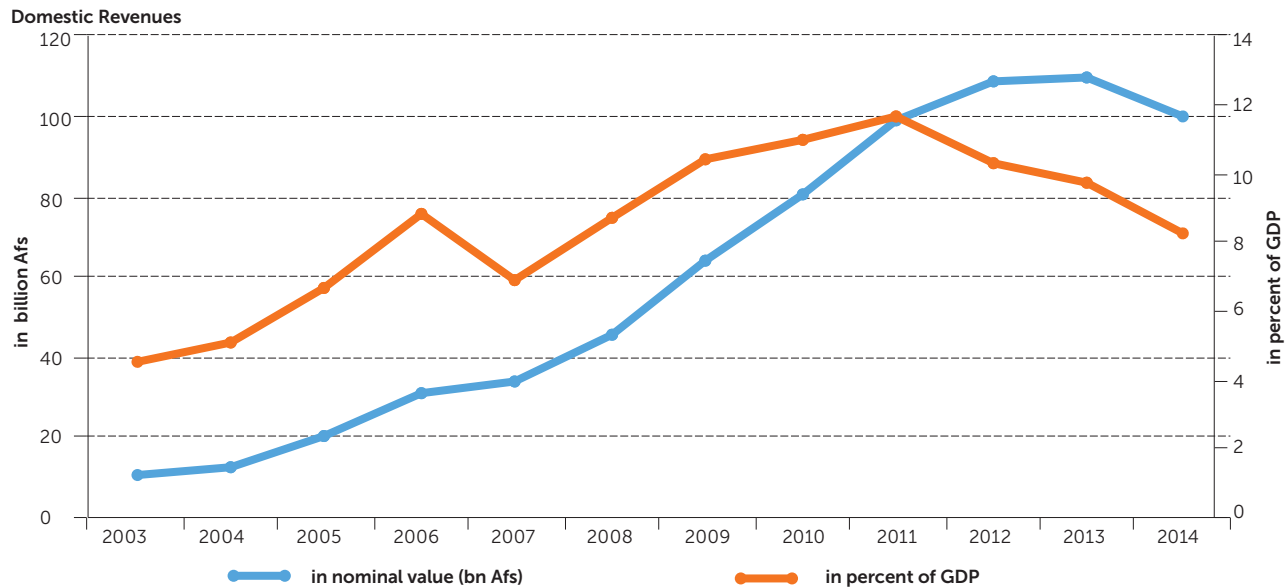
**The agricultural harvest in 2014 was strong for the third year in a row, but was up only marginally from the bumper year of 2012.** Agriculture growth (estimated at 1.9 percent in 2014, compared to -0.2 percent in 2013 and 18.2 percent in 2012) benefited in large part from robust cereals production, thanks both to well distributed, timely rainfall and an increase in irrigated area for wheat cultivation. Opium production (not part of estimated GDP) grew strongly in 2014 for the second year in a row, although the farm-gate price of opium declined by 20 percent. The total farm-gate value of opium was about \$850 million or about 4 percent of GDP, although the export value of opiates is likely twice as large.

**Afghanistan is in the midst of a fiscal crisis, with declining revenues leading to an unfinanced fiscal gap in 2014.** Domestic revenues fell from a peak

Growth of real GDP and sectors







of 11.6 percent of GDP in 2011 to 8.4 percent in 2014, because of the economic slowdown and weaknesses in tax and customs enforcement. The decline in revenue collection took place across all sources, including tax revenues, customs duties, and non-tax revenues. As a result, in spite of measures to restrain expenditures, the authorities faced a financing shortfall of about \$500 million in 2014, managed by drawing down cash reserves, accumulating arrears, and exceptional donor assistance. The authorities curtailed civilian operations and maintenance (O&M) and discretionary development expenditures, which were both lower even in nominal terms in 2014 compared to 2013. However, overall expenditures increased in 2014 because of higher security and mandated social benefit spending. These fiscal trends raise serious concerns about development outcomes going forward.

**Consumer price inflation dropped in 2014 as both food and non-food inflation softened.** Period average inflation was recorded at 4.4 percent in 2014 compared to 7.7 percent in 2013. The exchange rate remained stable during 2014, depreciating by only 2.4 percent vis-à-vis the US dollar as aid flows financed the large trade deficit.

## Outlook

**The growth outlook for 2015 remains weak.** Continued uncertainty and sluggish reforms mean that investor and consumer confidence show no signs of picking up before the second half of the year. The national



unity government is yet to deliver significant economic reforms and parliamentary elections are scheduled for 2015. Furthermore, unfavorable weather conditions point toward a contraction in agriculture. Growth is projected at 2.5 percent in 2015 and about 5 percent during 2016-18. The post-transition growth outlook is contingent on a relatively stable political and security environment and progress in key reforms, with agriculture and services likely to be among the key drivers, and extractive industries playing an increasing role in the medium term.

## Afghanistan

	2010	2011	2012	2013	2014	2015p	2016p	2017p	2018p
Nominal GDP (billion US\$)	15.9	17.9	20.5	20.3	20.8	22.2	24.1	26.0	28.2
Real GDP growth (%)	8.4	6.1	14.4	3.7	2.0	2.5	5.0	5.1	5.3
GDP per capita (US\$)	561	616	689	665	666	693	735	778	825
CPI inflation (period average, %)	7.7	10.2	6.4	7.7	4.4	5.0	5.5	5.0	5.0
Population (millions)	28.4	29.1	29.8	30.6	31.3	32.0	32.7	33.5	34.2
<b>In % of GDP, unless otherwise noted</b>									
Domestic revenues	11.0	11.6	10.3	9.7	8.4	9.3	9.8	10.5	11.6
Donor grants	12.0	11.3	13.0	14.5	15.1	17.4	18.3	19.8	21.0
Total core expenditures	21.1	23.3	23.8	24.7	26.0	29.2	30.1	32.6	35.1
Overall fiscal balance (after grants)	1.9	-0.4	-0.5	-0.5	-2.5	-2.5	-2.0	-2.3	-2.5
Trade balance	-45.9	-42.0	-41.9	-40.8	-38.2	-37.0	-36.1	-35.3	-33.4
Current acct balance (incl. grants)	3.1	3.5	4.2	3.7	5.1	1.3	-0.9	-2.2	-2.5

**In light of the fiscal crisis, restoring fiscal stability will require accelerating revenue enhancing reforms, additional discretionary assistance, and prioritizing expenditures.** The government began 2015 with a weak cash reserve position (\$150 million) and significant arrears (around \$200 million). Reforms to improve revenues continued to stall through the first three months of 2015 and a long delayed VAT appears to have been delayed for another three years. Afghanistan thus faces a financing gap in 2015 that is as large as last year, against the backdrop of a weaker cash position. This would thus require additional discretionary assistance and expenditure prioritization to mitigate impact on development outcomes. In the medium term, contingent on improvements in tax and customs administration and additional tax measures, revenues are projected to improve from 8.4 percent of GDP in 2014 to 11.6 percent by 2018.

### Challenges

**The new government of Afghanistan faces the dual challenge of restoring confidence in its economic prospects and addressing formidable medium term development challenges.** Afghanistan faces the challenge of creating jobs for 400,000 new entrants into the labor force each year in the face of declining international assistance. Furthermore, fragility and conflict remain pervasive. Addressing these challenges will require reforms from the new government in three areas: (i) restoring fiscal stability; (ii) restoring confidence and creating private sector jobs; and (iii) strengthening social cohesion and service delivery. Above all, high level commitment to tackle corruption and strengthen governance across the board will be critical to delivering on the success of reforms in these priority areas.

# Bangladesh

*Supply chain disruptions across the country due to political unrest dampened growth prospects. Buoyant imports and weak exports pushed the external current account into deficit but foreign exchange reserves continue rising. Undershooting of development expenditures and reduced subsidies have kept fiscal deficit in check despite revenue shortfall. The banking system remains vulnerable. With political stability, growth in the near-term is expected to recover underpinned by strong domestic demand, some improvement in the investment climate and continued macroeconomic stability.*

## Recent Developments

### FY15 growth is expected to be around 5.6 percent.

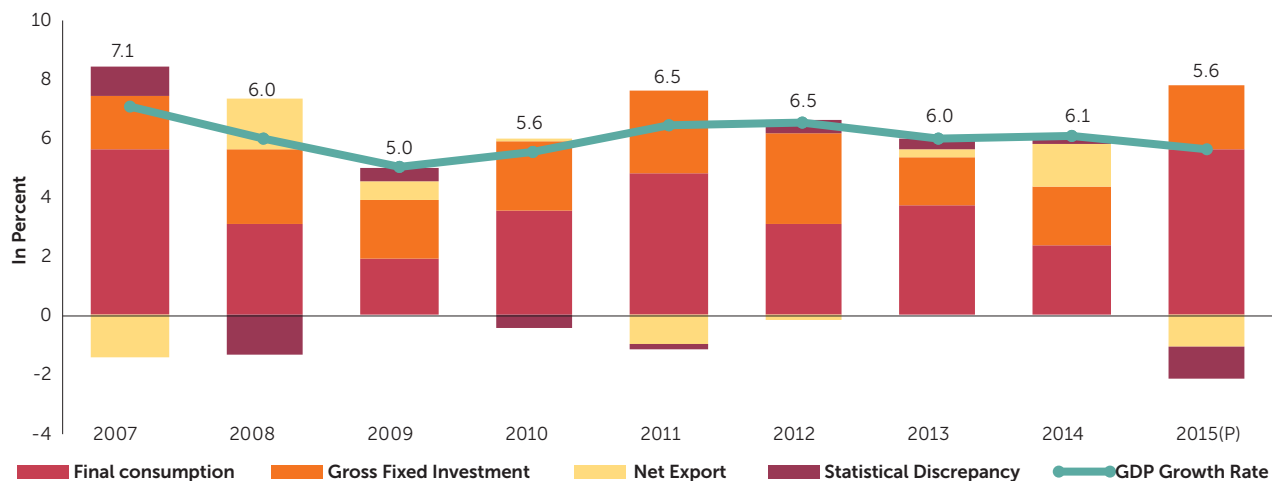
The economy benefitted from sustained political stability in 2014. Private consumption, imports and public investment grew faster in the first half of FY15 than a year earlier. However, a resurgence of political unrest since January 5, 2015 has taken a heavy toll on economic activity, in particular the services sector, agriculture, exports, and non-formal sector. Inter-district transportation has been disrupted, affecting domestic supply chains. Private investment has stagnated since FY12 due to growing political uncertainty and inadequate progress in addressing the structural constraints, particularly in providing land, transport, and energy.

**External balances remain comfortable despite weak export growth and strong imports.** Weak 2.1 percent

export growth reflected the adjustment of the garment industry to stricter labor and safety standards and weak external demand. Remittance growth rebounded. However, the current account moved to a \$1.3 billion deficit during July-January, FY15, compared to a \$2.5 billion surplus during the same period of the preceding year. Foreign exchange reserves surpassed the \$23 billion level by end-February 2015, equivalent to more than 5 months of imports. Foreign exchange intervention by BB to keep the \$/taka rate relatively stable has resulted in a 17.6 percent appreciation of the taka against the euro so far and a sustained appreciation of the real effective exchange rate.

**The banking system is vulnerable.** Overall, the financial sector is still shaky because of limited actions to improve corporate governance and accountability. The sector remains vulnerable to potential term shocks and economic slowdown.

Contribution to Annual GDP Growth



Source: World Bank

## Bangladesh

	2012	2013	2014	2015 (P)	2016 (P)	2017 (P)
Real gross domestic product	6.5	6.0	6.1	5.6	6.3	6.7
Private consumption	4.1	5.1	2.7	7.3	6.7	8.0
Government consumption	3.1	5.8	11.9	14.3	19.7	20.1
Gross fixed capital investment	10.6	5.4	6.4	7.4	12.0	12.1
Change in Inventories, % contribution	0.0	0.0	0.0	0.0	0.0	0.0
Statistical discrepancy, % contribution	0.4	0.4	0.3	-1.1	0.0	0.0
Exports, goods & services	12.5	2.5	6.3	7.0	8.2	10.1
Imports, goods & services	10.5	1.2	-0.9	11.2	20.2	22.9
GDP, at market price	6.5	6.0	6.1	5.6	6.3	6.7
Agriculture, % contribution	0.5	0.4	0.5	0.9	0.9	1.0
Industry, % contribution	2.5	2.6	2.3	1.0	1.9	1.8
Services, % contribution	3.4	2.9	3.0	3.0	3.5	3.7
Output Gap	-0.5	-0.7	-0.6	-0.8	-0.3	0.7
Inflation (Household Consumption Deflator)	9.9	6.8	7.5	7.0	7.1	7.2
Current account balance, % of GDP	-0.3	1.6	0.9	-0.5	-0.3	-0.7
Fiscal balance (excluding grants), % of GDP	-3.5	-3.9	-3.7	-3.5	-3.4	-2.8

Source: Bangladesh Bureau of Statistics and WB staff projection

**Fiscal prudence has continued.** The fiscal deficit is projected to remain 3.5 percent of GDP in FY15. Politics related disruptions and weak domestic economy led to shortfall in tax revenue collection relative to target in FY15. Expenditures have remained contained, helped by lower fuel subsidies with domestic fuel prices unchanged. Time and cost overruns continue to plague the implementation of development projects. Along with a steep rise in nonbank financing, undershooting of expenditure target has kept net bank credit to the central government in negative territory.

**Inflation is contained.** Inflation (y-o-y) declined to 6.1 percent in February 2015, compared with 7.4 percent in February 2014, driven mainly by a good rice harvest and lower global prices. Nonfood inflation showed greater volatility in recent months within the 5.5 to 6.5 percent range. Cautious monetary policy helped limit inflation volatility.

## Outlook

**Outlook for the near term is mixed.** Assuming sustained political stability, Bangladesh's strong domestic

demand base, gradually improving investment climate, and continued macroeconomic stability are expected to raise GDP growth to 6.3 percent in FY16, enabled by large investment in infrastructure and energy. Recovery in export growth and private investment is expected to boost aggregate demand while contributing to capacity creation. However, with rising imports boosted by private investment and export growth, the current account deficit is projected at 0.7 percent in FY17 after dropping to 0.3 percent in FY16 because of decline in oil import bill.

**Fiscal deficit is projected to remain stable at 3.4 percent of GDP in FY16 before declining to 2.8 percent in FY17 when the revenue impact of the implementation of the new VAT law kicks in.** The central government's debt-to-GDP ratio is projected to remain on a downward path with a low risk of debt distress.

**Monetary policy stance in the near term will remain restrained.** It will provide space for lending to activities which support investment and inclusive growth. BB's Monetary Policy Statement for January-June 2015 BB plans to limit broad money growth to 16.5 percent, while aiming to raise private credit growth to 15.5 percent. A tighter monetary policy may be warranted





if non-food inflation resumes an upward trend due to demand pressures. Taka should be allowed to depreciate if market forces push it in that direction.

## Challenges

**Domestic factors dominate the risk to the near term outlook.** The central risk is the prolongation of political instability. There are also concerns about financial sector vulnerability. These have potential fiscal implications. A protracted depreciation of the Euro could hurt exports, compounding the weaknesses due to real exchange rate appreciation. Even though international financial linkage is growing, Bangladesh's vulnerability to global financial volatility remains small.

**Growth remains below what is needed for Bangladesh to be in a comfort zone of middle-income by**

**2021.** The average annual GDP growth rate needs to rise to 7.5-8 percent to accelerate the pace of poverty reduction through the creation of more and better jobs in the domestic economy. This will have to be coupled with increases in female labor force participation rate to cushion the shrinkage in the demographic dividend due to declining rate of growth of working age population.

**The biggest, though not the only, challenge in increasing investment and female labor participation is ensuring durable political stability.** In addition, Bangladesh needs to make faster progress on easing barriers to women's participation in economic activities, establishing special economic zones; pay adequate attention to the private sector regulatory environment; improve the functioning of land markets to ensure the availability of land for manufacturing enterprises outside SEZs; and address the transport problem.

# Bhutan

*Growth rebounded in 2014 along with the lift of restrictions over credit and imports and with hydropower investment back on schedule. Bhutan's significant dissaving is illustrated by a large current account deficit. Priority will have to be given to private sector development and asset diversification if Bhutan wants to reduce its vulnerability to donor finance and address rising youth unemployment.*

## Recent Developments

**GDP growth in 2014 is estimated to 5.2 percent, after reaching a bottom low 2.05 percent in 2013.** Restrictions on credit, foreign exchange and imports put in place in 2013 to address the shortage of Indian Rupees were removed in July and August 2014 and replaced by more market friendly measures on credit and higher taxes to curb domestic demand. Additional drivers of growth in 2014 include hydropower construction back on track after the 2013 delays due to geological disruptions, the five-year plan implementation now in full swing and a record level of tourists following a special offer to Thailand over the low season of June-August. On the demand side, private consumption, supported by an increase in wages, is estimated to have grown by 6.6 percent. Growth of gross capital fixed investment is estimated to 22.4 percent, masking an even larger increment in the hydropower sector. Investment elsewhere has contracted, against the background of lagging investment climate reforms. Export earnings grew at 12.9 percent, supported by tourism expansion.

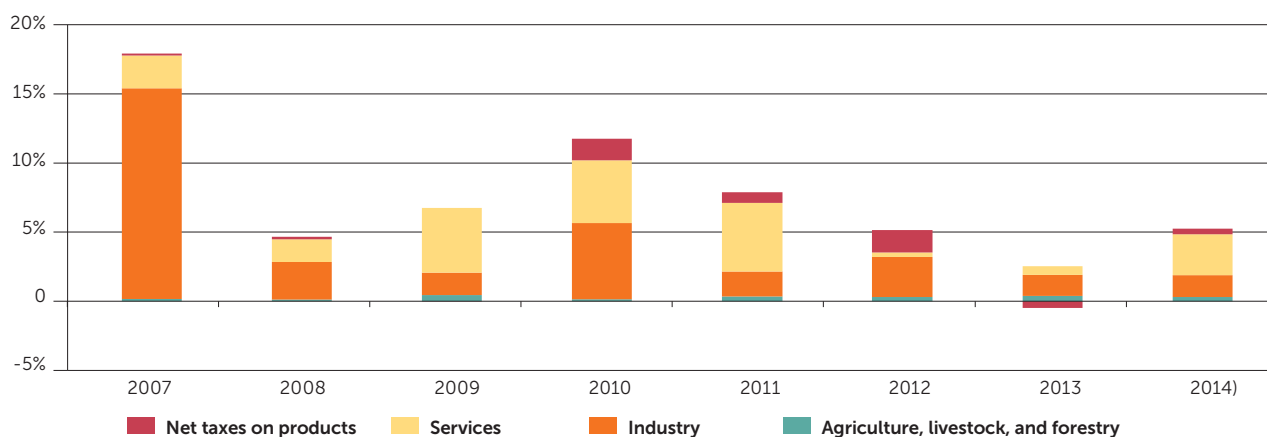
**The fiscal balance in FY14/15 is budgeted to remain balanced at 0.2 percent of GDP.** Civil service wages and allowances were increased by 19 to 23 percent respectively but the impact on spending is expected to be offset

by a reduction in other current and capital expenditures. Domestic revenues as a share of GDP have declined over the last three years, from 22 percent to an estimate of 18.9 percent in FY14/15, while grants finance about 27 percent of total spending, 70 percent of which is from India. Bhutan's public and publicly guaranteed external debt stood at 95 percent of GDP by end-2014, two thirds of which are from commercially profitable hydro projects. Domestic debt is limited to 5 percent of GDP.

**Bhutan runs a large current account deficit (estimated at about 25 percent of GDP in 2014/15), to which the hydropower sector contributed a third.** It is essentially financed by donor resources, of which India contributes the most through loans and grants to finance hydropower development. Foreign direct investment finances a low 8 percent of the capital account. International reserves had built up to US\$ 1196 million by November 2014, reflecting prudent management.

**Consumer price inflation in Bhutan has slowed to 6.3 percent in January 2015 from 11.3 percent at the end of 2013.** This decline was mainly driven by the decline in oil prices and India's easing of inflation (Bhutan has a fixed exchange rate with India from which it imports the majority of its consumption).

## Contributions to Annual GDP Growth



## Bhutan

	2012	2013	2014e	2015f	2016f	2017f
<b>Real gross domestic product</b>	5.1	2.0	5.2	6.7	5.9	6.0
Private consumption	5.0	12.7	6.6	6.6	6.6	6.6
Government consumption	-0.8	-9.6	22.4	7.5	5.8	5.7
Gross fixed capital investment	2.9	-26.2	2.6	19.7	13.8	-0.7
<b>Change in inventories (% contrib)</b>						
Statistical discrepancy (%GDP)	7	6	14	7	6	7
Exports, goods and services	-1.2	7.4	12.9	8.4	5.1	7.9
Imports, goods and services	-6.1	1.6	18.2	5.9	9.4	3.6
<b>GDP, at market prices</b>	5.1	2.0	5.2	6.7	5.9	6.0
Agriculture	2.3	2.9	2.3	2.6	1.8	1.8
Industry	6.8	3.5	3.6	6.5	5.8	5.6
Services	0.9	1.7	7.9	8.0	6.9	7.0
Output gap	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
CPI inflation, period average	9.5	11.3	6.3	6.0	6.0	6.0
Current account balance (%GDP)**	-21.7	-26.1	-25.9	-24.1	-26.5	-28.5
Fiscal balance (%GDP)**	2.0	-1.6	0.6	0.2	-0.3	0.2

Notes: e: estimates; f: forecasts; \* In annual percentage change percent, unless otherwise noted; \*\* Fiscal years (e.g. 2014 is 2013/2014). Sources: National Statistical Bureau, Royal Monetary Authority, Ministry of Finance, World Bank staff forecasts

## Outlook

**2015 economic activity is expected to gain momentum, driven by new hydropower construction and innovative tourism measures (“Visit Bhutan 2015”).** Agriculture is projected to grow at its low historic rate of 2 percent. This boost in economic activity could risk a resumption of overheating and macro imbalances. GDP will remain around 6 percent in the years after. Domestic demand will be driven by hydropower investment and, to a lesser extent, government consumption. Consumer inflation will closely follow India's tracks.

**The current account deficit is expected to continue growing over the next years, driven by hydropower projects in their construction phase.** The current account deficit outside the hydropower sector is forecasted to remain stable, supported by a robust growth in the tourism sector. Fiscal policy is assumed to remain in balance, supported by donor grants, with current spending contained, and capital spending following the patterns of the five-year plan disbursements. The revenue effort should weaken slightly, unless new measures to strengthen the tax base and limit the many exemptions and holidays are introduced. With moderate growth, poverty is expected to decline further, slowly shifting from rural to urban, along with migration.

**The risk of Bhutan's external debt distress continues to be moderate.** This is based on the commercial viability

of the hydropower projects, the risk-sharing agreement with India for hydropower loans, Bhutan's strong track record of project implementation, rapid growth in energy demand from India, committed donor support, and Bhutan's high level of international reserves.

## Challenges

**The outlook is positive but macroeconomic pressures on domestic demand will have to be managed.** Hydro-power projects coming on line in 2018 and 2019 will provide the much needed domestic resources to finance the -- fiscal and external current -- twin deficit. However, the extent to which this relief will be lasting depends on whether hydropower rents will be used to diversify the country's economic assets. Similarly, shared prosperity will depend on the ability of the economy to provide jobs to the educated youth whose aspirations increasingly differ from existing employment opportunities.

**While debt risk is still moderate, the rapid-build-up over the recent years' cautions against any additional non-concessional borrowing, given that Bhutan's debt carrying capacity will only improve in the long run reflecting significantly higher electricity exports when hydropower projects come on stream.** Efforts to deepen the financial sector will need to be sustained to provide the country the basis for financing sound and sustainable development and diversification

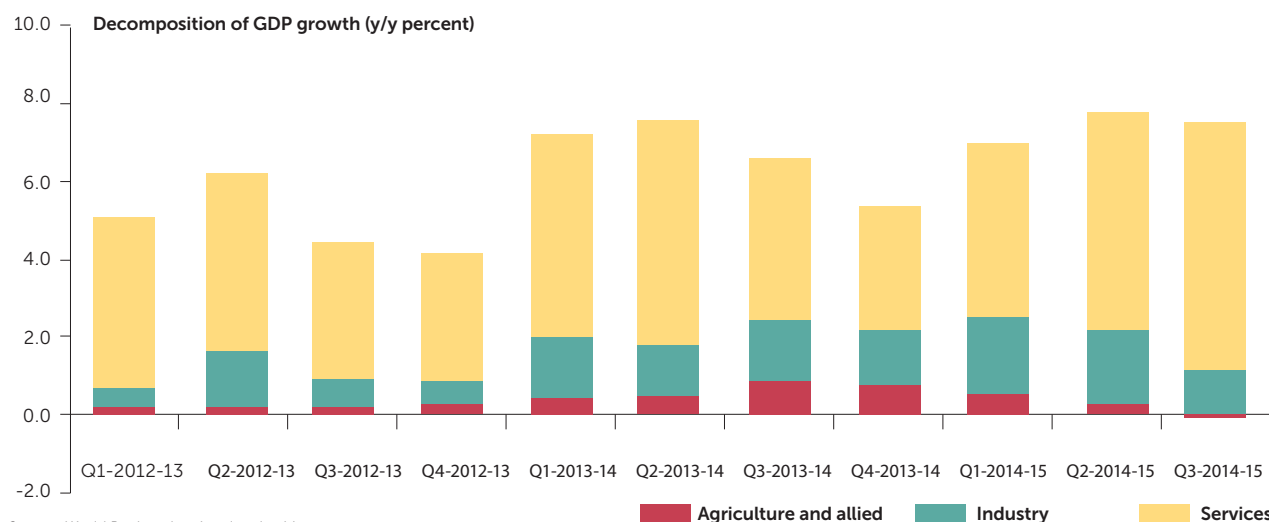
# India

## Recent Developments

Indian economy has taken strong strides towards higher and more inclusive growth. Recent economic activity has been on an upturn--growth has accelerated, inflation has declined, current account deficit has narrowed, and external buffers have been replenished. When evaluated on a longer-term horizon, growth has been inclusive and is correlated with a sharp decline in poverty during the last decade.

**GDP growth accelerated to 7.4 percent (at market prices) during the first three quarters, after being subdued at an average of 6 percent for the last eight quarters.** On the production side, growth was driven by services, which outperformed manufacturing. On the expenditure front, growth was driven largely by consumption, with modest contributions from investment and exports. Public and private sector investments suffered as many projects were held up, due to lack of timely regulatory clearance; land acquisition and inadequate access to finance.

**Underpinned by an unanticipated decline in food and oil prices – inflation moderated, public subsidies declined, and external balances improved.** Inflation pressures eased primarily on account of moderating food prices and generated some room for monetary accommodation – the Central Bank lowered policy rates twice in the current quarter. Simultaneously, an unanticipated decline in global crude prices bode well for India's current account balance; driven largely by a sharp decline in merchandise imports. Public finances also benefitted as declining global crude prices allowed for a significant reduction in fuel subsidies and a complete deregulation of diesel prices in October, 2014. However, the government slowed down the pace of medium term fiscal consolidation to make room for “infrastructure investment”, aiming to reduce the deficit to 3 percent of GDP in the next three years, instead of two, as was proposed in the previous budget.





## Outlook

**India's economy is poised to accelerate on the back of an ambitious reform agenda, and faster growth is expected to further drive down poverty.** Real GDP growth (at market prices) is expected to accelerate to 7.2 percent in 2014-15, accelerating to 7.6 percent in 2015-16 and 8.0 percent in 2017-18. If the past growth experiences are sustained, then the poverty rate is projected to decline to 15.5 percent by 2016, on back of higher growth projections. The outlook for the Indian economy is underpinned by two main trends: (i) contained crude oil prices, and (ii) a reform program which, if fully implemented, can unlock investment and boost TFP growth. Higher production capacity, commensurate with accumulating capital and increase in factor-productivity, and continued but targeted fiscal consolidation will help curb domestic and external imbalances in the face of rising domestic demand in the medium-term.

**Acceleration in real GDP growth will be driven largely by higher investments, which are expected to grow at an average of 12 percent during 2015-2017.**

Three broad measures have been taken to kick-start investments: (i) boosting direct budgetary support for infrastructure; (ii) executive action to expedite stalled critical projects; and (iii) legislative action for reducing commercial disputes in public contracts. Much of the pickup in output will be reflected in an expansion of the industrial sector in response to several reforms measures, which could improve the business environment and ease regulatory constraints, such as introduction of GST, single window clearance for registration, and

land acquisition reforms. The Union Budget for 2015-16 also presented a medium-term vision focused on unlocking private investment, improving the delivery of social benefits, and enhancing fiscal federalism by devolving more resources and more spending discretion to the states.

**Inflationary pressures are likely to ease gradually on account of lower crude prices, and an improved production capacity will prevent overheating in the medium-term.** The central bank's new inflation targeting stance is likely to further boost credibility of medium-term inflation of ~5 percent. The current account deficit is expected to narrow in the near-term due to lower value of crude imports (which account for more than one-third of total merchandise imports); but widen somewhat to meet the capital goods and investments requirements of the economy.

## Challenges

**Multiple downside risks suggest caution and highlight the importance of vigilance in implementation.**

On the external front, major risks stem from: low growth of India's key sources of trade, investment and remittance flows; and a possible increase in oil prices. On the domestic front, the most significant risks to the outlook are related to the implementation of the Government's ambitious and wide-ranging reform program. Effective policy implementation on many challenging fronts will be necessary to realize the meaningful and sustainable increase in investments embodied in the baseline scenario.

**Table India**

	2012	2013	2014f	2015 f	2016 f	2017 f
GDP, at constant market prices	5.1	6.9	7.2	7.5	7.9	8
Private consumption	5.5	6.2	6.1	7.4	8.5	9.0
Government consumption	1.7	8.2	8.6	8.7	8.0	7.5
Gross fixed capital investment	-0.3	2.9	4.0	9.0	12.0	13.0
Change in inventories, % contribution	-0.1	-1.8	0.5	0.4	0.1	-0.1
Exports, goods & services	6.6	7.2	0.5	6.3	7.5	8.5
Imports, goods & services	5.9	-8.4	-0.4	9.1	13.0	15.0
GDP, at constant factor prices	4.9	6.6	7.1	7.5	7.9	8.1
Agriculture	1.7	3.9	1.2	2.1	2.8	2.8
Industry	2.3	4.4	5.0	5.5	6.1	6.4
Services	7.9	9.1	10.6	10.5	10.5	10.5
Inflation (Household Consumption Deflator)	9.4	8.5	8.1	6.8	6.1	5.2
Inflation (Consumer Price Index)	9.7	10.7	6.7	..	..	..
Current account balance, % of GDP	-4.8	-1.8	-0.7	-0.9	-1.7	-2.7
Fiscal balance, % of GDP	-7.2	-6.8	-6.7	-6.1	-5.6	-4.7

# Maldives

*Economic growth continued its recovery from the 2012 dip, while inflation has slowed down, although recent political developments present a downside risk. The dominant tourism industry is operating on an enclave model of development, while fisheries, with largest share of employment, is only weakly linked. The challenges are fiscal and external imbalances driven by large and rising public spending leading to high debt, limited fiscal space and depleted reserves, and an undiversified economy, which primarily depends on tourism and fisheries.*

## Recent economic developments

Economic growth in 2014 is estimated to amount to 5.0 percent,<sup>1</sup> continuing the recovery in growth since hitting 1.3 percent in 2012. This is lower than the government's provisional full-year estimate of 6.8 percent, which was published in October. The main determinant of this estimate is the sharp slowdown in the growth in tourism bed-nights in November and December 2014, partly caused by the water crisis in Malé. Most other service sectors are estimated to have grown as well in 2014, while the industrial sector expanded by 13.2 percent in 2014. However, the agriculture and fisheries sector is estimated to have contracted by 2.1 percent in 2014 vis-à-vis a growth of 5 percent recorded in 2013.

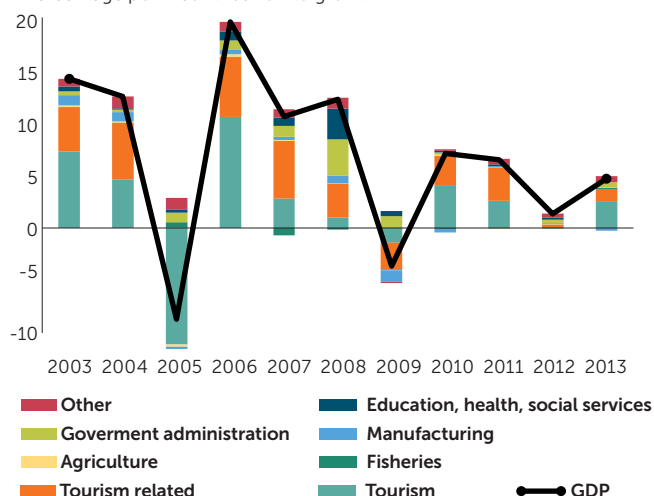
1 Data for 2014 and projections are in line with the projections in the joint Bank-Fund LIC-DSA and the IMF Article IV of January 2015; World Bank staff estimates.

Annual average inflation moderated even further in 2014, falling to 2.4 percent in 2014, down from 4.0 in 2013 driven by low food prices and international crude prices. The fall is particularly steep considering the double digit 10.9 percent inflation recorded only in 2012. As measured by the overall consumer price index (CPI) inflation in Malé has been unstable since 2009 with fluctuations large in magnitude. This decline was primarily driven by a slow growth of food and non-alcoholic beverages which grew at a slow pace of 1 percent in 2014 as opposed to 7.5 percent in 2013. During the second half of 2014, inflation fell even further driven largely by the drop in food prices.

In 2014 the fiscal deficit widened further to projected 11.6 percent of GDP in 2014. Despite high revenue of 32.4 percent of GDP, Maldives is spending beyond its means reaching 44 percent of GDP, leading to persistent fiscal imbalances. Driven by expenditure the

Sectoral contributions to growth

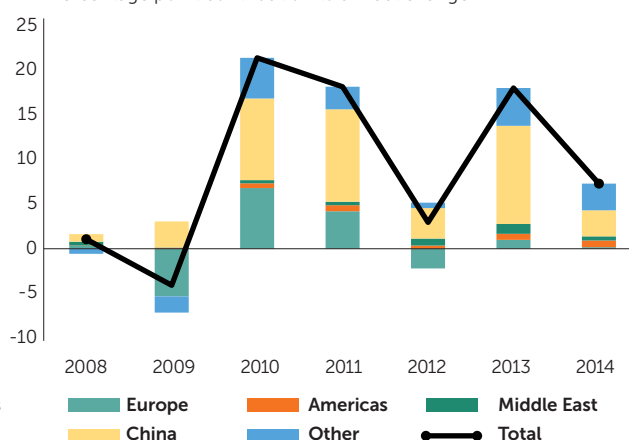
Percentage point contribution to growth



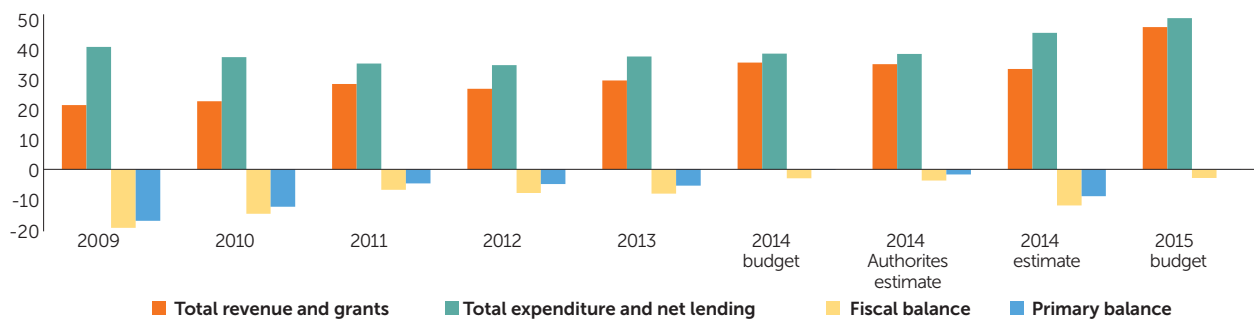
Source: National Bureau of Statistics, MMA, staff calculations

Drivers of change in tourism arrivals

Percentage point contribution to annual change



Fiscal accounts, actuals, budget and estimates  
Percent of GDP



fiscal deficit has been on an upward trajectory since 2011 and is estimated at 11.6 percent of GDP in 2014 from 7.8 percent of GDP in 2013, despite a budgeted deficit of only 2.8 percent of GDP. Subsidies, transfers and social welfare payments contributed substantially to the expansive spending. It should be noted that the authorities project the fiscal deficit in 2014 at only 3.4 percent of GDP.

**Although the country's risk of external debt distress has been reduced from high to moderate, overall public debt is high at 74.6 percent of GDP in 2014, and subject to vulnerabilities.** Meanwhile, the persistent current account deficit has led to an increasing level of external debt. Thanks to data revisions and a more favorable outlook, the country's risk of external debt distress has been reduced from high (2013 DSA update) to moderate. Although the level of external public and publicly guaranteed debt remains below the policy-dependent thresholds under the baseline, a shock to tourism exports could make it difficult for the country to service its external debt.

**The external accounts look much better thanks to a revision of balance of payments numbers.** Goods imports and tourism services exports nearly balance each other out, but substantial outflows through interest payments, dividends and remittances keep the current account in a deficit at 8.0 percent of GDP. The current account is more than fully financed by Foreign Direct Investment (FDI), and gross international reserves are estimated to have increased. Net FDI inflows are estimated at 13.3 percent of GDP.

**While usable reserves are estimated at less than half a months of imports, the private sector is able to supply sufficient quantities of foreign exchange.** As a result of the large improvement in net capital inflows, gross official reserves have increased from USD 368 million at end-2013 to USD 614 million at end-2014,

covering 2.8 months of imports of goods and services. However, net usable reserves remain low at USD 120 million, covering less than a month of imports. Faced with limited investment opportunities in the private sector, banks are parking their assets elsewhere; meanwhile financial soundness indicators have been improving

## Outlook

**Going forward growth is projected to remain at 5 percent in 2015, supported by tourism arrivals, while additional fiscal adjustment may have a negative impact on growth.** The 2015 budget foresees an ambitious fiscal consolidation mostly by increasing one-off revenue and planning a fiscal consolidation. Inflation is projected to remain subdued as global commodity prices are expected to remain low. Lower commodity prices will also benefit the current and fiscal accounts.

**Domestic and external risks remain.** Recent political developments may lead to travel advisories and reductions in tourism. The country remains vulnerable to external shocks, especially to tourism and global commodity prices. SOEs may pose further risks to fiscal sustainability, as most are loss-making and depend on government support, with only nine companies having contributed dividends to the budget in the last four years.

## Challenges

**The immediate macroeconomic challenge is the fiscal and external imbalances driven by high and rising public spending.** However, the economy also remains undiversified and sources of growth and employment remain misaligned. Besides, Maldives' form of tourism-led growth has followed an enclave model, reliant on imported goods, labor and finance.

# Nepal

*Development progress remains tributary –to a large extent– to exogenous factors, namely: weather patterns driving agricultural performance and remittance flows supporting domestic consumption and services sector activity. Public investment bottlenecks and the related infrastructure deficit (energy, roads, and irrigation) continue to constrain the productive potential of the economy, while political uncertainty undermines the environment for private investment. Despite an expected increase in recurrent spending and modest growth in capital spending, the budget is expected to remain in surplus largely thanks to high revenue growth and slower than planned capital budget execution. Inflation remains overwhelmingly determined by price trends in India and is thus projected to moderate in FY15 and going forward. External balances continue to be characterized by a widening trade deficit, though at a slower pace, essentially thanks to lower oil prices. Remittance inflows are expected to continue to make up for the gap, resulting in a significant current account surplus and accumulation of reserves. Excess liquidity in the financial system has eased as evidenced by the increase in the credit-to-deposit ratio of BFIs. Overall financial sector consolidation has continued to progress with improvements in CDR and NPLs. Main sources of uncertainty relate to: (i) political developments: though unlikely a breakdown of the constitutional drafting process could result in conflict and further depress investor confidence, and; (ii) the possible repercussion of falling oil prices on GCC demand for Nepali labor which could impact both consumption and financial sector stability via slower remittance growth.*

## Recent Developments

### FY15 growth is expected to be around 5 percent.

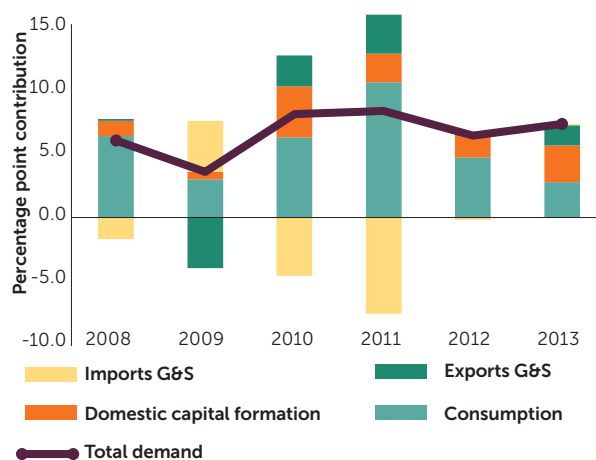
This moderate deceleration relative to FY14 is essentially on account (i) a 'base effect' following a very good FY14 performance (by historical standards), and (ii) lower agricultural output growth reflecting inclement weather during the peak planting season and limited investments in irrigation. On the expenditure side, the effect of slower remittance growth is expected to be counterbalanced by the impact of lower oil prices, while investment growth will continue to be constrained by (i) PIM and project implementation bottlenecks (public), as well political and policy uncertainty (private), especially in the hydro sector.

**External balances remain comfortable, despite weak export and strong import growth, thanks to lower oil prices and stable remittances.** Export value growth is expected to decelerate from a modest 5.4% in 2014 to 4.5%; however, import value growth is projected to moderate considerably, reflecting lower oil prices and the significant share of petroleum products in total imports. Though slowing down somewhat from FY14, remittance growth is expected to remain healthy at 9.8% offsetting the trade deficit and helping Nepal maintain a current account surplus equivalent to 4 percent of GDP (excluding grants). As a result, foreign

exchange reserves should continue to rise to over US\$7 billion, equivalent to 8.8 months of imports.

**Financial sector consolidation has continued to progress.** Excess liquidity in the financial system has considerably decreased from a surplus of NRs 60 billion at the end of FY14 to NRs 2 billion six months into FY15 reflecting increased loan disbursements, slower deposit growth and interventions by the NRB to mop up excess liquidity. The credit-to-deposit ratio increased to 85 percent by mid-FY15 from 80 percent a year before. At mid-year, major indicators of financial

Contributors to GDP Growth



Source: Central Bank of Sri Lanka



sector health were positive including: exposure to real estate loans (6%); NPLs (2.7%); CAR (11.3%).

**Fiscal policy remains consistent with macroeconomic stability, and in fact possibly too timid given the available fiscal space.** The budget is expected to remain in surplus in FY15 (for the third consecutive year), by over 1 percent of GDP. This reflects inter alia continued revenue collection growth, somewhat expanded current expenditures but constrained expansion of capital spending.

**Inflation is expected to moderate significantly.** Inflation averaged 7.3% in the first half of FY15 (down from 9.1% during the same period in FY14). The decline is mostly on account of a sharp slowdown in non-food inflation. Though the decline in global fuel prices has had no impact on inflation to date, the adoption of an automatic price adjustment mechanism is expected to lower prices in the second half of the year. As a result, and following trends in India, inflation is expected to moderate to 7.1 percent in FY15.

## Outlook

**The growth outlook for the near term is largely framed by supply side constraints.** With actual output at or possibly above potential and structural constraints to expanding the productive frontier of the economy, growth is expected to (i) remain in the 5-4.5% range over the near term (ii) be driven essentially by domestic consumption. On the supply side, the services sector is expected to continue to drive economic activity, with lackluster industrial growth (on account of energy constraints and labor market inefficiencies) and agricultural productivity growth constrained by low levels of investment in irrigation. While large hydro-projects may result in higher construction activity, significant lead times before exploitation begins means that production linkages will only materialize in the long run. On the demand side, domestic consumption enabled by remittances will continue to make the greatest contribution to output growth. Given the very modest export base, external conditions are unlikely to make a significant difference. Expected large investments in the hydropower sector may materialize but with limited positive (output, employment) spillovers initially and continued absorption capacity constraints will prevent a significant expansion of public investment.

**The budget is expected to remain in surplus over the near term, though declining gradually from 1.1% of**



**GDP in FY15 to 0.6% of GDP in FY17 as the expansion of spending gradually catches up with revenue growth.** Reflecting the limited financing needs of the GoN, public debt is to further decline to 22 percent of GDP by FY17 with Nepal remaining at low risk of debt distress.

**Slower remittance growth going forward, together with a deteriorating trade balance should gradually bring the current account surplus down: from 4 percent of GDP in FY15 to 0.4% (excluding grants) in FY17.**

**Inflation is expected to moderate significantly: reflecting both the overwhelming influence of price developments in India and the impact of lower fuel prices – as the automatic pricing mechanism allows prices of petrol, diesel and kerosene to reflect international prices.** Moreover, faced with the challenge of managing excess liquidity in the financial sector, the NRB is expected to maintain a relatively conservative stance and to make use of liquidity mopping instruments as needed. CPI inflation therefore is expected to moderate from 7.1 percent in FY15 to 6.1 percent in FY17.

**Short run outlook for prices and remittances bode well for poverty reduction and welfare of the bottom 40%.** The easing of prices of everyday commodities in particular will provide welcome respite to the urban



**Table: Nepal**

	2012	2013	2014	2015 (P)	2016 (P)	2017 (P)
Real gross domestic product (% contribution)	4.8	3.9	5.5	5.0	5.0	4.5
Private consumption	12.2	2.9	2.9	2.9	2.8	2.4
Government consumption	1.6	-0.8	1.8	2.1	2.4	1
Gross fixed capital investment	-1.1	2	1.6	1.5	1.7	1.8
Change in inventories	-7.1	3.9	3.7	3.8	3.3	0.8
Exports, goods & services	0.2	1.1	2.7	2.7	2.3	0.8
Imports, goods & services	1.3	5.2	7.2	8.1	7.6	2.3
Statistical discrepancy	0.2	0	0	0.1	0	0.1
GDP (factor cost)	4.6	3.5	5.2	4.6	4.6	4.1
Agriculture	1.6	0.4	1.5	1	1	0.9
Industry	0.4	0.4	0.4	0.4	0.4	0.4
Services	2.2	2.4	2.8	2.8	2.8	2.4
Inflation	8.3	9.9	9	7.1	6.4	6.1
Current account balance, % of GDP	4.8	3.3	4.6	5.8	3.8	2.1
Fiscal balance (Excluding grants), % of GDP	-0.6	2.1	2.2	1.1	0.9	0.6

Source: GoN Statistics and WB staff projection

poor who, as a group, have witnessed stagnating incomes and declining consumption in all occupation categories in recent years. Projections suggest a steady decline in poverty in the near term with the \$1.25/day PPP poverty incidence potentially reaching 15.6 in 2016.

## Challenges

**Risks to the near term outlook stem essentially from domestic factors.** After the failure of political parties to agree on the main parameters of a new constitution by the self-imposed deadline of January 22, there has been no progress and in fact greater polarization. A perpetuation of the current deadlock would (i) hamper legislative activity, and (ii) depress investor confidence

and perceptions of country risk. Though unlikely it could lead to sporadic unrest.

**A slowdown of growth in GCC countries could impact Nepal via remittances.** Though lower oil prices are unlikely to affect growth in GCC and the large infrastructure projects there are expected to continue as planned, any change affecting demand for Nepali labor could have significant economic repercussions.

**Growth remains below what would be needed for Nepal to achieve the target of graduating to MIC status by 2020.** For this annual GDP growth would need to reach at least 7 percent per annum. That said, remittances should continue to support disposable income growth and to drive down poverty incidence further.

# Pakistan

## Recent Development:

**Helped by cheap international oil prices and steady implementation of its reforms program, the economy has showed resilience.** Despite political uncertainty in H1-FY15 and the September 2014 floods in Punjab that affected agricultural crops, macroeconomic indicators have improved during ongoing FY15. Supported by a favorable slump in international oil prices, and stellar implementation of the IMF reform program reinforced by two Bank's Development Policy Credits at end FY14 to restructure the energy sector, foster private and financial sector developments and improve social protection and revenue mobilization; growth recovery remains underway, with projected GDP growth now at 4.4-4.6%.

**The external position is fragile but improving.** External current account deficit remains modest, at around 0.8% of GDP during H1-FY15 and on track to achieve about 1.2% of GDP by end-FY15. This outcome is supported by strong workers' remittances, which offset a chronically negative trade balance, a sustained decline in international commodity prices including oil, improved inflows in services account. Foreign exchange reserves held by central bank are considerably higher at \$10.5 billion, inducing stability in foreign exchange market

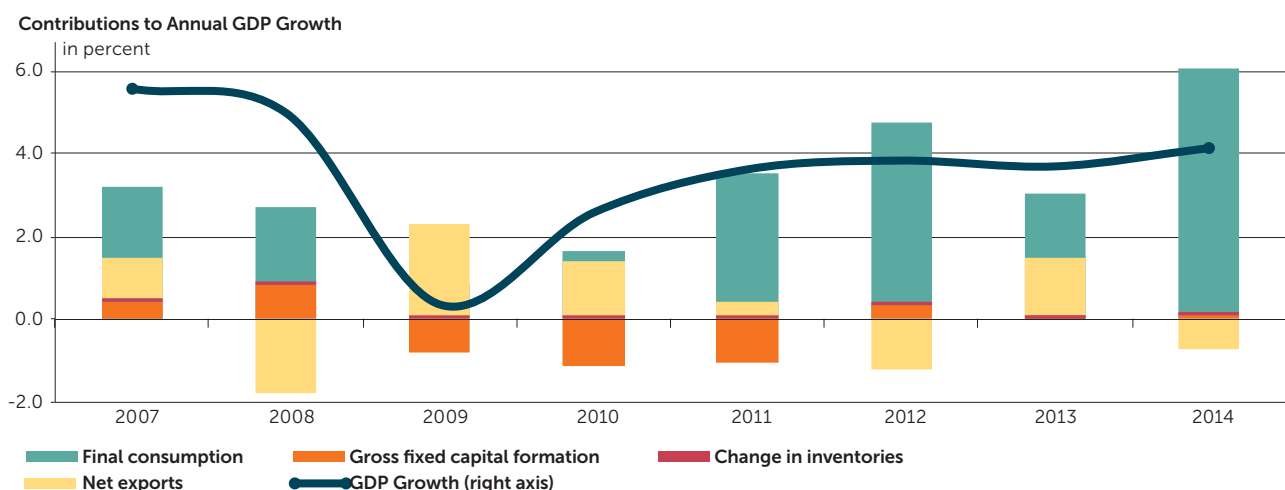
**The fiscal deficit is expected to be contained around 5% of GDP due to improved, but below target, tax collection, restricted current (especially power subsidies) and development expenditure, and small**

**provincial surpluses.** Federal tax collection growth is positive but slightly below target due to lower inflation and lower imported oil prices. On the expenditure side, much of adjustments are made on investment side. Public debt remains above the 60% of GDP, a ceiling imposed by legislation, but on a decreasing trend. Inflation is moderating. Average (12-m moving) CPI inflation remained in single digit, and hovering around 6.8% by January 2015 and expected to fall to about 5.5% at end FY15. Core inflation also softening.

**Pakistan's economic growth is showing signs of sustained recovery despite persistent energy constraints.** This is driven mainly by better harvest of cotton, wheat and rice crops, better performance in services and positive, albeit weaker than expected, manufacturing growth. Nevertheless energy constraints and weak external demand continue to pose challenge for growth outlook. On the demand side, growth continues to be driven by private consumption supported by growing worker remittances.

## Outlook:

**The medium-term framework FY15-18 projects gradual growth recovery-cum-low inflation, supported by fiscal consolidation and rebuilding of the external position.** This path assumes tackling of the key growth constraints: power load-shedding, cumbersome business environment, low access to finance and stable commodity prices. GDP growth is expected to



Source: Pakistan Economic Survey

## Pakistan

	2012	2013	2014	2015 f	2016 f	2017 f
Real gross domestic product	3.5	4.4	5.4	6.0	3.7	4.5
Private consumption	5.0	2.5	5.9	10.9	3.7	4.1
Government consumption	7.3	10.2	12.7	-10.7	4.7	3.8
Gross fixed capital investment	2.4	0.2	0.5	23.4	9.4	8.7
Change in inventories, % contrib	0.1	0.1	0.1	0.1	0.1	0.1
Statistical discrepancy (% GDP)	0.0	0.0	0.0	0.0	0.0	0.0
Exports, goods & services	-15.0	13.6	-1.4	5.1	8.9	7.3
Imports, goods & services	-3.1	1.6	3.7	31.8	11.8	7.3
GDP, at factor costs	3.8	3.7	4.1	4.4	4.6	4.8
Agriculture	3.6	2.9	2.1	3.0	3.1	3.3
Industry	2.5	1.4	5.8	5.7	6.1	6.3
Services	4.4	4.9	4.3	4.5	4.6	4.8
Output Gap	-2.5	-1.8	-0.2	1.6	0.8	0.9
CPI Inflation , period average	11.0	7.4	8.6	5.5	5.0	5.0
Current account balance, % of GDP	-2.1	-1.1	-1.3	-1.2	-1.2	-1.6
Fiscal balance, % of GDP	-8.4	-8.1	-4.7	-4.6	-4.2	-4.0

Note: a. Annual percentage change, b. Fiscal balance includes grants, f = forecast Source: World Bank.

recover to 5% in FY18 and onwards. On the supply side, growth is expected to be driven by the services and large-scale manufacturing sectors, which would benefit from decreased power load-shedding, improved business climate, and better availability of credit ensuing from fiscal consolidation. On the demand side growth will be supported by strong remittances, with strengthened private investment, renewed export dynamism, and to an increase in public investment. Inflation which is already below double digit since last two fiscal years is expected to settle around 5% by FY16 owing to continued fiscal prudence. Relatively steady international commodity prices and stable exchange rate are expected to help contain imported inflationary pressures.

**Fiscal consolidation is expected to continue in medium-term on the basis of effort to raise tax revenue, curtail subsidies, and while at the same time increase the spending for key public infrastructure and human resource development.** Revenues are projected to increase from 14.3% of GDP in FY14 to 15.4% in FY17 as a result a sound tax reform strategy. On the expenditure side, energy-related budgeted subsidies keep being reduced with power tariff adjustments, favored by the oil price windfall. The overall fiscal deficit will therefore decline from 5.5% of GDP in FY14 to 4.2% of GDP in FY17 and decline marginally thereafter.

**The current account deficit is expected to increase to 1.6% in FY17-- up from modest 1.2% of GDP in FY15.** Faster growth will require higher imports

(including oil) of raw materials. Export recovery and strong dynamism of remittances—despite some negative spillovers from lower oil prices in short to medium run on remittance catchment area of oil producing countries would keep financing the current account deficit in the medium term. Official foreign exchange reserves are expected to keep building from \$9.2 billion by the end of FY14, and projected to reach to \$15.4 billion (about 3.5 months of import coverage) by end FY15. It is expected that reserve build up will continue in medium term based on strong financial inflows.

### Challenges:

**The outlook is subject to downside risk.** First is the prospect of an early reversal of the fall in oil prices. Second are the replication of political events of the first semester that keep FDI flows and private investment low; which also affects foreign reserves, privatization program and growth prospects. An uncertain political environment undermines investor confidence and depresses economic activity. Third is the continuation of a troubled domestic energy sector that continues to endure a long-due complex inheritance on its circular debt. Its accumulation might affect the magnitude of the fiscal deficit. In the meantime, markets seem to underplay such risks. Pakistan's Emerging Markets Bonds Index Plus (EMBI+) risk spread keeps declining from the high levels 1,011 basis points in March 2013 to around 525 basis points as of December 31, 2015.

# Sri Lanka

*Sri Lanka has benefited from a peace dividend since the internal conflict ended in 2009. Sustained growth has contributed to a significant reduction in poverty; yet many pockets of poverty remain. Public debt is still high, fiscal revenue is low, and the external current account is in deficit. Much needs to be done in order to attract FDI, improve external sector competitiveness and arrest declining fiscal revenues.*

## Recent developments

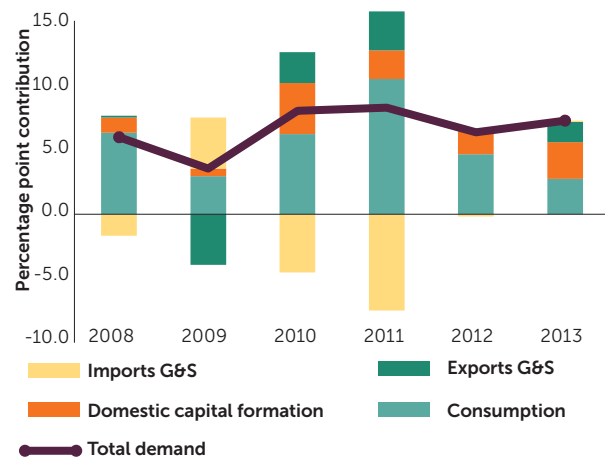
**Focus on election and constitutional reforms has not allowed much room for clarity on economic policies:**

Mr. Maithripala Sirisena emerged the victor in the January 2015 Presidential election. A cabinet minister under the previous ten-year strongman president, Mr. Sirisena left the governing party in late 2014 and contested from the opposition. After securing the victory, he appointed a new Premier and a Cabinet mainly from the opposition that helped him to win the election. Although the previous governing party still holds the majority in the parliament that could create fluid political situations, it has pledged the support to the new President's 100 day program<sup>1</sup>. The new government has announced that it would go for a parliamentary election by June 2015 to seek a fresh mandate.

**Growth remains high thanks to a peace dividend, but it is reliant on non-tradable sectors: Average growth stood at 7.5% for the period 2010-2013 reflecting a peace dividend and an aggressive policy thrust towards growth since the internal civil conflict ended in 2009.** The growth was mainly driven by non-tradable sectors and related investments. Indeed 50% of the total growth came from four non-tradable sectors during this period led by construction, transport and trade. The growth for 2014 is estimated at 7.4% y-o-y.

**Inflation remains benign mainly due to reduction of administered prices on fuel and energy: Inflation decreased to 2.1% in December 2014 compared to 4.7% in December 2013 on a y-o-y basis.** Annual Average inflation which followed a declining trend for 19 consecutive months reached 3.3% in December 2014 from 6.9% in December 2013. Downward revision of

Contributors to GDP Growth



Source: Central Bank of Sri Lanka

administered LP Gas prices and a few selected food items along with few rounds of reduction of taxes on fuel contributed significantly to the overall reduction.

**The current account deficit declined to 3.3% of GDP 2014 (est) compared to 3.9% in 2013 supported by strong tourism flows.** The deficit was financed by Foreign Direct Investment (FDI) flows of 1.9 percent of GDP; and government borrowings were more than adequate to cover the remainder. Gross official reserves strengthened to USD 8.2 billion, equivalent to 5.1 months of imports. The currency remained broadly stable with a marginal depreciation of 0.2 percent against the US Dollar for 2014.

**The budget deficit declined to 5.7% of GDP (est) in 2014 down from 5.9% recorded in 2013 thanks mainly to reduced interest cost in a low interest environment.** The government has been reducing expenditures in the face of persistently low fiscal revenues relative to GDP. Despite the deficit; with high growth rates and low average interest rates on debt, public debt is expected to have declined from 86.1 percent of GDP in 2009 to

<sup>1</sup> This program is intended provide relief to people, investigate alleged corruption under the previous regime and reform the existing powerful executive presidency.

75.5 percent of GDP while contingent liabilities in the form of treasury guarantees are estimated at 5.7 percent of GDP as of end 2014.

## Outlook and risks

**Growth is expected to decline to 6.9% y-o-y in 2015 due to deceleration of construction activities with the new government reassessing the investment-led growth model, partially set off by increased consumption thanks to increased public sector wages.** Inflation is expected to remain around 3.0%, as global commodity prices remain subdued and the taxes on key commodities are lowered.

**The fiscal deficit expected to narrow to 5.0% of GDP in 2015 thanks to proposed one-time revenue measures.** Going forward, measures are needed to increase revenues to avoid widening of the deficit in the wake of some populist proposals increasing costs on a permanent basis for 2015 and beyond. A slowdown in GDP growth might reverse the decline in the public debt-to-GDP ratio, which was largely dependent on fast GDP growth.

**The current account deficit is expected to narrow to 1.8% of GDP in 2015, reflecting savings on petroleum bill.** Exchange rate that came under depreciation pressure due to forex outflows in the first quarter of 2015 would likely to be managed using reserves in the next few months. A planned sovereign bond and other capital flows to the government would help mitigating pressures on the currency in the second half of the

year. Any upward pressure on oil prices could adversely affect the external balance. Tightening global financial conditions could lead to capital flight and debt roll-over could become expensive. Recent depreciation of Euro could affect competitiveness of exports given that Euro Zone is purchasing over 30% of Sri Lanka's exports.

## Challenges

**Fiscal revenue has been declining for the last decade, placing Sri Lanka among the lowest levels in South Asia, and below average for its income level.** This restricts the space for public investment and counter-cyclical policy.

**A persistent current account deficit is linked to structural issues in the export sector, which is in need of improved competitiveness and diversification.** Recent growth has been driven mainly by non-tradable sectors. Going forward, it will be difficult to sustain its high growth path without increasing growth in manufacturing and export sectors.

**With limited public and private national savings compared to national investment, Sri Lanka needs to attract FDI—in order to maintain its high growth rate.** However, Sri Lanka attracts less FDI than expected despite its geographic, education and infrastructure advantages. With the country on course to join upper middle income countries, concessional borrowing sources are drying up and are being replaced by borrowings on commercial terms, which could affect affordability.

	2012	2013	2014e	2015f	2016f	2017f
Real gross domestic product	6.3	7.3	7.4	6.9	6.6	6.5
Private consumption	6.8	3.6	7.4	6.9	6.6	6.5
Government consumption	-0.6	1.5	11.0	10.5	2.6	3.2
Gross fixed capital investment	10.7	9.1	9.5	14.8	12.6	12.4
Exports, goods & services	0.2	5.9	8.6	3.2	3.0	3.1
Imports, goods & services	0.5	-0.3	10.6	11.9	7.8	8.3
GDP, at market prices	6.3	7.3	7.4	6.9	6.6	6.5
Agriculture	5.2	4.7	0.3	3.5	3.5	3.5
Industry	10.3	9.9	11.4	8.7	7.6	7.5
Services	4.6	6.4	6.5	6.5	6.5	6.4
CPI Inflation, period average	7.6	6.9	3.3	3	5.3	5.5
Current account balance, % of GDP	-6.7	-3.9	-3.3	-1.8	-2.3	-2.6
Fiscal balance, % of GDP	-6.5	-5.9	-5.7	-5	-6.1	-5.9

Sources: Sources: CBSL, DCS, World Bank staff forecasts; Notes: e = estimate, f = forecast; 1/ In annual percentage change percent, unless otherwise noted





# South Asia at a glance

			AFG (1)	BGD (3)	BTN (6)	IND (9)	MDV (11)	NPL (12)	PAK (15)	LKA (17)	SAR (19)
BALANCE OF PAYMENTS	Real GDP Growth	2012	14.4	6.5	5.1	5.1	1.3	4.8	3.8	6.3	..
		2013	3.7	6.0	2.0	6.9	4.7	3.9	3.7	7.3	6.3
		2014	2.0	6.1	5.2	7.2 (p)	5.0 (est)	5.5	4.1	7.4 (est)	6.8
		Q3	..	..	..	8.1	..	..	..	7.7	8.0
		Q4	..	..	..	7.6	..	..	..	6.3	7.6
	Inflation (y-o-y %) (CY)	2012	7.2	6.5	3.4	9.7	10.7	9.4	9.7	7.5	8.5
		2013	7.6	7.5	8.6	10.7	3.6	9.0	7.7	6.9	7.7
		2014	4.6	7.0	8.2	6.7	2.1	8.4	7.2	3.3	6.8
		2015 Jan	0.7	6.0	6.3	5.2	0.1	..	3.9	3.2	3.9
		2015 Feb	..	6.1	6.3	5.4	..	..	3.2	0.6	5.4
	REER (CY)	2012	..	103.7	88.0	96.0	..	111.5	111.6	96.3	104.4
		2013	..	120.0	85.8	95.2	..	111.4	107.4	98.2	102.3
		2014	..	138.4	86.9	94.6	..	112.0	116.7	100.2	109.8
		2015 Jan	..	144.1	87.5	97.7	..	121.4	122.3	103.8	118.2
		2015 Feb	..	144.5	87.4	99.5	..	121.8	123.3	101.3	118.1
	Current Account (% of GDP)	2012	4.24 (2)	-0.3	-21.7	-4.8	-10.6	4.8	-2.1	-6.7	-4.1
		2013	3.71 (2)	1.6	-26.1	-1.8	-6.5	3.3	-1.1	-3.9	-2.0
		2014	5.1 (2)	0.9	-25.9	-0.7 (p)	-8.4 (est)	4.6	-1.2	-3.3 (est)	-1.1
		2015	1.3 (2) (p)	-0.5 (p)	-24.1 (p)	-0.9 (p)	-5 (p)	5.8 (p)	-1.2 (f)	-1.4 (p)	-1.2
	Trade in Balance (% of GDP)	2012	-41.9	-8.2 (4)	-31.0 (7)	-10.61 (10)	..	-23.5 (13)	-9.5 (16)	-15.8 (18)	..
		2013	-40.8	-5.9 (4)	-29.0 (7)	-7.99 (10)	..	-26.8 (13)	-8.8 (16)	-11.6 (18)	..
		2014	-38.2	..	-23.0 (7)	-7.02 (10)	..	..	..	-10.9 (18)	..
		2015	-37.0 (p)	..	..	..	..	..	..	..	..
	Merchandise Import Growth (CY)	2012	..	..	-7.1 (8)	5.9	..	3.4 (14)	4.8	-3.9	4.9
		2013	..	0.8 (5)	-1.8 (8)	-1.4	..	14.2 (14)	3.4	-3.3	-0.5
		2014	..	8.9 (5)	..	4.6	..	..	8.3	8.1	5.9
		2015	..	12.9 (5) (p)	..	..	..	..	..	..	..
	Merchandise Export Growth (CY)	2012	..	..	-2.4 (8)	2.0	..	1.9 (14)	-1.1	-5.2	1.7
		2013	..	10.7 (5)	3.9 (8)	8.2	..	10.3 (14)	4.8	7.7	8.3
		2014	..	12 (5)	..	4.0	..	..	0.4	8.9	4.1
		Q3	..	1.1	..	2.2	..	..	-8.9	7.4	1.5
		Q4	..	2.3	..	2.3	..	..	3.1	-6.0	2.1
	Reserves in Months of Import (CY)	2012	..	4.5	..	7.3	1.7	..	3.7	4.4	6.9
		2013	..	6.0	..	7.6	1.9	..	1.9	5.0	7.1
		2014	..	6.4	..	8.3	2.8 (est)	..	3.6	5.1 (est)	7.8
		2015	..	..	..	..	..	..	..	6.0 (p)	..
		Jan	..	7.3	..	10.5	3.6	..	4.8	..	9.8
		Feb	..	..	..	11.3	..	..	4.2	..	10.3
	Remittances (US\$ billion) (CY)	2011	0.3	12.1	0.01	28.2	0.003	4.2	12.2	5.1	62.1
		2012	0.4	14.2	0.02	20.7	0.003	4.8	14.0	6.0	60.1 (20)
		2013	0.5	13.8	0.01	32.3	..	5.6	14.6	6.4	73.3 (20)
		2014	..	14.9	..	39.0	..	..	17.0	7.0	78.0 (20)

			AFG (1)	BGD (3)	BTN (6)	IND (9)	MDV (11)	NPL (12)	PAK (15)	LKA (17)	SAR (19)
GOVERNMENT FINANCES	Fiscal Deficit (% of GDP)	2012	-0.6 (2)	-3.5	2.0	-7.2	-7.6	-0.6	-8.4	-6.5	-7.2 (21)
		2013	-0.5 (2)	-3.9	-1.6	-6.8	-7.8	2.1	-8.1	-5.9	-6.9 (21)
		2014	-2.5 (2)	-3.7	0.6	-6.7 (p)	-11.6 (est)	2.2	-4.7	-5.6 (est)	-6.7 (21)
		2015	-2.5 (2) (p)	-3.5 (p)	0.2 (p)	-6.1 (p)	-8.1 (p)	1.1 (p)	-4.7 (f)	-4.8 (p)	-6.5 (21)
	Public Debt to GDP (%)	2012	..	35.1	72.2	67.7	61.7	34.3	64.3	79.2	61.0 (20)
		2013	..	35.2	89.2	66.8	63.0	31.2	61.3	78.3	63.3 (20)
		2014	..	33.9 (est)	108.1 (est)	65.1 (p)	74.6 (est)	26.3	60.3	75.6 (est)	66.8 (20)
		2015	..	32.9 (est)	117.7 (est)	63.4 (p)	75.5 (p)	24.3 (est)	63.1 (est)	71.5 (p)	68.6 (20)
CONSUMPTION and INVESTMENT	Consumption (% of GDP)	2012	104.5	78.0 (4)	44.2 (7)	69.8	..	81.8 (13)	92.9 (16)	69.6 (18)	64.2
		2013	112.8	76.6 (4)	54.5 (7)	71.0	..	83.2 (13)	92.1 (16)	66.8 (18)	64.1
		2014	..	..	..	71.8 (p)	..	..	92.5 (16)	..	..
		2015	..	..	..	72.4 (p)	..	..	..	..	..
	Investment (% of GDP)	2012	16.8	28.4 (4)	65.8 (7)	31.4	..	20.8 (13)	15.1 (16)	28.9 (18)	28.3
		2013	17.7	28.7 (4)	50.3 (7)	29.7	..	22.6 (13)	14.6 (16)	29.2 (18)	26.6
		2014	..	..	..	28.8 (p)	..	..	14.0 (16)	..	..
		2015	..	..	..	30.8 (p)	..	..	..	..	..
	FDI (US\$ billion) (CY)	2012	0.1	1.7	0.02	24.0	0.5	0.1	0.7	0.9	28.2 (20)
		2013	0.1	1.6	0.05	28.2	0.8	0.1	1.3	0.9	33.0 (20)
		2014	..	..	..	34.4	0.84 (est)	0.1	1.5	1.0	36.9 (20)
	Portfolio Investment (US\$ billion) (CY)	2012	0.1	0.4	..	30.3	0.01	..	-0.1	2.1	32.8 (20)
		2013	0.1	0.8	..	7.0	-0.01	..	0.1	2.1	10.1 (20)
		2014	..	..	..	38.0	..	..	2.7	2.0	42.7 (20)

# Notes:

est Estimate  
f Forecast  
p Projections  
prov Provisional

CY Series for Calendar Year unless otherwise mentioned

## Afghanistan

Source: World Bank, IMF, National Authorities and Haver

- 1 2013 onwards is calendar year, preceding years correspond to solar year (Apr-Mar)
- 2 Including grants

## Bangladesh

Source: World Bank, IMF, National Authorities and Haver

- 3 These numbers are for fiscal year (July-June) unless otherwise mentioned  
For example; for 2014 numbers, 2013-2014 values are used.
- 4 WB Staff Calculations
- 5 Fiscal Year

## Bhutan

Source: World Bank, IMF, National Authorities and Haver

- 6 These numbers are for fiscal year unless otherwise mentioned (July-June).  
For example; for 2014 numbers, 2013-2014 values are used.
- 7 WB Staff Calculations
- 8 WDI Series, Goods and Services

## India

Source: World Bank, IMF, National Authorities and Haver

- 9 These numbers are for fiscal year unless otherwise mentioned (Apr-Mar). For  
example; for 2014 numbers, 2014-2015 values are used.
- 10 WB Staff Calculations

## Maldives

Source: World Bank, IMF, National Authorities and Haver

- 11 These numbers are for calendar year unless otherwise mentioned.

## Nepal

Source: World Bank, IMF, National Authorities and Haver

- 12 These numbers are for fiscal year unless otherwise mentioned (16 July - 15 July).  
For example; for 2014 numbers, 2013-2014 values are used.
- 13 WB Staff Calculations
- 14 WDI Series, Goods and Services

## Pakistan

Source: World Bank, IMF, National Authorities and Haver

- 15 These numbers are for fiscal year unless otherwise mentioned (July-June).  
For example; for 2014 numbers, 2013-2014 values are used.
- 16 WB Staff Calculations

## Sri Lanka

Source: World Bank, IMF, National Authorities and Haver

- 17 These numbers are for calendar year unless otherwise mentioned.
- 18 WB Staff Calculations

## SAR

Source: World Bank, IMF, National Authorities and Haver

- 19 These numbers are for calendar year unless otherwise mentioned.
- 20 WB Staff Calculations
- 21 Figures from World Bank GEP June 2014





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