South Asia Economic Focus

Spring 2014

Time to Refocus

THE WORLD BANK

1 2 3 4 17 16 15 14

ISBN (electronic): 978-1-4648-0273-7
DOI: 10.1596/ 978-1-4648-0273-7

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This report is a product of the Office of the Chief Economist for the South Asia Region. *Its preparation was led by Markus Kitzmuller (Economist, SARCE) under the oversight of Martin Rama (Chief Economist, South Asia Region). Substantive contributions to the focus section were made by Gabi Afram, Gunjan Gulati, Yuki Ikeda, Aurelien Kruse and Denis Medvedev. The report greatly benefitted from inputs and continued advice by Sanket Mohapatra and colleagues in the Development Economics Prospects Group (DECPG) under the supervision of Andrew Burns (Acting Director, DECPG). Colleagues providing information for country briefs include Kishan Abeygunawardana, Deepak Bhattasali, Genevieve Boyreau, Roshan Darshan, Daminda Fonseka, Camilo Gomez Osorio, Zahid Hussain, Omar Joya, Faruk Khan, Aurelien Kruse, Chandana Kularatne, Jose Lopez Calix, Jaba Misra, Saurav Shamsher Rana, Saadia Refaqat, Nadeem Rizwan, Adiba Sanjana, Smriti Seth, Saurabh Shome, Muhammad Waheed, and Salman Zaidi, under the guidance of Vinaya Swaroop (Sector Manager, Poverty Reduction and Economic Management, South Asia Region) and Ernesto May (Sector Director, Poverty Reduction and Economic management, South Asia Region). Valuable research assistance was provided by Bilgehan Gokcen and Ayesha Raheem. Gabriela Aguilar signed responsible for the layout, design and typesetting, and Neelam Chowdhry provided 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 6, 2014.

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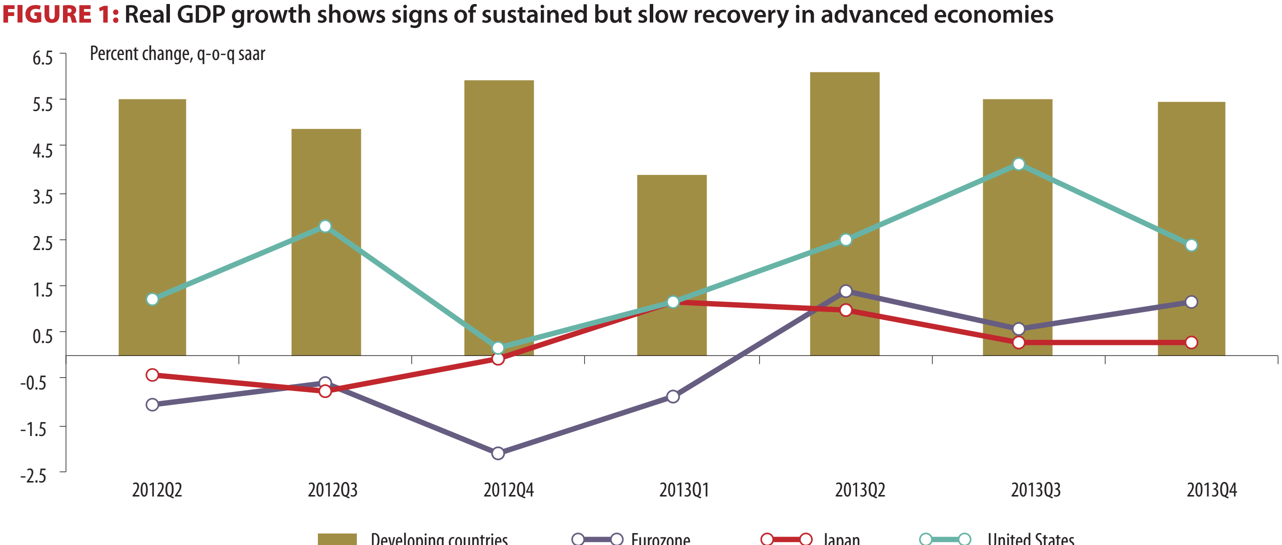
Recent economic developments

Gradual removal of stimulus policies continues as developed economies follow their expected path of slow but sustained recovery. After suffering from international portfolio rebalancing triggered by gradual removal of quantitative easing in the US announced in May 2013, India in particular and South Asia more broadly have managed to reduce external vulnerability. However, growth across the region continues to falter while formidable domestic challenges remain to be tackled.

Advanced economies recover while developing country growth remains weak

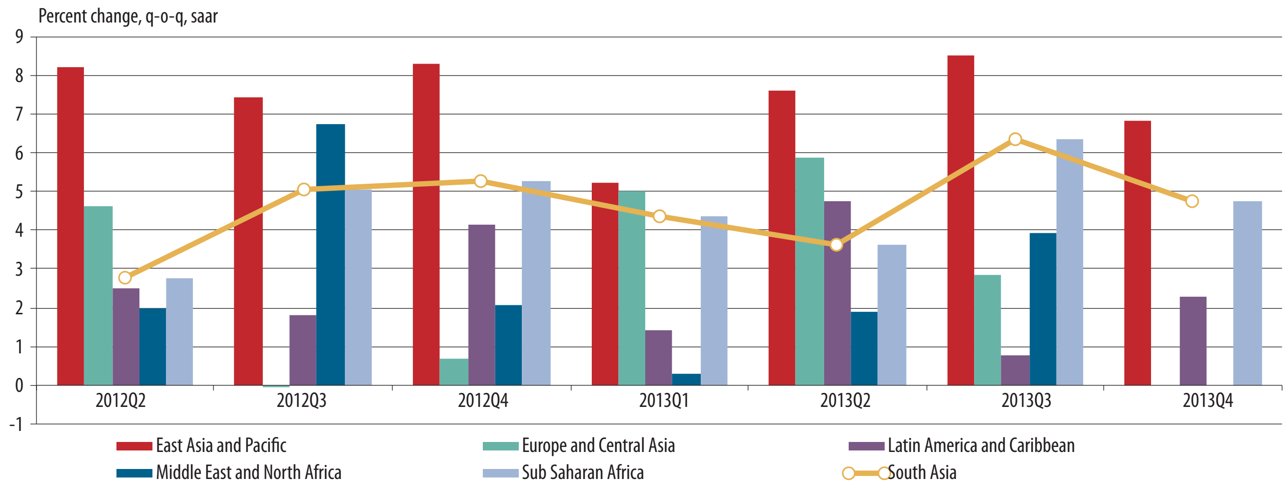
As advanced countries such as the US, Japan and even the Eurozone show signs of slow but sustained recovery, developing economies continue to exhibit slow and flat growth. In light of labor market improvements, and in spite of slowing growth in the last two quarters, the US Federal Reserve Bank decided to further cut monthly quantitative easing to US$ 55 billion starting April 2014. While there is little signs of inflation at this point, US interest rates may well be rising soon after QE ends. The Eurozone is also building momentum with market optimism increasing as sovereign credit

FIGURE 1: Real GDP growth shows signs of sustained but slow recovery in advanced economies



Source: World Bank DECPG

FIGURE 2: South Asia featured a strong cyclical rebound in 2013Q3



Source: The World Bank DEC Data
Note: DEC data is updated as of 03-13-2014

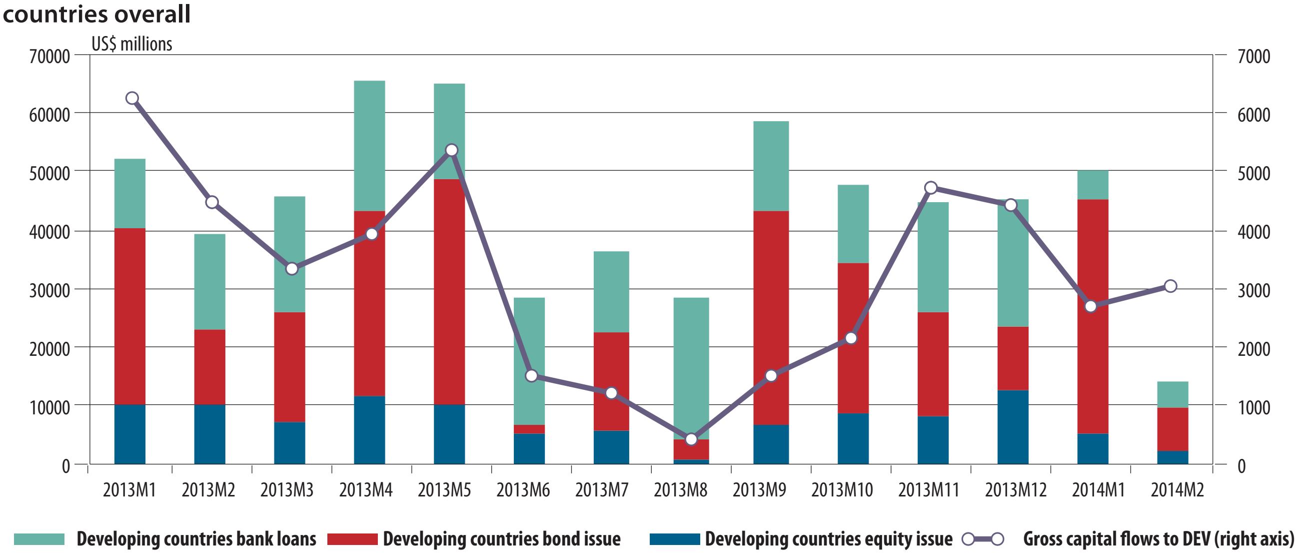
default swaps (e.g. for Portugal, Spain, Italy or Ireland) further tightened in March 2014; however, deflation risks and unemployment concerns remain.

South Asia experienced a strong cyclical rebound in 2013Q3 growth but has since slowed again. The strong regional growth performance between July and September 2013 can be largely attributed to a temporary pick up in export growth, investment activity as well as stronger agricultural output. Annual regional real GDP growth in 2013 is estimated at 4.8 percent, below East Asia and Pacific at 7.2 percent, but well above Middle East and North Africa, Latin America and Caribbean, and Europe and Central Asia.

Some emerging markets including India have turned around the wheel and reduced external vulnerabilities

Since the large impact of global portfolio rebalancing in May 2103, Emerging Markets have separated into a diverse group ranging from continuously fragile to resilient vis-à-vis external pressures. With the prospect of interest rates increasing gradually in advanced economies, developing countries find themselves in a brave new world characterized by a permanently more competitive environment for attracting international capital flows. Between May and August 2013, many

FIGURE 3: Capital flows to South Asia increased slightly in February 2014 against the trend for developing countries overall



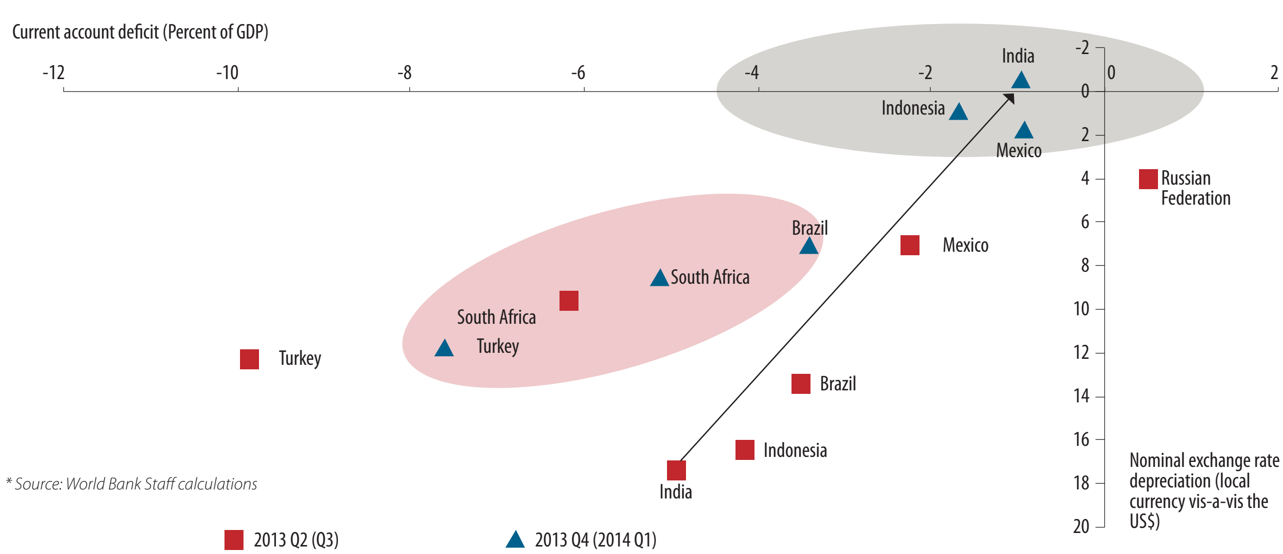
emerging markets have been hit hard by international portfolio rebalancing and capital outflows have put pressure on external financing of current account deficits across the board. However, during the second half of 2013, some countries managed to take profit of the short window of opportunity to reduce external vulnerabilities.

India has managed to turn around the wheel and minimize exposure to further tapering in 2014. Weak growth and exchange rate depreciation have characterized India for some time. A wide current account deficit (CAD), at 4.8 percent of GDP for FY2013, which had been increasingly financed through volatile portfolio flows, left the economy vulnerable to the first announcement of US tapering on May 22, 2013. However, since the period of sharp depreciation of the Indian rupee vis-à-vis the US$ between May and August 2013, increased export growth and restrictions on gold imports have helped to recover the trade balance and reduce the CAD. In addition, continuous tightening of monetary policy has signaled credibility regarding Reserve Bank of India's mission to address high inflation, thereby calming investors and further increase confidence into its economy. Hence, capital flows bounced back in 2013H2 and proved quite resilient in January and February 2014. India was joined by countries such as Indonesia or Mexico, while other emerging markets (most notably South Africa and Turkey) remained vulnerable and suffered repeated exchange rate effects in 2014.

Pressures on external balances across South Asia have eased

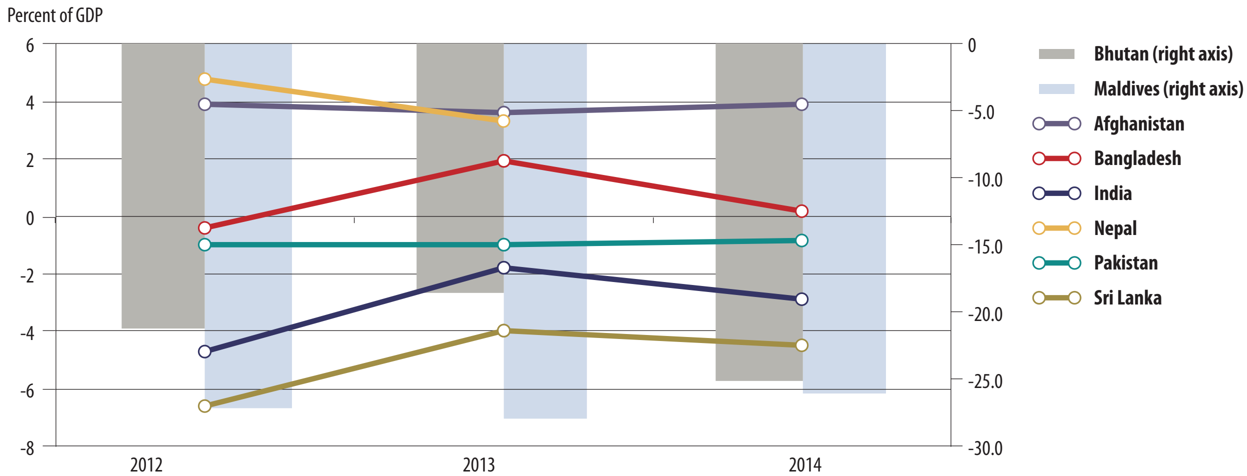
Current account deficits are getting easier to finance in most of the region. Most notably, India managed to significantly shrink its current account deficit (CAD) to pre-crisis levels, from 4.9 percent of GDP in 2013Q2 down to 0.9 percent in 2013Q4 (2.2 percent annual for FY2014 to date). India's annual CAD further is expected to stay between 2 and 3 percent of GDP in the short to middle run (1.8 percent for FY2014 with a possibility of some widening in FY2015). At the same time, Pakistan maintains a small current account deficit - at 0.9 percent of GDP during the first seven months of FY2014 with solid remittance inflows. Afghanistan features an estimated CAD (excluding grants) of 39.8 percent of GDP as opposed to a surplus of 3.6 percent once accounting for grants in 2013. In Bangladesh, the external balance remained in a comfortable zone with a declining trade deficit more than offsetting slower remittance growth. Nepal continues to accumulate a current account surplus on the back of a stunning increase in remittance flows (at 34.4 percent since the beginning of FY2014 as compared to also high 22 percent over the same period in FY2013) while solid export growth (with exports being on significantly smaller scale than imports) do not slow trade deficit increases. On another positive note, Sri Lanka's CAD is estimated to have decreased to around 4 percent of GDP in 2013, down from 6.6 percent in 2012.

FIGURE 4: India has managed a remarkable turn around and its nominal exchange rate proved highly resilient in early 2014



** Source: World Bank Staff calculations*

FIGURE 5: Current account balances (by fiscal year) are slowly shrinking, with the exception of Bhutan and Maldives



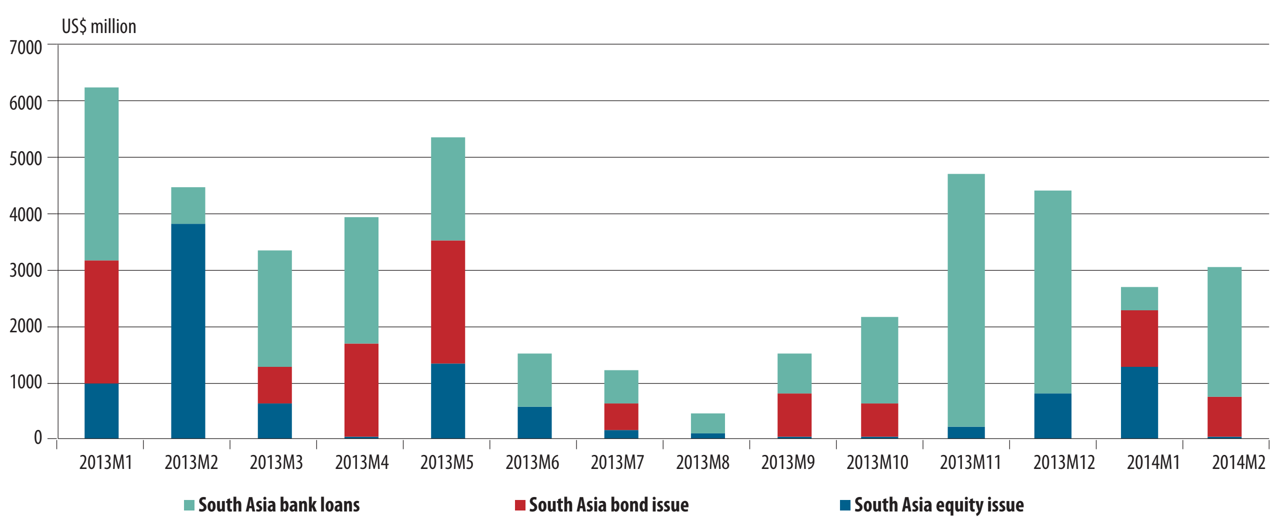
Source: World Bank and national authorities

Bhutan and Maldives constitute two outliers with very different implications. Both countries run large CADs, the former estimated at around 20 percent and the latter at 28 percent of GDP in 2013, however, with very different implications for external stability. While Bhutan's deficit is largely hydropower driven and well financed, Maldives' external balance is in a much more precarious state with continuous pressures on reserves to be expected.

Capital inflows into South Asia have regained some momentum and proved more resilient in January 2014 as opposed to May 2013. While regional gross capital inflows declined by 70 percent between May and August, 2013, with bank loans, as well as equity and bond issues all dipping, January 2014 saw a relatively smaller and qualitatively different dip in response to further tapering. While bonds remained a significant share of total flows through February, it is bank loans that mainly drive capital flows to the region since October 2013 - with the point exception of January 2014.

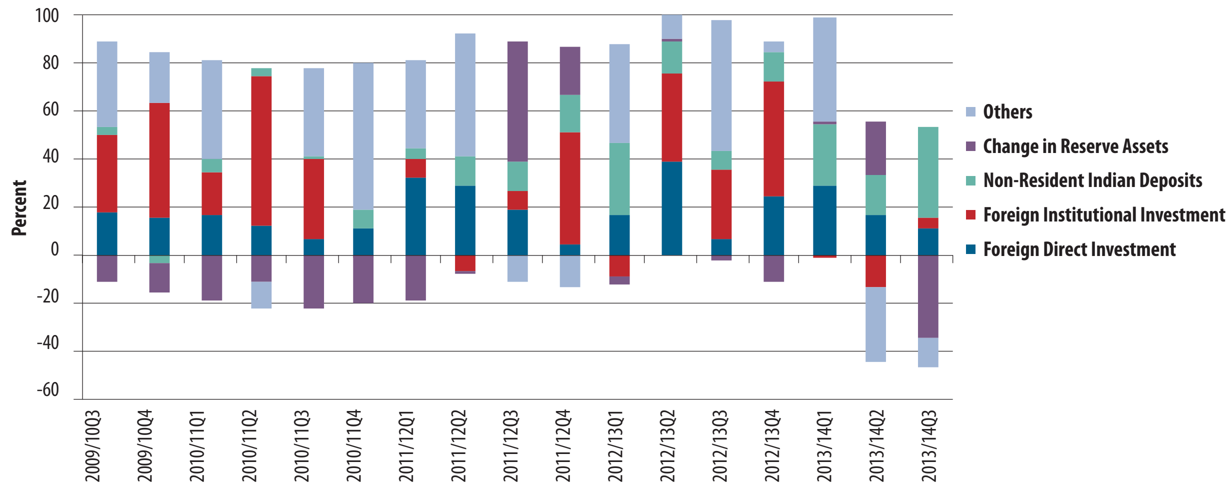
Many South Asian economies saw little change in their capital inflows. Pakistan continues its ongoing struggle on the capital and financial account, where Foreign Direct (FDI) and Portfolio Investment (FPI) flows remain at very low levels. Furthermore, higher debt service repayments as well as net repayments to

FIGURE 6: Capital flows (in US$ millions) to South Asia are more robust; however their primary composition has changed



Source: World Bank DECPG

FIGURE 7: India has recently financed its current account deficit mainly through increased Non Resident Indian deposits

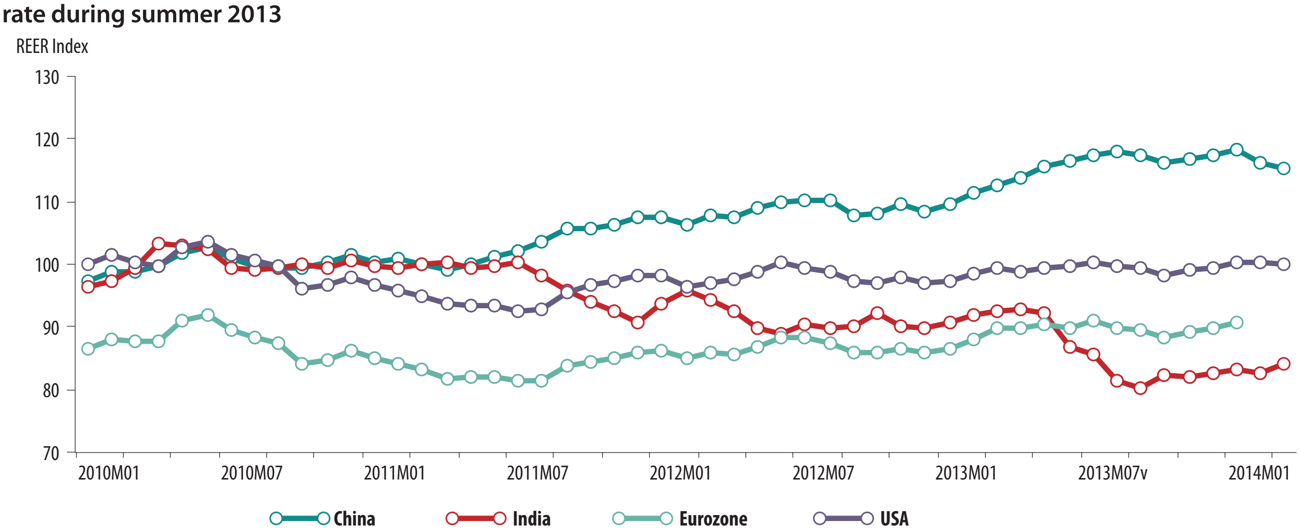


Source: Reserve Bank of India

the IMF during the first seven months of FY2014 put pressure on Pakistan's financial accounts and foreign exchange (FX) reserves. Also Bangladesh remains below its potential, attracting only a slightly higher US$ 840 million in stable FDI flows over FY2014H1 as compared to US$ 797 million in FY2013H1. Overall, the financial and capital account surplus is shrinking due to trade credit (net). Sri Lanka saw relatively healthy inflows, largely in the form of remittances and tourism earnings on the current account side, but also flows to government securities and an increase in FDI, although on a modest absolute level, on the capital account side.

India's capital inflows remain more than sufficient to finance its current account deficit. However, their composition has recently changed away from volatile portfolio flows to more stable flows. With FDI inflows remaining constant at 1.5 percent of GDP during Q1-Q3 FY2014, Non-Resident Indian deposits soared by more than 700 percent y-o-y in 2013Q4 to a total level of 2.6 percent of GDP over Q1-Q3 FY2014. However, also portfolio flows have started to return to India, where inflows of US$5.5 billion in December and January begin to make up for an outflow of US$15.7 billion over the preceding 6 months (May to November 2013).

FIGURE 8: India's real effective exchange rate (REER) has been depreciating for a while, but experienced an accelerated rate during summer 2013



Source: The World Bank DECPG and ECB

India also has been the major regional beneficiary from tapering induced increases in competitiveness. While the reversal of capital flows in summer 2013 has put pressure on the nominal rupee US$ exchange rate, it also has accelerated a longer-term trend towards real exchange rate depreciation, which has made India and South Asia overall more competitive (through the direct exchange rate and more broad business cycle transmission channels). Hence, export growth is estimated to have picked up to 15.7 percent for calendar year 2013. However, the recent loss of momentum in Indian export performance in early 2014 suggests that the FY2014Q2 hike may have been a level adjustment rather than a permanent acceleration of growth.

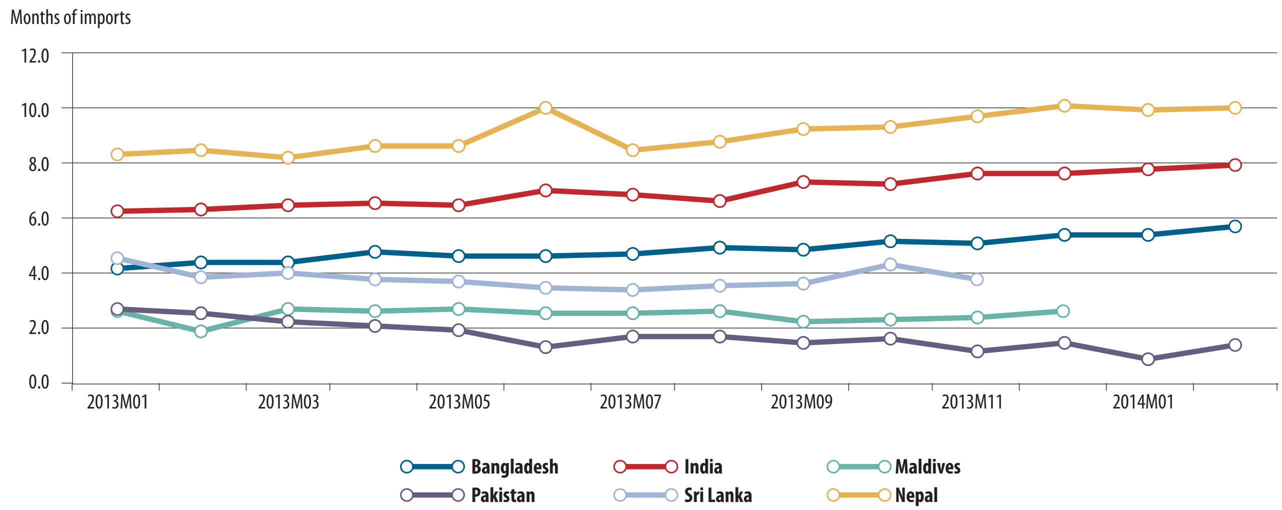
But also Bangladesh, Bhutan, Nepal and Sri Lanka experienced a significant boost in export growth. Bangladesh's trade deficit decreased due to strong exports with readymade garments (RMG) growing at 17.7 percent over the first seven months of FY2014 and total exports expanding by 14 percent over the first eight months of FY2014. In a slightly different manner, Nepal's pegged rupee significantly boosted exports, particularly to India, due to substitution by Indian importers. The increase in exports to India from 3.8 percent (over the first six months of FY2013) to 18.45 percent over the same period in FY2014 ultimately led to an overall growth in exports of 16 percent (FY2014H1) as compared to 10.2 percent (FY2013H1). Sri Lankan exports – mainly textiles and garments - also rebounded strongly in the second half of 2013, growing at 17 percent y-o-y to bring annual export growth for 2013 to 6.3 percent. Ultimately, Bhutan's export revenues (mainly from electricity sales to India) got boosted by favorable hydro flows due to better monsoon rains in 2013 without any exchange rate effects due to the peg with the Indian rupee and the fact that 90 percent of its energy exports go to India.

With the exception of Pakistan and Maldives, South Asian countries maintain solid reserve levels. Since the State Bank of Pakistan has begun to rebuild its external position through US$ purchases on the spot, net official reserves arrived at 1.1 months of import coverage as of March 12, 2014, after a bumpy ride from 1.3 months at the end of June 2013 to a staggering 0.6 month at the end of November 2013. Recent alleviation has come from unexpected inflows received bilaterally under the umbrella of the Pakistan Development Fund, and further easing is expected to come from CSF monies, 3G and 4G license as well as Eurobond issuance (US$ 0.5 to 1 billion in Q4). On the other hand, the stabilization of the rupee and the shift from volatile portfolio investments to more stable flows helped increase foreign reserves in India by US$8 billion during Q1-Q3 FY2014 to a current level of US$294 billion. Sri Lanka saw its gross international reserves increase to 5.3 months of imports by the end of January 2014, while Bangladesh's current and capital/financial account surplus continued a buildup of reserves in February 2014 to US$ 19 billion or 5.7 months of prospective FY2014 merchandise imports. As a result of a large balance of payments surplus, Nepal saw its reserves increase to 10.2 months of imports by January

FIGURE 9: A tapering induced competitiveness dividend began to materialize in the form of increased export growth in 2013 (here growth rates of total annual value in US$)

Source: World Bank and National Authorities

FIGURE 10: Foreign exchange reserves are broadly solidifying, except for Pakistan and Maldives



Source: World Bank and national authorities

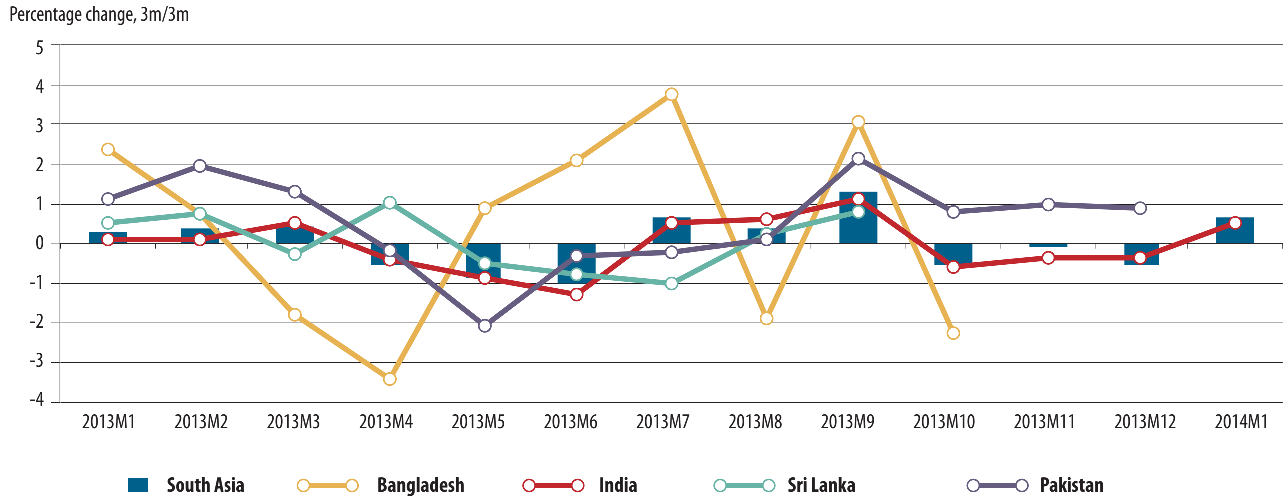
2014, while Sri Lanka's import coverage is estimated at 4.2 months for 2013 and projected to stay around 4 in 2014. While Bhutan's reserves have built up to over US$ 900 million by the end of November 2013, which is the equivalent of 13 months of merchandise imports, Maldives foreign exchange reserves are very low at 2.3 months of imports at the end of 2013 of which only 3 weeks were usable. Ultimately, Afghanistan's foreign reserves closed 2013 at almost the same level as for 2012, namely around 7 months of imports.a

Nonetheless, recent output growth in South Asia remains sluggish

Industrial production continues to be lackluster across South Asia. With the exception of Pakistan, all major South Asian economies continue to see slow and in some cases highly volatile growth in industrial production (IP) during the second half of 2013. While India saw IP growth (3m/3m) turn negative in October 2013, its recent IP has trended upwards and actually registered small but positive growth in February 2014 (at 0.5 percent 3m/3m crawl). Sri Lanka faced a steep increase in IP growth between July and September 2013, as did Pakistan slightly thereafter. In the latter, large scale manufacturing recorded an increase of 6.7 percent in the first half of FY2014, compared to 2.2 percent in the first half of FY2013, mainly driven by strong performance in the fertilizer, food, electronics and leather sub sectors. Bangladesh is subject to high volatility due to recent political turmoil (and partly irreversible output, employment and asset losses), where manufacturing growth paid a substantial toll in spite of stronger export growth, and industrial growth is projected to have slowed down to 7.9 percent for FY2014 compared to FY2013's 9 percent.

The overall South Asian growth motor continues to sputter, mainly due to India's subdued growth performance. While regional growth is estimated at 4.8 percent for calendar year 2013, many South Asian economies experienced slowing or flat growth. On the back of weak performance in the mining, construction and manufacturing sectors, India's overall real sector activity moderated in FY2014Q3 with real GDP growth (at factor costs) coming down to 4.7 percent y-o-y from 4.8 percent in FY2014Q2. Also Bangladesh's estimated growth of 5.4 percent for FY2014, down from 6 percent in FY2013, shows a continuation of the downward trend observed since FY2011, reflecting political uncertainties, supply side constraints, a suffering service sector and lower private investment. Also in large parts due to a marked fall in private investment, Pakistan's real GDP growth in FY2013 was subdued at 3.6 percent. However, industry and services growth, estimated at 5.2 and 5.7 percent respectively for FY2014Q1, are expected to open up an opportunity for faster annual FY2014 growth, projected at between 3.6 and 4 percent. Nepal, as opposed to its solid performance on the external side, continued its low growth path in FY2013 at 3.6

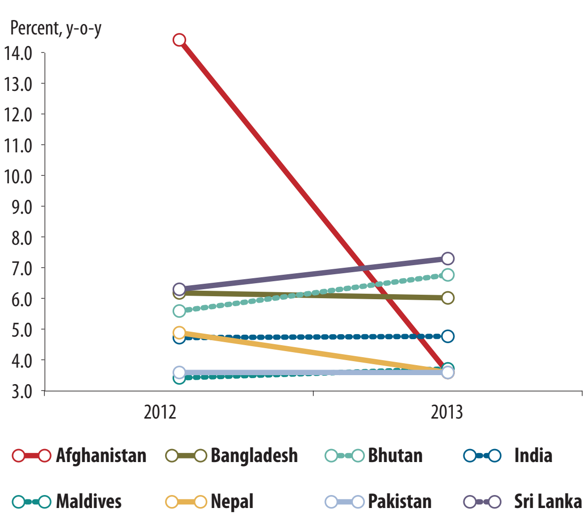
FIGURE 11: Industrial production growth remains weak and volatile across South Asian economies with the exception of Pakistan



Source: World Bank DECPG

percent down from 4.9 percent in FY2012. However, as agricultural output is expected to recover due to a good monsoon and services sector growth to continue at a healthy pace fuelled by remittances, growth should eventually bounce back to 4.5 percent in FY2014. On the upside, Sri Lanka shows faster growth at 7.3 percent in 2013, up from 6.4 percent in 2012, mainly driven by industry and services, and is expecting a stabilizing trajectory with a projected 2014 growth rate of 7.3 percent. Also Bhutan expects a growth rebound in 2013, driven by good rainfall increasing (hydropower) electricity generation and agricultural performance. Maldives

FIGURE 12: Real GDP growth (fiscal years) paints a mixed picture for South Asia

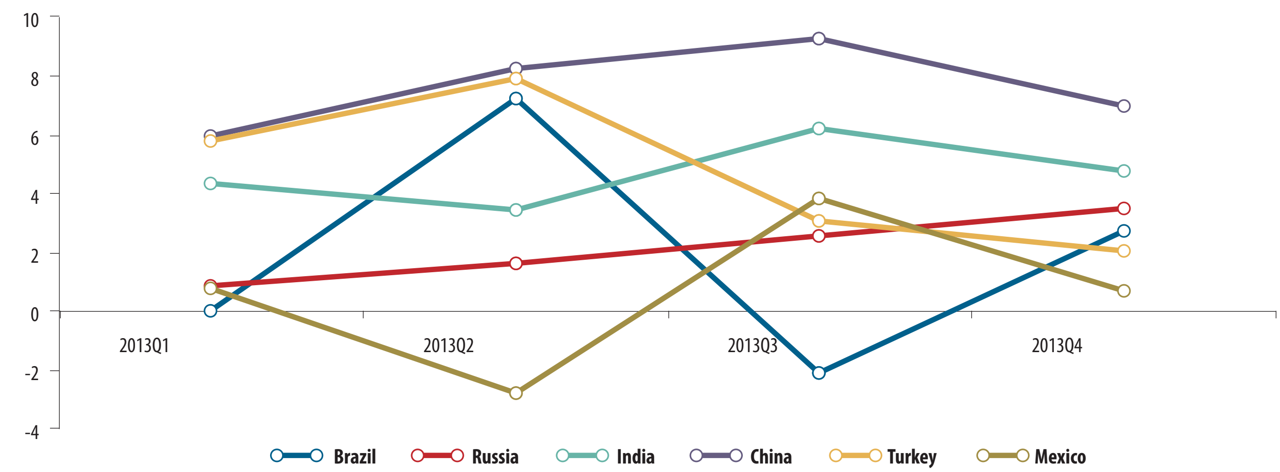


Source: World Bank and national authorities

and Afghanistan continue at the tail of the regional growth distribution at 3.7 percent and 3.6 percent in 2013, respectively. However, while Maldives expects a pick up to 4.5 percent in 2014 with tourism and its spillover effects to do the heavy lifting, real GDP growth in Afghanistan is projected to further slow to 3.2 percent, in spite of robust agricultural production and mainly due to uncertainties surrounding security and the April 2014 elections.

India's output growth has been cyclically rebounding in 2013Q3 but the momentum could not be carried forward into Q4. From a sectorial perspective, agriculture spurred by a good monsoon as well as improved industrial production in manufacturing, utilities and construction contributed significantly to the strong 2013Q3 growth performance, thereby complementing India's growth engine, the service sector, whose acceleration was led by finance and business services. In detail, agricultural growth increased to 3.7 percent for FY2014 to date, y-o-y, while industrial growth has expanded a mere 0.6 percent in FY2014 to date, again y-o-y (with output growth having dropped back into the negative at -0.7 percent in 2013Q4). Services, on the other hand, not only contribute 55 percent to total output, but also grew 7.6 percent in FY2014Q3, based on strong net export growth in financial, business and software services. On the expenditure side, while growth in public consumption supported aggregate demand, private consumption and investment lost speed in FY2014Q3, after they had featured a strong acceleration in FY2014Q2 with private expenditure increasing from 0.3 to 0.9 percent q-o-q, saar and

FIGURE 13: Real GDP growth (at market prices) bounced back strongly in India vis-à-vis other emerging markets in 2013Q3 but lost momentum in Q4



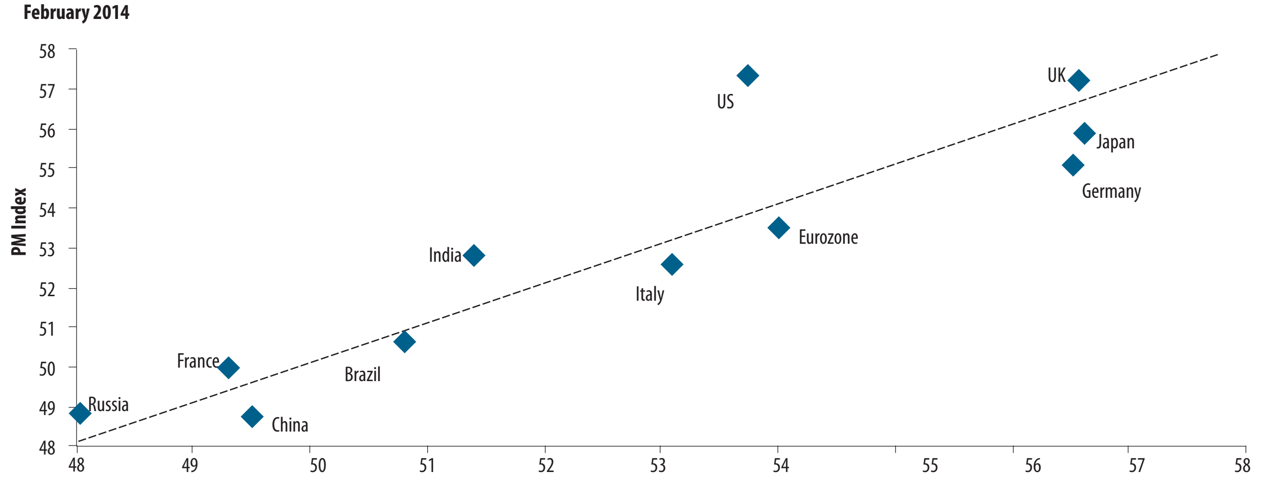
Source: World Bank DECPG

investment growing at 3.2 percent q-o-q, saar, up from a negative 3.6 percent.

However, India's growth performance vis-à-vis Emerging Market peers remains relatively strong. India comes out as the second fastest growing emerging market in 2013, only outperformed by China's continuously high but slightly decelerating expansion. Turkey and Brazil continue to struggle with the effects of US tapering, however, exports and industrial production begin to show signs of strengthening.

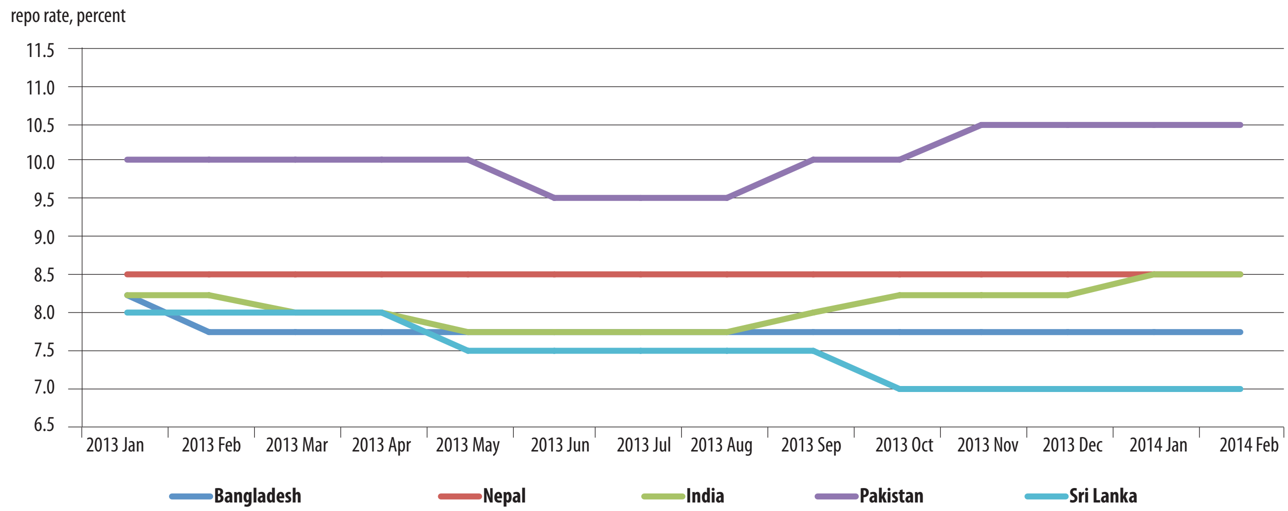
Expectations for India lacked confidence in the past but most recently have started to show signs of optimism. While business expectations – as measured by the RBI business expectation index - in India continue to stay below the 100 level that separates contraction from expansion in FY2014Q3, the Manufacturing Purchasing Managers' Index (PMI) places India above the 50 mark, thereby pointing to expectations of a better future. Interestingly, the absolute level of the PMI positively separates India from many of its emerging market peers. From a dynamic perspective, sentiment in India has been improving between January and February 2014, from 51.4 to 52.5. This rather positive expectation has received support from an actual pick up in industrial production in January 2014 breaking into positive territory at 0.1 percent y-o-y, largely driven by

FIGURE 14: India's Purchasing Managers' Index ranks well below many developed countries but clearly above its BRIC peers, and suggests better times ahead



Source: Markit

FIGURE 15: Policy rates reflect broad tightening of monetary policy, with the exception of Sri Lanka



Source: National central banks

a pickup in manufacturing with a monthly growth rate of 25.5 percent saar up from 5.7 percent the previous month. This trend may be further spilling over into the region more broadly given India's importance for South Asian business cycles.

Main risks and vulnerabilities are gradually shifting from external to domestic

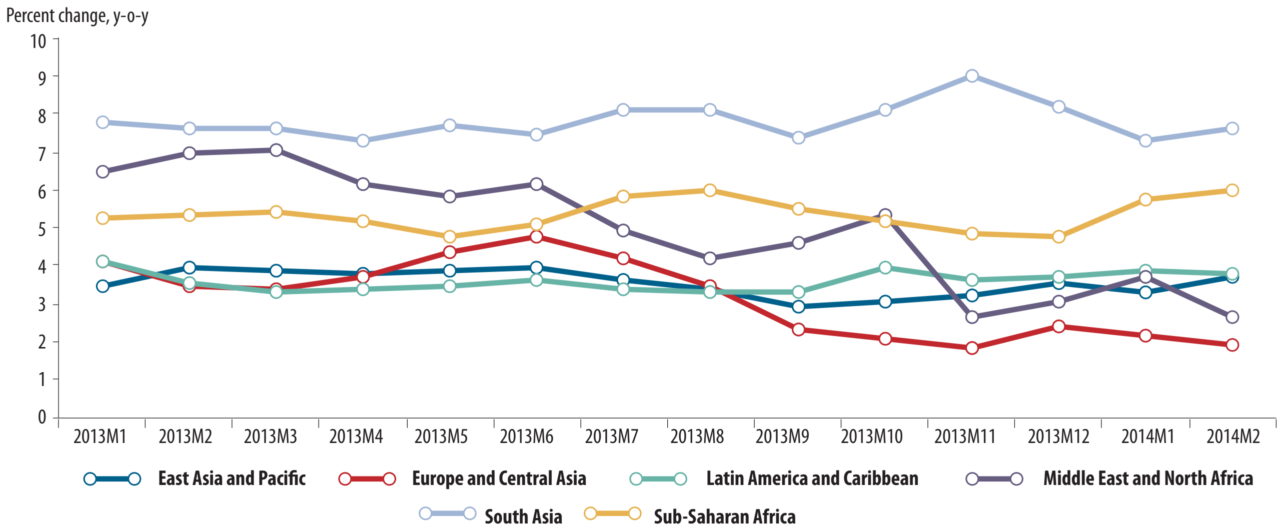
While further (disorderly) adjustment of long term interest rates remains as a tail risk for macroeconomic stability and growth, the weight is shifting towards domestic challenges. Vulnerabilities exist along the whole spectrum of potential domestic risk factors, from political risk and uncertainty due to social unrest and turmoil to fiscal stress related to persistent weaknesses in revenue generation and collection. Notably, partly fueled by recent global events, financial sector risk and exposure, e.g. to corporate debt in India, government debt in Pakistan or excess liquidity in Nepal, has been on the rise (see this edition's Focus section for a more detailed discussion).

Inflation remains high across South Asia but shows signs of losing momentum

Regional inflation in South Asia remains the highest among developing regions, even as monetary policy has been broadly tightened. Although almost all major regional central banks, with the notable exception of Sri Lanka's accommodative stance (where the monetary authorities have given sustaining faster economic growth a top priority), have recently followed a path of monetary tightening through increasing their main policy (repo) rates, CPI inflation has remained relatively high across South Asia and still dominates all other regions. Notably, Nepal Rastra Bank has chosen to keep its policy rate at eight percent and not attempt to sterilize the double speed growth of broad money (M2) fuelled by extraordinarily high remittance flows in FY2014H1. Overall, the tight monetary policy stance across South Asia has certainly helped to build confidence and send a strong signal to international investors.

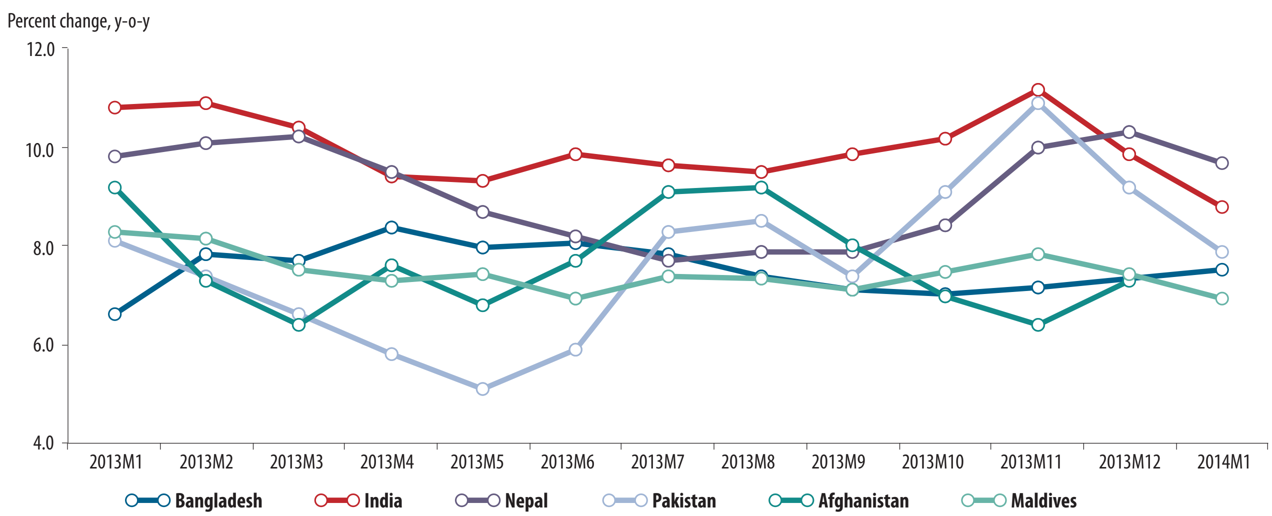
Favorable food price developments have contributed to headline inflation losing momentum. Food Prices in South Asia continue to be the main driver of CPI inflation. Recently, two key determinants have strongly supported a decline in food price inflation: Favorable weather (monsoon rains) eased pressure on the supply side while India has stopped increasing prices through its support price mechanism. Therefore, a reduction in food prices by 2.7 percentage points, particularly

FIGURE 16: South Asian CPI inflation remains high but upward pressures have recently begun to ease



Source:World Bank DECPG

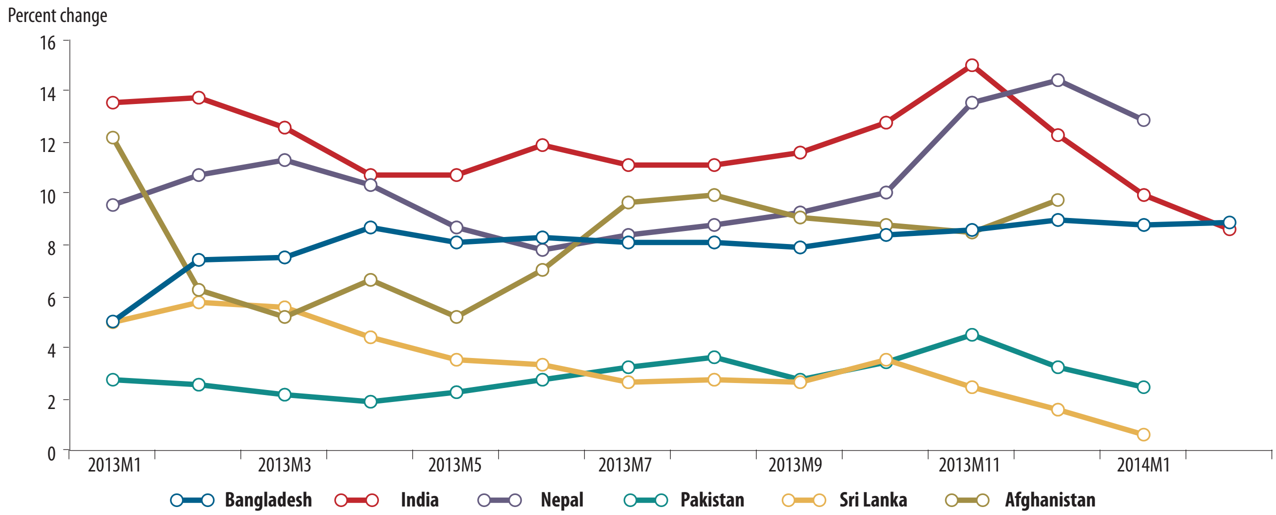
FIGURE 17: The recent downward trend in CPI is quite common across major South Asian countries



Source: The World Bank and national authorities

in December 2013 and January 2014, helped achieve an overall reduction in CPI inflation to 9.8 percent in FY2014 to date as compared to 10.2 percent in FY2013. The other commonly used headline inflation index, WPI, moderated to 6 percent in FY2014 to date (with a February y-o-y inflation rate of 4.7 percent only), down from 7.3 percent in FY2013. In Pakistan, favorable weather helped to dampen food prices and, together with a sharp reduction in administered prices brought headline inflation back into the single digits, averaging 8.6 percent over the first eight months of FY2014. On the downside, upward revisions of VAT (+2 percent) levied on selected manufacturing items as well as energy prices helped cement higher inflationary expectations. Sri Lanka saw headline inflation decreasing from 7.6 to 6.9 percent in 2013, also helped by lower food prices. Bangladesh constitutes a special case due to increased inflationary pressures because of supply side disruptions, particularly for food, and wage increases. In sum, food price inflation accelerated from 8.1 percent in July 2013 to 8.8 percent in February 2014, while headline inflation continues to move in a band between 7-7.5 percent in the first half of FY2014. As an exception to the rule, Nepal saw its inflation up at 9.7 percent (y-o-y) in January 2014, actually also driven by food prices which have started to slightly drop recently tracking India. Along the same lines, food price increases in Afghanistan led to upward

FIGURE 18: Food price inflation continues to be a major determinant of CPI movements across South Asian economies



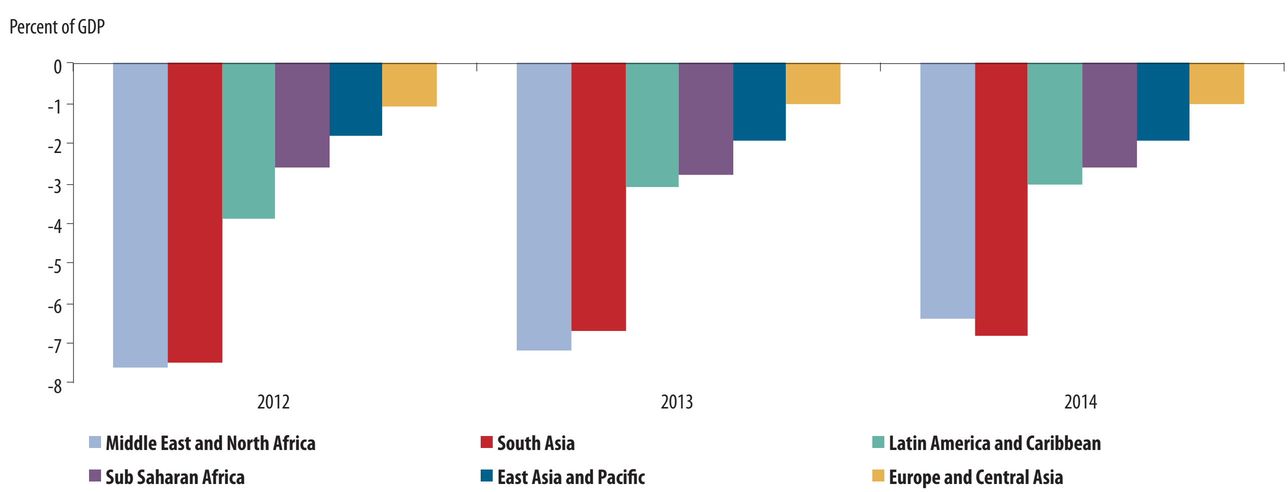
Source: World Bank and ILO

pressure in CPI inflation in the second half of 2013, however, remaining below double digits and averaging 7.7 percent over 2013 (up from 6.3 percent in 2012).

Fiscal deficits and sovereign debt continue to constrain many South Asian countries

Fiscal deficits and public debt in the region remain large, thereby constraining policy space. The average fiscal deficit across South Asian countries was estimated to be 6.7 percent of GDP in 2013, down from 7.5 percent in 2012. This puts South Asia second only to Middle East and North Africa (at 7.2 percent) across all developing regions. At the same time, public debt keeps on resisting downward pressures. The regional estimate for 2013 puts South Asian public debt at slightly below 67 percent of GDP, the highest debt level across all regions. However, as a large share of public debt is held domestically, sustainability is less endangered by exchange rate movements directly, but subject to domestic sources of risk, e.g. in the banking sector depending on relative exposure and hedging strategies of domestic financial institutions.

FIGURE 19: Despite fiscal consolidation budget deficits remain large in South Asia

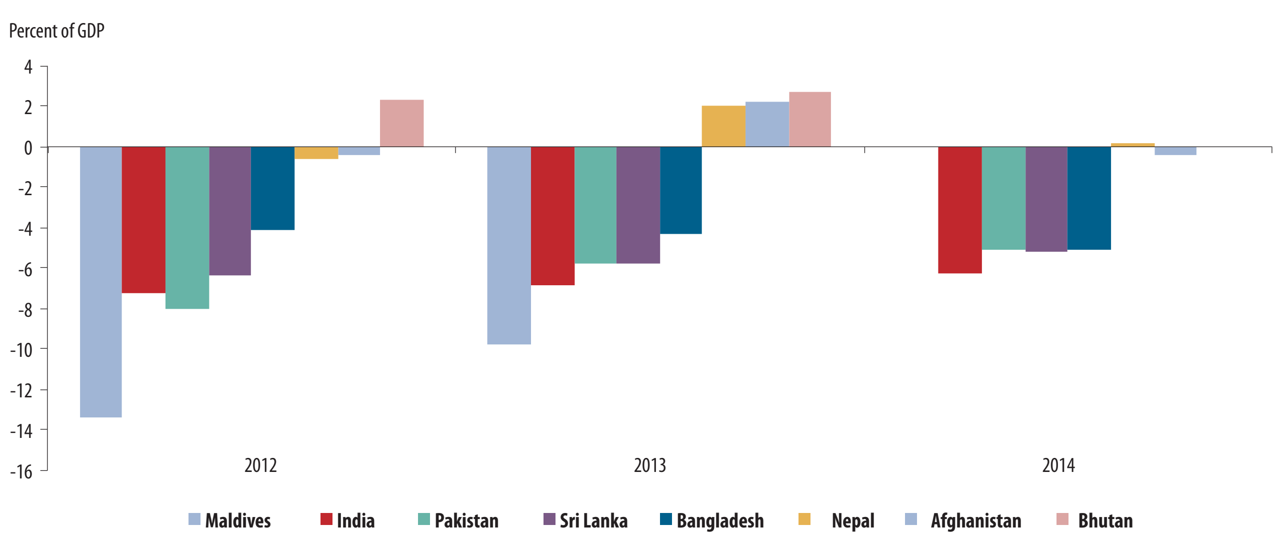


Source: The World Bank DECPG

Although many countries in South Asia continue their struggle to bring down fiscal deficits, some progress can be observed. India's central government FY2014 fiscal deficit is expected to be contained at 4.6 percent of GDP, a reduction from the 5.1 percent in FY2013. Fiscal deficit among Indian states registered at 2.3 percent of GDP in FY2013, above the budget estimate of 2.1 percent. Together with state deficits, the overall Indian fiscal deficit for FY2014 is projected at 6.3 percent of GDP. Also Pakistan, the second largest South Asian economy, shows some signs of progress in fiscal consolidation. In Bangladesh, fiscal outcomes are expected to suffer from severe revenue shortfalls and, unless expenditure is cut further, its deficit may come in at around 5.1 percent of GDP for FY2014, significantly above the budgeted 4.6 percent. With expenditure staying flat and revenues continuously weakening, Afghanistan's dependence on aid financing remains salient. Its financing gap increased from 13.5 percent of GDP in 2012 to 14.9 percent in 2013, while its fiscal sustainability ratio decreased in 2013. Bhutan experienced a fiscal deficit of 1 percent in FY2012, and expects a widening to 4.5 percent for FY2013 due to lower domestic revenues. As opposed to FY2013, Nepal adopted a full budget on day 1 of FY2014, and runs a comfortable surplus on account of low expenditure and robust revenue growth. Last but not least, Maldives found itself with an approximate fiscal deficit of around 13 percent of GDP (including unpaid commitments through arrears), leaving the cash constrained country in a difficult situation regarding deficit financing.

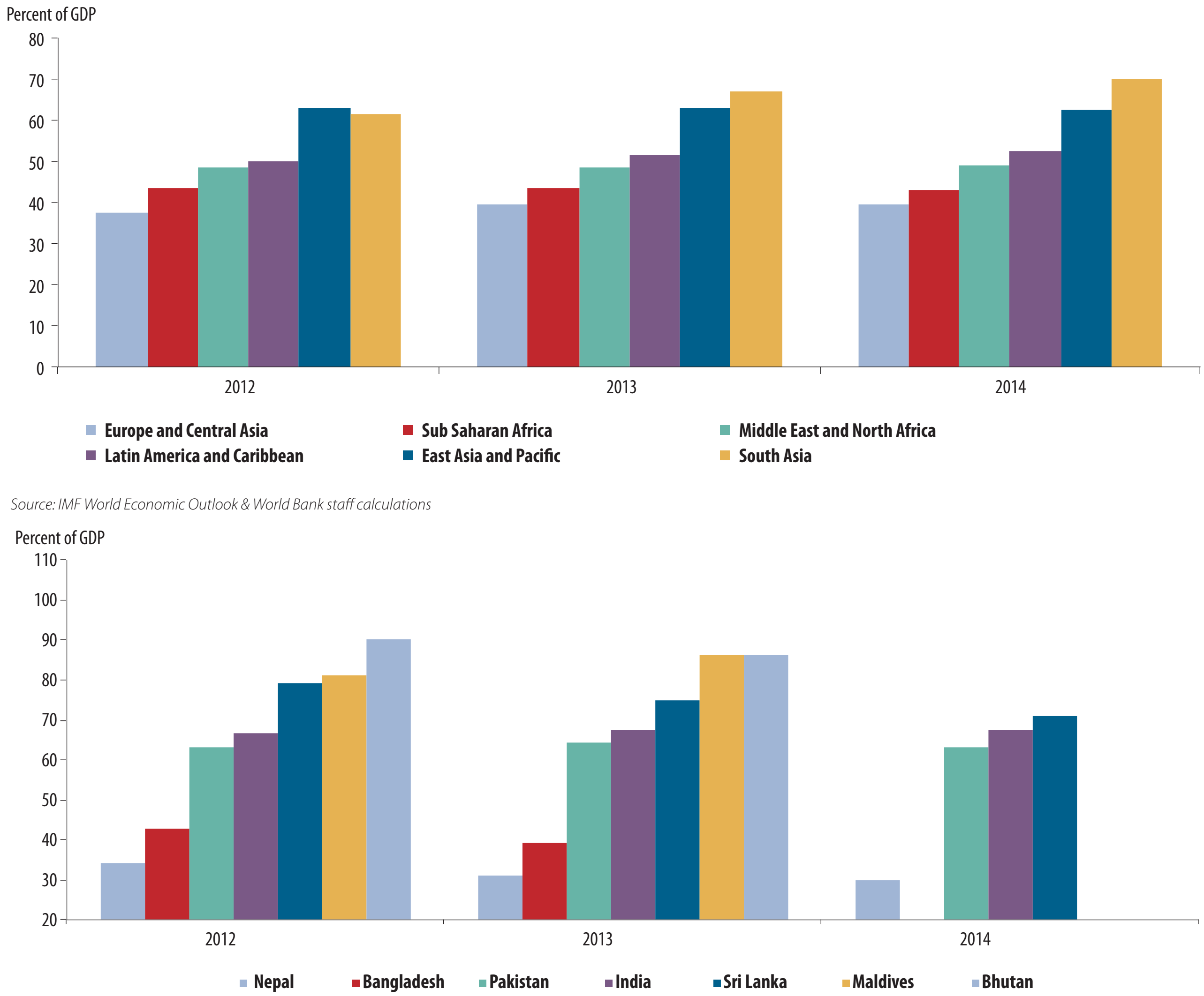
Across the region expenditure compression remains difficult while revenue generation and collection falls short of compensation. Many countries need to continuously compress expenditure to reach fiscal targets, while revenues broadly fall short of budgeted amounts. On the one hand, India compressed expenditures (for example in rural development, health and education) to 14 percent of GDP or 0.6 percent below budget in order to contain its fiscal deficit. Of course subsidies remain a large item with more than 2 percent of GDP per annum. On the other hand, FY2014 tax revenues currently are expected to fall short of the budget, bringing the total revenue shortfall to date to 0.5 percent of GDP and implying that Q4 revenues will have to grow by an ambitious 33.5 percent of the budget estimate to reach their budgeted amount. In Pakistan, the overall fiscal deficit is expected to fall from 8 percent of GDP in FY2013 to 5.8 percent in FY2014, with revenue collection on its way to recovery from a poor FY2013 performance and recurrent expenditure projected to remain below last year's level. Also Bangladesh fits in this picture, with revenue growth being severely off track and falling short of budget by about Tk. 82 billion between July 2013 and January 2014. At the same time, public expenditure remained below target in the beginning of FY2014 with the help of a lower subsidy bill. Sri Lanka experienced a shortfall in revenues due to sluggish tax collection (mainly due to lower imports) where total revenue collection rose by 1.2 percent over the first nine months of 2013 as opposed to an annual target rate of 20 percent, casting doubts over reliability of revenue estimates underlying targets. After a decade of strong revenue growth, also Afghanistan continued

FIGURE 20: Overall fiscal deficits (by fiscal year) remain sizeable in many South Asian countries



Source: The World Bank and national authorities

FIGURE 21: South Asian public debt stays stubbornly high and occupies the number one spot across regions in 2013



Source: The World Bank and national authorities

to experience a weakening of revenue collection in 2013 with a decline to 9.5 percent of GDP vis-à-vis 10.3 percent in 2012. Bhutan projects a drop in its domestic revenues for FY2013 to 19.5 percent (down from 20.8 percent of GDP in FY2012), mainly driven by non-hydro items such as business income taxes, excise duties and non-tax revenue.

Nepal and Maldives constitute interesting outliers. In Nepal, revenue streams are solid and likely to achieve targets in FY2014 while public capital expenditure lags its plan due to continued budget under-execution and absorptive bottlenecks. Maldives is spending beyond its means (with public expenditure at 42 percent of GDP) in spite of solid revenue collection – actually the highest of all South Asian countries at 32.8 percent of GDP.

Public debt remains broadly sustainable but continues to resist reduction. In light of continued fiscal deficits and following the trend of FY2012 and 13, also FY2014 saw India's total central government debt slightly increase to 51.5 percent of GDP, while state level debt to GDP is also likely to inch up a bit, leaving general government debt at an estimated 67.4 percent of GDP. Pakistan's debt to GDP ratio also remained above 60 percent over the past two fiscal years (FY2012 and 13), and exhibits a similar tendency during the first half of FY2014, standing at 58.9 percent, but with the expectation of again breaching the 60 percent ceiling by end of the FY. Sri Lanka's government debt is estimated to have decreased in 2013 to 75 percent of GDP, down from 79.1 percent in 2012. Bhutan's public debt remains high, at around 90 percent of GDP at the end of FY2013, and concentrated in external hydropower sector debt, which as long as commercially viable, keeps risks of debt distress at moderate levels. Following the dire fiscal situation and the choice of domestic (short term) financing, Maldives faces unsustainable interest rates at 10 percent (for T-bills) and sustained fiscal risks through arrears. Hence, the country is at high risk of debt distress where the current debt to GDP ratio of 86 percent of GDP is expected to deteriorate further in 2014 and 15.

A large part of public debt in South Asia is domestic, which reduces exposure to exchange rate related risks and adds to sustainability but may entail its own set of vulnerabilities. In India, the lion's share of total debt – 47.7 percent of GDP out of a total of 51.65 percent - is internal liabilities. Also Sri Lanka continues to hold a large majority of debt domestically, while other economies such as Bangladesh feature a more (internal-external) balanced debt portfolio. However, also domestic debt can imply vulnerabilities to stability and growth. In Pakistan, domestic debt in the amount of about Rs 6 trillion – a whopping 64.2 percent of the whole domestic debt portfolio - is short term and maturing in FY2014. Hence, refinancing risk is quite elevated. Also around 67 percent of domestic debt in Pakistan is exposed to interest rate changes within one year, as opposed to only 22 percent of external debt. Estimates suggest that in this environment, a 1 percent increase in domestic interest rates would boost interest payments by RS 63 billion while the same change in interest on external debt would lead only to an Rs 8.4 billion increase.

48000
1861
500
37000
2415
5251
84000
26500
59000
29591
3911
231

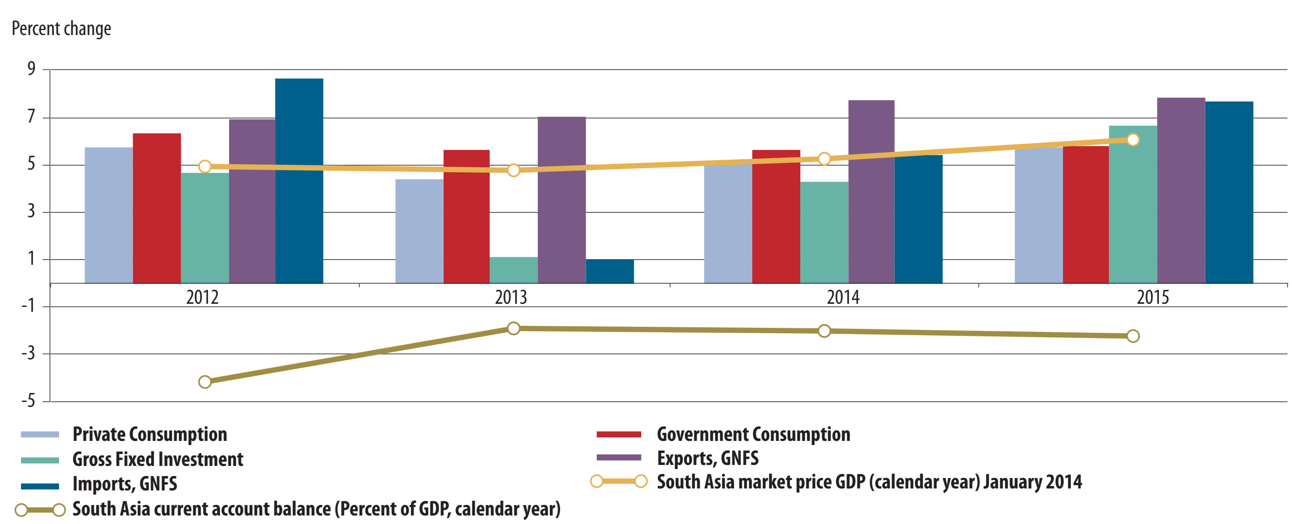
Outlook and policy

The overall short and medium term outlook for South Asia remains cautiously positive. External vulnerabilities are gradually giving way to domestic downside risks as primary concern for growth and macroeconomic stability. Hence, as previous regional economic updates have argued, any positive development in growth will depend on progress isolating domestic threats to and building buffers for macroeconomic stability, strengthening the investment climate, and removing infrastructure bottlenecks.

The overall outlook for South Asia remains on the upside

In line with the overall outlook on developing countries, regional growth in South Asia is projected to gradually increase. As higher import demand and economic growth in developed countries is expected to outweigh adverse effects from potentially lower capital inflows, regional real GDP growth in South Asia is expected to gradually increase from 4.8 percent in 2013 to 5.2 percent in 2014. The main pillars of this growth projection are a solid pick up in gross fixed investment as well as continued solid export growth. The regional current account deficit is down from its 2012 peak of 4.2 percent and expected to stay around 2 percent of GDP over the coming calendar year, hence reflecting the significant

FIGURE 22: South Asia's growth outlook remains moderately positive



Source: World Bank DECPG
Note: Forecasts are subject to constant revisions

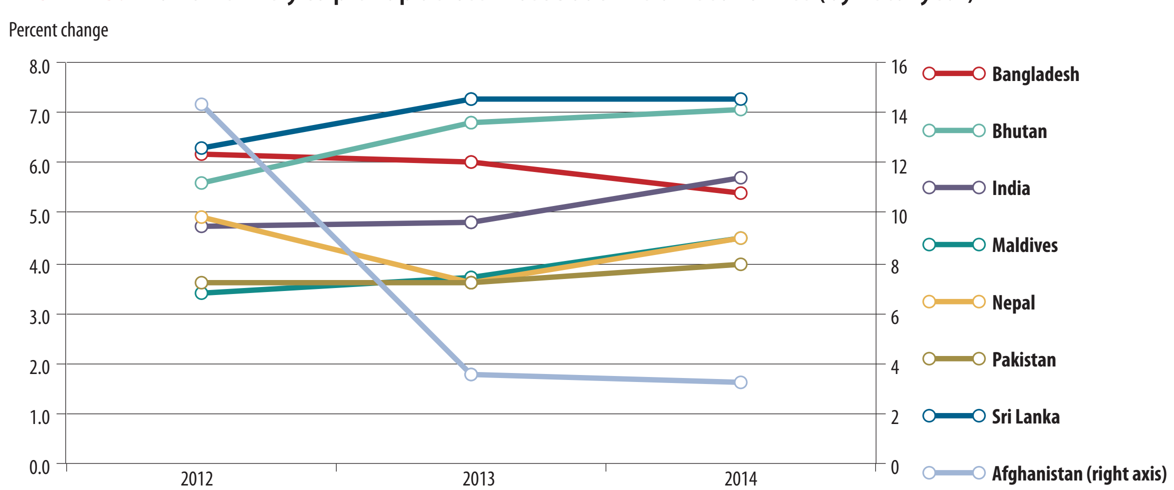
TABLE 1: South Asia's growth performance will depend on continued export strength and strong investment growth

Percent change	2012	2013	2014	2015
SAR market price GDP (calendar year) March 2014	4.9	4.8	5.2	5.8
Private Consumption	5.7	4.4	5.2	5.9
Government Consumption	6.3	5.6	5.7	6.0
Gross Fixed Investment	4.7	1.2	3.7	6.4
Exports, GNFS	6.9	7.0	6.3	6.5
Imports, GNFS	8.6	1.0	5.3	7.3
Statistical Discrepancy	0.3	-0.6	-0.4	-0.1
Change in inventories	0.8	-0.3	0.0	0.0
SAR Current a/c balance (Percent of GDP, calendar year)	-4.2	-2.5	-2.0	-2.2

reduction in India's CAD – mainly due to favorable export growth and restricted gold imports - but also a broader regional trend towards more balanced current accounts.

A strengthening of economic activity across most South Asian countries can be expected in the short term. Bolstered by a permanently more competitive exchange rate (hence solid export growth) and progress towards clearance of important investment projects (hence continuing investment recovery), India may see an acceleration of growth (in factor costs) in FY2014 to 4.8 percent, further to increase to 5.7 percent in FY2015 (or an equivalent of 5.6 percent in calendar year 2014, at market prices). Pakistan is also expected to build further momentum to projected FY2014 growth of 4 percent supported by less load shedding, resilient remittance flows, manufacturing export performance and a dynamic service sector. Nepal will recover from a bad year (FY2013) in terms of agricultural growth and budget execution, and likely grow at around 4.5 percent with strong remittances additionally boosting consumption and service sector growth. Sri Lankan real GDP growth is forecast to benefit from an increase in potential capacity from new infrastructure investments and rebuilding, hence potentially continuing to grow at 7.3 percent of GDP in 2014. Two exceptions stick out: Afghanistan is expected to suffer from continued uncertainty regarding transition as well as lower agricultural output, hence, only projected to grow at 3.2 percent in 2014. However, in the medium term, post transition growth may reach around 5 percent during 2015 and 2016, conditional upon a relatively stable security environment and agriculture as well as mining driving the acceleration. Bangladesh is set to pay the bill of political turmoil in terms of stagnating private investment paired with lower consumption due to decreasing remittance flows. Ultimately this leads to subdued service sector and industrial activity, with real GDP growth projected to come down to 5.4 percent in FY2014.

FIGURE 23: Growth is likely to pick up across most South Asian economies (by fiscal year)



Source: World Bank and national authorities

Domestic vulnerabilities are increasingly becoming the main source of risk

While external (and exogenous) downside risks remain, reducing domestic vulnerabilities becomes more central to achieving macroeconomic stability while following an accelerating growth path. Sustaining sufficient momentum in export growth is clearly dependent on further recovery and growth in South Asia's most important export destinations, namely the Eurozone and the US. However, the current pace of removal of Quantitative Easing in the US suggests no major disruptions to the expected recovery in the short term, while recent Eurozone statistics including sovereign bond spreads as well as output growth estimates also point towards a slow but sustained recovery. Hence, the ability to realize the necessary increase in investment in South Asia gains even more importance in the medium term, highlighting domestic risk factors ranging from inflation and debt (mostly domestic) sustainability to financial sector instability and the persistent structural (infrastructure) deficiencies in energy and transport across the region.

Political change bears great potential for growth and development while some uncertainty remains as a potential downside risk. Pakistan is a recent example of how peaceful elections yielding a strong and determined government can actually support economic performance and market perception. In India there exists consensus by now that whoever wins the 2014 elections - a colossal endeavor with over 800 million Indians allowed to vote - will put increasing emphasis on growth. Other South Asian economies face challenges related to political uncertainties. Afghanistan's growth slowed considerably in 2013 based on investor and consumer concerns while its future hangs in the balance with elections to determine the country's transition towards self-sufficiency. Bangladesh, on the other hand, will have to sort out sources of turmoil related to the modality of political transition that caused considerable unrest, worried investors and trading partners, and ultimately dampened economic activity and growth.

Reform momentum in important South Asian economies has been accelerating recently, underlining rising awareness of the urgent need to start tackling key challenges to structure and stability. In India, RBI led a broader effort to control inflation, increase access to finance and foster financial stability, notably including the easing of FDI restrictions in selected sectors, putting forward a proposal to strengthen the monetary policy framework and restructure bad loans, as well as steps to improve public financial management. In order to reinvigorate broad based private sector led growth in Pakistan, the government is pursuing a comprehensive program of economic and social reforms, with macroeconomic stability through fiscal consolidation being the first priority target. In addition, Pakistan has started to implement crucial structural reforms in the energy sector (mainly targeting tariffs and subsidies as well as sector performance and accountability), pushed ahead with the privatization of State Owned Enterprises, and has begun to remove distortions from the financial sector and the broader business environment (e.g. enacting the Credit Bureau law or the rolling out of an electronic platform for business registration). Also Bangladesh maintains an active reform agenda, spanning from revised minimum wage levels in the garment sector to increased power tariffs or macro-prudential regulation in the banking sector, however being significantly slowed down by recent political turmoil. Overall, these reforms constitute important first steps towards a more comprehensive and permanent effort to solidify macroeconomic stability and move towards an attractive investment and business environment needed to solve the region's main structural problems.

However, formidable domestic challenges in the form of financial sector vulnerabilities and continued weakness in revenue collection will need to be tackled in order to mobilize resources for investment. In other words, to provide incentives for efficient investment – both private and public – remains a necessary condition for achieving faster and sustained growth in South Asia. As the effects from external tapering gradually wear off, potential pressures that have built up in the financial sectors in the recent past may threaten financial sector stability or prevent banks from efficiently intermediating and boosting private investment and growth. As far as public investment is concerned, most South Asian countries are operating under tight fiscal conditions and are subject to weak revenue collection, which puts pressures on fiscal balances in the short term and constrains the mobilization of resources towards much needed infrastructure investment. In addition, as inflation remains high, although with a likely easing of pressures in the medium term, monetary policy space remains constrained.


सत्यनारायणाची महापुजा व
महिलांचे हळदी-कुंकू समारंभ
सर्व बंधु-भगिनींचे
शिवभवानी मित्र मंडळ (रजि.)

Focus: From external to domestic risk

After the 2013 experience of tapering talk inducing massive portfolio rebalancing away from Emerging Markets, the question remains as to what will happen as stimulus policies come to an end. Therefore, in order to analyze what impact future tapering may have on South Asia two key questions need to be answered. First, what determinants do explain the sharp rupee US$ exchange rate depreciation between May and September 2013? And second, will these same factors continue to transmit pressures from US tapering to South Asia?

Overall, the end of stimulus in advanced countries is good news for South Asia. It signals sustained recovery and growth translating into stronger demand for imports from South Asia, a region that traditionally exports to industrialized countries while having limited capital expenses. And as outlined above, many countries across the region have indeed witnessed significant increases in export growth since summer 2013.

Nonetheless, India showed vulnerability to tapering in 2013 as it does have exposure through deeper financial and capital markets. India is not only the "deepest" financial market in South Asia but also the most important regional destination of foreign investment and international capital flows. Hence, it was significantly affected by the first tapering talk in May 2013, experiencing on of the sharpest nominal exchange rate depreciations of all emerging market economies.

And what happens in India also affects other South Asian economies. India plays an important role as it is a major gateway and transmission channel for global shocks into the region, directly through exchange rate linkages or broader business cycle transmission[1]. Both Bhutan and Nepal are directly linked to the rupee exchange rate through a peg, but fluctuations in India do spill over more generally through a variety of other channels transmitting business cycles across the region including trade or cross border investment.

What to learn from the "tapering talk surprise"

The rapid rupee depreciation of 2013 earned India to be perceived as one of the worst performers among emerging market economies. More precisely, the Indian rupee came under heavy pressure after the US Federal Reserve signaled the possibility of tapering its Quantitative Easing (QE) program in May 2013. In the months to follow, the rupee depreciated sharply and fell by more than 20 percent vis-à-vis the US dollar (from 55 rupees to record low 68 rupees per dollar) as investors withdrew their funds from emerging markets. Over the same period, the 10-year Treasury note yields rose by 100 basis points from 1.93 percent. While other emerging-market currencies also came under stress around the same time, the Indian rupee was one of the most severely affected currencies between May and September 2013. Massive capital outflows from emerging markets were observed, with India experiencing a

1 See the Focus on business cycle transmission in South Asia in the Fall 2013 edition "A Wake-Up Call" of the South Asia Economic Focus (World Bank)

sharp decline in foreign portfolio investment. Net foreign portfolio investment inflows plunged from US$6,783 million to -US$8,627 million between May and June 2013.

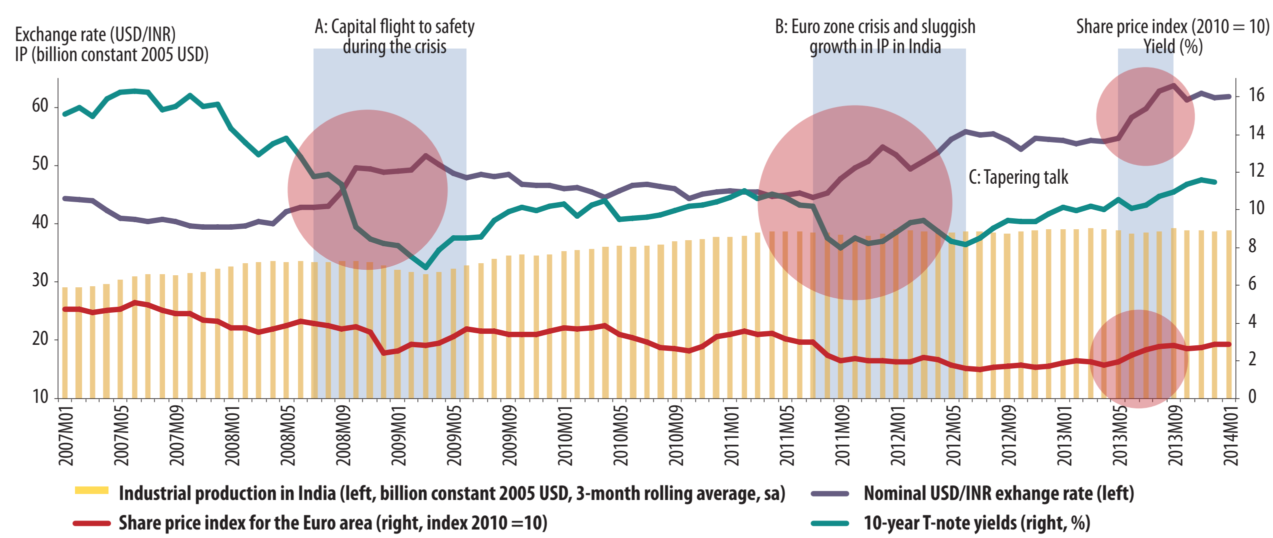
However, a rapid depreciation of the rupee had happened in previous occasions, and it had always been related to external events. In fact, the Indian rupee has experienced several sharp depreciations since 2007, and neither of the massive depreciations in 2008-09 and 2011-12 was associated with the rise of the Treasury note yields. This simple observation is consistent with the statistical insignificance of the yields in the entire sample period. The depreciation during the global financial crisis can be mostly explained by the slowdown in the US (and Europe) as well as a flight to safe investments, while the one starting in July 2011 was strongly affected by the weak economic conditions in the Euro area, high inflation and sluggish growth in industrial production in India.

A quick look into the past may shed some light on the heterogeneity of factors that interact at different points in time (and lay dormant or submissive in others) to drive investor sentiment and ultimately action. As investors base their choice of portfolio balance on a variety of factors that determine expected return – most notably growth expectations and related (macroeconomic or political) risk factors that may dampen growth prospects in a country – such considerations help explain relative differences in capital outflows and exchange rate movements across emerging market economies. Large external or internal imbalances may have acted as an amplifier of capital outflows. Hence, apart from the current account balance, other factors such as the growth of industrial production and global investors' risk appetite are also expected to play key roles.

A variety of intuitive and conceptually valid factors driving exchange rates as a result of the 2013 tapering surprise has been proposed. First, the relative openness of a countries' capital account has been put forward. In this respect, Eichengreen and Gupta (2014)[2] study the role of financial market depth and find that the size of the financial market ex ante positively correlates with the size of portfolio outflows ex post because investors seeking to rebalance their portfolios concentrated on countries with relatively deep financial systems. This has likely contributed to India experiencing such a severe decline in portfolio investment in June 2013. Second, US long term interest rates could have incentivized investors to reallocate their funds towards higher yields as tapering talk sent a strong signal of increasing interest. A third potential (co)determinant of exchange rate movements following the 2013 tapering signal was the current account balance. This suggestion is based upon an observed negative correlation between the share of current account in GDP and the rate of currency depreciation among emerging-market economies in 2013

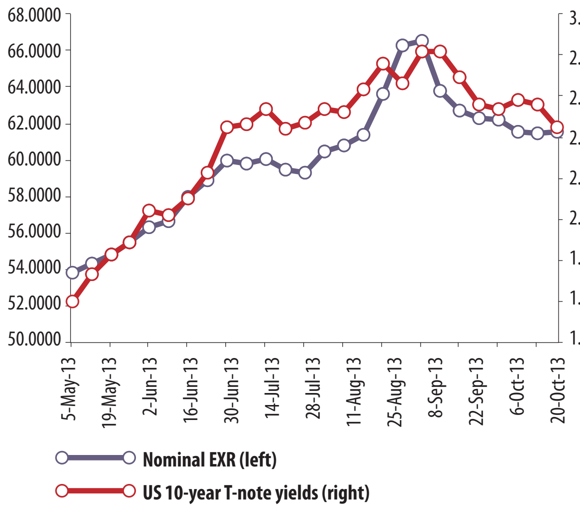
2 Eichengreen, B. and P. Gupta, 2014, "Tapering Talk: The Impact of Expectations of Reduced Federal Reserve Security Purchases on Emerging Markets," World Bank Policy Research Working Paper No.6754.

FIGURE 24: In various episodes rupee depreciation was driven by factors other than US interest rates



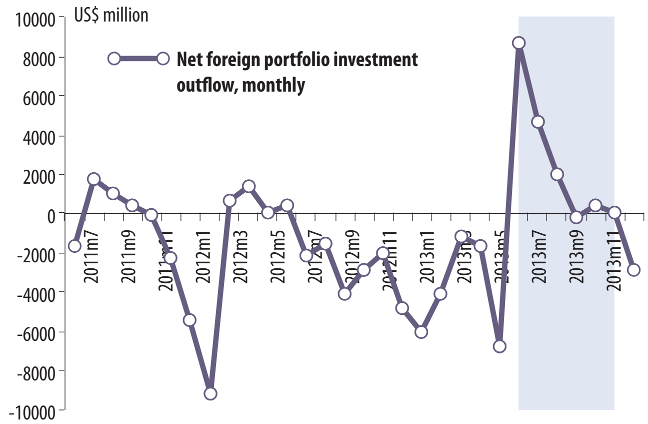
Source: Reserve Bank of India, Federal Reserve Economic Data and World Bank DECPG

FIGURE 25: India Nominal Exchange Rate and the US 10-year Treasury Note Yields move together between May-October 2013(Weekly data)



Source: Federal Reserve Economic Data

FIGURE 26: Net Foreign Portfolio Investment Outflows have been highly volatile in 2013 (Monthly data)



Source: Reserve Bank of India

Q2-Q4 and 2014 Q1. It suggests that the Indian rupee was most severely affected by the tapering in 2013 Q2 and Q3 because of its widening current account deficit in 2013 Q2. Eichengreen and Gupta (2014) also provide evidence in favor of a larger impact of tapering in countries that allowed the current account deficit to widen relatively more during the earlier period of quantitative easing.

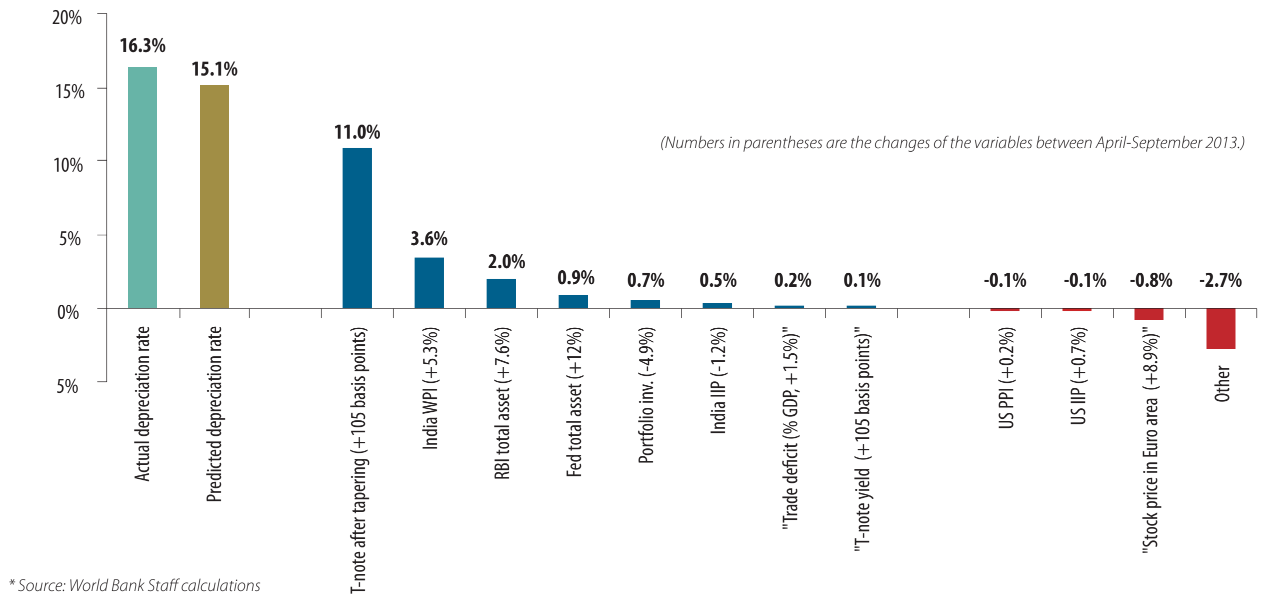
In order to quantify the impact of the tapering announcement on the nominal rupee US$ exchange rate and to disentangle the relative effects of the proposed factors a dynamic model is developed. To evaluate the relative importance of the changes of financial and macroeconomic variables in the long run, as a first step the error-correction model using monthly data over the entire sample period between January 2004 and November 2013 is estimated. As a second step, the estimated coefficients are applied to the period between April and September 2013, the peak of the response, to decompose the change in the nominal exchange rate into various factors over the specified short run. More precisely, the error-correction model is built around a long-run co-integrating relationship between the nominal exchange rate, the wholesale price index (WPI) in India, the producer price index (PPI) in the US, the industrial production indices in the two countries, and the lagged share of trade deficit in GDP in India. Short-run dynamics, on the other hand, are mainly captured by monetary and financial market variables, such as stock market indices and the balance sheet sizes of the central banks. Also yields of the 10-year US Treasury note and the net portfolio investment inflow are included as short-run explanatory variables.

The following main insights emerge:

Even after controlling for a comprehensive set of exchange rate determinants, the 10-year US T-bill yield emerges as the main driver of the drastic nominal rupee US$ exchange rate depreciation between May and September of 2013. The size of portfolio flows and trade deficit are also confirmed as significant but quantitatively small co-determinants, thereby supporting large and open capital accounts rather than macroeconomic fundamentals as drivers of exchange rate movements across emerging markets. In other words, global (and truly external) rather than domestic factors were central to this particular episode of Indian rupee depreciation.

For this particular short run episode, nearly 70 percent (11 percent out of 16.3 percent) of the change in the nominal exchange rate between April and September 2013 can be explained by the rise in the 10-year US Treasury note yields. Using the estimated coefficients, the relative effects of different factors on the rupee depreciation in summer 2013 can be quantified. Then it is found that the change in the yields on the 10-year US Treasury note constitutes the most important

FIGURE 27: **Decomposition of the Nominal Exchange Rate Change between April-September 2013 shows T-bill yields as the major driving force**



** Source: World Bank Staff calculations*

determinant of the respective change in the nominal exchange by 16.3 percent over the period of interest. In contrast, the sharp decline in portfolio investment and a modest rise in the trade deficit have only limited impacts on the rupee depreciation, although both have significant depreciation effects on the exchange rate in the long-run.

Intuitively, what happened in summer 2013 can be explained by simple adjustment of investor expectations regarding i) interest rate spreads and ii) the relative exposure of emerging markets to large portfolio rebalancing towards the US. Investors were surprised by the tapering announcement and immediately factored in the implied increase in the US long term interest rates. This pushed up T-bill yields and prompted investors to reallocate flexible funds towards the US. Large and open capital accounts (portfolio positions) allowed investors to withdraw money faster while perceived risk premia for those markets increased, thereby adding a notion of self-fulfillment to investor expectation regarding emerging markets.

However, the strong causal relationship between US long terms interest rates and the rupee US$ nominal exchange rate disappears over the longer run. More precisely, the significant effect of US T-bill yields is found to be restricted to the specific "short run" time frame – here May to November 2013 – while it is absent over the long run – here the full sample period from 2004 to 2013. This strongly suggests that during past episodes other factors may have been at the forefront of determining investment decisions.

External risk factors are likely to give way to domestic ones

The results indicate that a rise in the 10-year US Treasury note yields significantly contributed to the depreciation of the Indian rupee, however only for the period May to November 2013. A hypothetical 100 basis/1 percentage point(s) increase in the Treasury note yields after the announcement, for instance, would have implied an increase in the depreciation rate of the rupee by 10 percent. However, the Treasury note yields were statistically insignificant for the entire sample period, hence it can be concluded that a statistically significant relation between the yields and the exchange rate is confined strictly to the short run, here the 7 months following May 2013.

When estimated over the entire sample period (2004-2013), the 10-year US Treasury note yields do not appear as relevant determinants of the movements of the nominal exchange rate. The quantitative analysis confirms that the lagged trade deficit and portfolio investment inflow had depreciation and appreciation implications for the exchange rate, respectively, over the entire sample period. In contrast, while an outflow of

BOX 1: **Estimation Results of the Short-Run Error Correction Model**

Dependent variable: Δln(Nominal EXR) Increase = depreciation of the rupee	With T-note	With tapering dummy and T-note (Benchmark)
Δ(yields of the 10-year T-note)	0.007	0.001
Tapering dummy x ΔT-note yields		0.104***
Δln(Net foreign portfolio inv.)	-0.138***	-0.133***
Δln(India WPI) #	0.798***	0.668***
Δln(US PPI) #	-0.514***	-0.455***
Δtrade deficit, lagged (% in GDP) #	0.135**	0.110*
Δln(Indian industrial production), seasonally adj. #	-0.461***	-0.366**
Δln(US industrial production), seasonally adj. #	-0.174	-0.190
Δln(Share prices in the Euro area)	-0.088**	-0.087**
Δln(FED balance sheet size)	0.072**	0.073**
Δln(RBI balance sheet size)	0.270***	0.262***
Observations	117	117
Adjusted R-squared	0.559	0.596
#: variables included in the long-run equation	Standard errors in parentheses	
Significant depreciation factors	*** p<0.01, ** p<0.05, * p<0.1	
Significant appreciation factors		

foreign portfolio investment and a rise in the share of trade deficit in GDP led to a significant depreciation in the rupee throughout the sample period, they had only limited impacts on the behavior of the rupee after the tapering shock.

In light of these findings and recent developments, expected future increases in US interest rates due to tapering are unlikely to transmit comparable pressures and South Asia in the near term. In India, external vulnerabilities decreased drastically as the current account deficit shrank (due to higher export growth and import restrictions) and monetary policy tightened to keep inflationary expectations in check. As a result, also portfolio and capital flows to the region recovered, leaving the capital accounts in ample shape to finance smaller current account deficits. Then, in the first quarter of 2014, when tapering gradually proceeded, the stronger macroeconomic position paired with the early "pricing in" of tapering in US markets put little additional pressure on the Indian rupee. In the long run, investors are unlikely to focus on the long-term interest rate solely, while some countries including India could also reduce risk perceptions due to strengthened external positions. Hence, India remains a relatively attractive investment destination even after accounting for the US recovery, as witnessed by portfolio investment inflows being back to pre-shock levels by December 2013.

Considering that markets have permanently updated their expectations and priced in the lion's share of future tapering, a further rise in the US long term interest rates is unlikely[3] to cause a severe depreciation of the Indian rupee in the near future. India has significantly reduced its external vulnerability and its growth outlook remains positive and hence attractive for investors. In 2013 Q3 current account deficit narrowed sharply to 1.2 percent and fell to less than one

3 The World Bank Global Economic Prospects Volume 8 (January 2014) presents evidence in Chapter 3 that the pace of QE withdrawal significantly affects probability of distress in developing countries with currently unexpected rapid adjustment in interest rates bearing the highest risk.

percent in the following quarter, greatly helped by a fall in gold imports and export growth gaining momentum. Associated with the improvements in current account, the rupee exchange rate was stable during 2013 Q4 and 2014 Q1. In terms of reducing external vulnerability, India outperformed other emerging-market peers in recent months.

Going forward, South Asian economies will need to refocus and shift attention towards rising domestic risks that have been fueled by recent events and may but need not challenge financial stability and economic growth in the future. Along those lines, potential pressures emanating from the banking sectors in India, Pakistan and Nepal are identified and analyzed in more depth. Although tapering induced effects may have contributed to the building up of vulnerabilities in the private and public sector in the past, the above derived conclusions strongly motivate a refocus on a more domestic agenda. Hence, we look at the banking sector due to its increasing importance for South Asia's future stability and growth.

Banking sectors across South Asia constitute a key part of the financial system and are at the cutting edge between private sector activity, growth and macroeconomic and financial stability. We focus on three countries – India, Pakistan and Nepal – that constitute a fairly representative sample of potential risks and vulnerabilities emanating from South Asian banks. On the one hand, India's banks are increasingly exposed to risks inherent to corporate debt, which may ultimately affect the government's balance sheet through state banks and potential lending of last resort for distressed but systemically important banks. On the other hand, Pakistan is subject to dynamics of opposite direction, where private banks (and the economy) may suffer from a large exposure to short term government debt. Finally, Nepal provides interesting insights into questions related to excess liquidity, where we analyze the potential incentives for banks and central banks to maintain excess liquidity in more depth.

India's public banks and private (corporate) debt

Disproportionately faster growth of credit and capital inflows, compared to the rate of fixed investment growth, especially in infrastructure, has raised the leverage of domestic Indian corporates. As an immediate result of the tapering induced rupee depreciation, the financial health of many Indian corporations has increasingly come under pressure. Availability of cheap funds aided by loose monetary policy of the global central banks together with easing in some of the Asian economies lowered domestic interest rates, consequently prompting corporations to leverage up. However, the Fed's announcement of tapering in May last year tightened global liquidity, exerting pressure on most of the EM currencies and prompting central banks to raise interest rates again. This raises concerns about a spike in corporate default risk and its potential spillover effects to the banking sector in India.

Corporate leverage in India has increased beyond

FIGURE 28: Movement of key interest rates

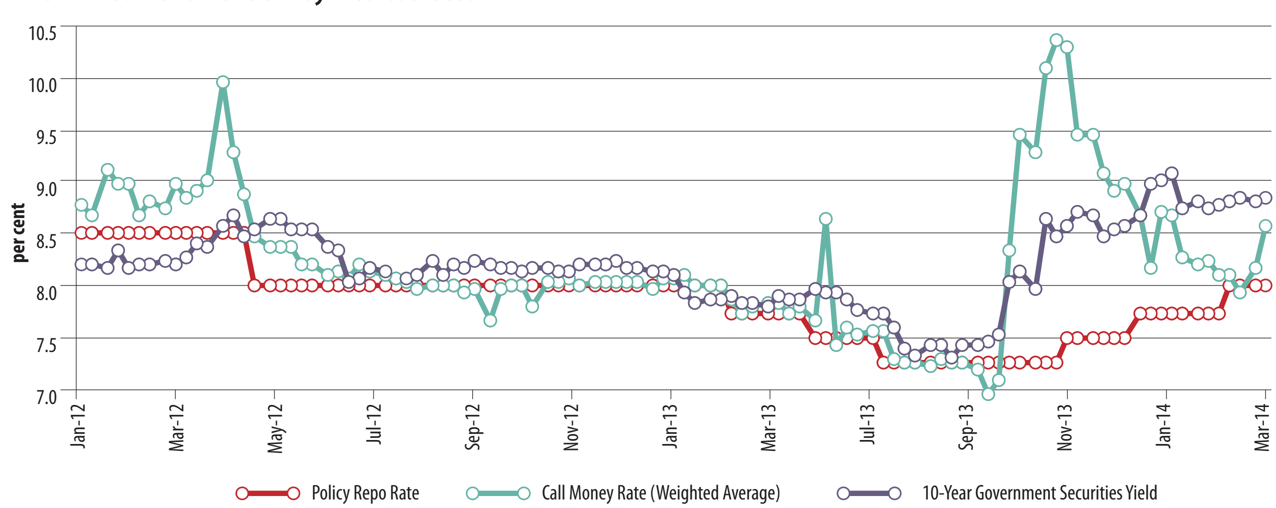
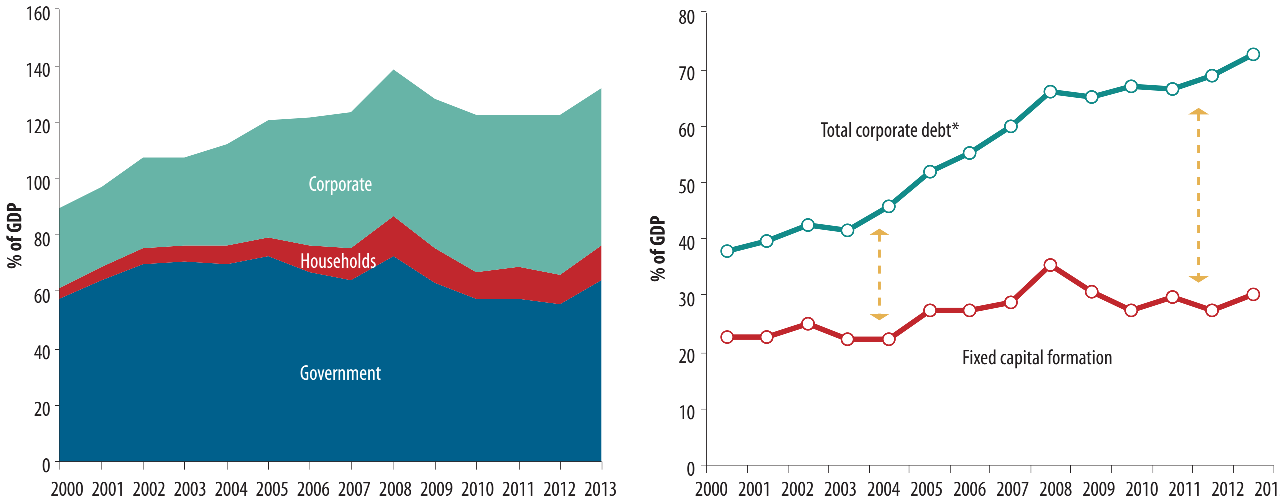


FIGURE 29: Domestic debt composition shows an increasing share of corporate debt while it increased disproportionately compared to fixed investment growth

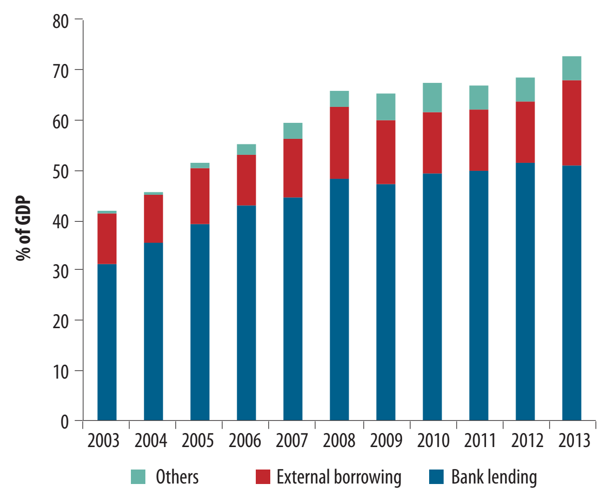


Source: Reserve Bank of India

levels seen in 2008, with bank lending making up the lion's share of corporate debt. Domestic corporate debt-to-GDP likely increased a sharp 16 percentage points during FY2004-FY2008, to 52 percent. However, during the last five years, the share is estimated to have marginally increased to 56 percent in FY13. Large part of leveraging happened in an environment of robust economic growth with expectations of sustained economic momentum. Real GDP expanded an average 8.7 percent per year during FY2004-08, but moderated to 7.1 percent during FY2009-13. In context of the Indian corporate sector, bank lending makes up majority of the domestic corporate debt. Corporate bonds—though growing briskly—still constitutes mere 3 percent of GDP. The share of bank lending to the private sector has significantly increased between the early 2000s and 2013 but remains lower than the regional average. Ultimately, disproportionately faster growth of credit and capital inflows, compared to the rate of fixed investment growth, raised the leverage of domestic corporates.

The sharp depreciation of the rupee in 2013 and slowdown in output growth has substantially increased the cost of servicing existing debt, especially of India's infrastructure companies. Although pressures have eased recently, external vulnerability has increased in the private sector. First, a significant part of corporate debt was in the form of external commercial borrowings – which usually have a 3-4 year tenure – and are near maturity. Anecdotal evidence indicates that heavily indebted firms are struggling to renegotiate debt repayment schedules. To bridge funding gaps or

FIGURE 30: Bank lending and overseas borrowing account for majority of corporate debt



Source: CEIC

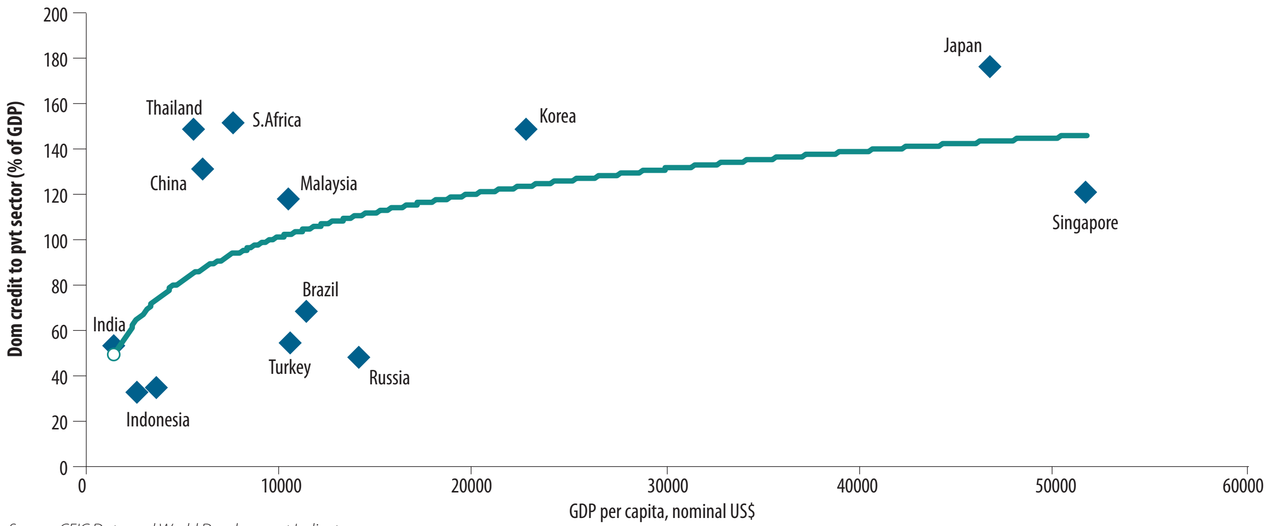
correct capital structures, sponsors are also considering stake/asset sales, examples being Lanco, Adani, GVK, GMR, Tata Power, Ramky Infrastructure. Second, even though the rupee has appreciated around 12 percent from its all-time lows in August last year, it is still nearly 10 percent weaker than that at the beginning of 2013. Thus, to the extent that some part of the borrowing remains unhedged, it could pose risks to the corporate balance sheets.

Pressures on Indian banks have been increasing as witnessed by an increase in NPAs. Cash flow pressures from a weak operating environment have been

BOX 2: Economic development and leverage:

While the total debt burden has increased in the region over the last decade; in most of the South Asian economies, including India, the debt-to-GDP ratios have remained well below those in advanced economies. This can partially be explained by the fact that better developed economies can be expected to have higher capacity to carry debt burden. As an economy matures, its financial market develops, helping to allocate capital efficiently – providing the corporates and households with wider and sophisticated tools to increase leverage.

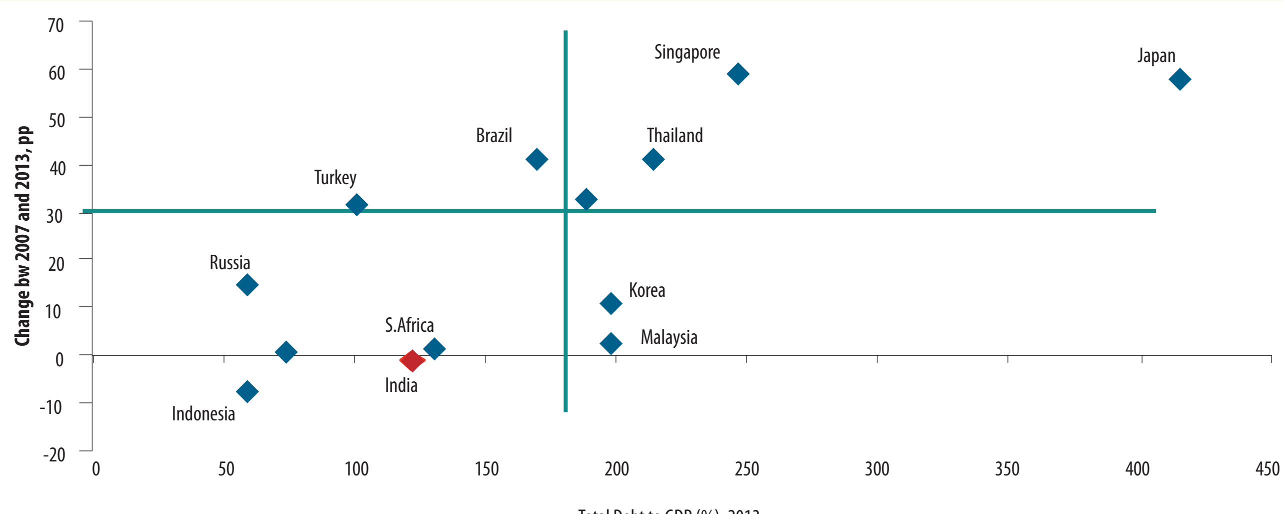
Growth in the share of bank lending maps economic expansion of a country quite well



Source: CEIC Data and World Development Indicators

The chart above indicates that economies with higher per capita income – Singapore, Japan, Korea—have significantly higher credit-to-GDP ratios as compared to the emerging economies of Brazil, Turkey, South Africa, Thailand, Malaysia and Indonesia. Despite having grown sharply over the last few years, India's private sector credit-to-GDP is well below most of its EM peers.

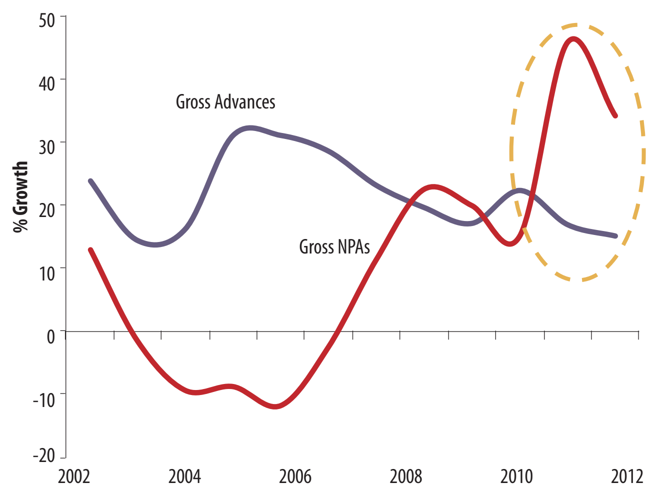
India is likely to be less vulnerable with relatively lower debt burden when compared to EM peers



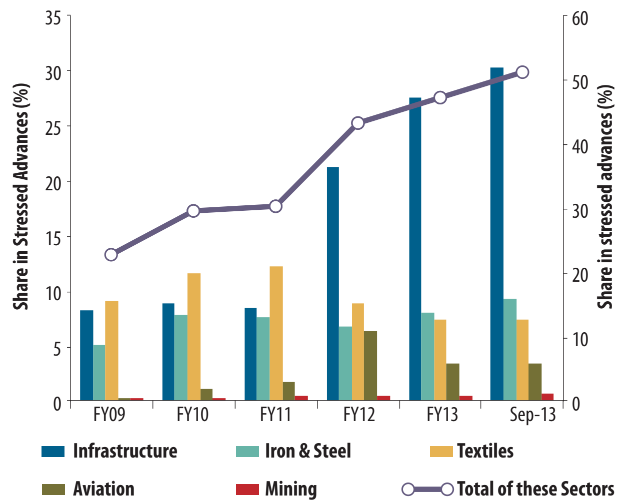
Source: CEIC Data and World Development Indicators

The figure above plots the change in total debt to GDP ratio since 2007 against its current level. Economies in the top right hand corner are expected to be more vulnerable as they have witnessed a sharp rise in leverage and carry a relatively large debt burden. Solely using this lens suggests that India is less likely to be at risk than some of the peers. However, a significant share of the corporate debt in India is funded externally, thus making the balance in the external account vulnerable to external financing.

FIGURE 31: Growth in NPAs far exceeds that in advances (left) and sector contributions to stressed advances (right)



Source: Reserve Bank of India



aggravated by high leverage of firms, making them more vulnerable to sustained periods of slowdown, delays in projects, or external shocks. Gross NPLs have risen to 4.1 percent as of December 31, 2013 from 3.6 percent in FY2013 and 2.5 percent in the previous two years. The picture looks worse if restructured assets are also included – estimated at 9.2 percent as of March 2013. There has been a steep rise in the number and value of the restructuring of loans, particularly of big ticket loans under the corporate debt restructuring (CDR) mechanism. CRISIL estimates that as much as 5.7 percent of advances as of March 2014 could be NPA (including slippages from restructured assets). [4] RBI stress tests indicate that GNPA ratio is expected to peak by September 2014 and improve thereafter. Under severe stress conditions, RBI estimates the GNPA ratio could reach 7 percent by March 2015.

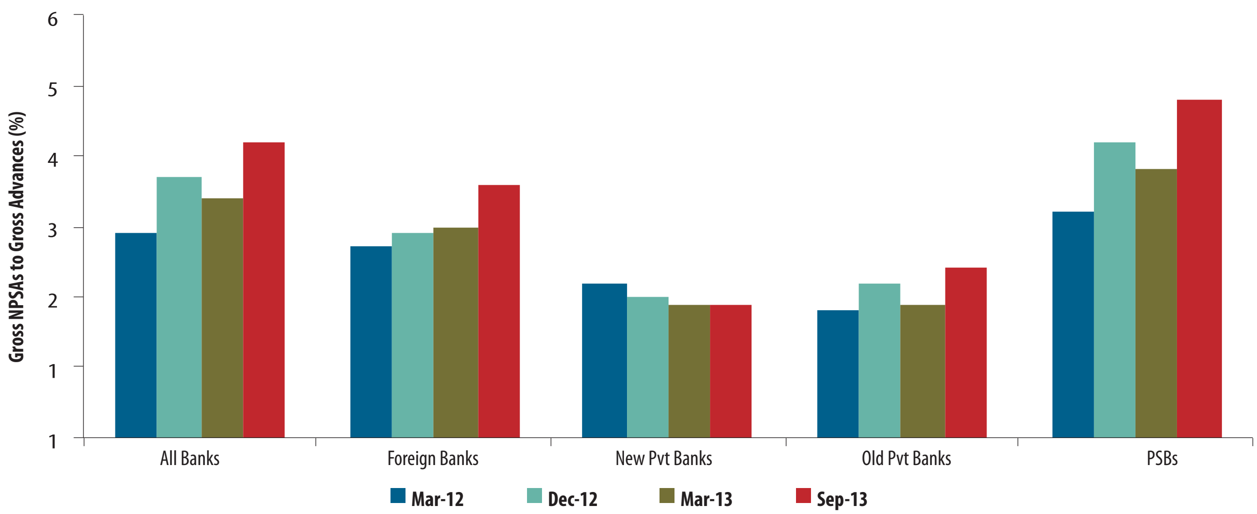
Infrastructure and related sectors are the largest contributors to bank NPAs and corporate debt restructuring cases. Infrastructure, iron & steel, aviation, and mining – which together contribute 20 percent to bank advances – accounted for around 44 percent of total stressed assets as of September 2013. These sectors were hit by operational challenges—such as lack of fuel availability and poor cash flow generations relative to those made at the time of conception of these projects—which have had a marked effect upon their credit quality. As of end-December 2013, infrastructure (including power and telecoms) accounted for 37 percent of live CDR cases, and the ratio rises to over 60 percent if iron & steel, construction, and ship building are also included. About 16 percent of infrastructure loans were restructured till March 2013. Performance in the sector continues to be affected by unresolved issues on fuel linkages (despite Coal India Fuel Supply Agreements), increasing dependence on imported coal, offtake risks on account weak discoms and regulatory/political risks in effecting tariff increases. Having said that, ultimate losses are expected to be low as these projects remain viable, expected to generate cash flow over the operational life.

Public-sector banks (PSBs) are most affected by growth in stressed assets. In India, PSBs are the largest contributor to stressed advances with 75 percent of advances generating 86 percent of stressed assets till September 2013. Some of the mid-sized public sector banks remain vulnerable to the elevated single-name / sector concentrations. PSBs approach to NPA management differs from other banks, as they retain a high proportion of restructured assets on their books. On the contrary, new private sector and foreign banks choose to write off rather than hold delinquent assets demonstrating more agility to act on the part of management.

Bank capitalization as required by Basel III may also pose a challenge for PSBs unless being spread out over the transition period. Funding challenges for the banking sector moderated as the loan growth slowed down in FY2014, however the imbalance could resurface once the demand for credit gathers pace with overall economic activity. Further, in line with the

4 H1 2013-14 Ratings Roundup

FIGURE 32: Stressed assets continue to grow



Source: Reserve Bank of India

BOX 3: The Transition to Basel III in India

An estimated Rs 5 trillion1[1] is the capital requirement of banks over 2013-2018 for Basel II and III purposes, of which non-equity capital is of the order of Rs3.25 trillion while equity capital is of the order of Rs1.75 trillion. Government of India would need to infuse between Rs 700-900 billion, depending on where it wants to maintain its shareholding leaving the balance to be funded through minority shareholders and capital markets. Whether markets have the appetite for common equity, debt or additional Tier I instruments (Basel III compliant) remains a risk factor. Also, capital assumptions assume a certain proportion of retained earnings to be ploughed back which under current conditions of stress may be an overestimate. Even assuming back ended requirements, the FY2015 requirement of Rs112 billion while manageable from the Government perspective, is a reduction from Rs140 billion of FY2014 and therefore warrants a question as to its adequacy given current asset quality stresses.

1 Approximately 80 percent of this would be for public sector banks.

Basel III requirements, the demand for Tier I capital is expected to increase from FY2015 onwards, increasing substantially in subsequent years till FY2018. Private sector banks, with better access to equity markets and currently healthy capital levels, are unlikely to face challenges in maintaining the required capitalization level. However, the situation could be challenging for state-owned banks which have weak credit profiles and are unable to sufficiently tap the capital markets. If raising capital is managed effectively by spreading out over the transition period, together with sustained improved performance, the impact of equity injections on government finances is unlikely to be burdensome.

Hence, unless mismanaged, the increase in corporate leverage and distressed assets will put some pressure on PSBs but overall is unlikely to pose systemic risks for the banking sector. The current corporate situation is unlikely to place insurmountable stress on the economy, but it does offer an opportunity to undertake reforms, including broader banking/financial sector reforms. Viability of the banking system appears adequate although profitability of some banks remains vulnerable to elevated sector/single borrower concentrations. Stressed assets of the banking system can be contained should the current growth prospects materialize and the investment cycle pick up as expected; as this would improve corporate cash flows and reduce default risk. However, delay in growth revival and an event of aggravated macro risks could worsen the credit pressures. However, the funding imbalance may surface with increased capital demand to meet the Basel III requirements and a pickup in credit growth.

Continued strengthening of the regulatory framework governing banking in India as well as a stable and committed government will be key factors for financial sector stability. Regulatory measures forcing banks to improve loan loss reserves (on restructured loans and exposures to corporates with large unhedged

FIGURE 33: Financial Sector Asset Composition

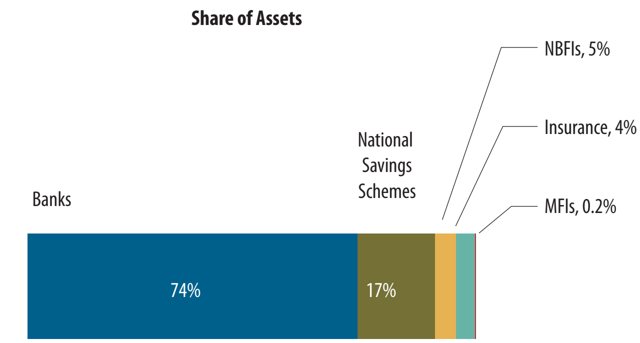
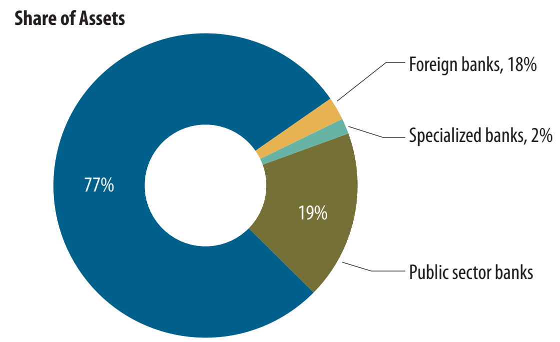


FIGURE 34: Asset Structure of Banking Sector



Source: State Bank of Pakistan Financial Sector Review 2011 and Quarterly Statistics of the Banking System December 2013

forex liabilities) and common equity injections will likely help the banking sector maintain adequate defenses. Further, the systemic support to the sector remains strong, as evidenced by recently announced allocations of government funds to bolster capital at public sector banks. It is also worth noting that Indian banks continue to have sound liquidity metrics, underpinned by a sizable domestic deposit base and minimal reliance on wholesale funding. And in light of upcoming elections, a stable government will help reviving both foreign as well as domestic investment needed to underpin growth and lift credit quality of Indian banks.

Pakistan's private banks and public debt

Pakistan has a largely private financial sector, with private commercial banks constituting the largest share of assets. The financial sector has over US$ 130 billion in assets, 74 percent of which are in the banking sector. Within the banking sector, private commercial banks make up 77 percent of assets, 79 percent of deposits and 75 percent of loans. These banks contribute to overall market efficiency, comprising 77 percent of income and 84 percent of profits before taxes.

Stability and performance of the banking sector has been strong over the last decade, reflected in solid assets growth, adequate liquidity, and growing profitability, while maintaining solvency and capital adequacy thresholds. The sector is largely

FIGURE 35: Banking Sector Growth

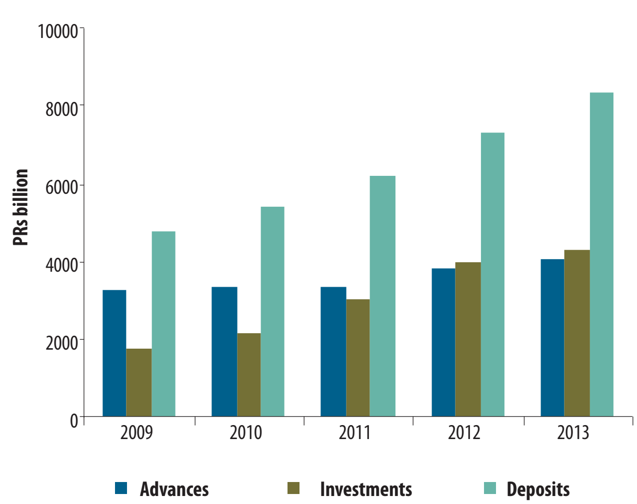
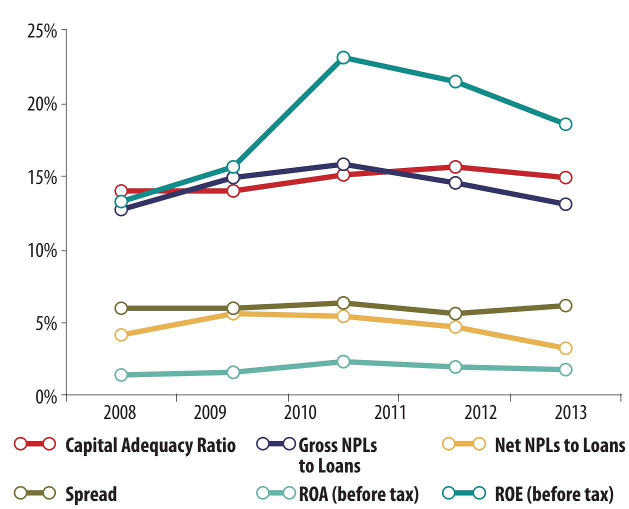


FIGURE 36: Banking Sector Performance



Source: State Bank of Pakistan Financial Sector Review 2011 and Quarterly Statistics of the Banking System December 2013 compliant with the Basel Core Principles. State Bank of Pakistan's banking sector supervision has remained relatively strong and independent over the past, and it has conducted regular financial stability reviews as well as stress tests. In August 2013, SBP decided to implement Basel III standards (issued by the Basel Committee on Banking Supervision) to further strengthen capital related rules.[5] The minimum capital adequacy ratio requirement is 10% of risk-weighted assets while the statutory minimum capital requirement is high at PRs 9 billion (US$ 90 million) which is considerably higher than in other South Asian economies such as India, Sri Lanka and Bangladesh.[6] Advances, investments and deposits have grown at compounded annual growth rates of 5 percent, 32 percent and 15 percent respectively in the five year period 2008-2013 (Figure 3). Return on equity and Return on assets peaked in 2011 at 23.0 percent and 2.2 percent respectively, and continue to be strong.

The banking system has very limited exposure to external shocks and has showed resilience amidst domestic shocks, but may now be vulnerable to reverse shock transmissions from the Government of Pakistan. The sector was not heavily impacted by the global financial crisis mainly because of limited inter-linkages with international financial and securities markets. Further, the sector showed resilience to domestic shocks in the form of the economic slowdown in the past five years. Gross non-performing loans (NPLs) increased significantly from 7.6 percent of total portfolio in 2007 to 15.7 percent in 2011. However, adequate provisioning kept net NPLs in check, and banks persisted with a risk-aversion to private sector credit despite strong liquidity positions. The Government of Pakistan has been dealing with BOP and fiscal imbalances that have intensified in recent years. An economic slowdown, weak external inflows, low revenue collection and high subsidies to support an unsustainable energy mix have all contributed to a significantly deteriorating balance sheet. To manage these pressures, the government has been relying heavily on domestic sources of funding (Figure 5). Annual borrowing from domestic banks was PRs 952 billion in FY13 compared to PRs 186 billion in FY09. Moreover, direct borrowing from SBP of PRs 505 billion in FY12 and another PRs 506 billion in FY13 has mopped up liquidity from the market.

The banking system now holds a substantial portion of the government's debt. The government's domestic debt has increased from PRs 3.9 trillion (30.3 percent of GDP) in FY09 to PRs 10.3 trillion (41.8 percent of GDP) in FY13. The domestic banking sector holds approximately 35 percent of this domestic debt. Finally, assets of the banking sector in recent years have continued to expand in the form of investments in government securities. As a result, banks now hold about 77.4 percent of government securities outstanding. Over 90 percent of these holdings are in short term (less than 1 year) market treasury bills, and profitability is

5 According to State Bank of Pakistan, BPRD Circular No. 06 of 2013, the instructions will become effective in a phased manner with full implementation intended by December 31, 2019.

6 There are four undercapitalized banks in the sector which are being closely monitored by SBP as part of the financial sector benchmarks set under Pakistan's current three-year IMF EFF arrangement.

FIGURE 37: Government Debt Profile

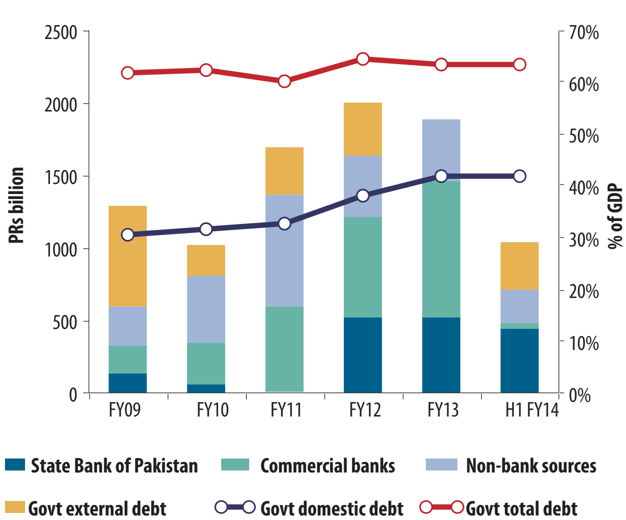
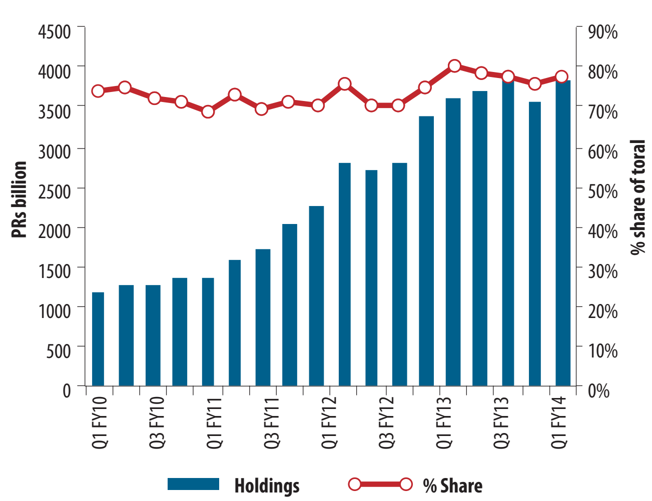


FIGURE 38: Bank Holdings of Government Securities



Source: State Bank of Pakistan Financial Sector Review 2013 (State of the Economy) and Monetary Statistics March 2014 linked to an accommodating interest rate environment. However, with debt levels of the government reaching unsustainable levels, and limited expansion of private sector credit, banks remain exposed to significant risk on government, which in turn is exposed to significant external account and fiscal shocks.

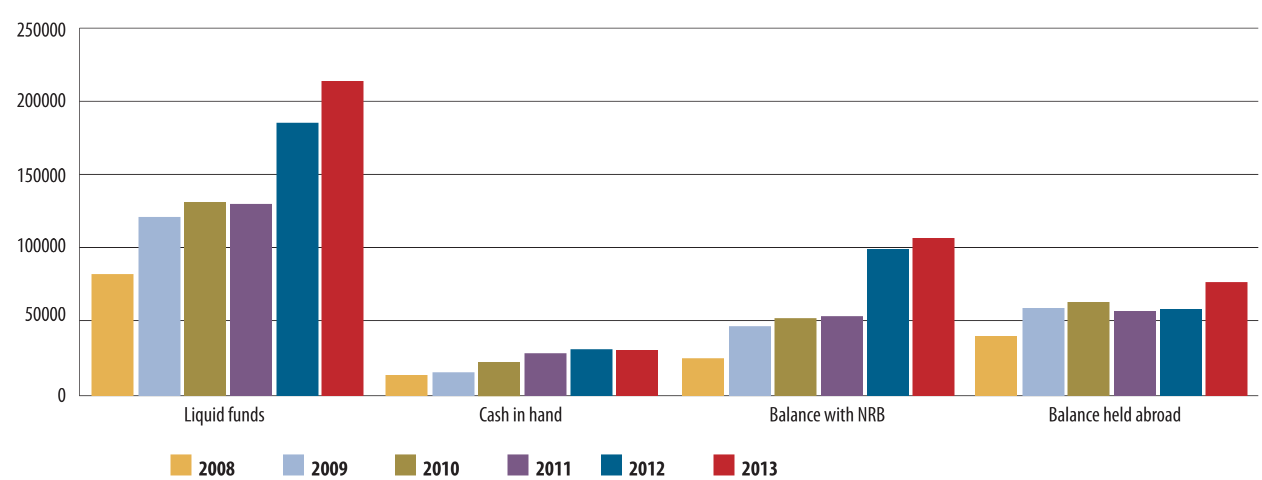
While the banking system has adequate absorption capacity for shocks transmitted through the government, the risk of such exposure is not adequately reflected. First, liquidity implications are not fully reflected because these large holdings of short term government securities are essentially being refinanced and rolled-over through new and larger auctions of market treasury bills. At the same time, these securities are traded only between designated banks - a secondary market through the stock exchange has been launched but has not yet been implemented. Second, there may be impacts on solvency and capital adequacy which are not being covered. Capital adequacy and risk weight of assets treat short term government securities as risk-free, thus increased government borrowing from banks has actually increased banks' capital adequacy ratios. Banks' overexposure to government debt, the government's vulnerable external account and fiscal positions, and the existence of a reverse shock transmission mechanism are proving to be a new source of systemic risk to the banking sector.

Nepal's banks and the question of liquidity

Since severe liquidity constraints had contributed to an "almost financial sector crisis" in mid-2011, excess liquidity has been building up in Nepal's financial system. Fuelled by remittance growth, Nepal's banking sector appears to be increasingly holding liquid assets rather than supporting productive investment through lending. Deposit mobilization increased by 8% in the first half of the year vs. 5.3% at the same time in FY2013; by contrast domestic credit growth slowed to 7.3% over the first 6 months of the fiscal year under the influence of both lower levels of government borrowing and slower growth of claims on the private sector (9% in the review period vs. 12.3% in the first half of FY2013). As a result, the loans-to-deposits ratio has been declining over time. Three commercial banks (8.8% market share) recorded Credit to Deposit Ratio (in LCY) in excess of 90% in the second quarter of FY2014 compared to five commercial banks (9% market share) in the previous quarter and eleven banks (30percent of the market) in the previous year. At the same time, treasury bills accounts of commercial banks increased significantly, almost doubling between FY2011 and FY2013. Reflecting these trends the interest rate spread between risky assets (private sector loans) and low risk assets (T-Bills) widened significantly.

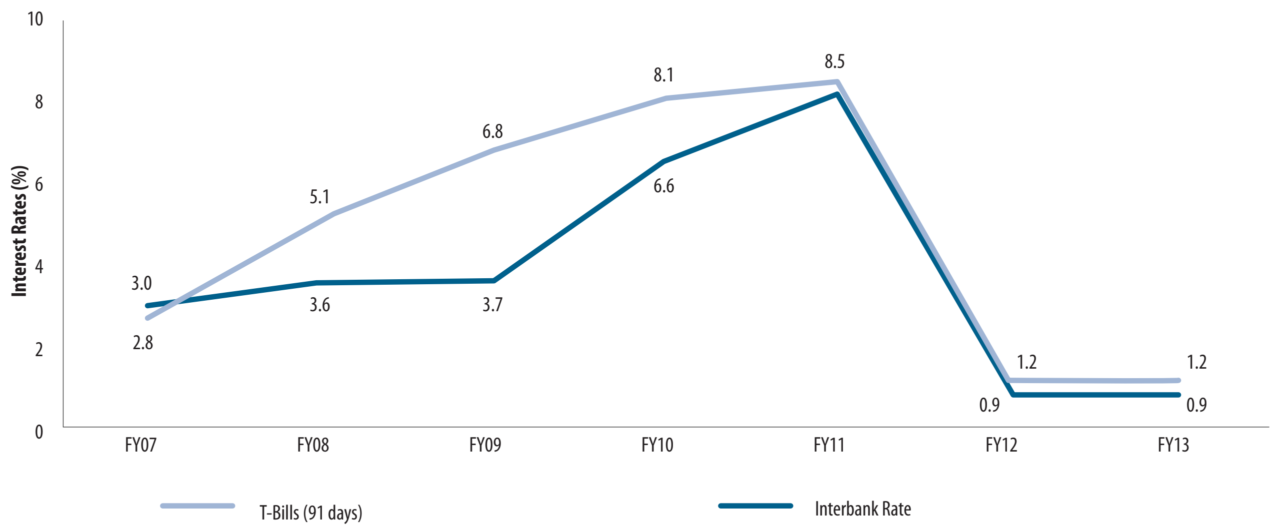
Banks appear to be withholding credit by maintaining high lending rates despite slower credit growth. In other words, prices may not be efficiently clearing

FIGURE 39: Liquid assets of commercial banks are increasing



Source: NRB

FIGURE 40: Interest rates may not effectively clear markets



the credit market at this point. While credit to the private sector remains high, the rate of credit growth has decreased significantly from FY2013. Also, the large interest spread between risky assets (credit to the private sector) and low risk assets (T-bills, deposits at NRB) is significant, indicating reluctance from banks to use the price mechanisms to attract greater demand for loanable funds. That is not because of involuntary rationing (although the NRB has imposed some limits to real estate related lending) but rather appears to be a voluntary behavior, possibly linked to psychological factors and/or a reassessment by banks of default risk and balance sheet weaknesses.

Excess liquidity may be costly in terms of growth effects and inflationary pressures. Excessive liquidity can be a source of concern for growth to the extent that it amounts, de facto, to a tightening of the money supply. Ceteris paribus, excessive liquidity means less lending to support non-government productive investment –for a given money base- and therefore slower overall economic growth. However, at the same time, it is potentially a source of inflationary pressure. Abundant liquidity comes at a cost for commercial banks (in the form of deposit) who will only hold it if they need to improve their balance sheets and/or consider the risk profile of borrowers to be too high. But such liquidity can be rapidly mobilized for lending if these parameters change and can translate in asset bubbles fueling inflation.

Choosing a monetary policy stance, therefore, involves a tradeoff between the objectives of avoiding an unnecessary slowdown in growth on one hand and controlling inflation on the other hand. Maintaining a relatively lose monetary policy and allowing the excess liquidity to remain is consistent with emphasis

BOX 4: Effects of excess liquidity

-On growth: as the bias toward liquidity implies a higher cost of borrowing (or credit rationing) leading businesses and households to defer investments or current expenditure and possibly to sectoral shifts in the composition of lending at the expense of smaller and less well established clients (flight to quality)
-On inflation: to the extent that it increases the capacity of the banking sector to boost credit in response to demand shocks, inflationary pressures could quickly become difficult to contain
-On financial sector stability: the effect is ambiguous: to the extent that banks can have access to cheap money, high levels of liquidity provide a boon to the banks' ability to rebuild their balance sheets; at the same time, if adequate safeguards are not in place and banks remain exposed to liquidity risks (as is the case in Nepal) banks could be tempted to engage in overly risky lending practices
-On monetary policy effectiveness: by affecting the ability of monetary authorities to stimulate demand and stabilize the economy during downturns: with banks already highly liquid (i) further attempts by the monetary authorities to stimulate demand would likely prove futile and (ii) the ability to regulate the money supply via reserve requirements and the money multiplier are also proportionately weaker.

on the growth objective. Draining off excess liquidity is consistent with a priority on the inflation objective. In other words, if sound demand for credit exists in the economy but does not materialize either because of reluctant investors and/or excessively risk-averse banks, then maintaining a relatively loose monetary policy may be justified. On the other hand, if banks are worried about balance sheet weaknesses and/or assess the existing demand for credit as too risky, then a loose policy stance combined with policy directives to expand lending could exacerbate financial sector woes and feed asset bubbles and inflation. NRB has identified two additional policy objectives namely, financial development and stability. Loose monetary policy is consistent with both, however its combination with policy directives to fix the spread that banks can maintain between deposit and lending rates is not and possibly counterproductive.

Ultimately, understanding the drivers of the credit slowdown is crucial. On the one hand political uncertainty, especially since the dissolution of the first Constituent Assembly and in the run-up to the elections, may have led private operators to postpone investment decisions; likewise the depreciation of the Nepali rupee may have led importers to reduce their demand for letters of credit. On the other hand however, the supply of credit may also have fallen (for any given level of interest rate –i.e. leftward shift of the supply curve) due to balance sheet weaknesses of banks and/or heightened perception of default risk. The banks' continued exposure to real estate – whose valuation is particularly hard and where the market remains subdued– adds to the constraints that banks face in assessing the true extent of their exposure and need for additional protection beyond those imposed by regulation. Perceptions could also be playing a part including the experience of crisis (an impaired loan portfolio) and/or heightened uncertainty (leading to regard previously normal loans as having now excessive risk). These two dynamics maybe re-enforcing each other since the most typical form of collateral is real-estate.

In the short run, NRB should closely monitor the evolution of bank balance sheets, stand ready to tighten monetary policy, and reconsider the proposed cap on interest rate margins between deposit and lending rates. First, the NRB should carry out an in depth review of weaknesses of BFIs and build capacity to provide effective supervision, as there is still uncertainty about the true health of Nepal's financial sector (e.g. the amount of ever green loans in the system) and a better diagnostic is needed. Second, given the relatively favorable macroeconomic outlook, Nepal is in the fortunate position to be able to afford a relatively conservative monetary policy stance. Third, the interest cap needs reconsideration as it adversely affects both the ability of banks to rebuild balance sheet strength and to use price mechanisms to discriminate between good and bad loans, and it may compromise the objective of restoring balance sheet health and allowing sound demand for credit to be met.

In the medium run, monetary policy objectives need to be clarified and the available monetary policy tool kit empowered to strategically deal with structural excess liquidity. While excess liquidity can result from temporary shocks, in Nepal this is increasingly a structural feature of the economy. The phenomenal and sustained rise in inward remittances and corresponding buildup of net foreign assets –other things equal- is steadily growing the money base. At the same time this overall steady rise is combined with short term fluctuations driven by remittances and asset bubbles (and their bursting), which discourage investors from making long term investments (due to the un-predictability of funding) and bank lending (due to the unpredictability of supply of credit). NRB, however, has acted with increasing frequency in FY2014 to absorb excess liquidity in the system via reverse repo and open market operations (outright sale auctions) but these are short term fixes, in fact more typically used for fine tuning purposes -to smooth the interest rate fluctuations caused by temporary variations in liquidity- than for long term management. As such they are different from so called structural operations that are used to adjust a central bank's long term position vis-à-vis the financial sector. Therefore, it will be important to develop a toolkit to deal with excess liquidity in a strategic way providing clarity and stability with respect to goals (inflation and growth) and adopt corresponding targets for bank liquidity and interest rates. Given the cost of sterilization, the best option is to tackle the inefficiencies that are at the source of involuntary or 'excessive' of liquidity. This implies that the GoN should continuously carry out structural reforms to improve the overall credit environment and the investment climate to make sure that banks can expand lending in a sustainable and safe manner to viable investments.

South Asia Country Briefs

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MALDIVES

NEPAL

PAKISTAN

SRI LANKA

Afghanistan

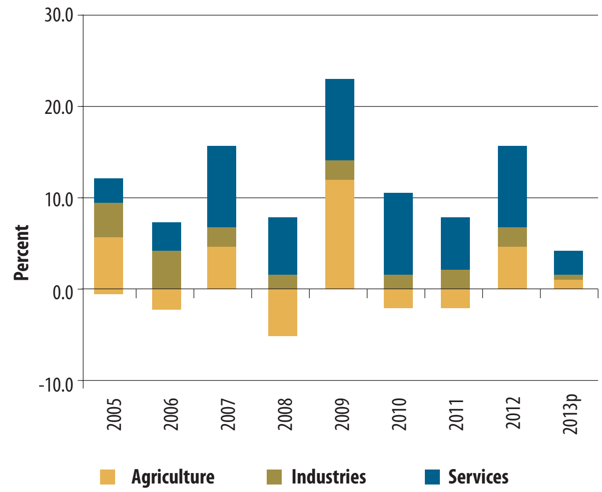
Recent Economic Developments

Economic growth fell dramatically in 2013, to an estimated 3.6 percent of GDP from 14.4 percent in 2012, as heightened uncertainty about the political and security transition led to a slump in investor and consumer confidence. It was the second successive year of robust agricultural output – cereals production rose 2.7 percent above the bumper harvest of 2012 – but the bounty could not make up for the falloff in private investment and tepid growth of non-agricultural sectors – construction, manufacturing and services. The number of new firm registrations fell sharply in 2013 to its lowest level in five years, with a reduction in both local and foreign new fixed investments.

The slide in confidence is rooted in concerns about national security and stability after most international forces withdraw in 2014 and doubts that a cohesive, broadly accepted government will take hold within a reasonable period after the April 2014 elections. Growth is projected to remain weak in 2014, although a smooth political and security transition would help bolster confidence and enable economic growth to pick up in 2015.

Revenue collection weakened in 2013, while Afghanistan's large security expenditure obligations and high aid dependence threaten to crowd out important civilian operating and development spending. After a decade of strong revenue growth, domestic revenues declined to 9.5 percent of GDP in 2013, from 10.3 percent in 2012 and a peak of 11.6 percent in 2011. Nominal revenues amounted to Afs 109 billion in 2013, almost level with the pro-rated figure for 2012. The decline in revenue collections is a result of the economic slowdown as well as weaknesses in enforcement in both tax and customs administration. Meanwhile, with more security spending moving into the budget, on-budget security expenditures increased to 11.5 percent of GDP in 2013 from 10.4 percent in 2012. Civilian expenditures, on the other hand, declined to 12.8 percent of GDP in 2013 from 13.4 percent in 2012, as the government tightened public spending following the mid-year budget review.

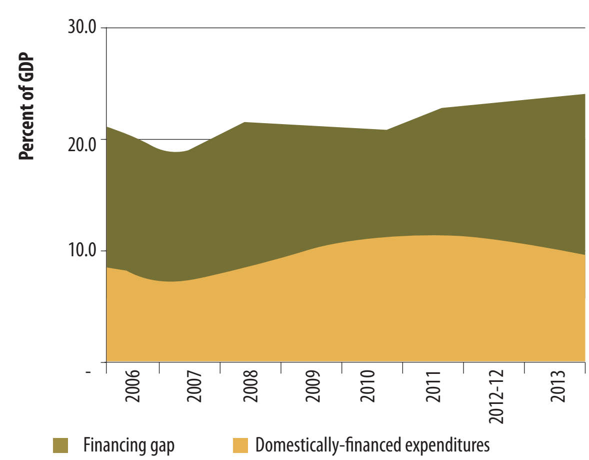
GDP Growth & Sectors, 2005-2013



Public expenditures rose only modestly in 2013, with total budget spending just 24.2 percent of GDP (US$5 billion) from 23.8 percent (US$4.9 billion) in 2012. Spending on sectors such as education, health, and agriculture & rural development increased modestly or held steady, while lower spending on infrastructure and economic governance accounted for most of the decline in civilian expenditures in the year. It was considerably lower than the previously projected 2013 budget spending of 26.7 percent of GDP, and is a result of austerity measures put in place to address the weak revenue collection and overall lower discretionary resources.

The Ministry of Finance introduced a variety of measures in 2013 to stabilize revenues, reduce leakages, and improve administration. These measures included the implementation of a computerized risk

Financing Gap:
Domestic vs. Total Core Expenditures



management module, improved procedures for random post-verification of examination, introduction of post-clearance audits, salary incentives for detection of non-compliance, and an increase in fuel valuation at customs. While the immediate effects of these measures have been modest to date, they have likely prevented an accelerated decline.

Consumer price inflation remained below 10 percent throughout the year. Period-average headline inflation increased slightly to 7.7 percent in 2013, up from 6.3 percent the previous year, but remained in single digits throughout the year. Furthermore, Afghanistan has enjoyed a period of relative price stability in the last two years compared to the fluctuations and acute swings in prices which occurred during and after the 2008 world commodity price crises.

Food price increases exceeded non-food increases in the second half of 2013, in contrast to the first half of the year. The increase in food prices (year-on-year) was 9.8 percent in December 2013, from 4.4 percent in December 2012. On the other hand, the increase in non-food prices moderated to 4.8 percent from 7.4 percent over the same period.

Foreign aid inflows continue to finance the large trade deficit and sustain foreign exchange reserves. The trade deficit remained large but declined slightly in 2013 as slower economic growth and demand led to a moderation of imports. Total estimated imports –both official and smuggling – declined by an estimated 4 percent, reducing the trade deficit from -42.4 percent of GDP in 2012 to -39.9 percent in 2013. Because of an exceptionally high level of unofficial trade in Afghanistan, official recorded exports are estimated to represent only one-fifth of total exports. Total exports in 2013 were estimated at US$2.6 billion, of which about US$500 million were recorded by official sources. (The large difference between total estimated and officially recorded exports is explained not by opium but by unofficial non-opium exports.) On the other hand, official imports were US$9.3 billion for 2013, while total imports were an estimated US$10.9 billion.

Illicit opium production and the area under poppy cultivation rebounded even more impressively than official agriculture in 2013. Though opium production is not reflected in official GDP growth figures, the UN Office on Drugs and Crime reports that opium production increased by almost 50 percent to 5,500 tons in 2013 and the total area under poppy cultivation expanded by 36 percent to 209,000 hectares (after a decline in 2012 due to adverse weather and disease). Despite substantial financial flows from opium production, analysis suggests that opium's contribution to Afghanistan's economic growth in the past 10 years has been minimal, although it is probably an important source of livelihood for a segment of the rural population.

Outlook and Policy

Economic growth is projected to remain weak at 3.2 percent in 2014 due to heightened uncertainty and lower agriculture output. Uncertainty surrounding the political and security transition is expected to persist through most of 2014, resulting in continued weakness in private investment and growth in the non-agricultural sectors. A smooth political and security transition would help restore confidence in the economy. At the same time, lower agriculture output is anticipated in 2014 as the winter precipitation has been assessed as less favorable. Taking into account the bumper harvest in 2013, agricultural output in 2014 is expected to be lower than in 2013, thus placing a further drag on growth prospects for 2014, explaining the lowered projection of 3.2 percent of GDP. In this context, public investment expenditures on essential infrastructure can provide an important prop for economic activity during this period of heightened uncertainty and also contribute to Afghanistan's medium-term growth prospects.

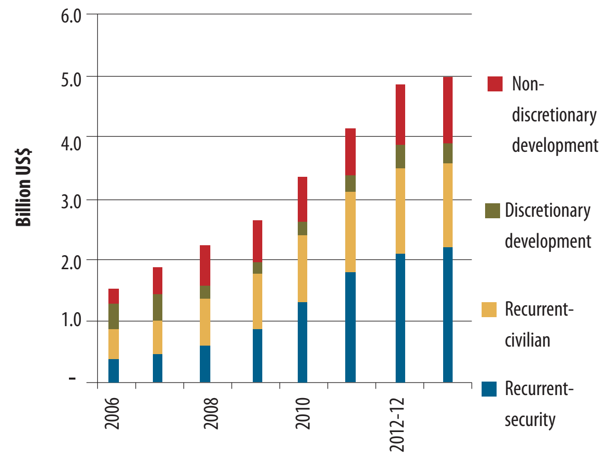
In the medium term, post-transition growth is projected at about 5 percent per year during 2015 to 2016. This is less than the average growth of 9.4 percent per year during 2003-12 that was fueled by the surge in international aid and security spending. The post-transition growth outlook is contingent upon a relatively stable security environment, with agriculture and extractive industries likely to be among the significant sectors driving growth. Agriculture accounts for about a quarter of GDP and is also linked closely to other parts of the economy, such as food and beverages (which account for almost all of manufacturing), and parts of transport and retail. Afghanistan has the potential to build on this foundation by reviving its historical position as an important exporter of fruits, nuts, vegetables, and other higher value-added products. This will require investments in irrigation and extension services to improve capacity, as well as efforts to build and improve downstream agro-processing activities. On the other hand, the extractive industries sector currently accounts for a very small share of GDP, but has significant potential in light of Afghanistan's deposits of copper, iron ore, and hydrocarbons. Unlocking this potential will require progress on the legislative framework, securing financing for the necessary infrastructure and, by adopting a "resource corridor" approach, enhancing the value of these resources for Afghan communities.

The medium-term growth outlook is subject to serious risks which will need to be carefully managed. Significant uncertainty surrounds the outcomes of the political and security transition in 2014. Continued violence, economic crime and systemic corruption also have often undermined progress in Afghanistan's governance and state-building agenda. Much will depend, therefore, on Afghanistan's success in achieving peace, stability and reconciliation.

Given the recent weakness in fiscal revenue performance, a concerted effort will be required from the authorities to improve revenue mobilization. Donors have committed to cover the budget financing gap, although these funds are contingent on satisfactory progress in the Tokyo Mutual Accountability Framework (TMAF), of which an important indicator is increasing domestic revenue. The July 2012 donor meeting in Tokyo pledged US$16 billion in development aid for Afghanistan over 2012-16. Together with earlier pledges on the security side, this means annual aid of about US$8 billion – roughly equally divided between civil and security aid.

The medium-term fiscal framework calls for an increase in revenues from 9.5 percent of GDP in 2013 to 11.1 percent in 2015 and 13.8 percent in 2018 (or just under one percentage point of GDP per year). In light of recent weaknesses in collections, the increase in revenues will require a concerted effort on the part of the Afghan authorities to (i) reduce leakages and strengthen customs administration; and (ii) expedite the introduction and implementation of the planned value-added tax (VAT). The natural resources sector also has the potential to contribute to revenues in the medium term, but the timeline for this has become more uncertain in light of recent developments in the sector.

Total Budgetary Expenditures, 2006-2013



Budget expenditures are expected to continue to rise, from about 24 percent of GDP in 2013 to about 30 percent of GDP by 2016. The increase in budget expenditures is largely a reflection of more spending moving on-budget from previously being undertaken directly by donors. There appears to be limited space to adjust expenditures without adversely affecting growth prospects and social outcomes.

Bangladesh

Recent Economic Developments

The falling growth trajectory of the last three years looks set to stay course in FY14 as political turmoil, stagnating private investment, and declining remittance continue to exact a toll on the Bangladesh economy. GDP growth is projected to fade to 5.4 percent in FY14, from 6 percent last year, but an export growth revival and uptick in public spending could yet stem the slide.

The political turmoil inflicted a value-added loss of about US$1.4 billion, of which 86 percent was in services, 11 percent in industry and the remaining 3 percent in agriculture. Growth performance in all major sectors is expected to be weakened by general strikes (hartals) and blockades. Business and consumer confidence in general was undermined by domestic and foreign investors' perceptions of declining rates of return on investment, and by reduced remittance and demand for Bangladeshi labor. Progress in the twin goals of eliminating poverty and boosting shared prosperity is likely to have slowed from the rate of the last three years because of slower growth and loss of employment.

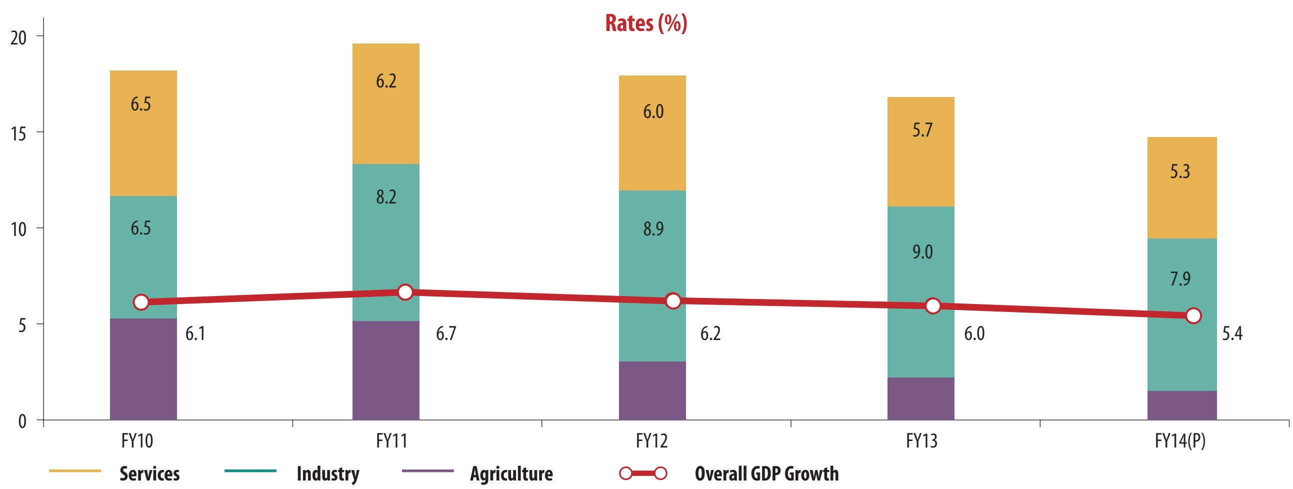
Inflation may rise to 7.5 percent this year, from 6.8 percent in FY13, due to the cost push from supply disruptions and wage increases. The political disturbances obstructed food distribution channels, throttled supplies, and drove up food prices. Stability in international commodity prices, weak domestic demand, and appreciation in the nominal exchange rate combined with a restrained monetary policy to moderate the increase in inflation.

External balances have remained comfortable due to strong export growth and weak imports which more than offset the decline in the level of workers' remittance. A large surplus in the overall balance of payments, driven primarily by an increased surplus in the current account, and the Bangladesh Bank (BB)'s frequent interventions to prevent appreciation of the nominal exchange rate led to further accumulation of official reserves to over five months of GNFS import cover.

Monetary policy was restrained, achieving broadly the targets for the first half of FY14. Implementation of monetary policy benefited from a slowdown in private credit growth. This contributed to an increase in excess liquidity despite the BB stepping up sterilization operations to counter above-target growth in net foreign assets.

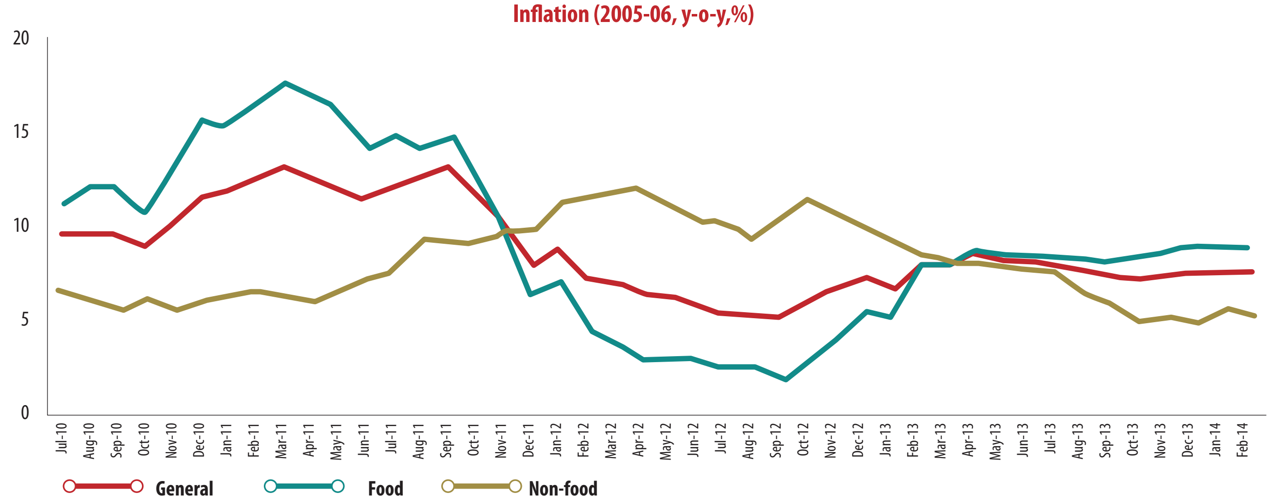
The financial sector has been stressed by deteriorating fundamentals of the banking sector in step with a rise in default risk across the board due to losses inflicted by prolonged disruptions in production and trade. The state-owned banks were already negatively impacted by the earlier financial scams. The growing nonperforming loans of private commercial banks are also a matter of concern. Capital market turnover has been increasing in the post-election period.

GDP Growth and Sector Growth Rates (%)



Source: Bangladesh Bureau of Statistics

Inflation (2005-06, y-o-y,%)



Source: Bangladesh Bureau of Statistics

Fiscal management faces serious challenges from a large, growing shortfall in NBR tax revenue, demand for fiscal support from sectors adversely affected by the political turmoil, and slower utilization of the annual development program. Tax revenue growth in the first seven months of FY14 was barely 10 percent. The usual shortfalls in public investment spending will probably not be sufficient to prevent the government overshooting the FY14 budget deficit target. Government bank borrowing so far has been contained, while net nonbank borrowing has increased.

The structural reform agenda came to a near standstill during the political crisis and has yet to regain normal momentum. The IMF's ECF program remained on track, however, and all end-June 2013 performance criteria and structural benchmarks were met. Bangladesh is well positioned to take advantage of the current favorable external environment to advance structural reforms and consolidate macroeconomic stability.

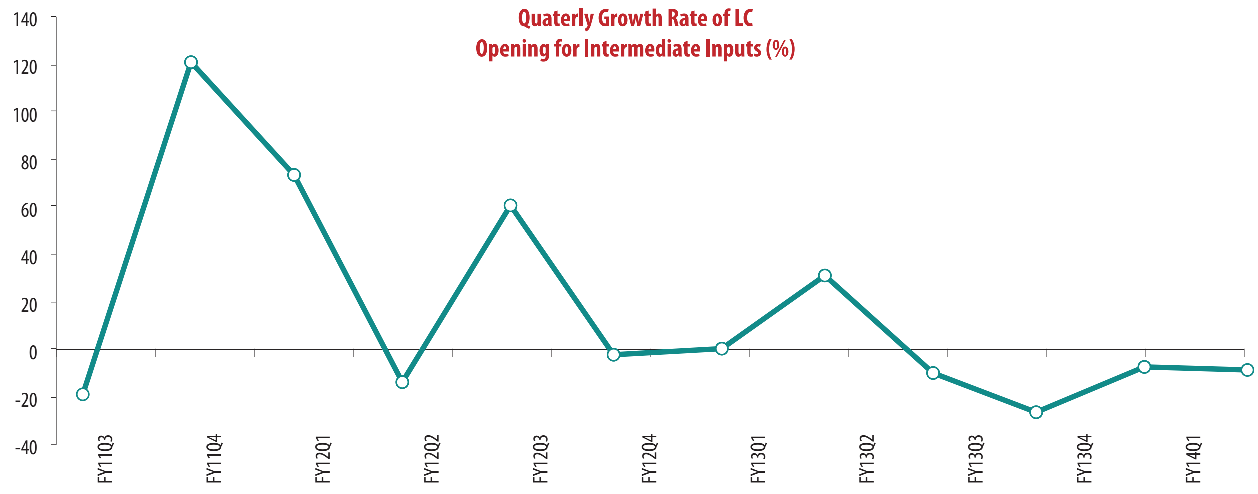
GDP growth lost momentum in recent years because of lingering uncertainties over the modalities of the political transition, slow pace of structural reforms, and the country's inability to firmly establish a transformative infrastructure. Bangladesh needs immediately to tackle three formidable sets of challenges: (i) resolve the remaining political uncertainties while maintaining stability, boosting investment in transformative infrastructure, especially in power and roads, and streamlining trade and investment regulations; (ii) conduct a successful transformation of the readymade garment (RMG) industry; and (iii) reverse the decline in remittance.

Bangladesh has made good progress in addressing the electricity shortage. The liquid fuel-based, high-cost generation plants brought much-needed breathing space. A multi-pronged strategy is needed to address the remaining demand-supply imbalance and to ensure the sustainability of adequate and reliable power. The policy priorities are to boost base-load supply, promote efficiency across the value chain, diversify fuel mix, and reduce the fiscal burden through better alignment of retail prices with unit costs.

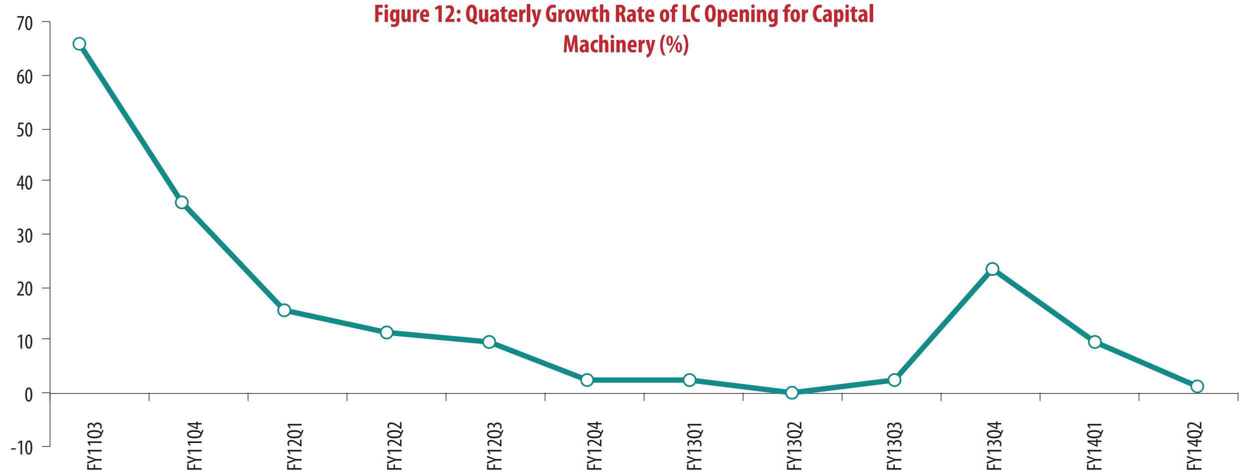
Outlook and Policy

The world economy is showing signs of rebound, which is critical to Bangladesh's recovery. Global GDP is projected to grow from 2.4 percent in 2013 to 3.2 percent this year, stabilizing at 3.4 percent and 3.5 percent in the next two years. The recovery is most advanced in the United States, which is projected to grow by 2.8 percent this year (from 1.8 percent in 2013), firming to 2.9 and 3.0 percent in the next two years. Growth in the Euro Area, after two years of contraction, is projected to be 1.1 percent this year, and 1.4 and 1.5 percent in the succeeding years. **This is bound to stimulate import demand in high-income economies, leading to a rebound in exports from developing countries like Bangladesh.** Global trade volumes rose at a 12.1 percent annualized pace (3m/3m saar) in December, from a low of -1.4 percent last August, with developing country exports expanding at a 21.1 percent pace, the fastest in nine months.

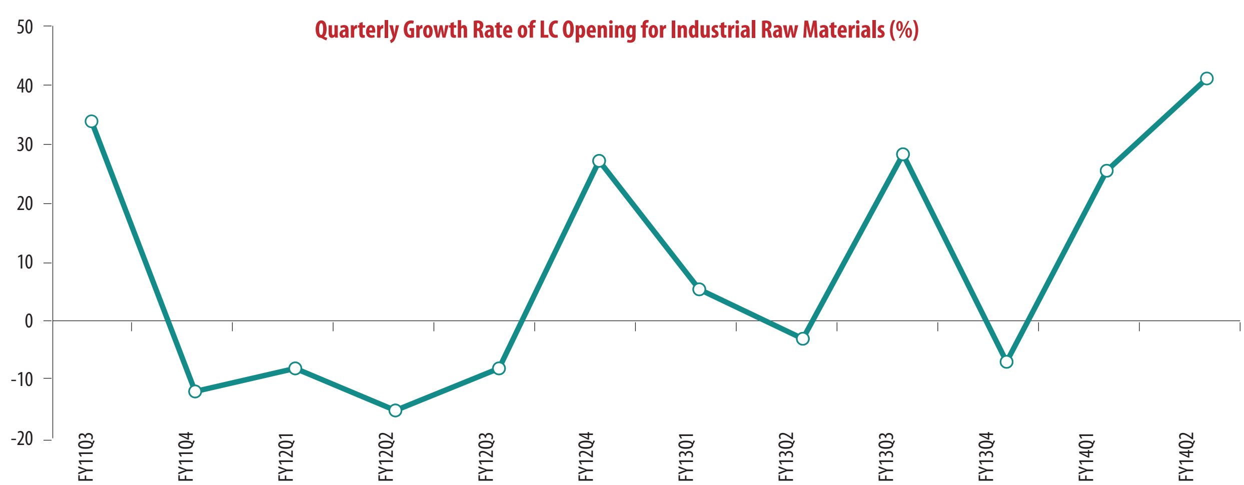
The slide in Bangladesh's growth has undermined



Source: Bangladesh Bank



Source: Bangladesh Bank



Source: Bangladesh Bank

the country's progress on the twin goals to eliminate extreme poverty and boost shared prosperity. Achievement of these goals is critical to the country's ambition to graduate from LDC status and become a middle-income country. Hopes for a rebound in growth lie especially in manufacturing and services. While manufacturing will likely benefit from stronger demand in high-income countries, the services sector will probably suffer, especially in FY14, from a decline in domestic demand due to employment losses and decreased remittance flows. If stability prevails, growth could rise to potential capacity (to around 6.5 percent) within a couple of years. But it is unlikely to accelerate much further without hitting capacity constraints and generating overheating pressures in the absence of continuing structural reforms and upgraded infrastructure.

The external balance may erode from the current comfortable level, but not too far beyond comfort. As the RMG industry upgrades factory and labor standards, export growth will likely recover after moderating in FY15. Remittance is expected to normalize from FY15, on the assumption that intensive international diplomacy succeeds persuading Saudi Arabia, the UAE, and Kuwait to relax restrictions on Bangladeshi labor and so reinvigorate migration and remittance. Import growth can be expected to rise with an uptick in private investment demand. However, reserves may still rise because of a stronger inflow of FDI and public external borrowing for infrastructure.

Adhering to the macroeconomic policy stance envisaged in the government's Medium-Term Macroeconomic Policy Framework underpinning the FY14 budget will contribute to external and internal economic stability. Monetary aggregates should remain restrained while providing room for a recovery in private credit growth to support the likely increase in private investment. Fiscal policy should allow a continued rise in public investment spending while restraining growth in recurrent expenditures, particularly untargeted subsidies and non-ADP capital spending. In the medium term, a moderate consolidation path anchored by a stronger tax collection effort should be continued.

If prudent macroeconomic management is sustained, inflation should approach a more normal 6 percent in the medium term. This assumes, of course, that international commodity prices are stable. In the case of a sustained trade shock the exchange rate could be allowed to adjust with a pass-through to inflation contained by monetary tightening and ensuring an adequate supply of liquidity to the markets. At the same time, some fiscal easing in the form of additional public investment and expansion of well-targeted safety nets to protect the poor and the vulnerable will help sustain growth without risking price stability.

Bhutan

Recent Economic Developments

Economic growth rebounded to about 6.5 percent in 2013 from a multi-year low of 4.6 percent in 2012. Hydropower construction, good rainfall (raising electricity generation by 10.7 percent), and improved agricultural output led the recovery. Non-hydro construction, however, is still stagnant because of housing loan restrictions and other government measures brought in 2012 to curb a rupee liquidity bubble. Tourism, which contributes one-fifth of non-hydro export revenues, grew at a low 10 percent in 2013 but raised convertible currency revenues by only 1 percent. The tight liquidity of the banking system has eased slightly, but the financial sector still shows signs of vulnerability, with limited supervision.

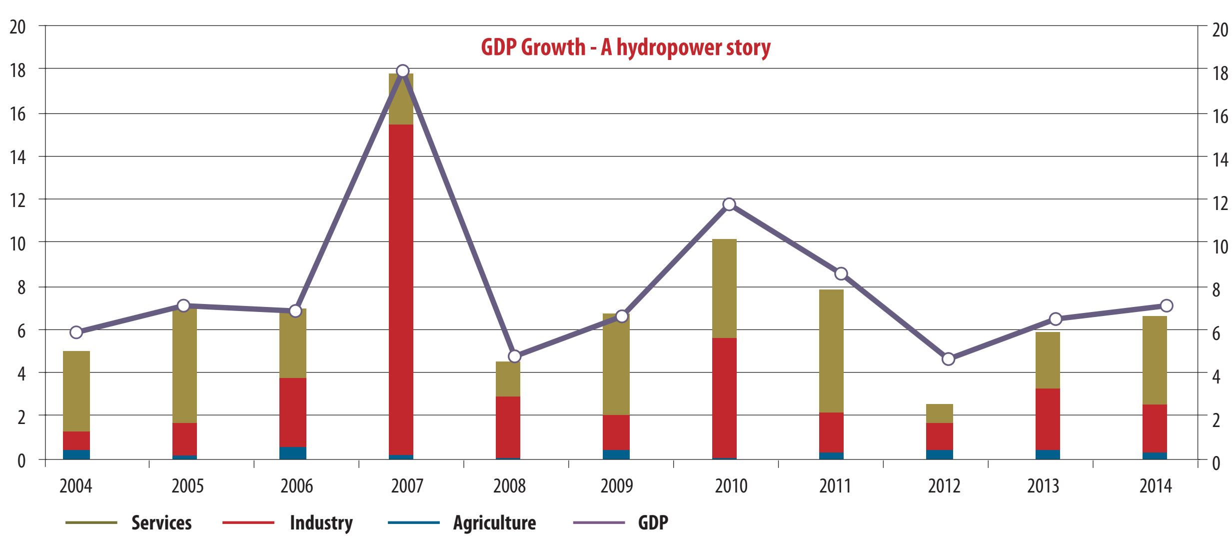
Bhutan runs a large and growing current account deficit. Public and publicly guaranteed external debt increased to 85 percent of GDP by end-FY2013, up 14 percentage points from FY2012. This was driven largely part by hydro sector-related external borrowing, mostly from India in a mix of loans (70 percent) and grants (30 percent) in Indian rupees. Grants financed around 36 percent of total spending in fiscal 2013.

Consumer price inflation – tied to India's by import dependency – will reach about 10 percent in 2013. Pressure remains, despite a slight easing in India at year-end; any upward motion in Indian subsidies (fuel, power, fertilizer) or a monsoon shock could ramp the rate.

The government continues to rely heavily on foreign – mainly Indian – grants to finance expenditure. The FY2014 budget projected a decline of nearly 9 percent in nominal spending from the revised budget for the previous year. The persistent shortage of rupees prompted the government to tighten expenditures to match available resources. A slow start to the budget year due to elections and a change of leadership, and delays in foreign grant disbursements also slowed spending.

Public and publicly guaranteed external debt increased to 85 percent of GDP at end-FY2013, driven mainly by hydro-related external borrowing (52 percent of GDP). But the risk of external debt distress remains moderate because of 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 Indian energy demand, committed donor support, and Bhutan's high level of international reserves.

The pace of poverty reduction in Bhutan has been rapid, broad-based and inclusive between 2007 and 2012. But rural vulnerability remains, magnified by out-migration. Officially, unemployment is relatively low and declining, though the statistical methodology needs fine-tuning to better reflect factors such as under-employment.



Outlook and Policy

The 2014 outlook is positive but macroeconomic pressures on domestic demand need to be managed. Growth is set to reach 7.3 percent supported by ongoing hydro and industrial construction and commissioning, possible lifting of the bans on imports and housing credit, disbursements from India to finance the 11th Five-Year-Plan, which will bring higher public capital spending, economic stimulus, increased public wages, and tourism expansion. But these developments carry a risk of resumed overheating and macro imbalances; monetary and fiscal policies must be tightened.

Domestic revenue is projected to decline to 19.5 percent of GDP in FY2014 from 20.8 percent in FY2013 due to lower non-hydro revenues such as business income tax, excise duties, and non-tax revenue. Hydro revenue remains stable at 3.7 percent in FY2014, with no new projects starting generation. The deficit in FY2015 should ease to 0.7 percent of GDP, as more revenues will kick in with commissioning of more hydro and industrial capacity.

Inflation in 2014 and beyond will be affected by a scheduled rise in electricity tariffs of up to 30 percent, while the impact on poverty should be modest, given the progressive nature of tariffs.

Grants should more than halve from 15 percent of GDP in FY2013 to about 6.6 percent, due to the slow implementation of the 11th FYP.

India

Recent Economic Developments

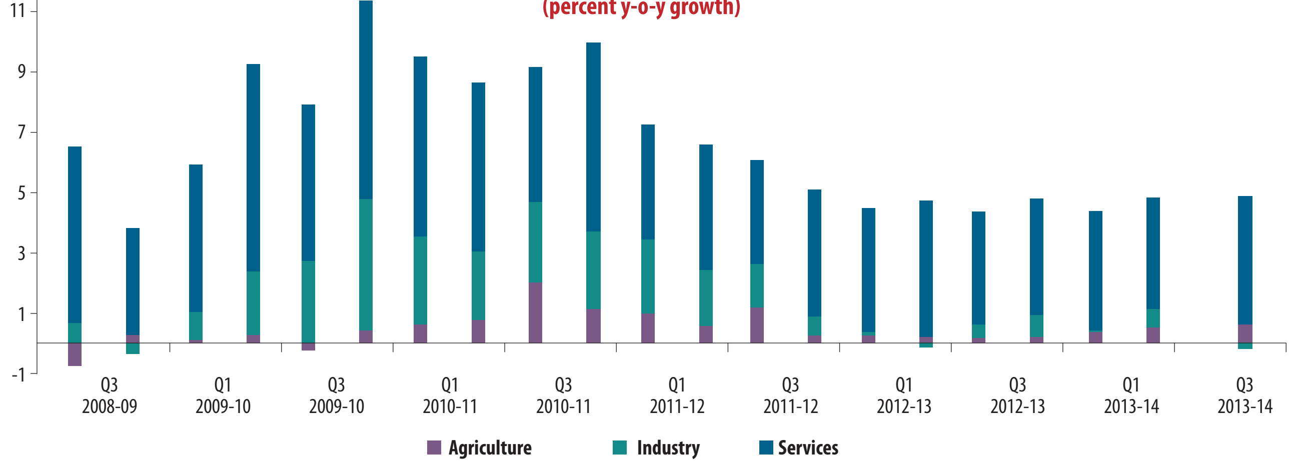
India's economic recovery remains tentative following a slowdown in growth in FY13. Revised national accounts estimates show that India's GDP growth fell to a decade-low 4.5 percent in FY13. Since then, the recovery has remained tentative, picking up pace in Q2 FY14 but losing some of the momentum in Q3. While agricultural growth has picked up due to good monsoon rains and service sector activity has remained strong, manufacturing has thus far been unable to stage a recovery. Net exports, buttressed by an improvement in exchange rate competitiveness over the summer, have supported growth on the demand side, but persistent weakness in consumer and business confidence has kept investment below its long-term average of 30 percent of GDP and has dampened consumer spending.

Private consumption and investment momentum waned in Q3 as business and consumer sentiment remained subdued. Q2 FY14 registered a significant pick-up in growth of private consumption expenditure (from 0.3 to 0.9 percent, q-o-q, saar) and a major rebound in investment (from -3.6 percent to 3.2 percent, q-o-q, saar). However, this pick-up was not reflected in consumer and business confidence, which in Q2 FY14 fell below the threshold level of 100 that separates contraction from expansion. As confidence levels did not return to expansion territory in Q3, the acceleration was not sustained: growth in private consumption slowed and investment contracted in the third quarter (both on a q-o-q and y-o-y basis).

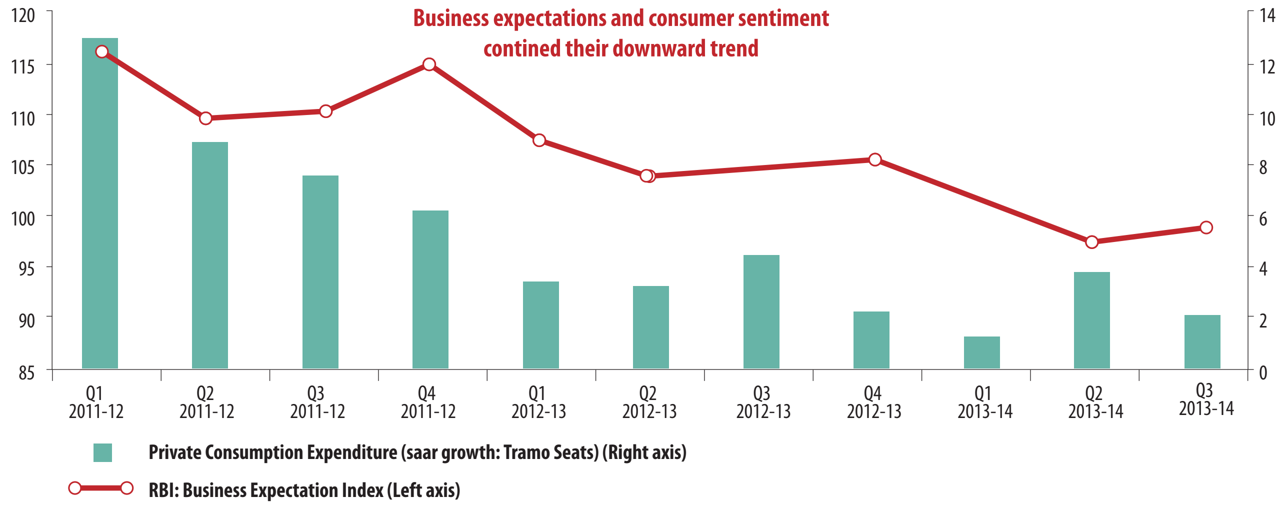
Inflation remains high despite the slowdown in GDP growth. Even though core inflation came down in early FY14 as output lagged below its long-term trend, pressure from food and fuel prices kept overall consumer inflation above 9 percent. Moreover, the stickiness in core inflation in the second half of the current fiscal year has been interpreted by some observers as indicative of high inflationary expectations feeding into overall inflation; this prompted the Reserve Bank of India (RBI) to adopt a tighter monetary stance and signal greater commitment to inflation targeting.

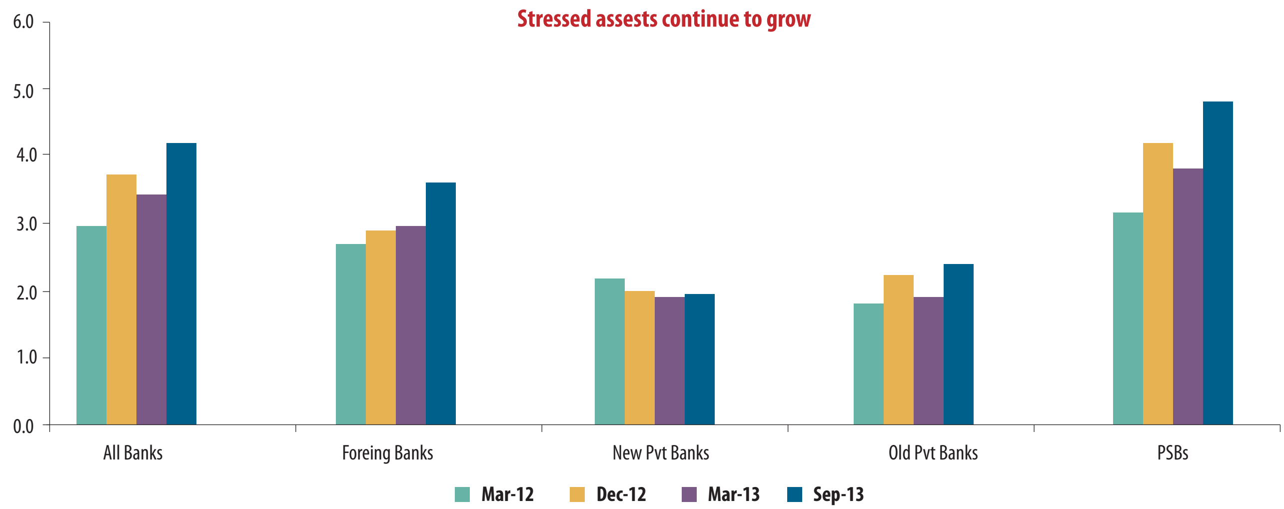
Deepening financial sector stress reflects persistent challenges in the real sector. Cash flow pressures due to a slower pace of economic activity have been aggravated by high leverage of firms, making them more vulnerable to sustained periods of slowdown, delays in projects, or external shocks. As a result, NPAs have risen to 4.1 percent as of December 31, 2013, from 3.4 percent at the beginning of the fiscal year. Although bank capital is sufficient by regulatory standards and the NPA situation is not an immediate threat to the soundness of the financial system, it is a source of worry and is adding stress to bank balance sheets. Public sector banks have been hit hardest by the deterioration in asset quality, largely because they tend to retain a high proportion of restructured assets on their books rather than writing them off. The increasing concern is that capital for sustaining good quality credit growth may be getting constrained. To carefully balance trade-offs

Economic growth remained subdued (percent y-o-y growth)



Source: Central Statistics Office and World Bank Staff estimates



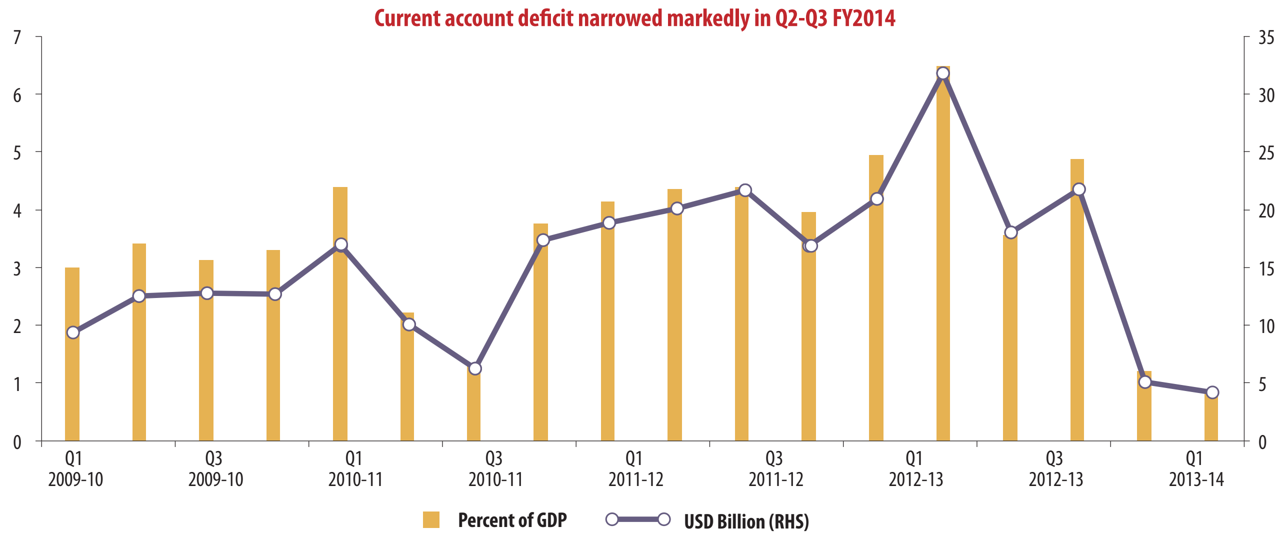


Source: Reserce Bank of India

between credit growth and risk, banks could consider adopting superior credit underwriting standards, ensuring early detection and timely resolution of problem assets, and improving the balance sheet strength to attract capital. Not taking these steps could run the risk of financial sector development getting crowded out by immediate concerns of asset quality.

Benefitting from the US tapering-induced depreciation in the rupee, the current account deficit has returned to pre-global crisis levels. Between May and August 2013, the Indian rupee lost more than 18 percent in value against the US dollar as global investors withdrew US$15 billion in portfolio flows from the country on fears of tapering in the US Federal Reserve's quantitative easing program. Similar concerns affected other emerging markets' currencies, and evidence suggests that outflows were linked more to India's large exposure to international markets than country-specific vulnerabilities such as inflation and the fiscal deficit. Since the summer and even as tapering began, India has substantially reduced its vulnerability to global market turmoil by containing the current account deficit (from 4.9 percent of GDP in Q1 to 0.9 percent of GDP in Q3 FY14), shoring up reserves (to US$294 billion, equivalent to more than six months of imports), and tightening monetary policy. India also experienced resurgence in capital inflows, with the important distinction that volatile portfolio flows are being replaced by more stable deposits by non-resident Indians. Overall, tapering-driven depreciation last summer has likely had a net positive effect as it stimulated exports, contained import demand, and incentivized long-term investors to come back looking for bargains.

Fiscal consolidation has continued despite pressures from lower tax revenue and high spending on subsidies. The authorities expect the FY14 central



government deficit to be contained at 4.6 percent of GDP, a reduction of 0.3 percentage points from a year ago and nearly 2 percentage points from the peak of FY10. On the revenue side, the improvement was driven by windfall receipts from the telecom spectrum auction and larger transfers from public sector enterprises, while tax revenue came in below budget estimates. Expenditure was controlled primarily by spending compression in rural development, health, and education, while the subsidy bill rose above the budgeted amount as this summer's rupee depreciation largely wiped out the gains from diesel subsidy reform. Despite the reduction in fiscal deficit, the decline in the central government's debt-to-GDP ratio – which fell by more than 15 percentage points in the second half of the 2000s – has come to a halt in FY13 and the debt ratio was expected to inch up marginally to 51.5 percent of GDP by the end of FY14 (March 31) due to the slowdown in GDP growth.

The reform momentum accelerated in the first half of FY14. Reforms were led mostly by the RBI, anchored around the central bank's renewed focus on controlling inflation, accelerating financial inclusion, and fostering financial stability. The central and state governments complemented the RBI's efforts with regulations to improve public financial management and ease food supply bottlenecks. Major reforms of FY14 include a new RBI proposal to strengthen the monetary policy framework and restructure bad loans, raising the ceilings and/or easing of FDI norms in a number of sectors, and steps to improve public finance management.

Outlook and Risks

Supported by a favorable global environment, India's economic recovery is expected to gain strength in the last quarter of FY14. Although the growth momentum waned somewhat in Q3 FY14, the pace of economic activity is expected to accelerate in Q4. Agricultural production is expected to pick up momentum as high soil moisture levels and increased rabi (winter crop) sowings are likely to translate into an increase in output. Four consecutive months of manufacturing PMI readings above the expansion threshold of 50 and a pick-up in industrial production in January suggest that the industrial sector may finally be on a path to recovery. Activity in the services sector is likely to remain strong, although the scope for significant further acceleration in Q4 is limited due to some compression in government spending as part of fiscal consolidation efforts. Overall, these developments could raise GDP growth in Q4 to around 5 percent y-o-y, pushing growth for the entire fiscal up to 4.8 percent.

India's potential growth remains high, but returning to potential will require a sustained improvement in manufacturing performance. Currently, estimates place India's potential GDP growth in the 6.3-6.9 percent range. Three consecutive years of below-potential growth have opened up a negative output gap and created space for acceleration in growth without a build-up of inflationary pressures. Under the baseline scenario of this report, recent progress on accelerating clearances of investment projects is expected to translate into an increase in the investment-to-GDP ratio, while exporters are expected to continue to take advantage of the more competitive exchange rate and strengthening global demand. These developments are expected to support a substantial strengthening of manufacturing growth in FY15 and FY16, which could in turn lead to acceleration in GDP growth to 5.7 and 6.5 percent, respectively.

Inflation is likely to continue to moderate, while the current account deficit is expected to remain in the range of 2 percent of GDP. As output remains below potential throughout the forecast period, momentum in core prices is likely to wane. Further reductions in core inflation are likely to be supported by the RBI's renewed focus on inflation, particularly in light of the recommendations of the Patel Committee report, which could bring down inflationary expectations. As Indian exporters continue to benefit from a more competitive exchange rate following this summer's bout of depreciation in the rupee while demand for imports remains subdued, the merchandise trade deficit in FY14 is likely to contract to below 8 percent of GDP from 10.6 percent of GDP in the previous year and the current account deficit is expected to decline to 1.8 percent of GDP in FY14. However, the deficit could widen somewhat in FY15 and FY16 as import growth picks up in line with accelerating demand and particularly rising imports of capital goods, which have been on the decline for the past two years.

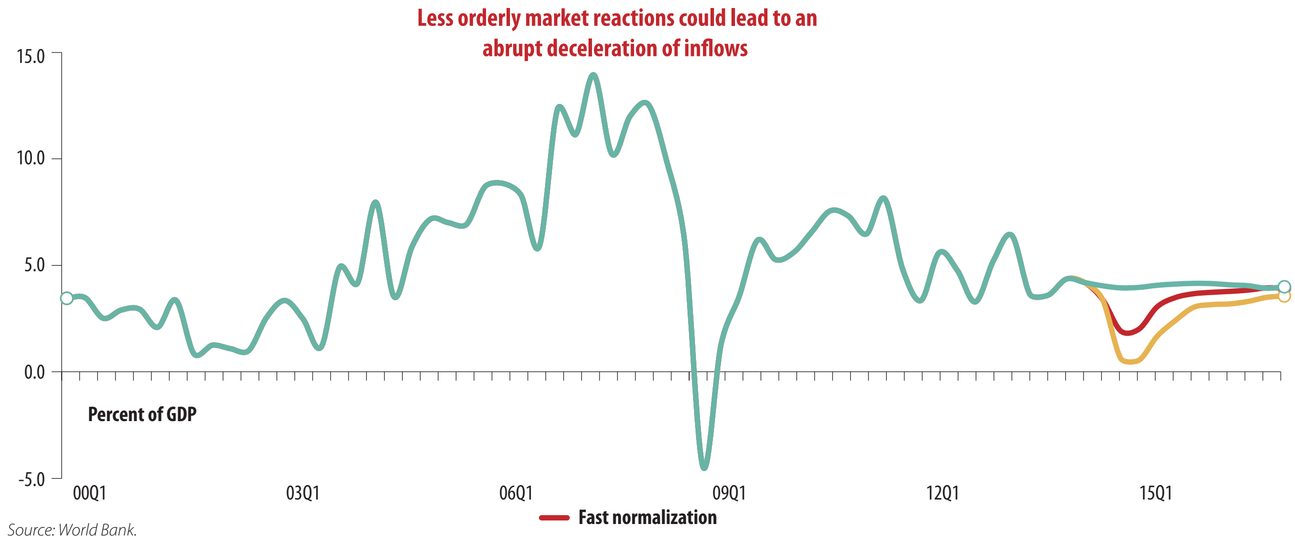
Fiscal consolidation is expected to continue, but achievement of fiscal targets could become more challenging. The expected acceleration in growth in FY15 could help in achieving revenue targets, although demand multipliers would need to be strong to translate a reduction in excise tax rates into higher revenues. Furthermore, additional policy efforts are likely to be required to contain oil subsidy spending around the budgeted amount. While the authorities have demonstrated a commitment to fiscal consolidation in previous years by limiting expenditure growth, sustained improvements over the long term are likely to require further efforts to strengthen the revenue base. Under these assumptions, together with continued fiscal consolidation at the state level, the general government deficit is expected to decline to 6.8 percent of GDP in FY14, and to fall further to 6.3 percent in FY15 and 5.9 percent in FY16. Delivering on the Finance Minister's objective of bringing the fiscal deficit down to 3 percent of GDP by FY17 will be critical to maintaining debt ratios on a sustainable downward trajectory, particularly as growth recovers to its high potential only gradually.

Government debt is likely to remain on a sustainable trajectory. Most of the decline in the debt-to-GDP ratio over the past decade can be attributed to a favorable macroeconomic environment and particularly rapid GDP growth. Under the baseline path growth, inflation, and fiscal deficit delineated in the previous discussion, the debt-to-GDP ratio is likely to rise in FY14 to 67.4 percent of GDP from 66.6 percent in the previous year. Thereafter, under the assumption that growth accelerates, the central government continues its fiscal consolidation efforts, and state governments remain on the adjustment path recommended by the 13th Finance Commission, the debt-to-GDP ratio could resume its earlier downward trend. The debt ratio could fall to 66.5 percent of GDP in FY16, though at a slower pace than before. Even if real interest rates rise, a recovery in growth and continued commitment to fiscal discipline are expected to offset any potential adverse effects on debt sustainability. On the other hand, risks to the primary balance or growth could have negative implications for the debt-to-GDP trajectory: if economic growth were to fall below the baseline projections in each of forecasting years by one standard deviation of the historical distribution, the general government's debt-to-GDP ratio could instead rise to 76 percent of GDP by FY16.

Decomposition of General Government Debt

(percent)	2013/14f	2014/15f	2015/16f
Debt-GDP Ratio (baseline)	67.4%	67.3%	66.5%
Change in Public Debt	0.8%	-0.1%	-0.8%
Identified flows	0.4%	-0.1%	-0.8%
Real Interest Rate	0.6%	0.9%	1.0%
Primary Balance	2.9%	2.7%	2.3%
Real GDP Growth	-3.1%	-3.6%	-4.1%
Residual	0.4%	0.0%	0.0%
Effects of shocks on debt-GDP ratio			
Fall in Real GDP growth	70.4%	73.4%	75.7%
Fall in Inflation rate	69.9%	72.4%	74.3%
Rise in Interest Rates	67.9%	68.3%	68.0%
Rise in Primary Balance	68.9%	70.3%	70.9%

Normally distributed shocks (drawn from history FY2002-FY2013) were introduced to real GDP growth, inflation rate and interest rate.
One standard deviation negative shock to the primary balance (taking the reference period as FY2002 - FY2013).



Source: World Bank.

Risks to the outlook are primarily on the downside. The baseline scenario in this report assumes a gradual improvement in the global environment and no significant adverse external shocks over the forecast period. External shocks, including slower global growth, higher oil prices due to heightened tensions in Eastern Europe, and further volatility in global financial markets due to disorderly unwinding of monetary policy stimulus in the high income countries, could have adverse consequences for the baseline trajectory. Domestically, the outlook is predicated on a recovery in investment and a strong pick-up in manufacturing growth. Should these conditions fail to materialize, growth in FY14 could fall to around 4.6 percent and remain below 5.5 percent in FY15 and FY16. The findings of the 7th Pay Commission, charged with revising the salaries and pensions of more than 800,000 central government employees and retirees, could have significant effects on public sector finances when it releases its report in about 18 months from now.

Maldives

Recent Economic Developments

Real GDP growth stood at 3.7 percent in 2013 and the outlook is positive, at 4.5 percent for 2014. Tourism demand is slowly picking up having a positive impact on growth in the non- tourism sectors. Chinese tourists continue to compensate for weaker arrivals from Europe, but overall the length of stay has declined, as has spending per tourist.

Growth, though dynamic, was less inclusive, as the tourism industry operates on an enclave model for development. The share of GDP from the primary sector, agriculture, mining, and fisheries that employs the largest share of Maldivians in the outer atolls was less than 0.3 percent of GDP in 2013.

Loose fiscal policy at a time of moderating economic growth magnified macroeconomic imbalances. Maldives is spending beyond its means. Its revenue-expenditure gap has widened over five years, financed with unsustainable public debt at increasing interest rates. The fiscal deficit closed 2013 at close to 10% of GDP and was financed through: (i) short-term commercial borrowing from the banking, private sector, and high net worth individuals, (ii) monetization of the deficit, and (iii) build-up of payment arrears, which risks affecting the real economy. Public finance imbalances seem to lie on the expenditure side, as revenue collection has been strong at above 32% of GDP in 2013.

Inflation moderated to 6 percent in 2013, although food inflation remained high.

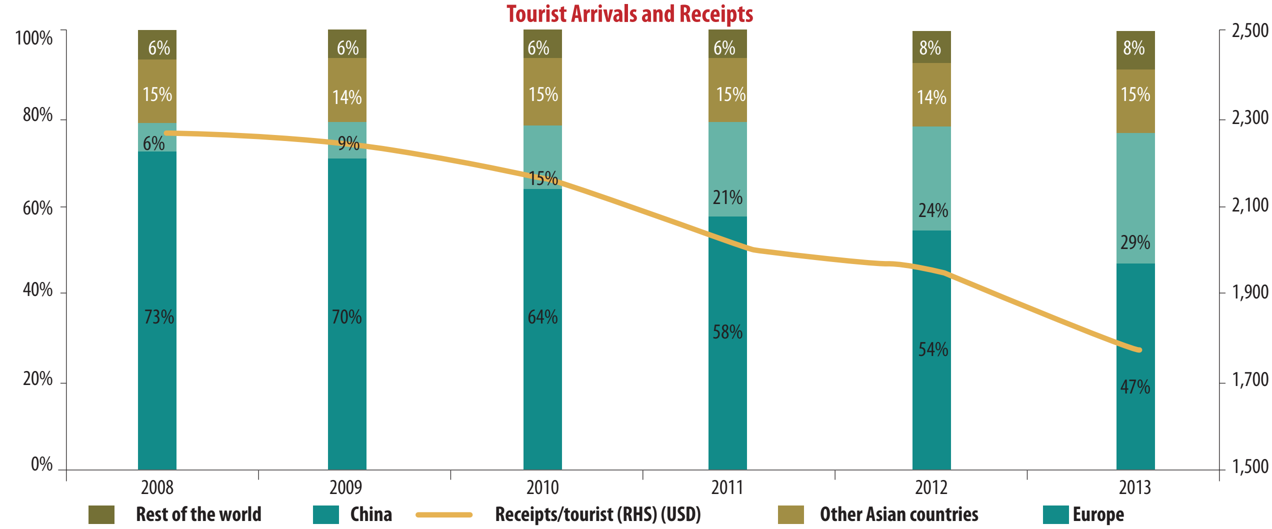
Outlook and Policy

Political stability, or lack thereof, will be a key determinant of economic growth. Though politics appear relatively stable after the March parliamentary elections, the longer-term prospects are harder to gauge as political groups still jostle for advantage. President Abdulla Yameen took office in November promising to end the fractiousness and instability that roiled Maldives for two years.

The positive outlook for growth this year is based on an expectation of stability and strong tourist arrivals, driven especially by the Chinese tourist segment. The MMA projects tourism to grow at 5.2 percent in 2014. Recovery of the European market would extend those tourists' visits, which were on the decline, and raise tourism receipts. Non-tourism sectors, too, will contribute to growth through demand for services, telecom and construction. The construction sector will be particularly dynamic with ongoing new resort developments and the leasing of 12 new islands.

Reserves will remain under pressure in 2014, and at critical levels. A record MVR 17.95 billion budget for 2014 (about 50 percent of GDP) and 3.2 percent financing gap leave scant fiscal space to accumulate reserves. Such high spending could boost the demand

Tourist Arrivals and Receipts



for imports and fuel the need for foreign exchange, putting pressure on reserves. Cash management will be tight. Higher tourism receipts, however, could contain pressure on the exchange and sustain the parallel dollar market at the current 10-15 percent premium level. The airport concession arbitration, to be decided in 2014, would put big pressure on reserves if a large payment is due.

Achieving fiscal sustainability will require short-term measures to address the cash crunch, and long-term structural measures that could entail political and social costs. Spending is under pressure from the civil service wage bill, subsidies and social contributions, transfers to state-owned enterprises, and capital spending in the outer atolls. An array of measures could be combined in a policy package accompanied with a communication strategy to sensitize the public on the need for reforms. Any delay in expenditure cuts would stretch resources and harm government's ability to pay salaries.

Nepal

Recent Economic Developments

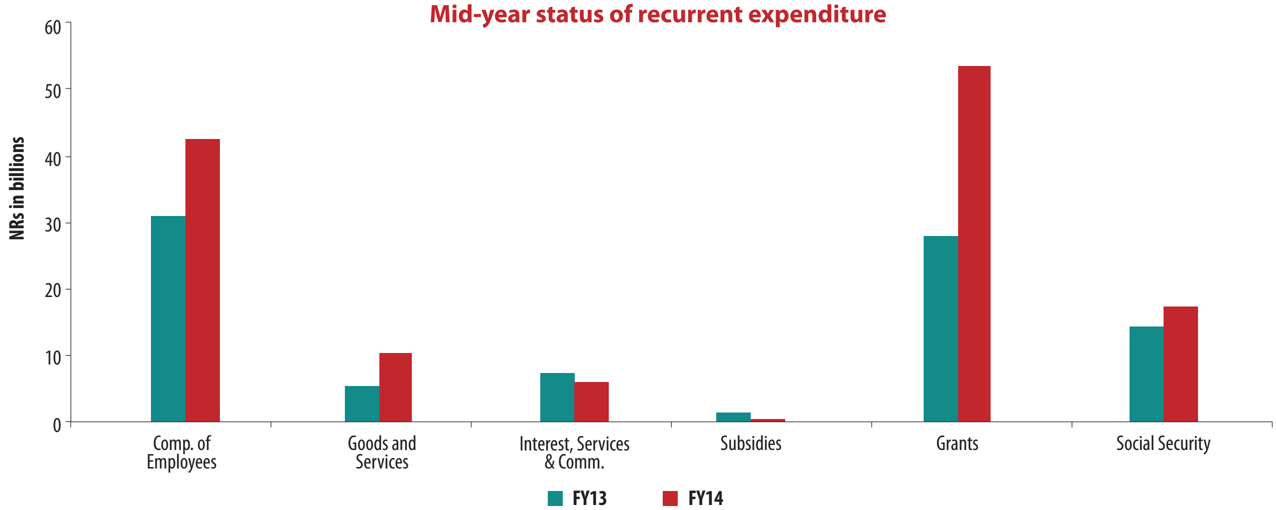
Prospects for more coherent economic policy-making, in step with vibrant private-sector activity, have been enhanced by the successful election of a new assembly and formation of a popularly mandated government. The uncertainties of the country's prolonged political transition and electoral period had stifled private sector investment and diverted attention of the bureaucracy away from difficult but crucial reforms. It is now incumbent on the new government to signal its intention to use the relative political stability as an opportunity to tackle the country's formidable challenges. This will require a bold and skillful balancing act to ensure that the arduous process of constitutional drafting is carried out in tandem with regular and improved governmental operations.

After weathering a difficult year, the economy is poised for a modest recovery. Nepal achieved only modest growth of 3.6 percent in FY13. This was due largely to poor performance of the agricultural sector and very modest levels of industrial activity. The only source of relief came from the services sector. Agriculture is expected to make the biggest difference in FY14, with expanded production on the back of a good harvest. Strong remittance inflows will continue to drive services sector expansion.

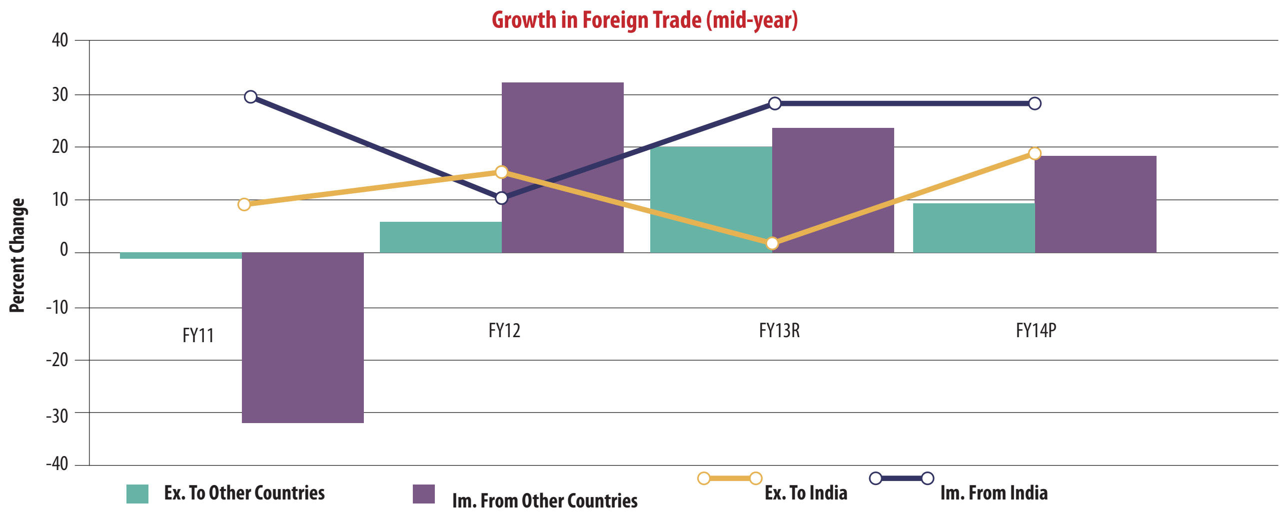
Nepal's internal and external balances are sound, but not for the right reasons. During the first half of FY14, the government has maintained a sizeable surplus – partly through continued revenue mobilization growth, but also low levels of spending. The slow mobilization of resources earmarked for capital projects is especially worrying. While much of the blame for low rates of budget execution and important bunching had been blamed previously on delayed budget approval, this was not the case in FY14 when a full budget was unveiled on day one of the fiscal year. In other words Nepal has yet to come to grips with the deep structural inefficiencies in budget planning, formulation and execution. This is crucial for not only short-term growth but also because infrastructure development is key to expanding the long-term growth potential of the economy and stimulating essential complementary private finance. On the external side, Nepal has benefited from the depreciation of the rupee and also –much more significantly– from a sharp increase in inward remittance.

Inflationary pressures have not subsided and the risk of second round effects is present. Inflation stood at 9.7 percent, y-o-y, in January 2014, driven by rising food prices. This contrasts with FY13 when non-food items were the inflationary driver. At the end of the second quarter of FY14, the index for food and beverage prices had registered a 12.9 percent increase, y-o-y, while that for non-food items had grown by only 6.9 percent. Within the food and beverage category, cereal grains and their products, vegetables, and meat and fish had experienced sharp price rises. Causes included a meat shortage due to an import quarantine because of avian flu fears, consumer stockpiling during the pre-election period, and higher import prices from India.

Mid-year status of recurrent expenditure



Source: FCGO

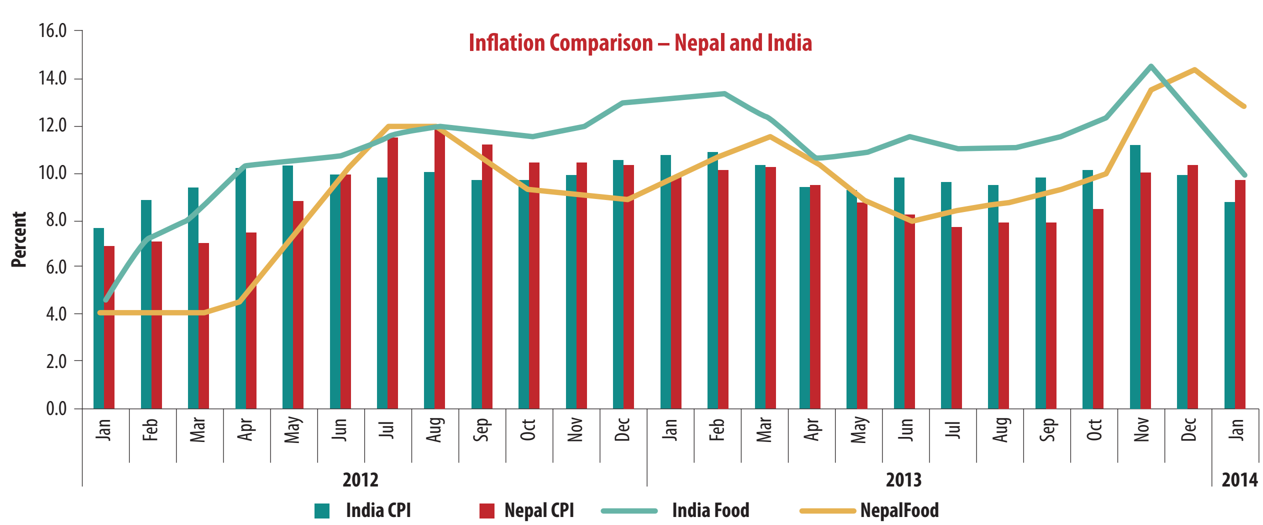


Source: MoF and NRB

Monetary policy has sought to achieve a delicate equilibrium between controlling inflation and supporting economic activity, but the optimum balance may evolve naturally and require corrections. Significant inflation, close to double digits, appears to have become a feature of the Nepali economy. While some factors may contribute to dampen inflationary pressure – most notably expanded agricultural output – significant growth in the money supply may eventually generate inflationary expectations and second-round effects that translate into higher imports (serving to lower reserves). From that viewpoint, the evolution of the quantity and quality of credit to the private sector will be important to monitor.

Structural reforms will be necessary to put Nepal on a more permanent path of higher growth. In order to achieve tangible gains and restore private sector confidence, Nepal's new government will need to define clear priorities and selectively invest its energy in catalytic interventions. Given Nepal's critical infrastructure gaps it would make sense for public policy to focus first and foremost on unlocking public investment and focusing policy initiatives and project implementation on the energy and transportation sectors.

Since remittance has become a defining feature of the Nepali economy the country must develop systems to manage excess liquidity and interest rate volatility. The significant buildup of liquidity in the financial sector reflects both strong push factors (remittance inflows translating into a build-up of net foreign assets) and weak pull factors (slowing credit growth and loose monetary policy). In the short term, the central Nepal Rastra Bank (NRB) will need to strike a balance between encouraging sound credit growth – so as not



Source: NRB + CSO, India

to compromise economic activity objectives – and containing inflation. At present this balance is particularly difficult to achieve because of uncertainties over the true health of the banking sector, weak risk management systems, and market failures. The NRB may also need to expand its toolset to deal with excess liquidity. In the medium term, resolving structural bottlenecks to achieve efficient credit-market function is a precondition for monetary policy to operate more smoothly and efficiently and to lower the risk of financial crisis.

Outlook and Policy

The outlook is cautiously optimistic for FY14. Our previous half-yearly assessment of Nepal's economic outlook, in October 2013, estimated that growth would reach 4.0-4.5 percent this year, driven mainly by increased agricultural output and improved execution of the budget. This has to some extent proved true. While the pace of capital expenditure may be below initial expectations, inward remittance inflows have been significantly above projected levels and should provide an additional boost to the services sector. On balance therefore, growth is projected to reach 4.5 percent, especially if capital spending picks up in the second half of the year.

The government of Nepal should take advantage of the calmer political waters to set a firm policy course and tackle emerging risks. The appointment of a new Finance Minister with deep experience and reformist credentials is a positive sign, and Minister Ram Sharan Mahat's initial commitment to "take forward the second round of reforms…in partnership with the private sector" is encouraging.

The key policy priorities include:

- **Developing and formulating a growth promotion vision or agenda.** Because Nepal's challenges are so numerous, it is particularly difficult to set out clear policy goals and priorities. The Nepalese authorities have formulated the goal to graduate to developing country status by 2022, but have not articulated the vision for development that would underpin that achievement, nor have they identified those policies and reforms that are the most important and urgent. In the absence of such clear priority setting, the process of development planning is unlikely to follow a strategic path.

- **Boosting public investment and infrastructure development.** Nepal is caught in a paradoxical situation. It is the only country in South Asia to record a budget surplus (helped by buoyant revenue growth), its level of indebtedness is modest, it is flush with liquidity (thanks to large remittance inflows), and yet it struggles to attract investment growth above its current low levels. However, investment growth is really the only means by which it can substantially and durably accelerate the pace of economic activity. The public sector has a key role to play in (i) providing a friendlier environment for the private sector to operate in, and (ii) developing the essential public infrastructure needed for firms to thrive and private funds to crowd in. This, in turn, requires maintaining a safe and stable macroeconomic environment.

- **Tackling enduring financial sector risks and managing excess liquidity.** Uncertainty over the true health of the financial sector remains the single most important macroeconomic risk for Nepal. A financial sector crisis – though highly unlikely at this juncture – would have devastating effects on public finances and economic growth. Furthermore, the ability of the financial sector to provide adequate credit to deserving borrowers is currently hampered by factors such as (i) distortionary policies, (ii) low levels of effective access to finance, (iii) poor risk management practices by monetary authorities and banks amplified by deficient information, and (iv) limited recourse for banks to find protection from delinquent borrowers. As a result the financial sector is operating sub-optimum, and the current excess liquidity in the system is largely a reflection of this state of affairs.

Pakistan

Recent Economic Developments

Pakistan's economy, though still weak (or below potential), has begun to show signs of improvement. Real GDP is projected to grow at 3.6-4.0 percent in FY14 – driven by dynamic manufacturing and service sectors, better energy availability, and early revival of investor confidence (Table 1). Nascent optimism, however, contrasts markedly with the slump in private investment last fiscal year, the lowest level in two decades.

Estimates of Economic Growth (%)			
	Q1-FY14E	Q1-FY13P	FY13
Real GDP	5.0	2.9	3.6
Agriculture	2.5	2.7	3.3
Industry	5.2	3.1	3.5
Services	5.7	2.9	3.7

E Estimated; P Projected
Source: Pakistan Bureau of Statistics

Inflation remains steady at 7.9 percent, y-o-y. The fiscal deficit is contained at around 6 percent of GDP due to improved tax collection and reduced expenditures. The current account deficit remains modest, at around 1 percent of GDP, supported by strong remittances and export dynamism, and the external position is slowly improving since monetary and exchange rate policies switched gear toward rebuilding reserves past November. Performance under the IMF program remains satisfactory, with the 2nd Review concluded on March 24. Domestic and external risks remain high, however, but are declining.

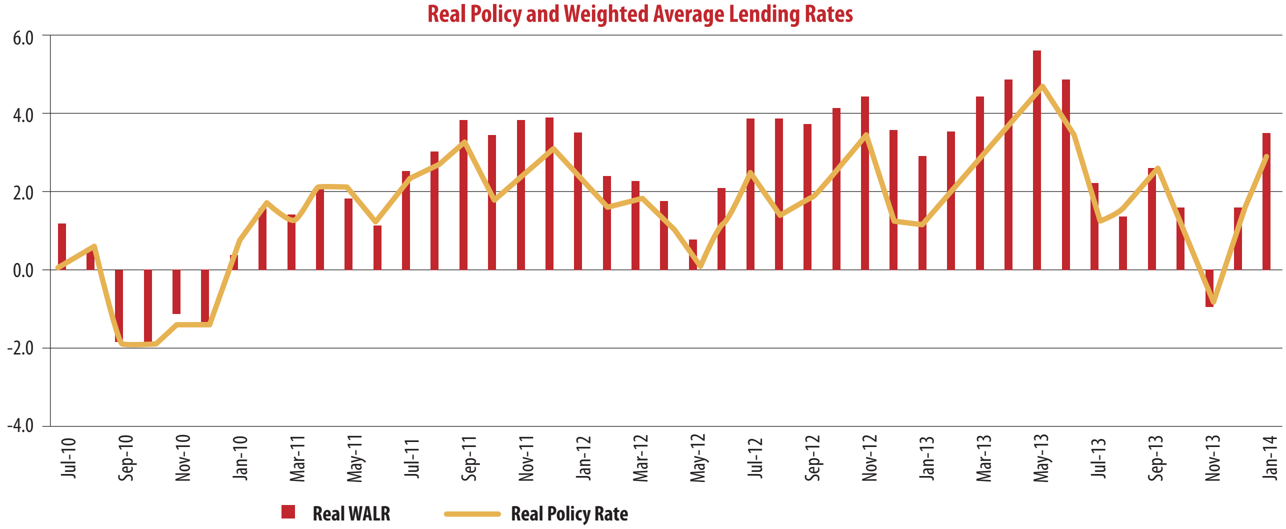
Thus far, the impulse to growth stems mainly from industry and services, while agriculture is estimated to slightly miss its annual target. An improved industrial sector performance can be attributed to better energy availability and post-election investor confidence. Even with this uptick in local industry, better performance by the telecom sector, and improved volumes of international wholesale and retail trade, the services sector appears to have stolen the limelight.

Estimates for first half of FY14 show growth improved in wholesale and retail trade, finance, and insurance. Acceleration in growth of large-scale manufacturing came from a strong performance of agro-based industries, iron and steel, construction, and external demand-driven cotton yarn- and fabrics-based textiles. Agriculture appears slightly below target because of underperformance of cotton, major kharif crop, due to shortage of water availability at the time of sowing. On the demand side, growth continues to be driven by private consumption. Credit to the private sector has started to rebound and had posted nominal growth of 4.6 percent, y-o-y, at mid-March 2014. However, private investment recovery is mild; much of it inherited from the crowding out of private-sector credit by government domestic borrowing, which grew at close to nil in FY13.

Corrective measures are being implemented to tighten the fiscal stance and ensure sustainability. Pakistan is on track to meet a fiscal deficit target of 5.8 percent of GDP in FY14. FBR collection is slightly below target but improving. On the expenditure side, energy-related subsidies have been reduced with tariff adjustments. However, although the government reduced the stock of circular debt, which led to reduced load-shedding in the first months of the year, the circular debt is re-emerging. Public investment – constrained by lack of fiscal space and any commitment to reduce the fiscal deficit – remains contained. Public debt remains above the 60 percent of GDP allowed by the Fiscal Responsibility Law, and justified by security reasons. As large fiscal deficits have been financed increasingly through domestic borrowing, rollover risk has increased. External financing available to the government during the first half of the year remained scarce, but is expected to improve significantly in the last two quarters.

The external position is fragile but strengthening. The current account deficit is small, at around 1 percent of GDP by end-FY13. In contrast, net official foreign exchange reserves declined to the equivalent of 1.3 months of imports at the end of June 2013 (bottoming out at 0.6 month of imports by the end of November 2013), though they had risen to above 1.1 month of imports as of March 26. This is partly due to the fact that since the second quarter of FY14, the State Bank of Pakistan (SBP) increased its policy rate and has started to purchase dollars on the spot market, turning decisively toward rebuilding the external position.

Real Policy and Weighted Average Lending Rates



Monetary tightening has been underway since end-2013. The SBP increased the policy rate by 50 basis points successively in September and November 2013 (Figure 1) to deal with two concerns: a continued deterioration in the balance of payments position, and a worsening of the inflation outlook during Q1-FY14. Real weighted average lending rates have been only marginally positive in recent months.

A temporary rise in the inflation rate was predictable in early FY14. The fiscal year started with the government revising the general sales tax rate upward from 16 percent to 17 percent. Furthermore, by October, the government levied an additional 2 percent value-added tax on selected manufacturing items. More significant were the several rounds of upward adjustments in the prices of energy items. The percentage of CPI non-food items registering double-digit inflation increased from 28 percent to 36 percent by December 2013. Nevertheless, non-food, non-energy core inflation has significantly declined, 8.3 percent July-February, or 190 bps lower than the same period last year, indicating that the risk of demand-driven inflation remains low.

Banking sector profitability was steady, declining only slightly in calendar year 2013. The benchmark interest rate (6-month KIBOR) increased from 9.4 percent in December 2012 to 10.2 percent in December 2013. Return on assets and return on equity during the last quarter of 2013 was at 1.7 percent and 18.4 percent, compared to 2 percent and 21.4 percent during the same period last year. The sector's liquidity and solvency positions remain strong backed by sluggish growth in advances and sizeable concentration of the asset portfolio in government securities which carry low risk weightages. Meanwhile, the microfinance sub-sector continues to expand.

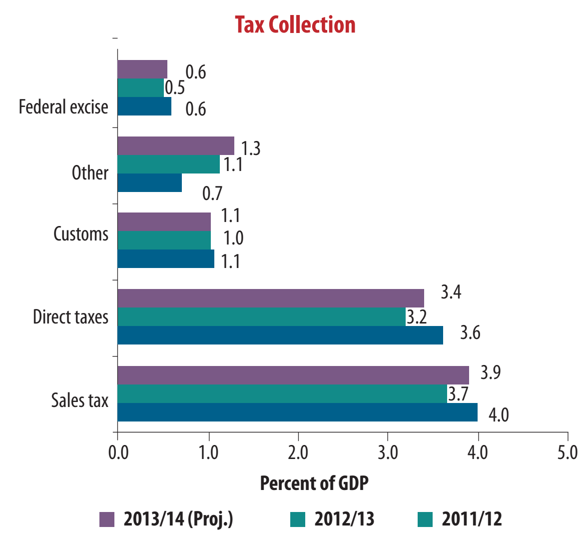
Non-Performing Loans (NPLs) showed a slight decline. NPLs decreased slightly, from 14.5 percent in December 2012 to 13.0 percent in December 2013. Adequate provisioning also kept net NPLs ratio in check at 3.1 percent in December 2013. NPLs in small and medium enterprises (SMEs) remain high, representing 32.3 percent of loans, followed by the agricultural sector (14 percent) and consumer sector (13.6 percent). The largest share of the portfolio is the corporate sector (66.8 percent of loans) where the NPL ratio is 13.4 percent.

Outlook and Policy

Given the modest international recovery, Pakistan's medium-term outlook presents moderate downside risks. The external environment is expected to starting improving gradually with global GDP growth rising from 3.2 percent in 2014 to 3.5 in 2016.

Three sources of risk remain worrisome: Pakistan imports more than it exports (the latter being constrained by low productivity and under-competitiveness); access to reliable energy remains uncertain; and unwieldy business regulation continues to constrain enterprise. Investors' concerns over governance issues, energy and prevailing security issues keep FDI flows and private investment low, which also affects foreign reserves. The troubled domestic energy sector continues to labor under a complex inheritance from its circular debt which might affect the magnitude of fiscal adjustment. On the other hand, Pakistan's Emerging Markets Bonds Index Plus (EMBI+) risk spread keeps declining from the high levels shown at the start of the new administration. Market confidence in the government's program and its steady implementation is bearing fruit, as the EMBI has almost halved from 1,011 basis points in March 2013 to around 468 basis points as of March 26, 2014. The government intends to benefit from this and return to the international markets with the placement of a US$500 million-US$1 billion Eurobond in the fourth quarter of the current fiscal year.

Revenue collection is expected to be close to the revised target of Rs 2,345 billion. On the basis of performance during the first half of the year, the seasonality in fiscal transactions and the expected impact of government's policy actions, it is projected that FBR tax collection would not only recover from the exceptionally poor performance of FY13, but its tax-to-GDP ratio would much exceed the level achieved in FY12 and be quite close to its annual revised target (10.3 percent of GDP – Figure 2).



Collection of all federal taxes is projected to be significantly higher than last year while owing to a positive trend in collection of provincial tax, especially services general sales tax, some increase is expected to come from the collection of provincial revenue.

Recurrent expenditure is expected to remain below the level achieved last year. Current expenditure of the federal government is projected to decline. The government's austerity measures are responsible for a significant reduction in federal government "other" recurrent spending, while better financial health of SOEs would imply smaller demand on federal grants to support these enterprises. Interest payments would be higher due to higher accumulated debt, increase in interest rate by SBP and depreciation of rupee. Development spending of the government (inclusive of net lending to the public corporate sector) is projected to decline from 5 percent of GDP in FY13 to 4.1 percent in FY14 but only because of a sharp fall in net lending.

Overall, the fiscal deficit is expected to fall to 5.8 percent in FY14 of GDP, from 8 percent last year. About half of the effort is expected to come from revenue increases and the other half from the reduction of untargeted power subsidies and recurrent spending. Provinces are also expected to generate small fiscal surpluses. Taking into account the additional fiscal space, along with increased development spending, the fiscal deficit is expected to reach 4.5 percent of GDP in FY16. Expected budget support from multilateral donor agencies (i.e., the World Bank and ADB) should also improve external financing for the budget, but repayments, especially to the IMF, will also be higher. In net terms, the external financing position in FY14 is expected to be substantially better than in FY13.

In the medium term, Pakistan's real GDP growth is projected to regain momentum slowly, to reach 4.4 percent by FY16. At the sector level, the initial economic expansion will be supported by less load-shedding and resilient remittance complemented on the supply side by manufacturing exports and dynamic services. Official figures place inflation in single digits by end-2013, but some pressures related to hikes in administered prices for provisions such as oil, electricity, and gas, might put pressure by end-fiscal year toward a 9-10 percent rate. As fiscal consolidation and monetary tightening proceed, average inflation should approach its medium-term target 84 percent over medium-term.

The current account deficit is projected to approach a modest 1 percent of GDP by end-FY14, and remain so during the projection period. Higher financial inflows are expected to be attracted by lower country risk, privatizations, new trade relations with neighbors and the opening of special economic zones and multilateral flows. Official foreign exchange reserves are expected to build from US$6.0 billion by the end of FY13 to about US$16 billion by end-FY16 (equivalent to three months of imports).

Sri Lanka

Recent Economic Developments

Economic growth looks to have risen to 7.3 percent in 2013, from the 6.3 percent registered the previous year, driven by the services and industry sectors. The bounce-back began in the second quarter of 2013, and is expected to continue through the last quarter and beyond.

The services sector, accounting for nearly 60 percent of GDP, grew by an average 6.4 percent for the year, underpinned by strong performance in wholesale and retail trade (another 23 percent of the economy), hotels and restaurants, transport and communications, as well as the banking and finance sub-sectors. While industrial-sector growth moderated in the third quarter of 2013, it remained buoyant at 9.9 percent, from 10.3 percent in 2012, propelled mainly by the construction and manufacturing subsectors.

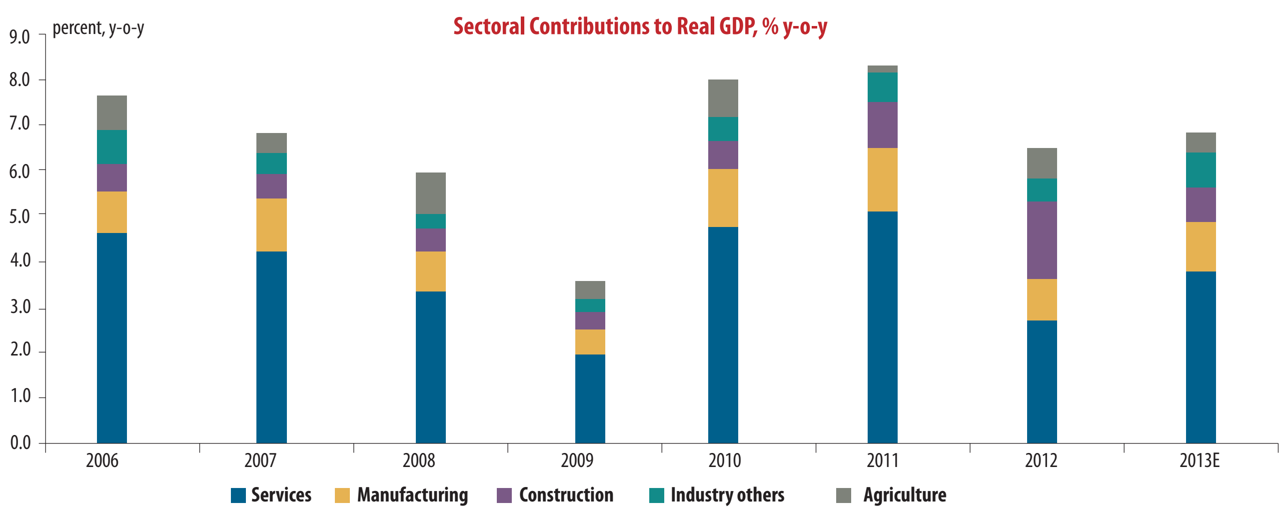
The agricultural sector bounced back strongly in the second-half of 2013 to record a growth of 4.2 percent for the year. This was especially impressive since flooding had ravaged the country's main maha season and contracted output by 0.4 percent in the first half of the year. The rebound was due largely to impressive paddy production in the secondary yala season; one-third of total paddy production originates in the formerly war-affected North and East provinces.

Inflation remained subdued, with headline inflation moderating to 6.9 percent in 2013 from 7.6 percent in 2012. The outlook for inflation remains favorable supported by subdued international commodity prices, improved domestic supply conditions, and well-contained demand-driven inflationary pressures. Lower inflationary expectations are evident in the sharp reduction in treasury yields. Over the past 16 months (from 12.85 percent in November 2012 to 7.07 percent in February 2014) 12-month treasury-bond yields in primary auctions have declined by 578 basis points, while longer-term T-bonds (1-4 years) have seen a yield decrease of 100 basis points.

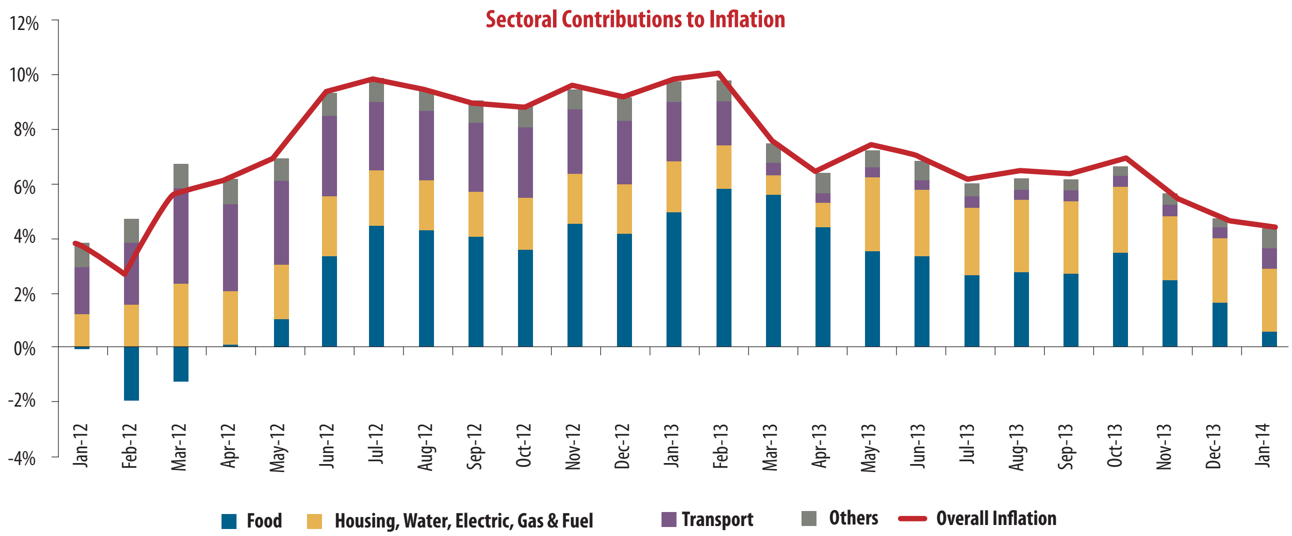
Private sector credit growth has been sluggish through most of 2013. The overall policy stance remains accommodative because the monetary authorities have prioritized high economic growth, targeting 8 percent. Therefore, the two main reasons to justify monetary easing are declining core-inflation and the availability of space for monetary easing – lower credit growth and lower imports growth.

By contrast, public sector borrowing continued to rise, by 24 percent for the central government and 25 percent for state-owned enterprises (SOEs), during the year. The increases were due mainly to the government placing higher budgetary emphasis on domestic sources for financing, the lower interest rates making domestic borrowings more attractive, and the private sector's aversion to credit in the climate of monetary accommodation, which prompted banks to place their excess funds in government securities.

Sectoral Contributions to Real GDP, % y-o-y



Source: CBLS and Department of Census and Statistics Sri Lanka



The government curtailed expenditures during the first nine months of 2013 in an attempt to meet the fiscal deficit target of 5.8 percent of GDP. This was in response to poor revenue performance from the shortfall in trade-related taxes, and followed a trend towards stricter management of fiscal spending in recent years.

External finances were poor during the first nine months of 2013. The external financing during the period was LKR 95 billion but authorities expect this to reach LKR 149 billion by year-end. In the absence of a Euro bond issue for the first time in four years, domestic bank funding will finance the bulk of the fiscal deficit in 2013.

The current account deficit is estimated to decline to 4.0 percent of GDP in 2013, from 6.6 percent in 2012 on the back of lower imports and continued healthy inflows of workers' remittance and tourism receipts.

The Central Bank has cut policy rates three times for a combined 125 basis points since December 2012. In December 2013, the Central Bank established a Standing Rate Corridor (SRC) in place of the current Policy Rate Corridor. The Monetary Board also decided to reduce the Standing Lending Facility Rate of the Central Bank by 50 basis points to 8.00 per cent, thereby compressing the Standing Rate Corridor to 150 basis points from 200 basis points. It is expected that this compression will facilitate the reduction of the interest spread of banks without affecting the deposit rates offered by banks to their customers. In June 2013, the Central Bank removed the credit ceiling for commercial banks and amended regulations to permit commercial banks to hold required reserves against an average of two weeks of liabilities rather than one week, in order to provide the banks greater flexibility in managing liquidity. In line with monetary policy easing, between November 2012 and February 2014, money market interest rates have responded accordingly, with the T-bill yield and Average Prime Lending Rate (APLR) dropping by 578 basis points and 486 basis points.

In January 2014, the Central Bank released a master plan for consolidation of the financial sector. Banking and non-bank financial institutions (NBFIs) will be consolidated by mergers and absorption of businesses. The Central Bank also prohibited the institutions involved in the consolidation from retrenching staff or reducing wages after the fact. The Central Bank has made the move in order to strengthen capital buffers for the financial sector. It is expected that the project will leave at least five Sri Lankan banks with assets of LKR 1 trillion or more each, and about 20 NBFIs with an asset base of over LKR 20 billion each. The Central Bank expected completion of the NBFI consolidation by end-March 2014, and the entire process to be finalized by the end of the year.

Outlook and Policy

GDP growth is expected to accelerate further, to 7.3 percent in 2014. The stronger momentum of activity projected for the second half of 2013 will also lead to stronger carry-over into 2014. This growth is supported by an increase in capacity from new infrastructure investments and rebuilding. But a relatively protracted recovery in high-income countries and tightening of international financial conditions will constrain a more robust rebound for Sri Lanka within the forecast horizon.

Risks to the outlook include:

Maintaining fiscal consolidation. Recent efforts at fiscal consolidation could go off track if the authorities are unable to collect the budgeted tax revenue and/or rising interest costs should the currency depreciate. In such an event, the central government may resort to increased borrowing from the domestic banking sector, possibly crowding out private sector credit.

The precarious financial position of two of the largest state-owned corporations, the Ceylon Electricity Board (CEB) and the Ceylon Petroleum Corporation (CPC). A drought in 2014 would increase the already-substantial losses of the CEB. Inadequate rainfall increases the cost of electricity generation because it is produced by furnace oil rather than hydropower. The unresponsiveness of electricity tariffs to changing conditions has already undermined the viability of the CEB. As a result of its higher dependence on thermal power, the CEB's operating loss would increase. This would trigger further below-cost provisions of furnace oil by the CPC to the CEB increasing the CPC's losses as well. The greater the losses of the CEB the more it undermines private-sector credit growth and, by extension, investment and GDP growth. The situation could be aggravated by the government having to transfer additional resources to bolster the balance sheets of these two state-owned corporations – a substantial fiscal cost. Increased administered prices to cover the losses of the CPC and CEB could have temporary inflationary impact and reduce overall consumption expenditure.

Weathering global commodity prices. Rising global oil prices and depreciation of the Sri Lanka rupee could put pressure on prices. Oil prices could rise due to geopolitical tensions in Middle-East, particularly Syria.

Declining exports-to-GDP. Given that the growth in the two key export sectors – i.e., tea and apparel – remains stagnant, there is a risk that there will be a continued decline in the exports-to-GDP ratio. There needs to be a new thrust towards diversification of both product and export markets to ensure that the trade balance remains manageable.

Managing the economic fundamentals in the face of currency fluctuations of major trading partners. Further depreciation of the Indian rupee could reduce FDI inflows and tourist arrivals from India, and inhibit Sri Lankan exports to India. India represents the single largest trading partner and the single largest source of tourist arrivals. Furthermore, since India is the single largest source of imported goods to Sri Lanka (19 percent of total imports in 2012), a deprecation of the Indian rupee would likely drive up imports from India, thereby inflicting further deterioration in the trade balance.

The three primary challenges to foreign direct investment in Sri Lanka are (i) policy uncertainty and inconsistency with respect to macroeconomic and trade and industrial policy, (ii) administrative, bureaucratic, and organizational constraints, and (iii) relatively high production costs.

			AFG (1)	BGD (5)	BTN (9)	IND (12)	MDV (15)	NPL (19)	PAK (22)	LKA (25)	SAR (28)
OUTPUT and PRICES	Real GDP Growth	2010	8.4	6.1	10.0	10.3 (13)	7.1	4.8	3.7	8.0	9.9
		2011	6.1	6.7	8.1	6.6	7.0	3.4	4.4	8.2	7.2
		2012	14.4	6.2	5.6 (prov)	4.7	3.4	4.9	3.6	6.3	4.2
		2013	3.6	6.0	6.8 (p)	4.8 (p)	3.7 (e)	3.6 (e)	3.6	7.3 (prov)	4.8
		Q4	..	..	..	4.7	..	..	..	8.2	..
		2014	3.2 (p)	5.4 (p)	7.1 (p)	5.7 (p)	4.5 (p)	4.5 (p)	4 (p)	7.3 (p)	5.2 (f)
		Q1	..	..	..	..	..	..	5.0 (e)	..	..
	Inflation (y-o-y)	2010	7.7	6.8	8.3	10.4	6.2	9.5	13.7	6.2	7.6
		2011	10.2	10.9	13.5	8.4	11.3	9.6	11.0	6.7	8.5
		2012	6.4	8.7	5.5 (prov)	10.4	10.9	8.3	7.4	7.6	8.6
		2013	7.7	6.8	8 (p)	10.2	6 (e)	9.9 (e)	10.0	6.9 (prov)	7.6
		Dec	7.3	7.3	11.86	9.9	3.2	10.3	9.2	4.7	8.2
		2014	6.1 (p)	7 (p)	..	9.8	2.0	9.8 (p)	4.7	7.5 (p)	4.1
		Jan	..	7.5	..	8.8	3.2	9.7	7.9	4.4	7.3
		Feb	..	7.4	..	8.1	..	..	7.9	4.3	7.6
	Core Inflation	2010	9.8 (2)	4.8	..	5.0	..	5.8	9.3	7 (26)	..
		2011	14.6	6.8	..	7.3	..	6.4	9.9	6.9	..
		2012	6.6	11.5	..	5.4	..	10.7	10.6	5.8	..
		2013	7.0	7.5 (6)	..	4.9	..	9.9 (20)	9.8 (23)	4.4	..
		2014	6 (p)	..	..	..	..	..	..	..	..
		Jan	..	..	..	..	..	..	8.1	..	..
	Food Inflation	2010	-1.4	10.1	10 (Q4)	14.2	12.4	15.1	..	6.9	11.4
		2011	12.1	12.8	9 (Q4)	7.9	12.0	14.7	11	9.0	11.4
		2012	4.6	7.5	11.8 (Q4)	8.1	-8.0	7.6	9	5.0	4.9
		2013	..	7.8	9.41 (Q3)	9.3	-2.0	9.7	8	12.0	..
		Dec	9.8	9	..	12.3	..	14.4	3.2	1.6	..
		2014	..	..	..	..	..	..	..	..	..
		Jan	..	8.8	..	10.0	..	12.9	2.5	0.6	..
		Feb	..	8.8	..	8.6	..	..	..	..	..
BALANCE of PAYMENTS	Current Account (% of GDP)	2010	2.8 (3)	3.7 (7)	-24.1	-2.7	-9.2	-2.4	0.1	-2.2	-2.6
		2011	3.1	0.8	-25.6	-4.2	-21.4	-0.9	-2.1	-7.8	-3.1
		2012	3.9	-0.4	-21.2	-4.7	-27.1	4.8	-1.0	-6.6	-4.1
		2013	3.6	1.9	-18.6	-1.8 (p)	-27.9 (e)	3.3 (e)	-1	-4.0 (prov)	-2.5
		2014	3.9 (p)	0.2 (p)	-25.0	-2.8 (p)	-26.02 (p)	-0.8 (p)	-0.8 (p)	-4.4 (p)	-2 (e)
	Trade Balance (% of GDP)	2010	-45.9	-5.2 (8)	-25 (10)	-7.5	15.1 (e) (16)	-26.2	-0.5	-9.7	-5
		2011	-42	-6.9	-20.3	-8.8	3 (e)	-25.8	-8	-16.5	-6
		2012	-41.9	-7.8	-18.1 (prov)	-10.5	-3.1 (e)	-24.3	-7.4 (p)	-15.9	..
		2013	-39.9	-5.0	-16.4 (p)	..	-6 (p)	-27.1	..	-13.3 (p)	..
	Import Growth	2010	5.1	21.3	-13.3	28.8	-6.5	35.7	4.7	15.4	19.0
		2011	2.7	41.8	36.9	24.2	24.0	9.2	19.2	23.9	10.2
		2012	11.2	9.9	39.4	1.1	20.4	3.9	0.2	0.0	4.2
		2013	-4	0.8	-3.3	-7.7 (p)	1.1 (e)	11.1	4.2	6.2	1 (e)
		Nov	..	..	..	-12.2	..	..	..	..	
		2014	-1.8 (p)	14.2 (p)	2.4	5.5	-2.6 (e)		3.7 (e)	9.4 (e)	5.30 €

			AFG (1)	BGD (5)	BTN (9)	IND (12)	MDV (15)	NPL (19)	PAK (22)	LKA (25)	SAR (28)
BALANCE of PAYMENTS	Export Growth	2010	4.7	10.8	19.1	37.5	-18.6	-7.3	7.2	10.3	22.8
		2011	1.5	41.5	11.4	17.9	55.1	9.1	6.8	20.4	18.8
		2012	2.6	5.9	-5.8	0.3	22.6	3	1.3	-5.9	1
		2013	-5.1	11.2	0.5	2.2 (p)	-1.8 (e)	-4.6	3.3	6.3 (H2)	7 (e)
		Nov/Dec	..	16.6	..	6.7 (Dec)	..	..	..	..	13.8 (Nov)
		2014	-8.0 (p)	11 (p)	11.2	7.8 (e)	-2 (e)	..	7.3 (e)	7.3 (e)	6.3 (e)
		Jan	..	15.1	..	4.8	..	..	..	..	..
		Feb	..	14.0	..	-2.6	..	..	..	..	..
	Remittances (US$ billion)	2010	-0.02	10.84	-0.06	49.65	-0.19	3.44	9.68	3.60	82 (29)
		2011	0.01	12.06	-0.08	58.42	-0.21	4.18	12.24	4.57	97
		2012	0.11	14.07	-0.06	63.86	-0.25	4.74	13.98	5.32	109 (e)
		2013	..	..	..	..	..	0.49 (Dec)	13.90	6.80	..
			AFG (1)	BGD (5)	BTN (9)	IND (12)	MDV (15)	NPL (19)	PAK (22)	LKA (25)	SAR (28)
GOVERNMENT FINANCES and MACRO POLICIES	Fiscal Deficit (% of GDP)	2010	1.9 (4)	-3.7	3.4	-6.9	-15.7	-0.8	-6.5 (24)	-8	-8
		2011	-0.4	-4.0	3.9	-7.6	-11.3	-0.9	-8.8	-6.9	-7.9
		2012	-0.4	-4.1	2.3 (e)	-7.2	-13.4	-0.6	-8.0	-6.4	-7.5
		2013	2.2	-4.3	2.7 (b)	-6.8 (p)	-9.8 (e) (17)	2 (e)	-5.8	-5.8 (prov)	-6.7
		2014	-0.4 (p)	-5.1 (p)	-0.7	-6.3 (p)	-23.6 (p)	0.2 (p)	-5.1 (p)	-5.2 (p)	-6.8
	Public Debt to GDP (%)	2010	13.8	42.9	69.0	67.4	65.7	35.4	59.4	81.9	..
		2011	13.2	44.2	72.0	66.8	72.4	33.0	63.7	78.5	..
		2012	11 (e)	42.8	90.0	66.6	81.0	34.1	63.0	79.1	..
		2013	..	39.3	86.2	67.4 (p)	86.2 (e)	31.0 (e)	64.2	75.0 (prov)	..
		2014	..	..	100.2	67.3 (p)	121.9 (p)	30.0 (p)	63.2 (p)	71.1 (p)	..
	Reserves in Months of Import	2010	6.7	5.4	10.5	7.1	3.9	5.4	3.7	5.9	7
		2011	6.9	3.9	25.4 (prov)	6.8 (14)	2.7	5.8	2.9	3.5	..
		2012	7.7	3.3	27.8 (p)	6.6	2.4	7.2	..	4.3	..
		2013	7.3	4.6	23 (p)	..	2.6 (e)	7.6 (e)	..	4.2 (prov)	..
		Nov/Dec	7 (Dec)	5.4 (Dec)	..	7.6 (Nov)	2.3-2.4 (Dec)	10.1 (Dec)	0.6 (Nov)	3.8 (Nov)	6.8
		2014	7.5(p)	4.4(p)	..	..	..	7.8(p)	..	4.4(p)	..
		Jan	..	5.4	..	7.8	..	9.9	0.9	..	..
		Feb	..	5.7	..	8	..	10	1.4	..	..
	REER	2010	114.4	108.3	97.4 (11)	100.0	124.5 (18)	54.1 (21)	100.0	81.9 (27)	100
		2011	126.2	108.9	98.6 (p)	97.5	135.0	46.0	102.8	57.34	98.0
		2012	127	105.2	..	91.5	120.3	40.3	104.3	47.8	92.7
		2013	125.3	111.6	..	86.8	..	..	102.2	..	88.2
		Q4	..	..	..	82.4	..	..	99.7	..	84.0
		2014	..	..	..	83.4	..	..	103.9	..	85.3
		Q1	..	..	..	83.4	..	..	103.9	..	85.3

			AFG (1)	BGD (5)	BTN (9)	IND (12)	MDV (15)	NPL (19)	PAK (22)	LKA (25)	SAR (28)
CONSUMPTION and INVESTMENT	Consumption (% of GDP)	2010	120	82	66.3 (e)	69.9	..	88	90	66	..
		2011	120	84	64.1 (e)	72.7	..	91	92	70	..
		2012	..	..	63.2 (e)	74.7	..	80	..	69 (e)	..
		2013	..	..	60.7 (p)	73.1 (p)	..	88	..	..	..
	Investment (% of GDP)	2010	27	19.4	51.6 (e)	30.9	..	32.5	16	28	28
		2011	25	19.5	59.4 (e)	31.8	..	32.8	12.5	30	27
		2012	..	20.0	61.8 (e)	30.4	..	..	11	28 (e)	..
		2013	..	19	65 (p)	29 (p)	..	..	..	..	..
	FDI (US$ billion)	2010	..	0.9	0.03	9.4	0. 22 (e)	0.1	1.6	0.9	30.4
		2011	..	0.8	0.02	22.1	0. 28 (e)	0.1	0.7	1.5	35.7
		2012	..	1.0	0.02 (pro)	19.8	0.16 (e)	0.1	1.2	1.3	29.7 (e)
		2013	..	..	0.01 (p)	22 (p)	0.22 (p)	0.01 (H1)	1.3	2.1 (p)	36.9 (e)
	Portfolio Investment (US$ billion)	2010	..	-0.07	..	28.2	..	0.0	0.3	-0.46	29.9
		2011	..	0.01	..	16.6	..	0.0	-0.14	-0.29	-4.8
		2012	..	0.06	..	26.7	..	0.0	0.03	0.5	11.5 (e)
		2013	..	..	..	2 (p)	..	..	0	..	16.4 (f)

e Estimate
f Forecast
p Projections
prov Provisional

Afghanistan
1 2013 onwards is calender year, preceding years correspond to solar year (Apr-Mar)
2 Core inflation (exc. Fuel and cereal, %)
3 Including grants
4 Including grants

Bangladesh
5 These numbers are for fiscal year unless otherwise mentioned. For example; for 2012 numbers, 2012-2013 values are used.
6 (Avg of Jan-Feb)
7 Including transfers
8 WB Staff Calculations

Bhutan
9 These numbers are for fiscal year unless otherwise mentioned. For example; for 2010 numbers, 2010-2011 values are used.
10 WB Staff Calculations
11 WB Staff Calculations

India
12 These numbers are for fiscal year unless otherwise mentioned. For example; for 2012 numbers, 2012-2013 values are used.
13 Real GDP Growth (at market prices)
14 Calendar year for 2011 and 2012

Maldives
15 These numbers are for calendar year unless otherwise mentioned.
16 WB Staff Calculations
17 2013 is est at around 3% of GDP
18 WB Staff Calculations

Nepal
19 These numbers are for calendar year unless otherwise mentioned.
20 (Avg of Jan-Feb)
21 WB Staff Calculations

Pakistan
22 These numbers are for fiscal year unless otherwise mentioned. For example; for 2012 numbers, 2012-2013 values are used.
23 (Avg of Jan-Feb)
24 Excluding grants

Sri Lanka
25 These numbers are for calendar year unless otherwise mentioned.
26 (Avg of Jan-Feb for 2010-2012)
27 WB Staff Calculations

SAR
28 These numbers are for calendar year unless otherwise mentioned.
29 Remittances numbers are taken from GEP 2013 Jan report and they are calendar year numbers (US$ billions)

THE WORLD BANK

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