

# Making (De)centralization Work



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

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# Table of contents

## Recent economic developments 8

Overview	9
Global growth moderated	10
South Asia is losing its shine	11
Just another industrial production cycle?	13
Don't blame the trade	14
Moderate inflation but rising food prices	16
What is going on in India?	17
References	21

## South Asia economic outlook 22

Overview	23
Uncertain global environment	24
Uncertain domestic environment	25
Growth revised downward, but rebound expected	28
References	34
Appendix	35

## Making (de)centralization work 36

Overview	37
South Asia is further decentralizing	38
One size doesn't fit all	39
Partial decentralization	40
Decentralization and centralization belong together	43
Optimal allocation of central resources is key to success	45
Better geospatial data can improve evidence-based policy designs	48
Conclusions	50
References	52
Appendix	54

## South Asia country briefs 58

Recent economic developments	70
Outlook	70
Risks and challenges	70

## South Asia at a glance 84



# RECENT ECONOMIC DEVELOPMENTS







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## Overview

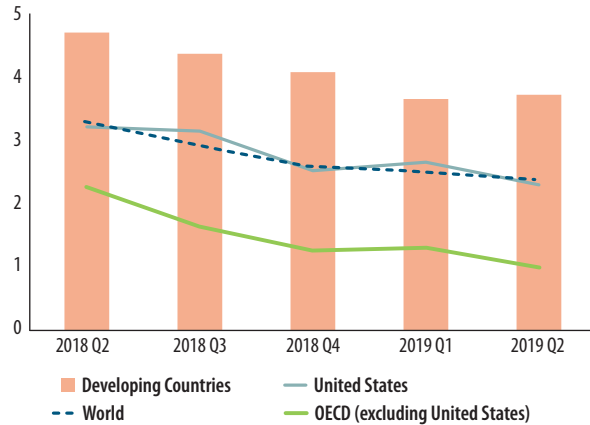
- ❖ **Global GDP growth is decelerating, while trade and industrial production are stagnating.** The slowdown started early 2018 and is strongest in investments and other cyclical components of GDP. Uncertainty caused by trade tensions, Brexit, and oil supply is weighing on global confidence.
- ❖ **In recent quarters, South Asia was no longer the fastest growing region in the world.** In most South Asian countries, growth is expected to be below long-run averages this year. The growth slowdown is reflected in weak stock markets and tensions in financial markets.
- ❖ **There is significant diversity across countries, which is evident in the high-frequency data of industrial production (IP).** India's IP cycle is more pronounced than in other parts of the world, which might explain the recent remarkably weak GDP data (relative to recent averages). In Pakistan, IP contracted much earlier than in the rest of the world, as the country suffered a macroeconomic crisis. In Bangladesh, despite slowing somewhat IP remains surprisingly strong, as the country's garment industry benefitted from the trade tensions between the United States and China.
- ❖ **Current account deficits have declined in the region, as is often the case during economic downturns.** The sharp declines in import volumes reflect the weakness in investments. The only moderate deceleration of export volumes signifies that the slowdown in South Asia does not primarily reflect weak external demand, but rather weak domestic demand, affected by global and domestic uncertainties.
- ❖ **Inflation remains near target in most countries, but food price inflation is picking up.** Inflation below target offers room for monetary policy easing in some countries. After declining last year, food prices picked up recently. Empirical evidence suggests that food prices in South Asia are driven by rainfall and oil prices, and not by international food prices.
- ❖ **The remarkable weakness of Indian economic activity during the first half of 2019 is largely driven by external and cyclical factors.** However, during this downturn several structural problems have come to the surface. One of these problems is related to vulnerabilities in the financial markets that have constrained credit supply. Financial sector reforms are needed to bring India back to a rapid growth path.



### Figure 1: Global GDP growth moderated and trade and industrial production are stagnating.

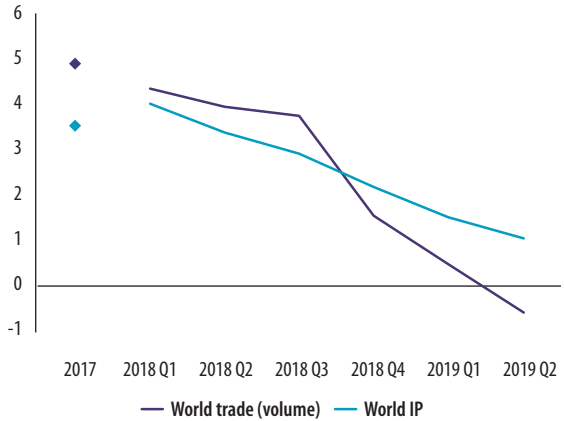
Global GDP growth slowed from an average of 3.0 percent in 2018 to 2.4 percent in the second quarter of 2019 and world trade and industrial production growth, both more cyclical variables, decelerated strongly.

**Real GDP growth**  
Percent change, y-o-y



Source: World Bank.

**World trade and industrial production**  
Percent change, y-o-y



Source: Netherlands Bureau for Economic Policy Analysis (CPB).

## Global growth moderated

In the second quarter of this year, global GDP growth declined for the sixth quarter in a row, trade growth was below 1.0 percent, and global industrial production even contracted (Figure 1). Global GDP growth slowed to 2.4 percent in the second quarter of 2019, compared to 3.3 percent a year ago. The slowdown was broad based and driven both by developing and developed countries. For the former, growth declined to 3.7 percent, well below the average growth rate of 4.3 percent over the last five years. Growth in OECD countries, excluding the United States, was only 1.0 percent and hit a 6-year low. In the United States, a crucial export market for South Asian countries (World Bank 2019), growth slowed to 2.3 percent in the second quarter of this year compared to 3.2 percent a year ago. World trade and industrial production are usually more volatile, and in fact their growth decelerated even faster. World trade grew below one percent in the second quarter of this year and

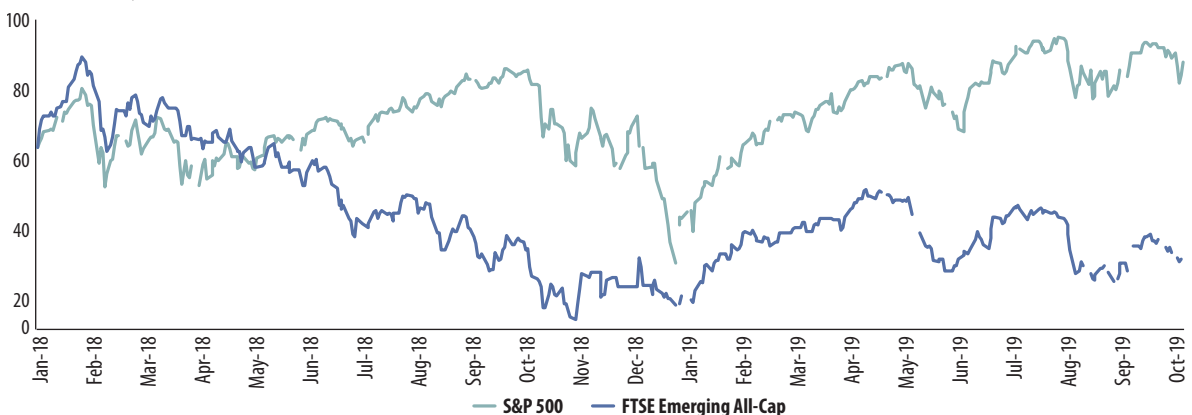
industrial production even contracted. Both trade and industrial production are related to investment demand and their hefty slowdowns point to weak investor confidence, as the trade tensions between the US and China, the possibility of a no-deal Brexit, and the Japan-South Korea dispute all weigh on investment sentiments. In addition, the rising tensions between Iran and Saudi Arabia/USA loom over the oil price and consequently the prospects for the global economy.

This year, US and emerging market stock prices co-move strongly, signaling a global cycle (Figure 2). Strong GDP growth in the US last year led to expectations of rising US interest rates, which tightened external financing conditions for emerging markets (World Bank 2018a) and resulted in a negative correlation of US and emerging market stock price movements between March and October 2018. Since then, however, the correlation between the two stock price indices has been relatively high at 0.7. This is the result of global factors

### Figure 2: Co-movement between US and emerging market stocks point to a global cycle.

After opposing trends last year, US and emerging market stock prices are positively correlated again, signaling a global cycle. After US and emerging market stocks recovered in early 2019, both lost again more recently.

**United States and emerging market stocks**  
Index, 100=January 2, 2018

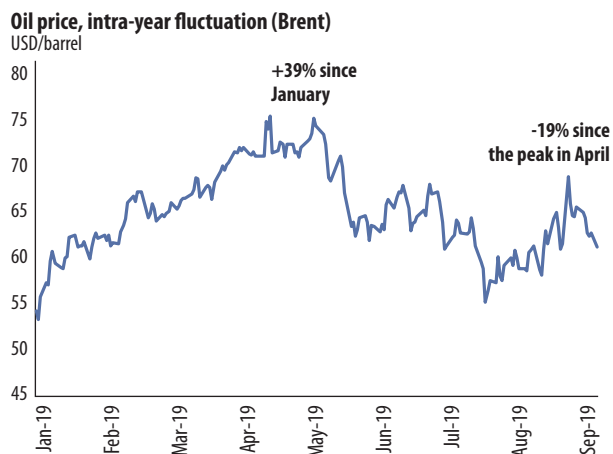


Source: Haver Analytics.  
Note: The last observation is October 4, 2019.

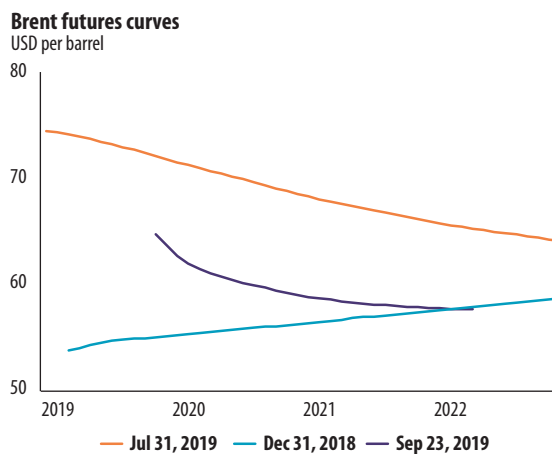


**Figure 3: The oil price remains very volatile but is expected to be below 60 USD per barrel in the medium-run.**

At the end of last year, the oil price was 64 USD per barrel. It increased by nearly 40 percent until April of this year and subsequently fell by 25 percent until September. Recently, the price jumped to nearly 70 USD per barrel following attacks on Saudi oil production. However, it started falling again and currently stands at around 60 USD per barrel.



Source: Haver Analytics.  
Note: The last observation is September 30, 2019.



Sources: Bloomberg and World Bank.  
Notes: Futures curves as reported on the closing prices of the respective day. The last observation is December 2022.

driving both advanced and emerging markets jointly – the world is experiencing a global cycle. Both US and emerging stock markets gained early in the year, but US stocks outperformed those in emerging markets. Stock prices from January to May increased by 13.1 percent in the US and by 7.9 percent in emerging markets. Since then, however, both indices have fluctuated strongly without a clear trend, illustrating the heightened uncertainty in the global economy.

**Oil price volatility remains high and oil price futures suggest prices may remain around 60 USD per barrel (Figure 3).** Over the course of this year, the price of oil has fluctuated between a low of 53 USD per barrel and a high of 75 USD per barrel. After rising until mid-April, when it reached values above 70, it fell again in line with concerns about weakening global demand. However, after the disruption of Saudi oil production in September, caused by attacks on two major oil facilities, the oil price jumped to

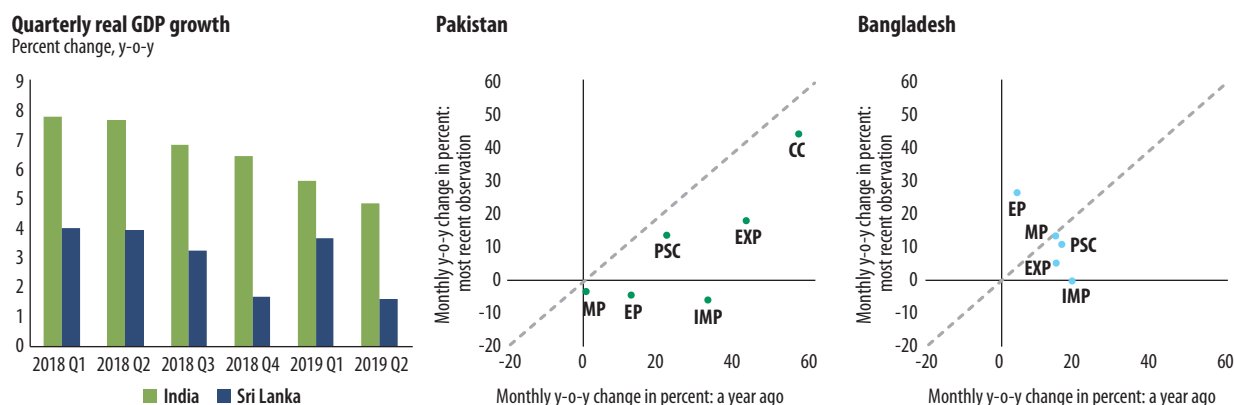
nearly 70 USD per barrel again. The subsequent tensions between Iran and Saudi Arabia have increased uncertainty about future oil price movements. Higher oil prices could further worsen the global economic downturn. In a survey conducted for this report (see Box 2), South Asian economists expressed more concern about oil prices than about global GDP and trade growth decelerations. However, oil price futures suggest that prices will remain close to 60 USD per barrel.

## South Asia is losing its shine

**In line with global developments, economic activity is moderating in many countries in South Asia (Figure 4).** In India, quarterly growth has declined for five quarters in a row. The 5 percent (y-o-y) growth in the second quarter of this year was the lowest since the first

**Figure 4: Economic activity in South Asia is slowing down.**

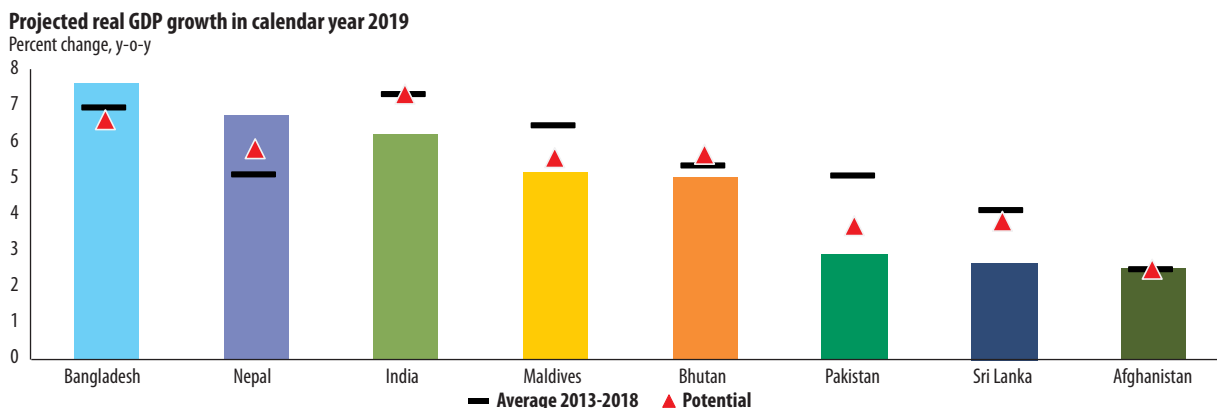
Quarterly growth declined strongly in India and has been weak in Sri Lanka in the second quarter of this year. In Bangladesh and Pakistan, high-frequency indicators signal a slowing economic activity.



Sources: World Bank, Trading Economics, National Authorities, and Haver Analytics.  
Notes: EXP= Exports, IMP= Imports, MP= Manufacturing Production, PSC= Private Sector Credit, EP= Electricity Production, CC= Consumer Confidence.



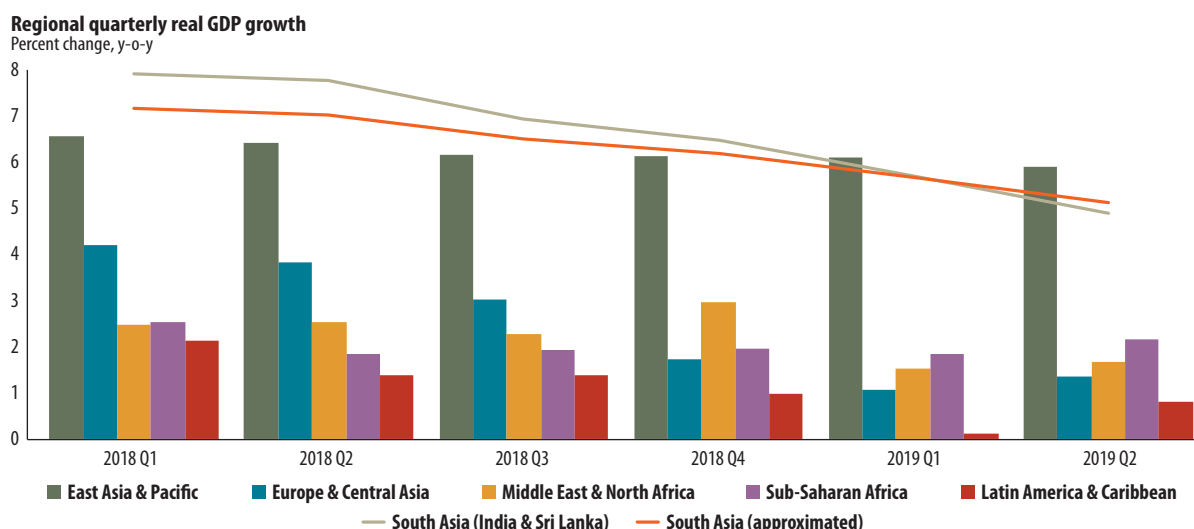
**Figure 5: Many South Asian countries are growing below medium-term averages and potential.**  
*In six out of the eight countries in South Asia, growth projections for fiscal year 2019 are below medium-run averages and potential.*



Source: World Bank.  
 Notes: Bars represent forecasts for 2019, horizontal line markers represent the average growth between 2013 and 2018, and triangles represent the potential growth based on the World Bank's macroeconomic and fiscal model (Burns et al. 2019). Real GDP growth is in calendar years for all countries.

**Figure 6: South Asia is not the fastest growing region in the world anymore.**

*With 5.1 percent, South Asia's growth has been below growth in East Asia and Pacific in the second quarter of this year. Quarterly growth peaked in 2016 with 7.5 percent and since then has decelerated strongly.*



Source: World Bank.  
 Notes: Data is for countries that report quarterly data. The grey line is for all South Asian countries, the quarterly data for which was approximated using linear interpolation.

quarter of 2013. In Sri Lanka, growth fell to just 1.6 percent in the second quarter of this year due to the Easter attacks. While this was the slowest growth in over 4 years, it was still higher than many expected. For Pakistan and Bangladesh, the second and third largest economies in the region, unfortunately no up-to-date quarterly GDP data is available. But high-frequency indicators in these countries, suggest slowing economic activity as well. Imports were stable in July 2019 in Bangladesh and even decreased in Pakistan in August 2019, while they increased over 18 percent (y-o-y) a year ago in Bangladesh and over 30 percent (y-o-y) in Pakistan. Manufacturing production in Pakistan contracted by over 3 percent (y-o-y) in March 2019, while it was still growing a year earlier. Other indicators like private sector credit also point to a slowdown in these countries.

in Sri Lanka has been below long-run averages for some time and consistent with that potential growth is below its long-run average as well. In Pakistan, measures to restore macroeconomic stability weigh heavily on growth, which is expected to have dropped to 3.3 percent in fiscal year 2018/19. Growth is also expected to decelerate below long-run trends and potential in Bhutan, Maldives, and India this year. None of these countries grew below long-run trends or potential last year. In Afghanistan, growth this year benefits from improved farming conditions and is expected to be the long-run average, which is equal to potential. The two exceptions are Nepal and Bangladesh, which are leading growth in South Asia and are expected to have grown above potential and long-run averages in fiscal year 2018/19.

**Most South Asian countries are expected to grow below long-run averages this year (Figure 5).** Growth

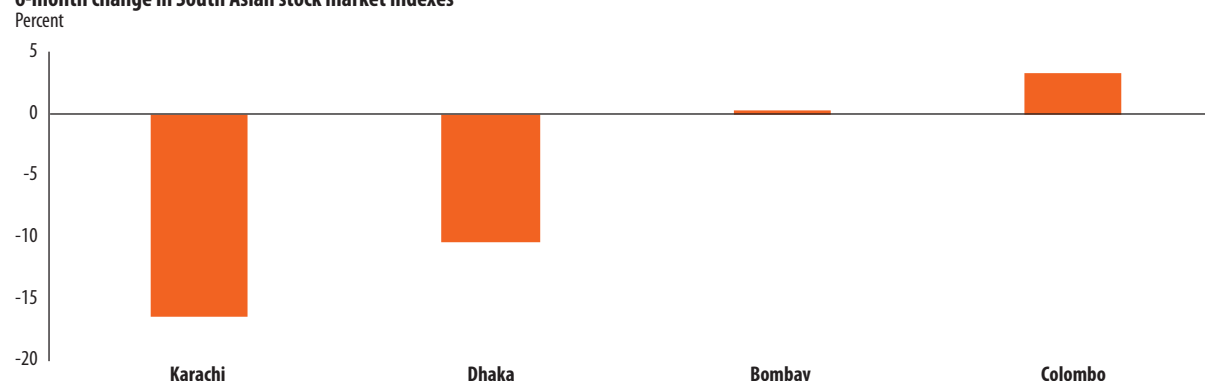
**In the last two quarters, South Asia has not been the fastest growing region in the world anymore (Figure 6).** India's GDP accounts for 84 percent of regional GDP



## Figure 7: Stock markets in South Asia mostly turned downward.

While stock prices remained stable in India and gained momentum in Sri Lanka following an initial slowdown due to the terror attacks, they declined significantly in Bangladesh and Pakistan.

### 6-month change in South Asian stock market indexes



Sources: Haver Analytics and staff calculations.

Notes: Growth rates are calculated using daily price data. The last observation is October 4, 2019.

and hence drives regional growth. But strong changes in growth in other countries also can have a significant impact on regional growth. The only two countries reporting up-to-date quarterly GDP growth in South Asia are India and Sri Lanka. But whether approximations of the other countries' quarterly growth rates are included in the regional growth rate or not, the region has not been the fastest growing in the world for the last two quarters. It had been growing faster than all other regions since 2015, but the region's 5.1 percent (y-o-y) growth in the second quarter of this year was below growth in East Asia and Pacific. The continued deceleration in the second quarter resulted in a larger gap with East Asia and Pacific.

**In line with macroeconomic and financial developments, stock prices in South Asia have fallen (Figure 7).** Over the course of the last six months, stock prices have declined strongly in Pakistan and Bangladesh, remained nearly stable in India and gained somewhat in Sri Lanka. In Pakistan, the decline was triggered by the economic slowdown and macroeconomic adjustment policies and was particularly sharp between May and August. Pakistan's stock market index dropped to its lowest level in August 2019 amid the rising tensions between Pakistan and India over the Kashmir dispute. Over the last month, however, the KSE has been bullish and went up by over 6 percent. In Bangladesh, the stock market continues to tumble; stock prices have fallen by 10 percent since March. The Dhaka Stock Exchange (DSEX) index hit a 33-month low in September. Reasons for the downturn despite continued high growth include financial sector stability concerns and liquidity constraints of banks and non-bank financial companies (NBFCs). In India, the SENSEX has been stable since March. In Sri Lanka, stock prices have gone up by 3 percent compared to six months ago. While the Colombo Stock Exchange was on a strong downward trend until May due to the economic lethargy after the terror attacks, it has reversed course in recent months.

## Just another industrial production cycle?

**Global industrial production cycles are strongly correlated with GDP, but they are more pronounced (Figure 8).** The correlation between global industrial production and GDP growth from 2009 to 2018 was 0.97. The strong and positive correlation shows that when industrial production grew fast, GDP tended to grow fast as well (and the other way around). The correlation between industrial production and GDP is especially strong in China, where industrial production accounts for more than half of the economy. But in the US the relationship is also strong, despite industrial production accounting for less than a fifth of the economy. One reason is the spill-overs from industrial production to services. In South Asia, the share of industrial production in overall economic activity is close to the world average and much smaller than in China. Yet, the correlation between industrial production and GDP is large as well, especially in India and Bangladesh. In Sri Lanka and Pakistan, this correlation is somewhat weaker.

**The relationship between industrial production cycles in different countries is stronger than between GDP cycles.** Despite South Asian countries not exporting a lot of merchandise goods (World Bank 2019), industrial production in South Asia is strongly correlated with industrial production elsewhere. The relationship between industrial production in South Asia and in the US, China, and the rest of the world is strong (Figure 9). Industrial production refers to the output of industrial establishments but also covers sectors such as mining and gas, and hence commodity price booms may contribute to the strong relationship. Therefore, given the weakness in industrial production in both advanced economies and emerging markets around the world, weakness in South Asia is not a surprise.

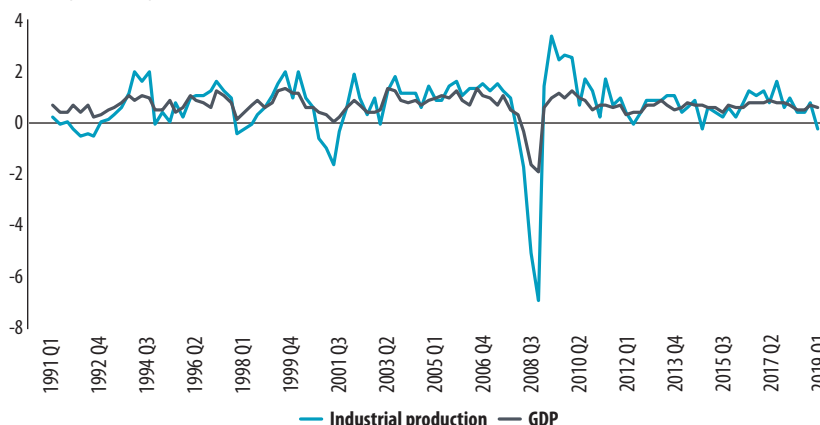
**The recent decline in industrial production across South Asian countries follows global developments, but it is more pronounced and idiosyncratic factors are at play as well.** In the rest of the world, industrial production started to slow earlier than in India, which



### Figure 8: Industrial production cycles and GDP are correlated.

Industrial production is correlated with GDP around the world. In South Asia, the correlation is stronger in India and Bangladesh compared to Pakistan and Sri Lanka.

**Global IP and GDP momentum**  
Percent, quarter-on-quarter



Country	Share of IP in GDP	Correlation IP/GDP
Bangladesh	33	0.75
China	54	0.98
India	26	0.93
Sri Lanka	25	0.30
Pakistan	18	0.52
United States	19	0.88
World	26	0.97

Source: World Bank and staff calculations.

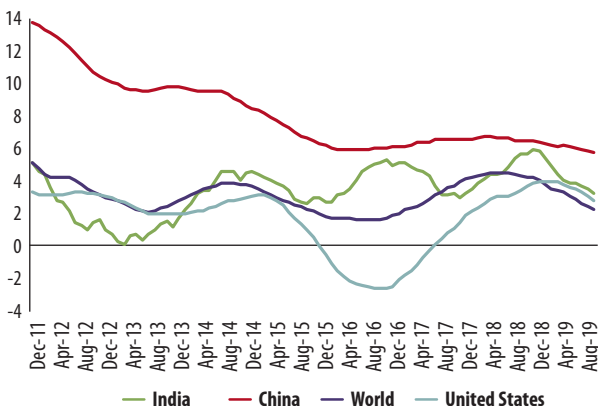
Notes: The growth rates, shares, and correlations are computed using annual data of IP and GDP in 2010 USD constant prices. The share refers to 2018 and the correlation has been computed from 2009 to 2018. The correlation is the ratio of total common variation (covariance) between industrial production and GDP growth to a measure of the total variation (the product of the standard deviations).

### Figure 9: Industrial production cycles are correlated across the world.

The decline in growth is in line with global developments, as industrial production slows.

**Industrial production**

Percent, y-o-y, 12-month moving average

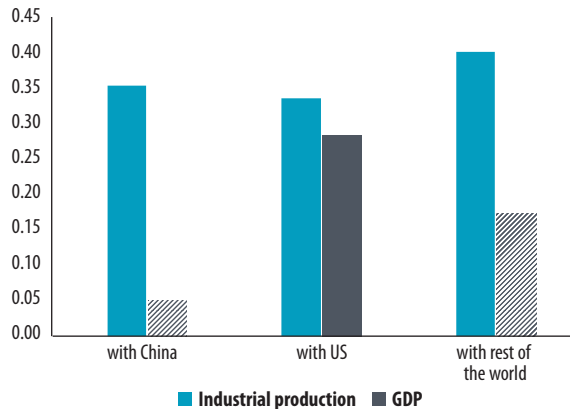


Source: World Bank.

Note: The last observation is August 2019.

**Relationship between GDP and IP in South Asia and the world**

Regression coefficient



Source: World Bank and staff calculations.

Notes: Solid bars represent coefficients that are significant and patterned bars represent coefficients that are not significant. All GDP and IP series are in growth rates. The frequency of data is annual and covers years 1999 to 2018. The countries included in South Asia are India, Pakistan, and Bangladesh. Rest of the world was calculated using the world industrial production less South Asia, China, and United States.

experienced an industrial production boom in 2016 and early 2017. After some moderation industrial production accelerated again in 2018 but this year, in line with the rest of the world, Indian industrial production is slowing (Figure 10). Industrial production in Pakistan has continued its collapse that began at the beginning of last year, and now industrial production is even contracting. Bangladesh, on the other hand, benefits from its strong garment sector and from trade diversion arising from the trade tensions between the US and China. Despite some slowdowns recently, its industrial production is growing faster than the overall economy, making it the only country in South Asia that continues to industrialize. However, the growth is coming primarily from the ready-made-garments sector, while other major exporting sectors are not performing as well and hence the industrialization is neither broad based nor sufficiently diversified.

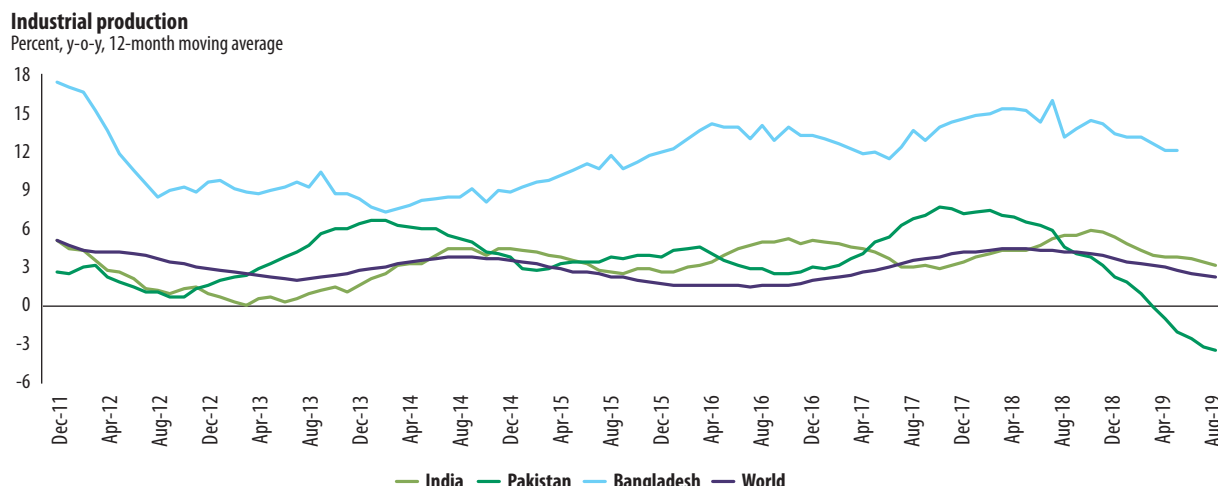
## Don't blame the trade

Exports grew faster than imports in the first two quarters of 2019, suggesting weak domestic demand (Figure 11). Thus, weakening global conditions do not seem to be affecting South Asia through the trade channel. Apart from Pakistan, South Asian exports continued growing fast in the first quarter of this year, but export growth moderated strongly in India in the second quarter. Import growth, on the other hand, has declined severely across countries in South Asia, and imports even contracted between 15 and 20 percent (y-o-y) in Pakistan and Sri Lanka. The different developments for exports and imports have led to a reduction of the trade imbalances for all countries. In addition, the stronger declines in imports suggest that the trade channel is not



### Figure 10: Industrial production in South Asia shows idiosyncratic developments as well.

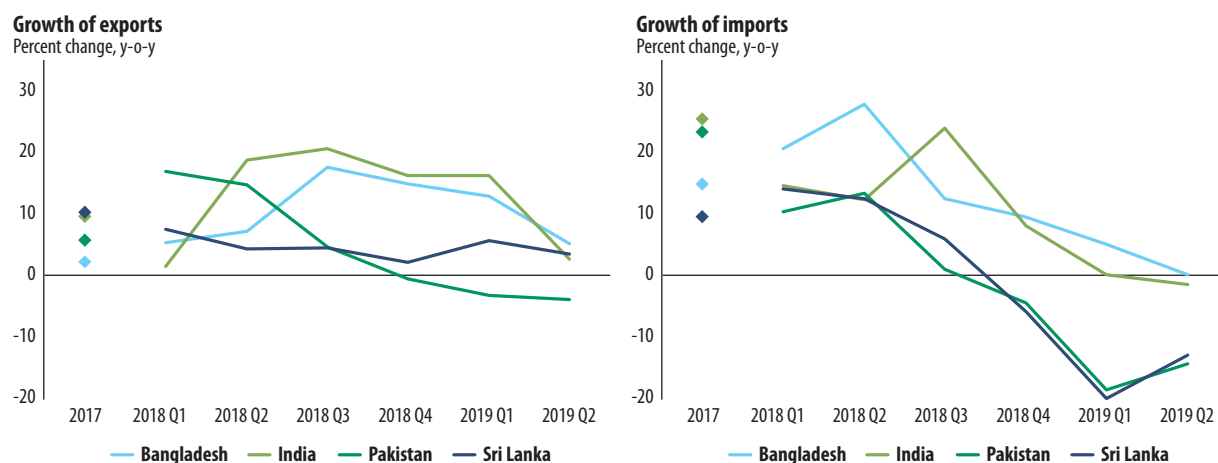
The recent decline in industrial production growth is in line with global developments, but at the same time there are important idiosyncratic developments in Pakistan and Bangladesh.



Source: World Bank.  
Note: The last observation is May 2019 for Bangladesh and August 2019 for the rest.

### Figure 11: Imports are falling while exports keep growing, suggesting weak domestic demand.

Nominal exports are growing faster than imports, suggesting weak domestic demand. In Pakistan and Sri Lanka, imports are contracting sharply.



Sources: International Monetary Fund (IMF) and World Bank.  
Notes: Exports are in current USD. The year 2017 represents the average of 2017.

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Notes: Imports are in current USD. The year 2017 represents the average of 2017.

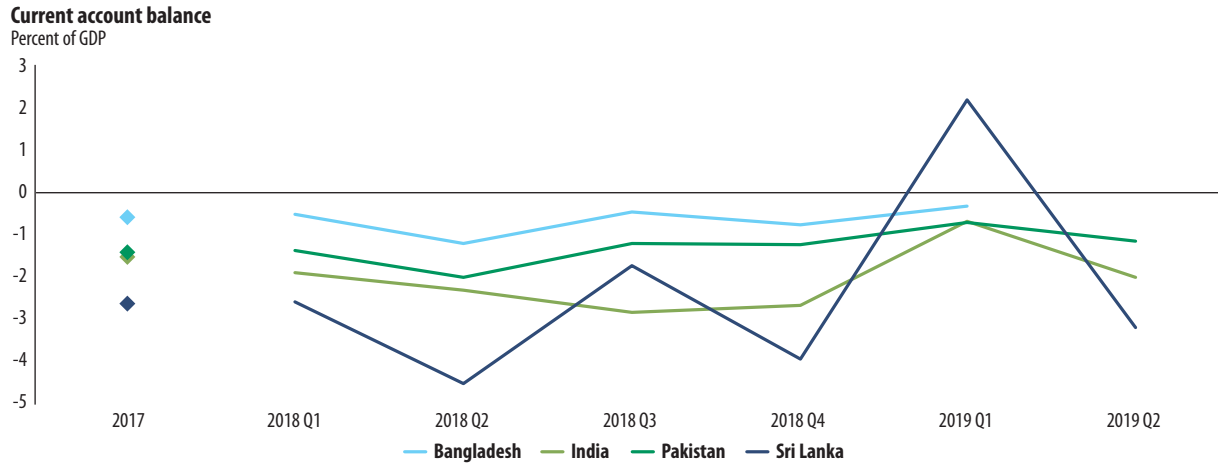
responsible for the current economic slowdown in South Asia. Oil prices increased between mid-2017 and October 2018, contributing to rising imports back then. Since then, the oil price has decreased, which contributed to the decline in imports. However, non-oil imports show the same dynamics. This indicates that after strong domestic demand growth in recent years (see World Bank 2019), domestic demand has started to moderate.

**Closing current account balances are easing concerns about external imbalances (Figure 12).** Last year, double-digit import growth and tighter financial conditions made it more difficult for South Asian countries to finance the increasing current account deficits. In some countries,

capital flows reversed, while credit default spreads increased, and currencies depreciated. This challenging situation bottomed out six months ago (World Bank 2019) and has further improved since then. In addition to a closing trade gap, the current account was supported by strong remittances inflows, which grew in all countries except Sri Lanka. FDI flows, on the other hand, were mostly flat, with Pakistan being the only exception with a continuous fall since 2018. In line with these developments, current account imbalances are closing. Sri Lanka registered a surplus of 2 percent of GDP in the first quarter of the year, but the current account was again in deficit in the second quarter due to the Easter attacks. Increased external stability is reflected in mostly stable exchange rates in South Asia.

**Figure 12: Current account balances are closing, easing concerns about external imbalances.**

Helped by the closing of the trade gap, current account deficits in South Asia are closing.



Sources: Haver Analytics and National Authorities.

Notes: Quarterly GDP for Bangladesh and Pakistan were derived from annual GDP and assumed to be constant for all four quarters. The year 2017 represents the average of 2017.

## Moderate inflation but rising food prices

**Inflation is below target in India and Sri Lanka, but above in Pakistan, and monetary policies are adjusting (Figure 13).** In line with lower economic activity, inflation rates in India declined from 5.0 percent a year ago to 3.2 percent at the end of the second quarter of this year. And in line with growth below potential, inflation was below the mid-point of the Reserve Bank of India's (RBI) inflation target band. The RBI used this room to become the first central bank in the Asia-Pacific region to begin an easing cycle. It shifted the policy stance from "neutral" to "accommodative" and reduced the repo rate by 135 basis points (year to date) to 5.1 percent. Sri Lanka also

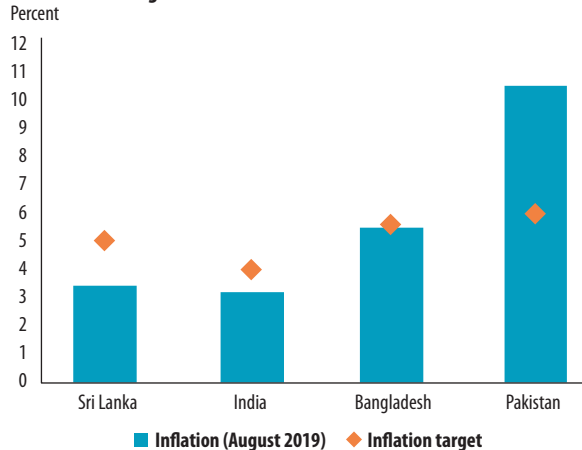
eased its monetary policy stance and has lowered rates twice this year already. In August, the Central Bank of Sri Lanka announced a 50-basis points rate cut to boost credit flows to support growth. Pakistan, on the other hand, has now increased its main policy rate nine times since the beginning of last year. The last increase took place in July, when the State Bank of Pakistan increased its rate by 100 basis points to 13.25 percent, due to high inflationary and external pressures. The central banks in Nepal and Bangladesh have left interest rates unchanged since mid-2018. The Bangladesh's central bank kept its 12.5 percent target for broad money growth unchanged in July.

**Across South Asia, food prices have been increasing over the last few months (Figure 14).** Food prices in

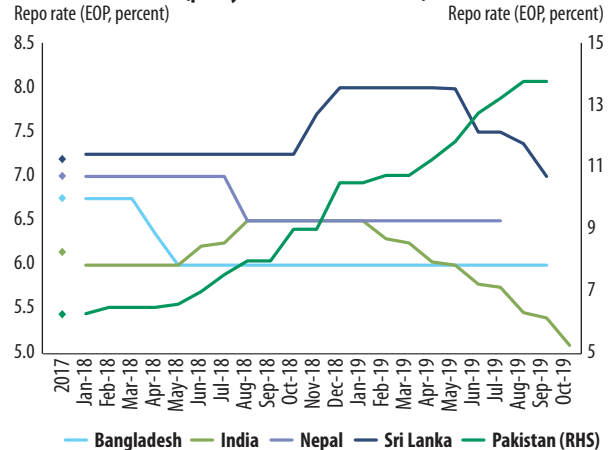
**Figure 13: Inflation is below target in Sri Lanka and India but above in Pakistan, and monetary policy is adjusting accordingly.**

In line with growth below potential, inflation is below target in Sri Lanka and India. In Bangladesh inflation is at the target, and in Pakistan strong exchange rate adjustments resulted in strongly increasing prices. Consequently, Sri Lanka and India started easing cycles and Pakistan sharply increased its policy rate.

### Inflation and target inflation



### Official interest rate (policy instrument/base rate)



Sources: Inflation target data is from Haver Analytics and National Authorities. Current inflation data is from World Bank.

Notes: Sri Lanka is moving toward an inflation-targeting regime; this figure uses the implicit target defined as the midpoint of the target band between 4 and 6 percent.

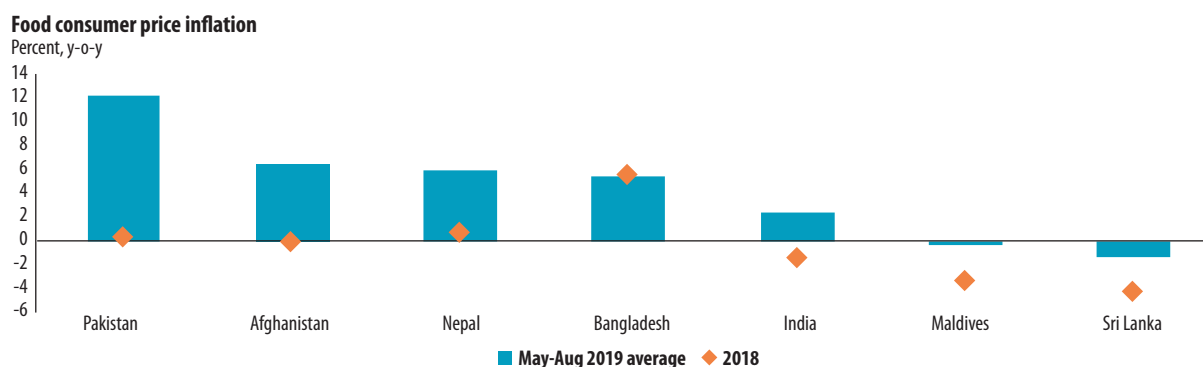
Sources: Haver Analytics and National Central Banks.

Notes: The year 2017 represents the average of 2017. The last observation is October 2019 for India, July 2019 for Nepal, and September 2019 for the rest.



**Figure 14: In contrast to last year, food prices recently increased.**

In Pakistan, Afghanistan, Nepal, and Bangladesh, food prices are around a 6 percent higher than a year ago.



Sources: Afghanistan, Bangladesh, India, Pakistan and Sri Lanka National Authorities. Maldives data series from MMA / Haver Analytics.

Notes: The year 2018 represents the percent change between Dec-2017 and Dec-2018. The last observation is July 2019 for Nepal, June 2019 for Afghanistan, and August 2019 for the rest.

2018 were stable in Pakistan, Afghanistan, and Nepal and fell in India, Maldives, and Sri Lanka. However, food prices recently have been increasing in all countries except Sri Lanka. In Pakistan, Afghanistan, Nepal, and Bangladesh, food prices are more than 6 percent higher than a year ago. Food prices are especially important for poverty reduction. On the one hand, food expenditures represent a substantial share of consumption for poor people (Attanasio et al. 2013). On the other hand, sustained increases in food prices have often benefited the poor and likely contributed to faster global poverty reduction, since their incomes depend positively on food prices (Headey and Martin 2016). In South Asia the negative effect prevails, and the region is vulnerable to increasing food inflation especially because of the large segment of the population living near the poverty line. If food prices increase by 10 percent, the poor population increases by over 2.1 percentage points on average; however, differences within the region are large. Sri Lanka is least affected by rising food prices, and rural India and Bangladesh are most affected (Carrasco and Mukhopadhyay 2012). Food prices partly depend on the monsoon patterns (see Box 1). This year, the monsoon started late and many areas in South Asia received less rain than typical at the beginning of the season. In mid-July, however, heavy rainfalls helped push rainfall very close to the 50-year average.

## What is going on in India?

**India's cyclical slowdown is severe.** Quarterly GDP growth slowed for 5 quarters in a row, declining from a peak of 8.1 percent in the first quarter of 2018 to only 5.0 percent in the second quarter of this year (Figure 15). Growth decelerated by 3 percentage points in the last year and growth in the second quarter of this year was the lowest in over six years. Manufacturing growth fell from over 10 percent a year ago to below 1 percent in the second quarter of 2019. This drop follows the global trend but is more pronounced. Services and construction also started decelerating over the last quarters, suggesting that the slowdown is not related to idiosyncratic factors related to a specific sector. Export growth recently declined – in line with slowing world growth and weak external demand – but cannot alone explain India's sharp downturn.

**The slowdown is mostly due to a deceleration in domestic demand.** After years of contributing to high growth rates (World Bank 2018a), domestic demand slipped and contributed the most to the disappointing performance in the last quarter. Private consumption and investment both grew slower than overall GDP in the second quarter of this year. Investment grew 4.0 percent (y-o-y) in the second quarter, compared to 13.3 percent a year ago, while private consumption grew 3.1 percent, compared to 7.3 percent a year ago. One reason for slowing private consumption is the strong contraction of car sales that started in mid-2018, driven in part by higher insurance premia, new emission norms, uncertainty about GST cuts, and the squeeze in the non-bank financial companies (NBFC) sector (see Chapter 2). However, global sentiments may also play a role since car sales are down in Europe and China as well. Together, consumption and investment grew 6.0 percentage points slower than a year ago. In line with weakening domestic demand, import growth fell from 11.0 percent a year ago to only 4.2 percent in the second quarter of this year. With a growth rate of 8.6 percent, government consumption has become the fastest growing expenditure component. The recent slowdown in India is not surprising given global economic developments, and even slowdowns driven by domestic demand can be caused by external shocks through capital flows or global sentiment, but the downturn is more pronounced than elsewhere.

**In such a weak economic environment, structural issues surface and the weak financial sector is becoming a drag on growth.** Despite high economic growth in the last decade, India's banking system still has a significant level of non-performing assets of close to 10 percent of total assets (Figure 16, left panel), some of which were generated or revealed during the global financial crisis. The introduction of the 2016 bankruptcy code and re-capitalizations of state-owned banks were necessary steps, but not enough to resolve the weakness. The high share of non-performing assets in the banking sector did not immediately result in a significant fall in overall credit, because non-banking financial companies (NBFCs) increased their credit supply to the real sector. Recently NBFCs came under liquidity stress and NBFC funding has contracted severely. Before that, NBFCs financed 40 percent of car sales, and hence the squeeze contributed to



## Box 1: The drivers of food price inflation in South Asia

**Food is an essential and large component of the consumption basket in South Asia and strongly impacts aggregate inflation.** In addition to the direct effect, rising food prices translate into higher non-food prices because workers demand higher wages, raising the cost of production and by default the prices of non-food items as well. Around three quarters of the variation in consumer price inflation in Afghanistan, India, Sri Lanka, and Pakistan can be attributed to food price fluctuations (World Bank 2019). In recent months, food prices in South Asia have increased sharply.

**Among the many factors that may impact food prices, the following three seem the most obvious ones: global food prices, oil prices, and unusual rainfall patterns.** Both global factors (e.g. food and oil prices) and regional factors (e.g. rainfall patterns, which are correlated across South Asian countries) have been shown to matter for food prices in South Asia (World Bank 2019). To understand how important the different factors are, we compile monthly data from January 2013 to December 2016 for food prices in Bangladesh, India, Pakistan, and Sri Lanka, global food prices (FAO food price index), oil prices (average of Brent, Dubai, WTI) and rainfall for Bangladesh, India, Pakistan, and Sri Lanka (data from World Bank).

**We compute both extreme deficient and surplus rainfall.** As a measure of unusual rainfall patterns, we define deficient or surplus rainfall as the percent deviation from country-specific and month-specific averages by the following formula:

$$\text{Rain}_{\text{month deviation}} = \frac{\text{Rain}_{\text{month}} - \text{Rain}_{\text{avg month}}}{\text{Rain}_{\text{avg month}}} \text{ for } n = \{1, \dots, 12\}$$

**From this series we create dummies to capture months of extreme rainfall.** The first dummy captures months of deficient rain, which are defined as months with rain at least one standard deviation below the typical rain in this country in this month. The second one captures months of surplus rain, defined as months with rain at least one standard deviation above the typical rain in this country during this month, but not above twice the standard deviation. In contrast to deficiency, there are many months of extreme surplus rain, so a dummy variable is included for months when rainfall is above twice the standard deviation.

**Table 1: Food prices are impacted by oil prices and deficient rainfall, but not by global food prices.**

	Deficient rain	Surplus rain	Extreme surplus	Oil price	Global food price	Constant	Fixed effects	# of countries	Within country R <sup>2</sup>
Food prices	1.2**	0.3	1.4	5.4***	0.01	YES	YES	4	0.46

Sources: Food and Agriculture Organization of the United Nations, World Bank, Haver Analytics, and staff calculations.

Notes: Coefficients are from a pooled panel regression of Bangladesh, India, Pakistan, and Sri Lanka from January 2013 to December 2016. Standard errors in parentheses; \*\* p<0.05, \*\*\* p<0.01.

**Oil prices and deficient rainfall affect South Asian food prices, but global food prices do not (Table 1).** We run a pooled panel regression of food prices in South Asia (Bangladesh, India, Pakistan, and Sri Lanka) on global food prices, oil prices, and extreme rainfall. The within-country fit of the regression, with a coefficient of determination of 0.46, is remarkable. Higher oil prices increase agricultural production costs, for example, through fertilizers and the cost of gasoline to run agricultural equipment. And indeed, oil prices significantly affect food prices in South Asia. Food prices also tend to be higher in months of extreme surplus rain, but the relationship is not statistically significant (the same result is found when surplus rain and extreme surplus rain are combined). Deficient rainfall, however, has a statistically significant effect on food prices. In months in which the rainfall is at least one standard deviation below normal, food prices are 1.2 percentage points higher. Across South Asia, most of the year's total rain falls during the monsoon and large parts of the total cropped area is not irrigated, making the farmers heavily dependent on rainfall. It seems likely that the weak start of the monsoon in 2019 has contributed to the higher food prices observed in recent months. Afghanistan, following a severe drought in 2018, experienced more precipitation and snowfalls in early 2019, which is expected to improve farming conditions and agricultural production. The effect of rainfall deviations can also explain the co-movement in inflation rates amongst the South Asian economies (Blagrove 2019). Global food prices are often alluded to as a significant factor explaining movements in food prices in South Asia. While they are correlated with food prices in South Asia, they are not a significant factor in our regression, suggesting that both are commonly driven by oil prices.

the recent consumption slowdown. There are some signs of improvement in the financial sector. The non-performing assets ratio decreased from March 2018 to March 2019 for both public and private banks and both in industry and services (Figure 16, left and middle panels). And despite new regulatory and supervisory efforts from the RBI that resulted in greater market discipline, overall credit growth in the economy picked up again in July (Figure 16, right panel). But these positive developments leave no room for complacency, as financial sector conditions

could deteriorate further if the recent slowdown is not properly addressed and contained.

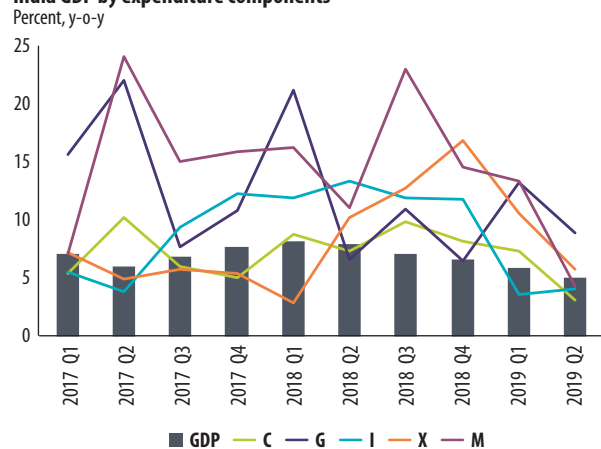
**This critical situation demands decisive policy actions, and initial government steps point in the right direction.** The deceleration in growth in the context of slowing global GDP and trade growth, as well as an uncertain external environment, bears resemblance to 2008 and 2012/13 when GDP growth in India slumped. Both monetary and fiscal policy measures are needed



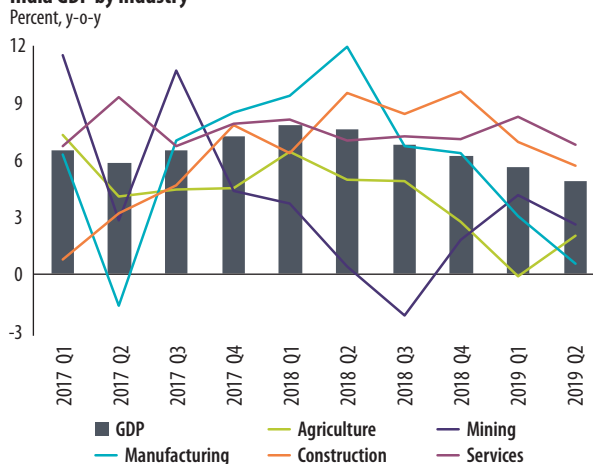
### Figure 15: India's strong slowdown is driven by domestic demand.

India's slowdown is broad-based but mostly driven by domestic demand. Apart from government consumption, all demand components have been weakening. Manufacturing growth fell from over 10 percent a year ago to below 1 percent in the second quarter of this year. Growth in agriculture and services has been muted as well.

**India GDP by expenditure components**



**India GDP by industry**



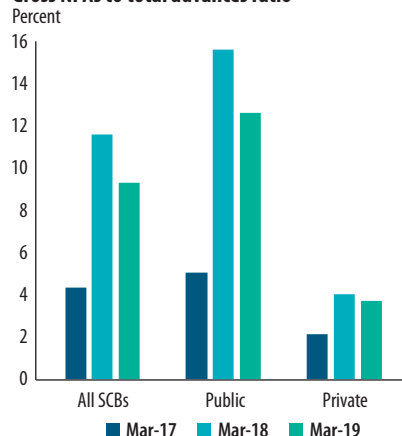
Sources: Central Statistics Office and Haver Analytics.  
Notes: C=Private consumption, I=Investment and G=Government consumption, X=Exports, M=Imports. GDP growth by expenditure is in market prices.

Sources: Central Statistics Office and Haver Analytics.  
Note: GDP growth by industry is in basic prices.

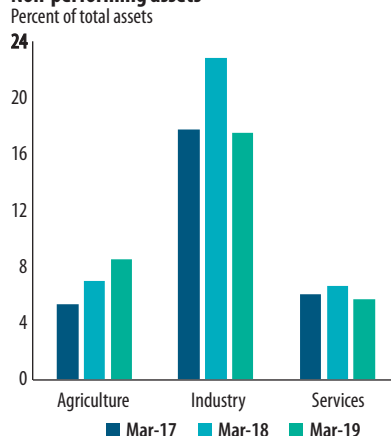
### Figure 16: Credit has been sluggish and the uptick in July leaves no room for complacency.

Credit growth slowed down from February to June but increased again in July. Non-performing loans continue to be high, especially related to industry and more in public than in private banks.

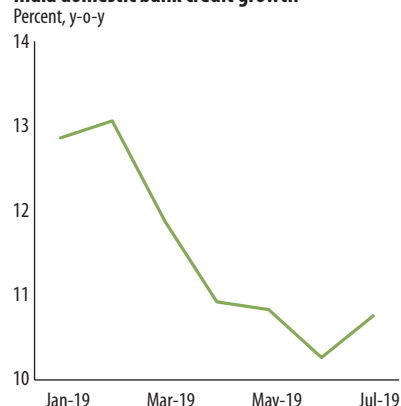
**Gross NPAs to total advances ratio**



**Non-performing assets**



**India domestic bank credit growth**



Sources: Reserve Bank of India and CEIC.  
Notes: NPAs stand for non-performing assets and SCBs stand for scheduled banks, which means banks included in the Second Schedule of the Reserve Bank of India Act, 1934.

to contain the downturn, and both the RBI and the government of India have already reacted. The RBI began an easing cycle at the beginning of the year, and below-target inflation will allow for further easing. Despite surplus inter-bank liquidity, however, monetary transmission has been weak and bank lending rates have not reacted much. India's government has recently launched a stimulus package that will support the ongoing expansionary monetary policy. While monetary policy will continue to act as the main countercyclical tool, the fiscal measure is expected to have a positive economic impact. The stimulus package came as a surprise and will amount to 0.7 percent of GDP. It includes the rollback of some previous corporate tax increases and some additional tax cuts. As part of the package, more mergers of the publicly-owned banks are planned and around USD 32bn will be available

for bank recapitalization. In addition to giving the RBI regulatory authority over the housing financial sector and NBFCs, the government is planning to give partial credit guarantees to public sector banks and included measures in the budget to address NBFCs funding needs. All these measures will help to contain the downturn, but also raise concerns about fiscal space (World Bank 2018b). Right before the announcement of the stimulus, the RBI communicated that the margin left for fiscal stimulus was not too wide. The current situation illustrates how important it is to preserve fiscal space in good times to be able to manage economic downturns. In South Asia, however, procyclical public spending and a positive expenditure multiplier imply that fiscal policy often amplifies boom-and-bust cycles rather than smoothing them (Beyer and Milivojevic 2019).



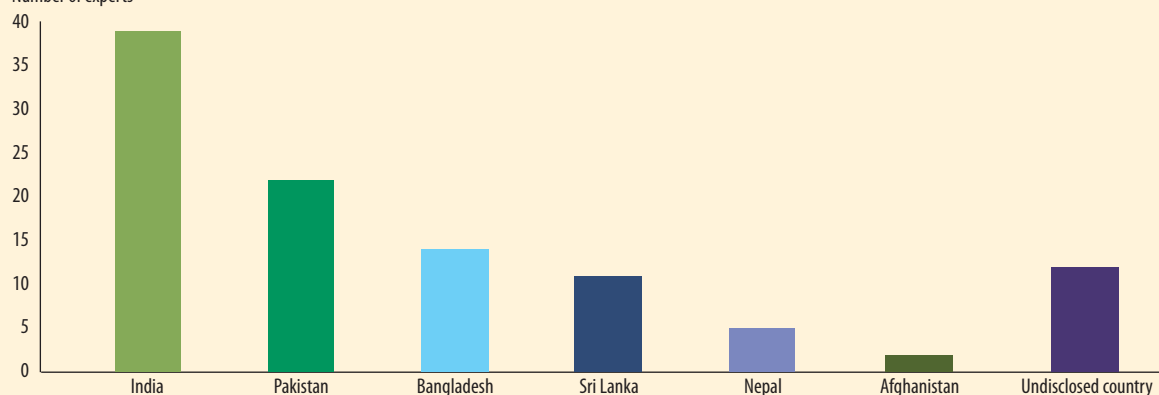
## Box 2: Views from the South Asia Economic Policy Network

The South Asia Economic Policy Network, launched by the office of the regional Chief Economist at the World Bank in 2017, represents an attempt to engage more strongly with thinkers and doers across South Asia. The objective is to be more proactive in nurturing the exchange of ideas and to learn more systematically from colleagues and counterparts in the region. The Network currently focuses broadly on macroeconomics and includes nearly 400 researchers and practitioners from the region. Network members include researchers from seven South Asia countries, selected based on peer recognition, recent conference presentations, and research outputs. Many of them are academics at renowned universities, others are researchers in central banks and think tanks, and some are affiliated with policy-making institutions.

Figure 17: Over 100 researchers and practitioners shared their views.

### Survey among South Asia Policy Network

Number of experts



Source: South Asia Economic Policy Network.

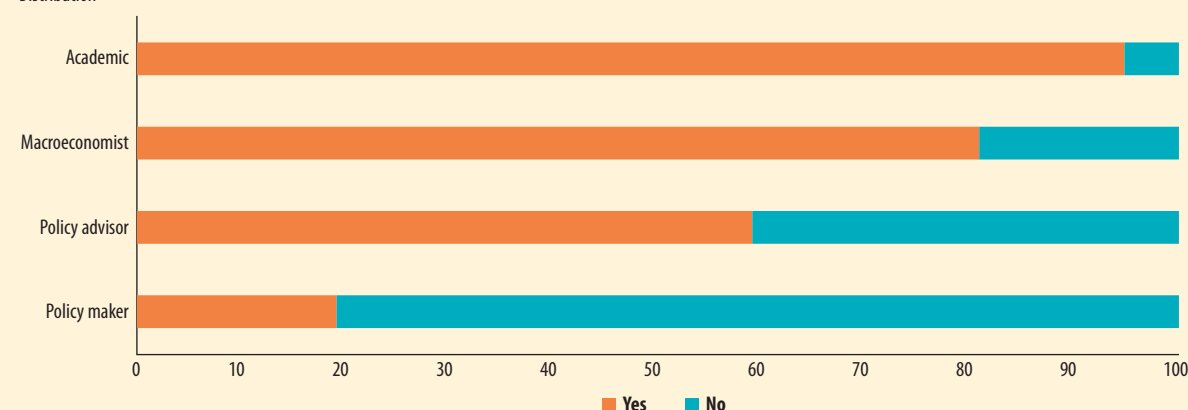
As for the last three editions of this report, a short opinion survey was conducted of Network members. The objective was to take the pulse of informed and influential experts about economic developments in their countries. We also used the survey to gather their views on fiscal decentralization.

With 105 filled-in questionnaires from 6 countries, over 27 percent of the invited experts responded to the survey. Almost all respondents identified themselves as academics and around 80 percent as macroeconomists. Almost one third of the respondents are involved in policy making and almost two thirds in policy advising. Responses regarding the economic situation are summarized here. The views on decentralization are reported throughout the third chapter.

Figure 18: A diverse range of experts participated in the survey.

### Self-assessment of respondents

Distribution



Source: South Asia Economic Policy Network.

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

Respondents anticipate different GDP growth developments in different countries. In Pakistan and India, there is a strong consensus that the growth rate will come down. In the other countries, the diffusion index signals stable growth, with a slight expectation

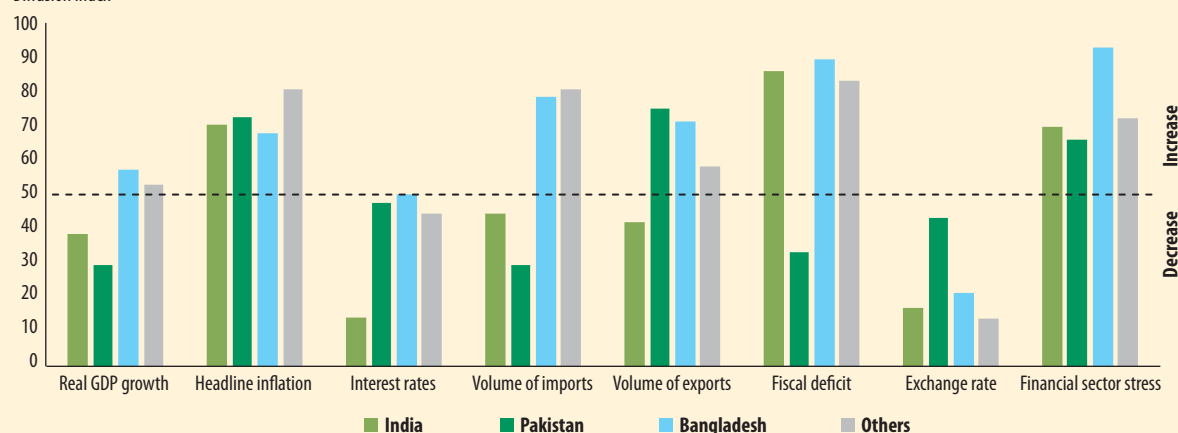


of increased growth in Bangladesh. Network members expect that inflation will pick-up across all countries, but there still is an expectation of declining interest rates across all countries. Especially Indian economists agree that the easing cycle will continue. In Pakistan, on the other hand, most economists (though not by a large margin) expect an end of the tightening cycle. In India imports and exports are strongly expected to decrease, which seems pessimistic but is in line with the most recent developments and the experts' expectation of lower growth. In Pakistan, while imports are expected to decrease, exports are expected to increase, showing some optimism regarding continued external re-balancing. In all other countries the volume of imports and exports are both expected to increase. And in all countries except Pakistan, Network members strongly agree that fiscal deficits will increase over the next six months. Most Network members also agree that their currencies will be under pressure over the next six months. Finally, across the region there is a consensus that financial sector stress will rise, and the situation seems most worrying in Bangladesh.

**Figure 19: Views on the outlook are not very optimistic.**

**What do you expect to happen in your country within the next six months?**

Diffusion index



Sources: South Asia Economic Policy Network and staff calculations.

Notes: The index is calculated as follows:  $\text{Index} = (P1 \times 100) + (P2 \times 50) + (P3 \times 0)$ , where P1 is the proportion of responses that report that the variable will increase, P2 is the proportion of responses that report that the variable will remain unchanged, and P3 is the proportion of responses that report that the variable will decline.

**There are some notable differences in expectations compared to six months ago.** As forecasted by the Pakistani experts six months ago, interest rates in the country indeed increased, and the fiscal deficit worsened. Different from six months ago, they now expect lower interest rates and a lower fiscal deficit. In India, amid surprising trade data, experts have adjusted their views on future import growth and now expect a continuation of the decline.

**The survey offered room to express general views on the economy.** In Bangladesh, economists seem very concerned about the balance of payments and the financial sector, and in both Bangladesh and India experts raised concerns about the quality of growth and its measurement. Experts in India also express apprehension regarding the global environment which may lead to further stagnation of the economy. Pakistani respondents expressed optimism that after an initial deceleration of growth, the macroeconomic adjustment policies will result in higher potential growth, partly through an improved export performance. They do however express concern regarding the risks associated with oil price variations which may in turn affect inflation and growth. In Sri Lanka, experts argued that in light of the upcoming elections, the economic situation may worsen before improving again.

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# SOUTH ASIA ECONOMIC OUTLOOK

22





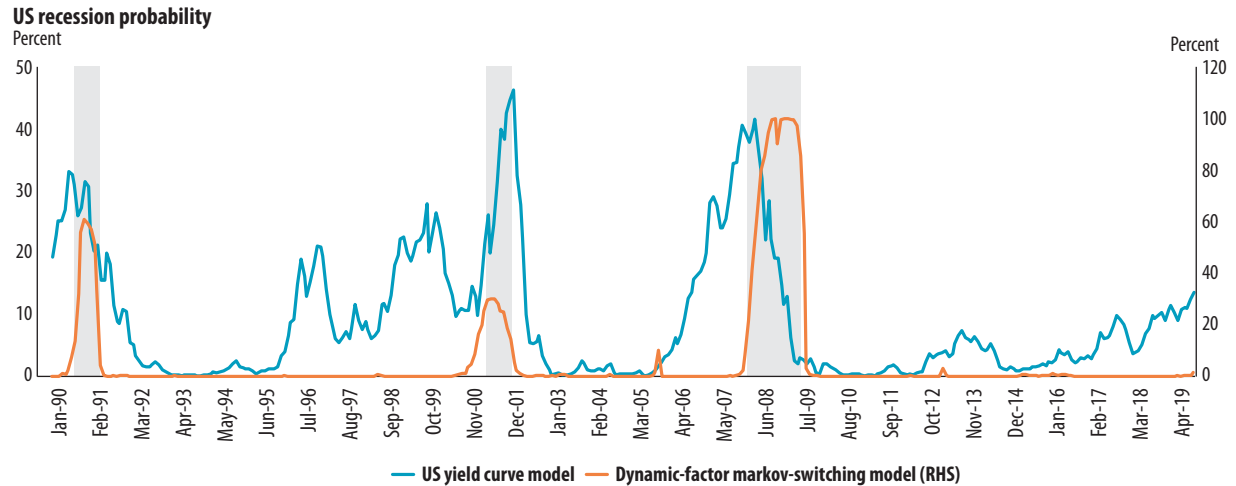
PHOTO BY AMIT K. SHUTTERSTOCK

## Overview

- ❖ **Uncertainty in global markets and a worsening global outlook have become more important drivers of the forecast of economic growth in South Asia.**
- ❖ **Macro-financial risks have increased in South Asia and high-frequency data suggest a sharp downturn in the investment cycle.** There is a danger that slowing growth and deteriorating balance sheets of banks and corporates are reinforcing each other.
- ❖ **Growth forecasts for South Asia are revised downward.** Compared to six months ago, GDP growth is revised downward by 1.1 percentage points for this year and by 0.8 and 0.4 percentage points for the next two years. With 5.9 percent, growth in 2019 is now forecast to be 0.7 percentage points lower than growth in 2018. Compared to earlier forecasts, less private consumption and more government consumption is expected. The projected modest recovery to 6.3 percent in 2020 and 6.7 percent in 2021 is tentative as forecasts under current circumstances, particularly for investment, are highly uncertain.

**Figure 20: The US yield curve suggests a US recession may be ahead, reflecting a worsening outlook.**

The US yield curve inverted recently and hence models predicting the probability of a recession in the US based on the yield curve predict an increasing probability, while others do not.



Sources: Sources: Federal Reserve Bank of New York, Federal Reserve Bank of St. Louis (FRED), and National Bureau of Economic Research (NBER).  
Notes: The orange line is the smoothed US recession probabilities derived from the FRED. It is obtained from a dynamic-factor Markov-switching model applied to four monthly coincident variables: non-farm payroll employment, the index of industrial production, real personal income excluding transfer payments, and real manufacturing and trade sales. The blue line is the probability of a recession in 12 months derived from the US yield curve model of the Federal Reserve Bank of New York. The shaded areas represent past recessions. Last observation is August 2019.

## Uncertain global environment

The global outlook is rapidly worsening, and in the current global economic environment South Asia's growth outlook is especially unclear. Some major economies are decelerating substantially in 2019 and are projected to slow down further in 2020 (World Bank 2019). Nine out of ten countries are expected to grow slower this year compared to last (IMF 2019). The trade tensions between China and the US have not been resolved and the US yield curve recently inverted, which means that the interest rates on short-term bonds became higher than the interest rates on long-term bonds. Some investors interpret such a switch as a signal that an economic downturn is ahead. Models that predict the possibility of a recession in the US based on the yield curve show indeed a rising probability. The probability of a recession in the next 12 months derived from the US yield curve model of the Federal Reserve Bank of New York, for example, has tripled since the beginning of last year and was 15 percent as of August 2019 (Figure 20). However, the probability is much lower in other models that consider other variables (Figure 20). A sharper-than-expected slowdown, including a possibility of

recession in major economies such as the US and the Eurozone, could have severe spillover effects to South Asia through trade, financial, and confidence channels.

**Global growth spillovers matter for South Asia.** Despite South Asia not being integrated into world markets as much as most other regions (World Bank 2019), it is not isolated from global developments. Unexpected changes in GDP growth in the US, the Eurozone and China, for example, all have strong implications for growth in South Asia. These can be quantified with a Structural Bayesian Vector Autoregression Model as described in Appendix A1 (Almansour *et al.* 2015). Real GDP shocks in the US and the Eurozone affect India immediately and the effect is rather persistent (Table 2). After two years, the cumulative impact from a one percentage point GDP shock in the US on India is 1.4 percentage points, and from a shock of the same size in the Eurozone it is 1.1 percentage points. This is 30 percent and 25 percent of the effect in the destination, the US and the Eurozone respectively. The spillovers from Chinese GDP shocks follow a different pattern: while there is no effect on impact, it builds slowly over time and after two years the impact is even larger than for

**Table 2: Real GDP shocks in the US, the Eurozone, and China transmit to India.**

Unexpected changes in real GDP in the US and the Eurozone have an immediate and persistent effect on economic activity in India. While Chinese shocks take some time to affect India, their effect builds up strongly.

	Transmission of real GDP shock (percentage points)					
	US-US	US-India	EU-EU	EU-India	China-China	China-India
On impact	1.00	0.66	1.00	0.98	1.00	-0.09
End of first year	3.41	1.61	3.59	2.04	3.11	0.20
End of second year	4.47	1.36	4.38	1.12	4.90	1.74

Sources: Haver, IMF database, FRED, World Bank, and staff calculations.  
Note: Spillovers based on Bayesian VAR of Almansour *et al.* 2015 (see Appendix A1).

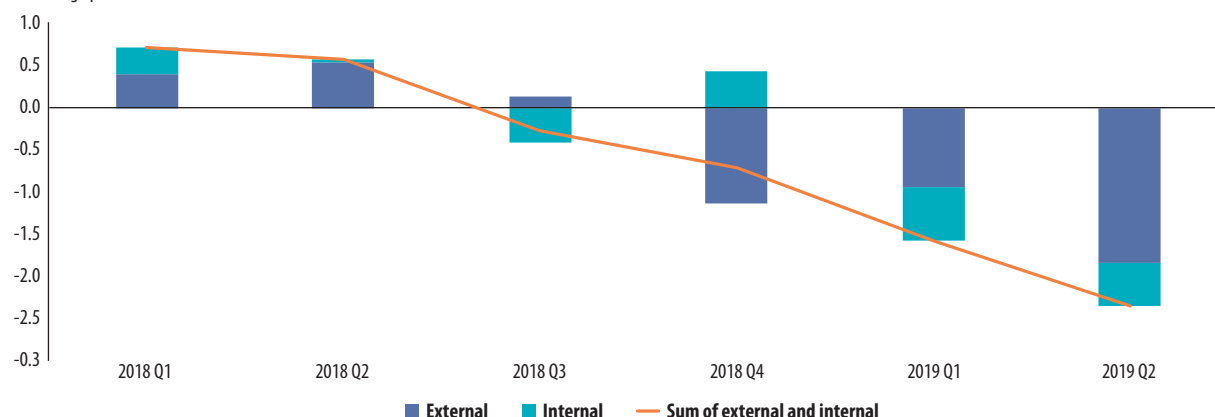


**Figure 21: External factors have contributed substantially to the recent GDP growth slowdown in India.**

A decomposition of Indian growth deviations with a Bayesian VAR model unveils a large contribution of external factors.

**Historical decomposition of real GDP deviations**

Percentage points



Sources: Haver Analytics, IMF, FRED, World Bank, and staff calculations.

Note: Spillovers based on Bayesian VAR of Almansour et al. 2015 (see Appendix A1).

shocks in the US or the Eurozone. This pattern is found in other emerging markets as well and attributed to lagged terms of trade effects (Almansour *et al.* 2015). For Sri Lanka, the model suggests much weaker spillovers. To quantify the spillovers to Bangladesh and Pakistan, one needs to approximate their quarterly GDP, which can be done using industrial production as a high-frequency indicator (Appendix A1). A shock in the US seems to have a similar effect in Pakistan to the one in India, but no effect can be identified for Bangladesh. A shock in the Eurozone has a very strong but short-lived effect on Pakistan, and a more persistent effect in Bangladesh. A shock in China has a large initial and persistent effect on growth in Pakistan, and a small initial impact in Bangladesh that then grows over time. Taken together, these results confirm that growth developments in other countries matter for South Asia.

**External factors have worsened over the last year.**

The methodology used to assess growth spillovers can also be used to decompose growth deviations into those caused by external factors and those caused by domestic factors. The external factors considered are real GDP growth in the US, the Eurozone and China (to capture global demand shocks), US inflation (to approximate advanced economies supply shocks), changes in the 10-year US Treasury bond rate (to capture the stance of monetary policy in advanced countries), the EMBI Global yield (to capture changes in emerging market financing conditions), and terms-of-trade growth (to capture factors other than those from external demand or financing conditions). From 1998 to 2018, the external variables explain 30 percent of the variation in Indian GDP, while the remaining variation is explained by domestic factors (in the model captured by Indian GDP, inflation, short-term interest rates and the exchange rate of the Indian rupee versus the USD). While the external factors were still beneficial for India (and presumably the rest of South Asia) at the beginning of last year, they turned negative at the end of it (Figure 21). For the disappointing second quarter in 2019 (calendar year), 80 percent of the deviation from more normal growth was caused by external factors. The external conditions

could further deteriorate if an unexpected tightening in global financial conditions elevates borrowing costs to unsustainable levels and leads to capital outflows from South Asia. In addition, geopolitical risks remain high and the recent attacks on Saudi Arabia’s oil production have intensified concerns about the increasing tensions between Saudi Arabia and Iran that could hike oil prices and worsen the global outlook.

**Uncertain domestic environment**

**High-frequency data point at a sharp deceleration in consumption and industrial production.**

Compared to a year ago, private consumption and investment growth have been much lower so far this year (Figure 22, left panel). In India, private consumption declined by 4.2 percentage points in the second quarter of this year, compared to a year before. And in Sri Lanka, private consumption declined by 4.0 percentage points in the second quarter of this year, compared to a year before. In addition, industrial production growth has decelerated strongly in Pakistan and Bangladesh (Figure 22, right panel). The correlation between industrial production and investment has been high in both countries, with 0.56 in Pakistan and 0.75 in Bangladesh since 1992. In Pakistan, industrial production grew 6 percentage points slower in the last three months compared to the same months a year earlier and even in Bangladesh, where industrial production growth remained strong, it came down by 4 percentage points recently. This indicates that steep decelerations in GDP growth and investment during this and next year are possible.

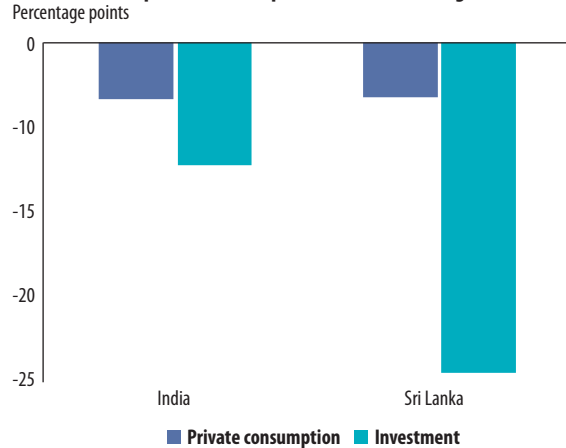
**Investment cycles are more pronounced than those in GDP and private consumption.**

In the past, investment growth has been highly correlated with private consumption growth and investment has been much more volatile (Figure 23). High-frequency data related to consumption suggests that private consumption may slow down in a similar magnitude as in 2008 and 2012. The last two times private consumption dropped by a similar magnitude, investment growth decelerated

**Figure 22: High-frequency data suggest the recent investment cycle may have ended.**

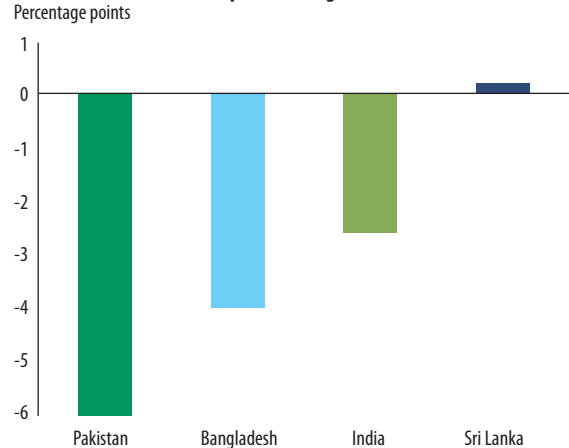
High-frequency indicators show that private consumption and investment growth are strongly decelerating across South Asia.

**Deceleration of private consumption and investment growth**



Source: World Bank.  
Notes: The most recent observation is 2019Q2 and growth in these quarters is compared to growth a year before.

**Deceleration of industrial production growth**

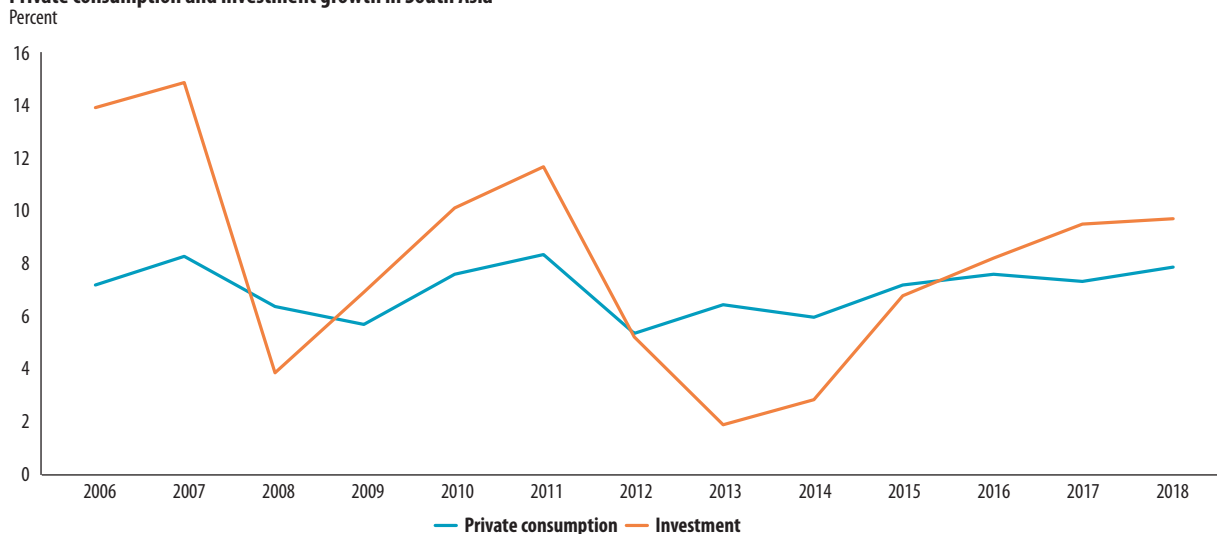


Sources: World Bank.  
Notes: The growth in the last three months with available data is compared to a year ago. The last observation for Bangladesh is May 2019 and for the rest it is July 2019.

**Figure 23: Private consumption and investment growth co-move, and the latter is more volatile.**

Growth in private consumption and investment are highly correlated but investment cycles are much more pronounced.

**Private consumption and investment growth in South Asia**



Source: World Bank.

strongly. In 2008, private consumption slowed by two percentage points, and investment growth by over 10 percentage points. In 2012, private consumption growth declined again by 2 percentage points and investment growth dropped by 7 percentage points in that year and by another 3 percentage points the next year, despite a recovery of consumption growth. Thus, the most recent data on consumption indicate the potential for a severe slowdown in investment.

**The growth of investment in South Asia is determined both by internal and external conditions.**

One way to analyze the determinants of private investment growth is by means of an error-correction model, which explains deviations of private investment growth around an equilibrium growth rate determined by the growth of GDP. For India, private investment growth does follow this long-run relationship (as confirmed by the negative sign in the first row of Table 3).

Deviations from the equilibrium are typically explained by movements in the real rental rate of capital and an accelerator effect. The latter is related to over-proportionate changes in investment growth following changes in GDP. Depending on the model specification, we find an accelerator in India between 1.3 and 2.0, close to the ones found in other countries (Burns *et al.* 2019). In addition to the standard variables, one can add domestic economic uncertainty (Baker, Bloom and Davis 2016). As expected, higher uncertainty weakens investment growth in India, which may be particularly important at the current juncture. In addition, one can add external variables to test whether the issues outlined above effect private investment. And indeed, both global industrial production and world trade growth are positively related to investment in India. The current slowdown in these variables is hence likely to bring private investment growth down. Interestingly, once these external conditions are considered, the



**Table 3: Private investment growth depends on internal and external conditions.**

	Change of private investment in India		
	Model 1	Model 2	Model 3
Deviations from long-run trend (error correction)	-	-	-
GDP growth in short-run (accelerator)	+	(.)	(.)
Change in cost of capital	-	-	-
Economic policy uncertainty (lagged)	-	-	-
World industrial production growth		+	
World trade growth			+

Sources: World Bank; CPB; and Baker, Bloom, and Davis (2016).

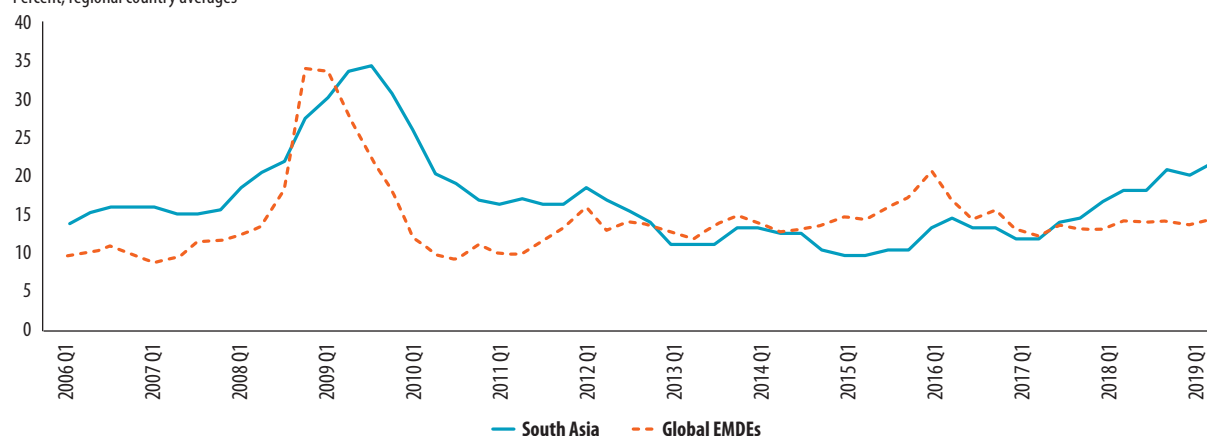
Notes: + and - signs mean that the terms have a positive/negative impact and are statistically significant at least at the 10 percent level. (.) means that the variable is not statistically significant at the 10 percent level. See Appendix A2 for details on the model and estimation.

**Figure 24: Rising financial tensions may harm investment growth.**

Macro-financial risks in South Asia continued to increase over the last twelve months.

**Global EMEs and South Asia EFI macro-financial risk indices**

Percent, regional country averages



Source: World Bank.

Notes: EMDE=Emerging Market and Developing Economies. EFI=Equitable Growth, Finance, and Institutions Global Practice at the World Bank. The risk indices are the number of risks signaling as a percent of nine risks and are calculated as four-quarter moving averages. A risk is considered "signaling" if it exceeds a rating of 7 which corresponds to the 80th percentile. The nine risk dimensions captured are- 1. Spillover risk from the external environment, 2. Macroeconomic risks, 3. Banking risks, 4. Public sector risks, 5. Corporate sector risks, 6. Household risks, 7. Market and liquidity risks, 8. Monetary and financial conditions, and 9. Risk appetite. The index covers 44 EMEs and 3 South Asian economies.

accelerator becomes statistically insignificant. In models for Bangladesh and Pakistan, we find the accelerator to be smaller or not statistically significant even without adding these variables, which may signal data issues in these countries.

**Financial market developments could interfere with investment growth across South Asia.** In contrast to other EMDEs, macro-financial risks in South Asia are rising (Figure 24). As regional growth is decelerating, non-performing assets are likely to rise further, from already high levels. And any further deterioration in balance sheets of banks and corporates would further constrain domestic and foreign investment. Weak financial sectors and rising macro-financial risks hence threaten to cut off any rebound in South Asia's investment:

- ❖ **In Bangladesh**, pressures on loanable funds, constrained by low deposit growth rates and increasing NPLs, could impact credit growth more than anticipated. The undercapitalization of its state-owned

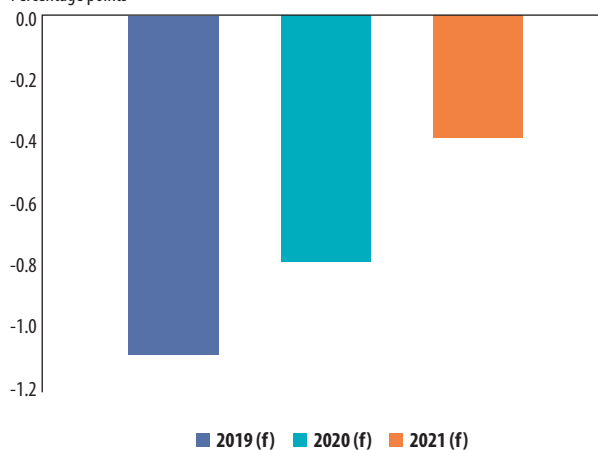
banks (SOBs) and the credibility of its Letter of Credit guarantees in international markets remain a worry. While an adequate reserve coverage provides a buffer against contagion for now, reserves have declined recently and are already below the levels of comparable emerging market economies.

- ❖ **In India**, non-bank financial companies in India remain vulnerable to financial stress, despite liquidity enhancing measures. New defaults in this sector could trigger a broader liquidity crunch. And the sector's significant share in total loans and its linkages with the banking sector through liabilities, pose broad-based contagion risks. These are further exacerbated by the over-leveraged balance sheets of the corporate sector.
- ❖ **In Pakistan**, increased pressures on the asset quality and capital adequacy buffers due to the economic slowdown and inflationary environment could hold back the forecast rebound in growth, especially when strong short-term deposit mobilization (due to recent increases in policy rates) continues to be intermediated mostly towards government securities.

## Figure 25: Growth forecasts for South Asia are revised downward but growth is still expected to remain strong.

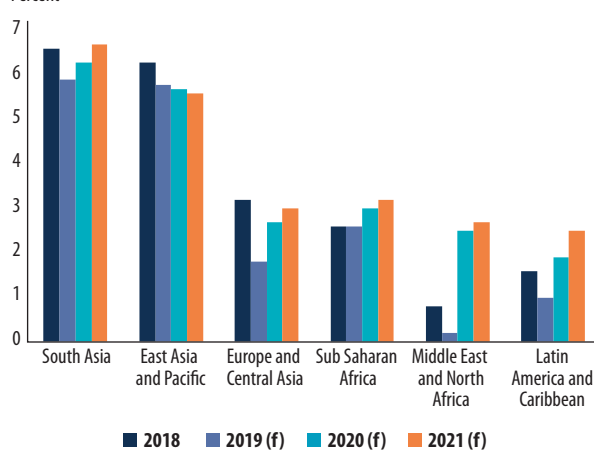
South Asia's GDP growth is revised downward compared to six months ago by 1.1 percentage points this year and by 0.8 and 0.4 percentage points for the next two years. For 2019, growth is now forecast to be lower than last year. Nevertheless, growth in 2019 could remain the highest in the world and growth dynamics could turn around again from the next year onward.

**Revisions to real GDP growth in South Asia**  
Percentage points



Source: World Bank.  
Notes: (f)= forecast. Revisions are the percentage point change in projections from the Spring 2019 edition of the report.

**Real GDP growth**  
Percent



Source: World Bank.  
Note: (f)= forecast.

**Other domestic risks remain severe.** Within the region, recent tensions between major economies remain a concern and a re-escalation could further impair confidence and weigh on investment in the region. In addition, there are country-specific risks. In Sri Lanka, reduced tourism receipts, following the recent attacks, will exert pressure on external accounts, despite reduced import demand. Since the fiscal balance may deteriorate amid contracting revenues, large refinancing needs, weak fiscal buffers, and high debt make the country vulnerable to rollover risks. Maldives needs to strike an appropriate balance between making large investments needed to close infrastructure gaps, potentially boosting tourism, increasing resilience to climate change and easing constraints in service delivery, versus managing the rapid accumulation of public debt. And in Nepal risks to the outlook primarily arise from capacity constraints, especially at the subnational level (see Chapter 3), and delays in reform implementation.

## Growth revised downward, but rebound expected

**Growth forecasts for South Asia are considerably revised downward and yet the outlook remains positive.** The recent economic developments (see Chapter 1) have clouded the outlook for South Asia, and growth forecasts have been revised downward compared to six months ago (World Bank 2019). For 2019, expected growth is now 1.1 percentage points below the expectation in March due to downward revisions in Bhutan, India, Maldives, Pakistan, and Sri Lanka. The downward revision for this year carries over into the next two years, with a downward revision of 0.8 percentage points in 2020 and 0.4 percentage points in 2021 (Figure 25, left panel). Nevertheless, regional growth is projected to pick-up again, from an estimated 5.9 percent this year to

6.3 percent in 2020 and to 6.7 percent in 2021 (Figure 25, right panel). Despite growing slower than East Asia and Pacific in the first half of this year (see Chapter 1), the expected annual growth would push the region slightly above East Asia and Pacific for the whole year.

**Growth of private consumption and investment has been downgraded and more government consumption is expected** (Table 4). Compared to six months ago, the expected contribution from private consumption has been revised downward by 1.0 percentage point this year and by 0.8 percentage points the following year, and the expected contribution of investment has been revised downward slightly by 0.1 percentage points this year and 0.2 percentage points next year. Consequently, only a weak recovery is predicted for 2020. The contribution from investment is expected to be 2.6 percentage points this year and 2.7 percentage points over the forecast horizon. The contribution from private consumption is expected to rise slightly from 3.1 percentage points this year to 3.2 percentage points in 2020 (Figure 26). The contribution of government consumption, on the other hand, has been revised upwards by 0.1 percentage points for this year and by 0.2 percentage points in the next year in expectation of countercyclical fiscal policies. While these would support growth, such policies could exacerbate concerns about missing fiscal space and the sustainability of budget deficits in South Asia (World Bank 2018). In line with a weakening global trade outlook, expected export growth in South Asia has been revised downward as well. However, anticipated import growth has been revised downward more, so that the forecast contribution of net exports to regional growth is now expected to be less negative.

**Investment growth and turning points are difficult to forecast.** Even over the last two years, in which regional investment and private consumption growth



**Table 4: The projected contribution of private consumption has been weakened strongly for this year and the next.**

Compared to earlier forecasts, expected contributions from private consumption, investment and exports have been weakened, while higher government consumption and lower export will support growth.

	Private consumption	Government consumption	Gross fixed investment	Exports	Imports	GDP
2018	0.2	0.0	0.0	0.0	(0.2)	(0.3)
2019 (f)	(1.0)	0.1	(0.1)	(0.6)	(1.3)	(1.1)
2020 (f)	(0.8)	0.2	(0.2)	(1.0)	(1.4)	(0.8)
2021 (f)	(0.1)	0.0	(0.1)	(1.1)	(1.4)	(0.4)

Source: World Bank.

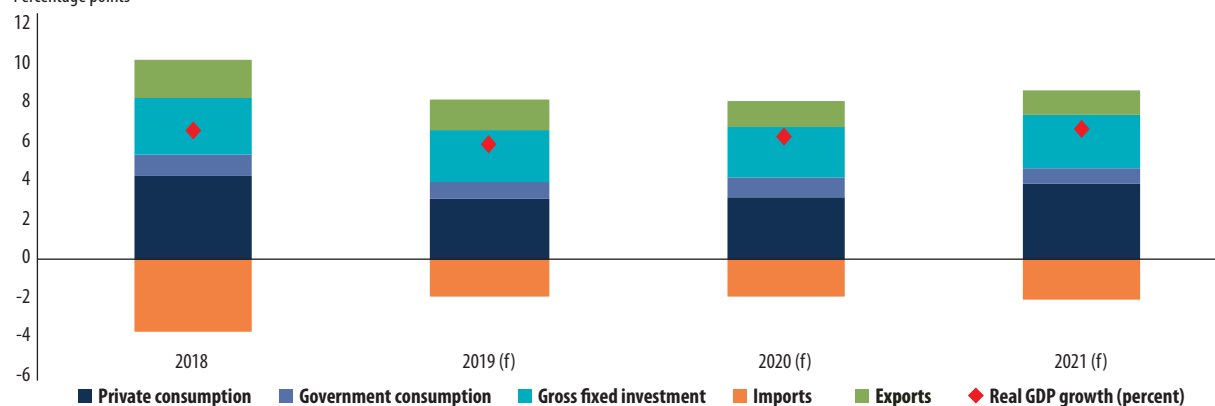
Notes: (f)= forecast. Revisions are the percentage point change in projections from the Spring 2019 edition of the report. Numbers in parenthesis refer to downward revisions.

**Figure 26: A slight rebound in investment and private consumption is predicted for next year.**

The contribution of private consumption is expected to soften to 3.1 percentage points and to average 3.6 percentage points over the forecast horizon. The contribution of investment is expected to decline slightly to 2.6 percentage points this year and to average 2.7 percentage points subsequently. Future growth is expected to continue to be driven by private consumption and investment.

**Contributions to growth in South Asia**

Percentage points



Source: World Bank.

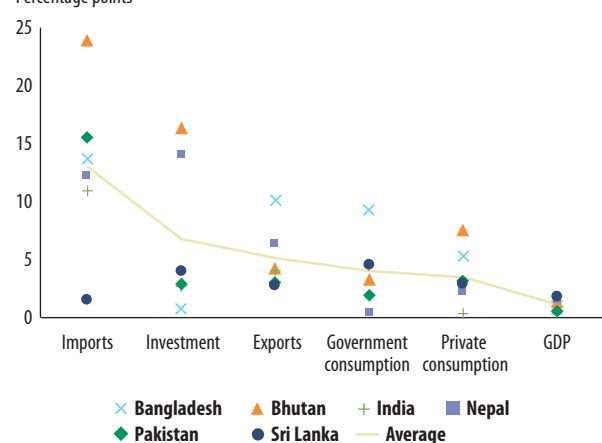
Note: (f)= forecast.

**Figure 27: Since investment is more volatile than other demand components, it is difficult to forecast.**

Uncertainty in global and domestic markets makes investments very volatile, and hence difficult to forecast.

**Average of absolute forecast errors in 2017 and 2018**

Percentage points

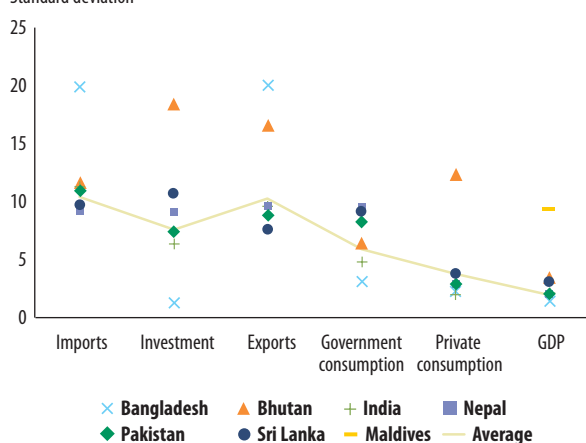


Source: World Bank.

Note: The forecast errors are from the third release prior to the release of first estimates.

**Volatility of demand components from 2000 to 2018**

Standard deviation



Source: World Bank.

Note: The volatility of the demand components is calculated from 2000 to 2018.

were rather stable, the investment forecast errors have only been exceeded by the forecast errors of imports (Figure 27, left panel; for a detailed assessment of the forecasts presented in this report see Box 1). Apart from

imports and exports, investment also tends to be the most volatile component of GDP (Figure 27, right panel). The average standard deviation of investment growth in South Asia from 2000 to 2018 was twice as high as that

**Table 5: The outlook for South Asian countries is mixed.**

GDP forecasts for South Asian countries are mixed, with accelerated growth in some countries, and some deceleration in others.

	Real GDP growth at market prices in percent				Revision to forecasts from April 2019		
	2018	2019 (e, f)	2020 (f)	2021 (f)	2019 (e, f)	2020 (f)	2021 (f)
Afghanistan (CY)	1.8	2.5	3.0	3.5	0.0	(0.2)	0.0
Bangladesh (FY)	7.9	8.1	7.2	7.3	0.8	(0.3)	0.1
Bhutan (CY)	4.6	5.0	7.4	5.9	(0.4)	2.0	0.7
India (FY)	6.8	6.0	6.9	7.2	(1.5)	(0.6)	(0.3)
Maldives (CY)	6.7	5.2	5.5	5.6	(0.6)	0.3	0.3
Nepal (FY)	6.7	7.1	6.4	6.5	1.1	0.3	0.3
Pakistan(FY, factor prices)	5.5	3.3	2.4	3.0	0.0	(0.3)	(0.9)
Sri Lanka (CY)	3.2	2.7	3.3	3.7	(0.8)	(0.3)	0.0

Source: World Bank.

Notes: (e)= estimate; (f)= forecast. CY= calendar year, FY= fiscal year. In Bangladesh, Bhutan, Nepal, and Pakistan, 2019 refers to FY2018/19 and ended in June 2019 (mid-July 2019 for Nepal). For India, 2019 refers to FY2019/20 and will end in March 2020. Numbers in parenthesis refer to downward revisions.

of private consumption growth. Forecasting investment growth is hence always a challenge, but in the current environment future investment growth is especially uncertain. Since 2006, the momentum of regional annual growth changed six times (Figure 28). However, over the same period, the forecasts predicted a change of the momentum in only three instances. Since forecasts tend to uphold recent trends, few trend changes are projected. In addition, of the three projected turning points, only one materialized and the other five were missed. The only one that was correctly expected was the strong recovery in 2010, which did indeed seem very likely at the end of 2009. For this year, no downturn was predicted in January, but instead projections foresaw an acceleration of 0.3 percentage points. It hence remains particularly uncertain whether the growth momentum will indeed swing back next year already.

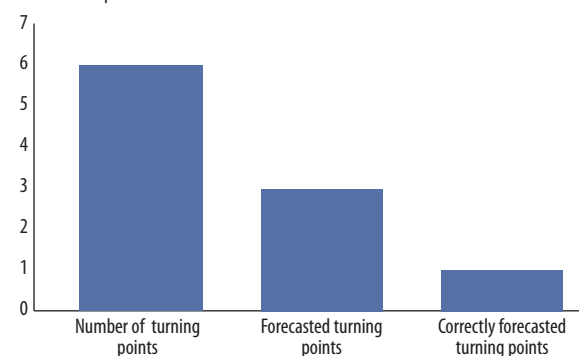
**For some countries in South Asia growth is projected to accelerate, but for others the growth rate is expected to decline (Table 5):**

- ❖ **In Afghanistan**, with improved farming conditions and assuming political stability after the elections, growth is expected to recover and reach 3 percent in 2020 and 3.5 percent in 2021. However, the outlook is highly vulnerable and may be affected by deteriorating confidence due to uncertainty around international security assistance, election related violence, and peace negotiations with the Taliban.
- ❖ **In Bangladesh**, GDP is projected to moderate to 7.2 percent this fiscal year and 7.3 percent the following one. The outlook is clouded by rising financial sector vulnerability, but the economy is likely to maintain growth above 7 percent, supported by a robust macroeconomic framework, political stability, and strong public investments.
- ❖ **In Bhutan**, GDP growth is expected to jump to 7.4 percent this fiscal year with the commissioning of Mangdechhu, a new hydro power plant, and the completion of the maintenance of Tala, another one. Growth in fiscal year 2021 is forecast just below 6

**Figure 28: Turning points are difficult to project.**

The momentum of regional annual growth changed six times since 2006. While in three instances a turning point was projected, it only materialized for the strong recovery in 2010.

**Turning points in regional real GDP growth since 2006**  
Number of experts



Source: World Bank and staff calculations.

Notes: A turning point is defined as a year in which the growth momentum changes direction. Stable growth is considered a turning point if the momentum changes the following year.

percent on the base of strong tourism growth and increased revenue from the existing power plants.

- ❖ **In India**, after the broad-based deceleration in the first quarters of this fiscal year, growth is projected to fall to 6.0 percent this fiscal year. Growth is then expected to gradually recover to 6.9 percent in fiscal year 2020 and to 7.2 percent in the following year.
- ❖ **In Maldives**, growth is expected to reach 5.2 percent in 2019, due to a slowdown in construction following the completion of the international airport and a connecting bridge. However, with support from new infrastructure investment and the expansion of tourism, growth is expected to pick up again to an average of 5.6 percent over the forecast horizon.
- ❖ **In Nepal**, GDP growth is projected to average 6.5 percent over this and next fiscal year, backed by higher investment and public consumption and strong services due to rising tourist arrivals.



### Box 3: South Asia Economic Focus forecasting performance

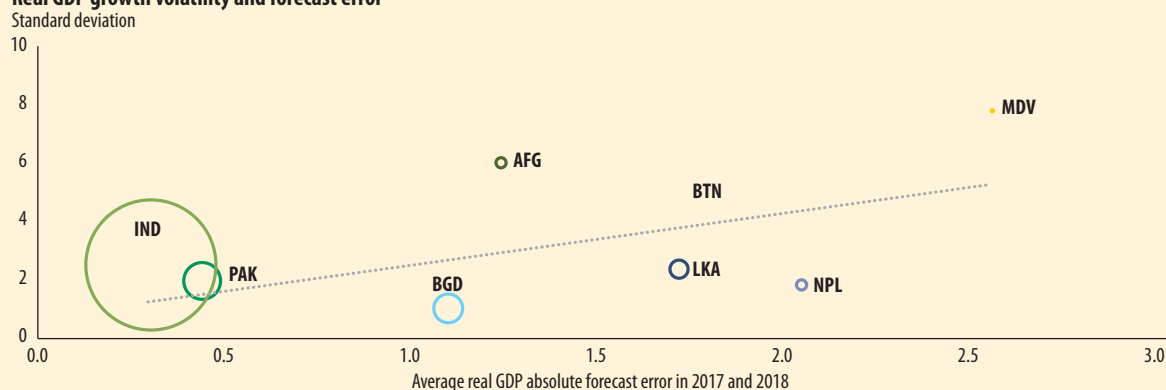
The forecasts reported in this publication are generated by country economists within the World Bank’s Macroeconomics, Trade and Investment Global Practice and are based on the World Bank’s macroeconomic and fiscal model (MFMOD). Although the functional forms of the 181 individual country models are similar, the parameters are estimated at the country level. The forecasts across countries are linked and the export market growth of each country is calculated as a trade-weighted average of imports of each of its trading partners. Other cross-country linkages come through balancing remittances flows, the real effective exchange rate, and export and import prices, which are a function of world commodity prices and local cost considerations (Burns *et al.* 2019).

To assess our forecasting performance, we computed the forecast error for real GDP growth and its components for 2017 and 2018. Given the different fiscal years in South Asia, we compare countries relative to the release of first estimates after the end of the (fiscal) year and not based on the chronological order of forecast releases. The growth reported in the latest available release is considered to be the actual growth and may refer to preliminary estimates (first release), revised estimates (second release), or actual data (third release). The forecast error is defined as actual growth minus forecasted growth, which makes use of the most up-to-date data but of course assumes that the latest reported data is true. Due to measurement issues reflected in large data revisions in South Asia, forecast errors may hence change with new data releases.

**Figure 29: Forecast errors in South Asia depend on country characteristics.**

*Forecasts for larger countries with lower volatility of growth rates have been more precise.*

#### Real GDP growth volatility and forecast error



Sources: World Bank and staff calculations.

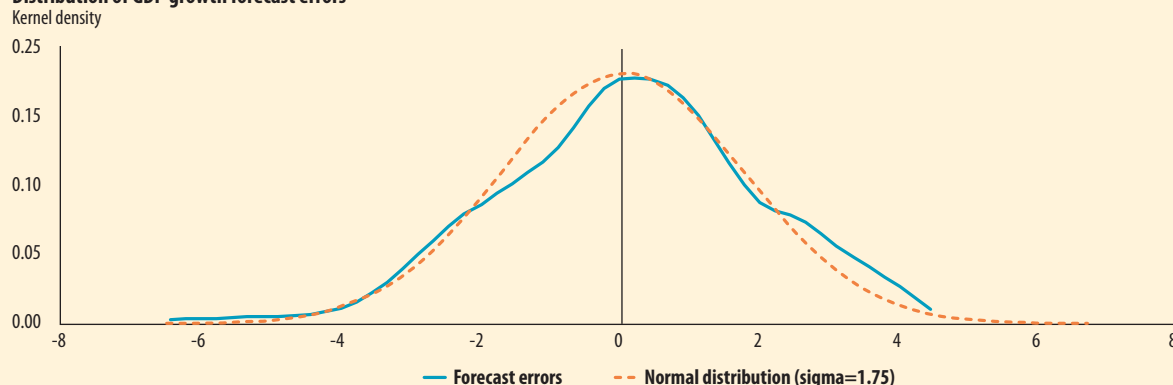
Notes: AFG=Afghanistan, BGD=Bangladesh, BTN=Bhutan, IND=India, MDV=Maldives, NPL=Nepal, PAK=Pakistan, SLK=Sri Lanka. The size of the bubbles refers to the size of the economy measured as 2018 real GDP in 2010 USD. The forecast errors of the five releases prior to the release of first estimates are averaged. The data in the latest available report is considered the actual.

The forecasts have been more precise for larger countries, whose growth is less volatile (Figure 29). The forecasts were most precise for India, Pakistan, and Bangladesh. In these countries, real GDP growth tends to be less volatile than in smaller countries, and for all these economies the state of the economy can be assessed based on numerous meaningful high-frequency indicators like industrial production and import growth. For some of the smaller countries – Sri Lanka, Bhutan, and Nepal – the average forecast error has been larger. Growth is especially volatile for Afghanistan and Maldives and hence particularly difficult to forecast. While in 2017 and 2018 the forecasts for Afghanistan were close to the actual, the forecast error for Maldives was by far the largest.

**Figure 30: GDP forecasts in South Asia were not biased...**

*Forecast errors for South Asian countries have been normally distributed around 0.*

#### Distribution of GDP growth forecast errors

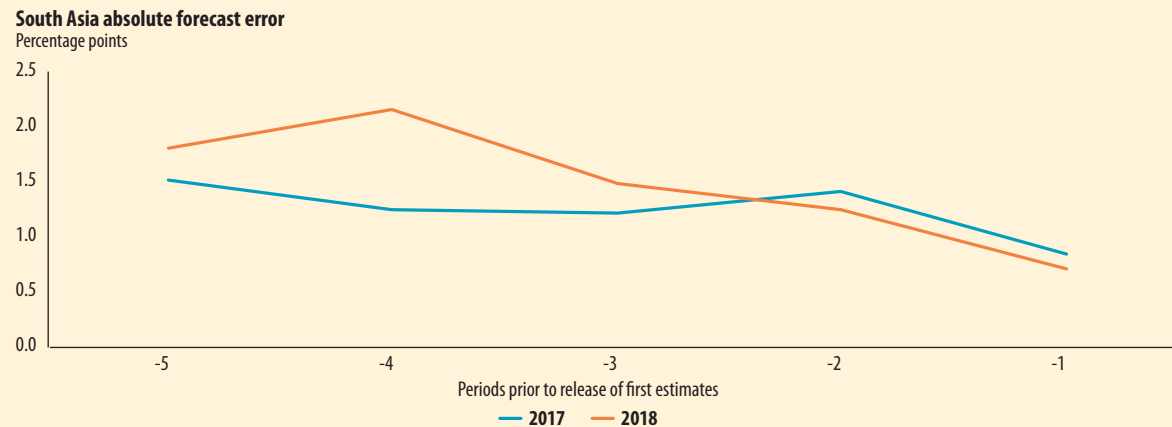


Source: World Bank and staff calculations.

Notes: The density shows five forecast errors (related to different releases) from all South Asian countries for 2017 and 2018.

**Figure 31: ... and became better as the end of the fiscal year approached.**

On average, forecasts improved as the fiscal years progressed.



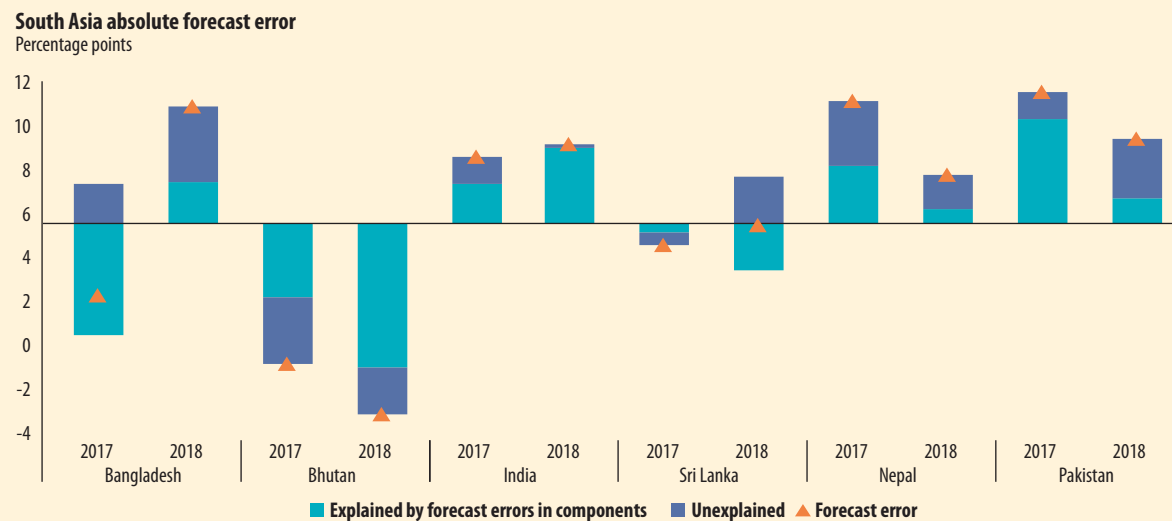
Source: World Bank and staff calculations.

Notes: The forecast errors are simple averages of all South Asian countries. The numbers refer to the release before the release of first estimates (-1), the second release before (-2) and so on.

The forecast errors have been normally distributed around 0 (Figure 30) and improved as the fiscal years progressed (Figure 31). That fact that forecast errors have a mean close to zero implies that there was no regional bias in the forecasts: real GDP growth has neither been systematically overpredicted nor systematically underpredicted. In addition, too low and too high forecasts have been equally distributed around 0. After the fiscal years had started and the first high-frequency data became available, the average forecast error declined. Declines have been especially strong in Pakistan, where the average error over the two years declined from 0.7 percentage points a year before the last forecast to only 0.1 percentage points before the release of first estimates, and in Sri Lanka, where it declined from an average of 2.3 percent to 1 percentage point.

**Figure 32: Import forecast errors in South Asia**

For the last two years, errors in import forecasts have been large, but they are mostly explained by getting other components wrong.



Source: World Bank and staff calculations.

Import growth forecast errors are large but often related to forecast errors in other GDP components. For the last two years, average import forecasts have been too low in India, Nepal, and Pakistan, but far too high for Bhutan (Figure 32). Import forecasts can be too low if the other GDP components have forecast errors, or if the relationship with other demand components like investment and consumption has played out differently than expected, for example due to changing terms of trade. In many countries in South Asia, the relationship between import growth and the growth of other components is rather stable due to stable import intensities of the different components. In India and Pakistan, for example, a model predicting import growth based on the growth of the other GDP demand components from 2000 to 2018 can explain 88 percent of the variation in import growth. With such a model one can decompose the forecast error into contributions explained by forecast errors in the other GDP components and unexplained parts. In India, nearly the full forecast error is explained by forecast errors in components and in Pakistan and Bhutan, they are also the major contributor.

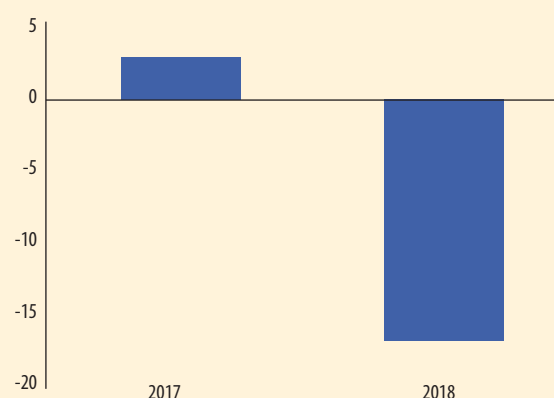


**The forecast errors of imports are often intuitive.** In Pakistan and Nepal, an underprediction of imports coincided with an underprediction of growth in 2017. In both countries, investment growth rates were stronger than expected, in the former related to the China-Pakistan Economic Corridor and in the latter to the rebound after the end of the trade disruption. It was the other way around in Bhutan due to delays in the construction of hydropower projects. In India, on the other hand, imports were underpredicted in the same year, while growth was overpredicted, and the unexpectedly high import growth was partly related to the demonetization in November the year before. In 2018, Nepal imported more than expected partly due to the construction of subnational government offices reflected in higher than expected investment. Overall, the link between forecast errors in other components and import growth was somewhat less strong in 2018 compared to 2017, as the share of errors explained by other components went down from 55 percent to 45 percent. One reason may have been higher than expected oil price, which resulted in higher costs of the oil imports and potentially affected the import intensity of the different demand components (Figure 33).

**Figure 33: Forecast error of oil prices in 2017 and 2018**

*For 2018, oil prices were underestimated, which contributed to large import forecast errors.*

**Overestimation and underestimation of oil prices**  
Percent



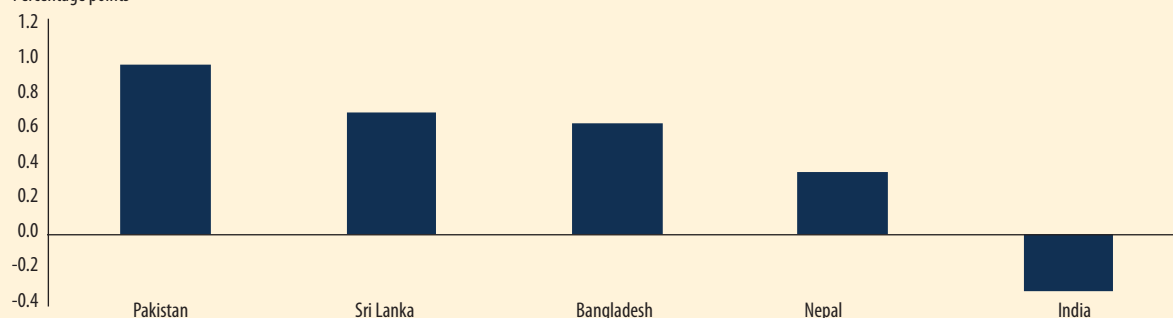
Source: World Bank and staff calculations.  
Note: The forecast errors are those of the third release prior to the release of first estimates.

#### Box 4: Growth expectations from within the region

**Figure 34: Growth forecasts are broadly in line with expectations of regional experts.**

*South Asian experts expect higher growth than forecasted by the World Bank in Pakistan, Sri Lanka, Bangladesh, and Nepal, and lower growth than forecasted for India.*

**Difference between expected growth by experts and World Bank forecasts**  
Percentage points



Sources: South Asia Economic Policy Network, World Bank, and staff calculations.  
Notes: The difference between the mean expected growth and World Bank Forecasts is calculated. The mean is calculated aggregating the responses from the South Asia Economic Network Survey for each country. There were 5 responses from Nepal, 7 from Sri Lanka, 10 from Bangladesh, 15 from Pakistan and 32 from India. For Bangladesh, India, Nepal, and Pakistan expected and forecasted growth is for the current fiscal year, whereas for Sri Lanka it is for the next fiscal year.

#### **Compared to expectations of regional experts, growth forecasts are somewhat lower in most countries but higher in India.**

For the first time, respondents to the survey conducted for this report (see Box 2 in Chapter 1) were asked what they expect the growth rate in their countries for the current fiscal year to be (next fiscal year for Afghanistan, Maldives and Sri Lanka). Results are only reported for countries with at least 5 responses (Figure 34). In Pakistan, Sri Lanka, Bangladesh, and Nepal, respondents predict that growth will exceed the World Bank forecast. In Pakistan, regional experts project 1.0 percentage point higher growth and in Sri Lanka and Bangladesh the mean forecast is 0.7 percentage points above the World Bank forecasts. In Nepal, the mean forecast is 0.4 percentage points higher. India is the only country for which experts expect lower growth. The average expectation is 0.3 percentage points lower. Indian economists were further asked whether they consider the recent slowdown a structural or a cyclical phenomenon. Over 65 percent said that both structural and cyclical factors are causing the slowdown, 25 percent see only structural factors at play and only around 10 percent consider the slowdown purely cyclical. This contrasts slightly with our explanation of the downturn that emphasizes cyclical patterns (see Chapter 1).

**Looking at the distribution of the experts' growth expectations confirms that these are broadly aligned with the forecasts presented in this report.** To do so, one can compare the difference of the World Bank's forecast not to the mean of the responses, but to the 25th percentile, if it is lower, and the 75th percentile, if it is higher. In Sri Lanka, Nepal, and India, the World Bank forecasts fall within this range. Only in Pakistan and Bangladesh, less than a quarter of the experts expect a lower growth than the World Bank forecasts.

- ❖ **In Pakistan**, growth is projected to deteriorate further to 2.4 percent this fiscal year, as monetary policy remains tight and the planned fiscal consolidation will compress domestic demand. The program signed with the IMF is expected to help growth recover from fiscal year 2021-22 onwards.
- ❖ **In Sri Lanka**, growth softened to 2.7 percent in 2019. However, supported by recovering investment and exports, as the security challenges and political uncertainty dissipate, it is projected to reach 3.3 percent in 2020 and 3.7 percent in 2021.

More details on each of the country forecasts are provided in Chapter 4 featuring country briefs. Box 4 compares the World Bank forecasts to the growth expectations of regional experts.

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## Appendix A1: A Bayesian VAR analysis quantifying the effect of external factors on Indian GDP

The analysis is an update of the analysis by Almansour *et al.* (2015) and presented first in IMF (2014). It uses a standard structural vector autoregression (SVAR) model of the following form:

$$A(L)y_t = \varepsilon_t = A_0 u_t$$

in which  $y_t$  is a  $k \times 1$  vector, where  $k$  is the total number of endogenous variables,  $A(L)$  is a  $k \times k$  matrix polynomial of lag operator  $L$  with lag length  $p$ , and  $\varepsilon_t$  is a  $k \times 1$  vector of contemporaneously correlated, mean-zero reduced-form errors. The contemporaneous relationships across variables are disentangled by mapping  $\varepsilon_t$  to a  $k \times 1$  vector of mutually orthogonal, mean-zero, structural shocks,  $v_t$ , through the  $k \times k$  matrix  $A_0$ . The vector  $y_t$  includes the following variables: US, Eurozone, and China real GDP growth, US inflation, the nominal 10-year U.S. government bond rate, the J.P. Morgan Emerging Markets Bond Index EMBI global yield, India's terms-of-trade growth, Indian real GDP growth, Indian inflation, the rate of real appreciation of the Indian rupee vis-à-vis the USD, and the Indian short-term interest rate. The first seven variables constitute the external block, and the remaining variables the domestic block. Structural shocks are identified based on (i) the restriction that shocks to the external block are exogenous to shocks to the internal block contemporaneously, (ii) a recursive (Cholesky) scheme within the external block (in the order listed above). The lag structure and Bayesian estimation strategy are exactly as in Almansour *et al.* (2015). We updated the original dataset used by Almansour *et al.* (2015) and updated it with data from Haver, IMF, FRED, and the World Bank. We estimated different specifications in which we replaced GDP with industrial production and India with Pakistan and Bangladesh. For Pakistan and Bangladesh, we approximated quarterly GDP growth using industrial production with the Denton method. We are grateful to Rupa Duttagupta and Aqib Aslam (both with the IMF) for sharing their estimation code.

## Appendix A2: Estimating an investment equation for India

We follow Burns *et al.* (2019) and use an error-correction form to model the non-stationary but cointegrated relationship between investment and GDP in India. Our model captures the long-run cointegrated relationship and short-run fluctuations in the following form:

$$\Delta \log I_t^p = \mu + \gamma \left( \log I_{t-1}^p - \log \left( \frac{(\delta_{t-1} + g_{t-1})(1-\alpha)P_{t-1}Y_{t-1}^*}{R_{t-1}} \right) \right) + \beta_1 \Delta \log GDP + \beta_2 \Delta \log (R_t/P_t) + \beta_3 \text{Uncertainty}_{t-1} + \beta_4 \Delta \log \text{World IP} + \beta_5 \Delta \log \text{World trade}$$

This equation relates the growth rate of private investment,  $\Delta \log I_t^p$ , to GDP,  $\Delta \log GDP$ , and rental cost of capital,  $\Delta \log (R_t/P_t)$ . We augment the model to account for the lagged economic policy uncertainty,  $\text{Uncertainty}_{t-1}$ , and growth of world industrial production and trade,  $\text{World IP}$  and  $\text{World trade}$ . This way we extend the number of factors that can affect investment in the short-run. They are particularly relevant for the economic context of India today and turn out to be statistically significant at least at the 10 percent level. The term  $\log I_{t-1}^p - \log \left( \frac{(\delta_{t-1} + g_{t-1})(1-\alpha)P_{t-1}Y_{t-1}^*}{R_{t-1}} \right)$  captures the long-run cointegrated relationship; the model ensures that the long-term relationship between investment and economic growth holds, i.e., the cointegrating relationship is always verified in the long-term. This cointegrated relationship is derived from the long-run equation  $\log I_{t-1}^p = \log \left( \frac{(\delta_{t-1} + g_{t-1})(1-\alpha)P_{t-1}Y_{t-1}^*}{R_{t-1}} \right) + \varepsilon_t$ , where the elasticity is equal to one and the expected value of  $\varepsilon_t$  is zero. Finally, the parameter  $\gamma$  measures the speed of adjustment in the absence of additional shocks. We estimate similar models also for Bangladesh and Pakistan.

The data for investment, GDP, the rental rate of capital, and the labor share are from the World Bank. The Economic Policy Uncertainty Index comes from Baker *et al.* (2016), and the world industrial production and world trade growth rates come from the Netherlands' CBP economic outlook. The model is estimated with annual data from 2003 to 2018, restricted by the availability of the Economic Policy Uncertainty Index.





# MAKING (DE)CENTRALIZATION WORK



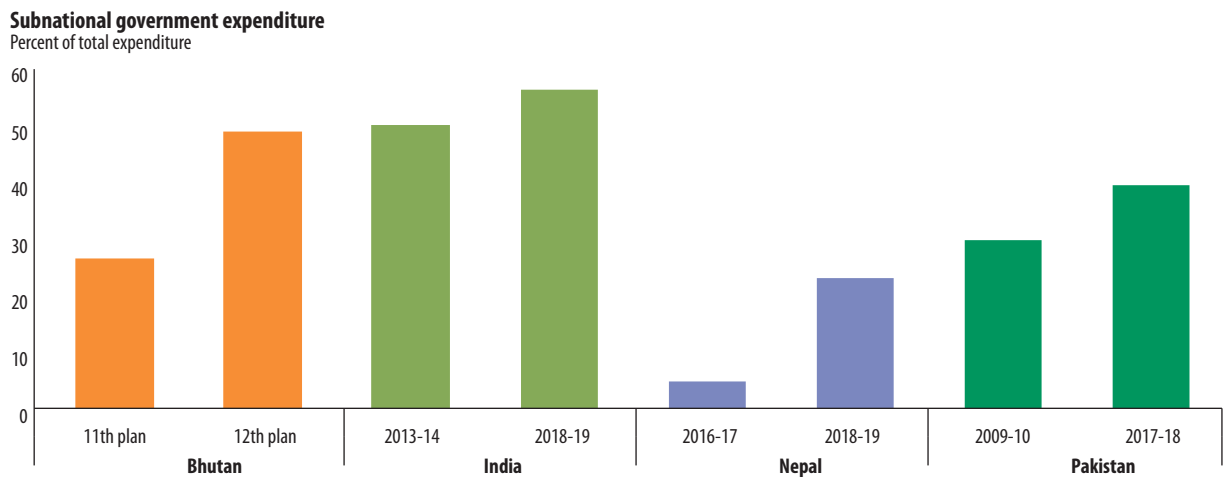


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## Overview

- ❖ **In many countries in South Asia, further decentralization is a high policy priority.** In Bhutan, the new five-year plan includes a prominent decentralization pillar. In India, the share of spending by states in public spending has increased and the 15th Financing Commission is working on new recommendations to recalibrate competitive federalism and improve local self-governance. In Maldives, the new government promised to empower local government councils again. In Nepal, the transition into a federal republic and the operationalization of provincial and local governments is in full swing. And in Pakistan, the National Financing Commission is currently discussing the revenue sharing agreement between provinces and states, and some provinces are enacting strong local government reforms.
- ❖ **These policies are part of a global decentralization trend, which aims to improve local service delivery.** As economies are becoming more complex, central governments find it increasingly difficult to manage service delivery. Locally elected officials, directly accountable to citizens, are better placed to supply services according to local preferences. The assumption is also that local service delivery can reduce transaction costs.
- ❖ **Empirical evidence of the effectiveness of decentralization is mixed, a result which is often attributed to partial decentralization.** Public service delivery in South Asia remains disappointing. Nearly half of the people still lack access to basic sanitation services and the region accounts for most of the world's uneducated people. The explanation of the lack of results is often that decentralization has not gone far enough. Key decisions are still taken by higher levels of government. The allocation of resources to local governments is unpredictable. Few opportunities exist for local governments to raise own revenues. In this environment of partial decentralization local governments lack institutional capacity. Although these are all critical constraints, they are not a sufficient explanation for South Asia's disappointing performance in service delivery.
- ❖ **Successful development requires both decentralization and centralization at the same time.** A core task of an effective central government is to create integrated markets in which local communities compete and to facilitate mobility across local boundaries. Central governments can also address equity concerns and support disadvantaged regions to give all citizens equal opportunities, irrespective of where they are born. Finally, central governments can set standards for education, health care, the environment, and other services. Without an effective central government decentralization can degenerate into fragmentation. With fragmentation, local economies are not competitive and opportunities of elite capture by local officials emerge. The middle level of government (states or provinces) often has a strong own identity. Preserving that historical identity is important, but it should not prevent empowerment of both the local and central level.

**Figure 35: Many South Asian countries are further decentralizing.**



Sources: Reserve Bank of India (Handbook of Statistics on the Indian Economy Tables 98 and 104); Ministry of Finance for Pakistan, Nepal, and Bhutan.

Notes: For Bhutan, the 12th plan refers to planned expenditure for 2018-2023 and the total expenditure excludes the flagship programs. For Nepal, this is budgeted expenditure for FY2018/19 is defined as the sum of provincial plus local level expenditure (found in the budget speech annex 3 and 4) and for FY2016/17 is defined as the sum of grants to local bodies and local allowances. For India the expenditure is state level and for Pakistan it is provincial.

- ❖ **In the interplay between central and local governments, the allocation of resources plays a crucial role.** This allocation should balance equity concerns with an efficient allocation of resources and the right incentives to improve the efficiency of service delivery at all local levels. Preliminary empirical results presented in this chapter suggest that South Asia is more successful in addressing equity concerns than in achieving efficient solutions.
- ❖ **A lack of geospatial data on expenditure and development outcomes remains a major constraint.** More and better data is needed for the design of policies that can create an environment in which autonomous local communities can compete in integrated markets with equal opportunities. Evidence-based policy designs require also understanding of economic mobility: what determines where people want to live, where people want to work, and where firms want to invest?

## South Asia is further decentralizing

**Political and fiscal decentralization has a long history in South Asia.** The Panchayat system of local self-governance dates to at least 250 CE, but plenty of evidence suggests that self-governing villages have existed much longer. And the debate about decentralization goes back as long. In the Mauryan period, for example, local officials became more powerful under the reign of King Ashoka. But it was during the subsequent Gupta period that the government's centralized power gradually eroded while provincial governments gained power and autonomous governments in several cities of northern India emerged (Chakrabarti 1996). During the British rule, there was little interference with the existing Panchayati systems, but British Colonial rule replaced other institutional arrangements with more centralized ones. The British also created local governments, but these were fully controlled by the imperial bureaucracy (Cheema, Khwaja, and Qadir 2003). After independence, India's federation was considerably centralized to foster

policy uniformity, and due to an emphasis on national interests and security (Singh 2018). Similarly, in Pakistan there was initially little emphasis on local governments, partly because these were tied strongly to the British before independence (Cheema, Khwaja, and Khan 2005).

**Most countries in South Asia actively pursue fiscal decentralization.** In recent years, there is once again a push for further decentralization. This is reflected in an increased share of subnational spending in overall government expenditure (Figure 35). In some cases, this is driven by political reasons. In Nepal, for example, the new Constitution ended a civil war and the federal restructuring was fundamental to sustained peace. In other cases, the main objective is to bring service delivery closer to the citizens.

- ❖ **In Bhutan, the Local Government Act enacted in 2009 implemented a program of decentralization and devolution of power and authority.** The Act tasks all local governments with specific objectives, including promoting Gross National Happiness, providing democratic and accountable government, preserving culture and tradition, promoting development, and protecting public health. Local governments are administrative divisions prohibited from making laws, but they are empowered to make rules and regulations. The new five-year plan introduced this year includes a prominent decentralization pillar, and local government expenditure is expected to reach one half of total expenditure in the coming years (Figure 35). The government published the final draft of the National Decentralization Policy in July of this year.
- ❖ **In India, the 14th Financing Commission recommendations resulted in a larger fund allocation to the 29 states and gave them more spending autonomy.** The share of state spending increased from 51 percent in 2013-14 to 58 percent in 2018-19 (Figure 35). The main responsibilities of the state governments include public order, police, and administration of justice, public health, agriculture, local government, as well as jointly deciding with the Centre on areas such as education and the environment. The



73rd and 74th Constitutional Amendment, passed in 1992, aimed to replicate the center and state model for state-local relations and gave recognition and protection to local governments as institutions of self-governance. However, devolution remains partial, even in the front runners among the states. In many cases, political devolution of powers to local government has not been accompanied by the requisite devolution of fiscal powers. In addition, some responsibilities like town planning that could be devolved to the over 250,000 local bodies remain at the state level.

❖ **In the Maldives, as envisioned in the 2008 constitution, the Decentralization Act of 2010 expanded local governance structures and introduced atolls, islands, and cities as administrative divisions each run by a local council.** The democratically elected councils were supposed to provide basic services such as road maintenance, preschool and vocational education, social services and pest control. After regress in the recent past, decentralization is now back on the agenda and the new government promised to empower local government councils again.

❖ **In Nepal, the new Constitution, which came into effect in 2015, restructured Nepal into a federal republic and introduced provincial and local governments.** Some of the responsibilities of provincial and local governments include town police, basic health and sanitation, local taxes (e.g. wealth tax, house rent tax), basic secondary education, local roads, rural roads, irrigation, collection of statistics and records, and water supply. Local governments also formulate their own budgets, specify tax rates and collect revenue. However, the constitution states that the imposition of taxes and collection of revenue on matters that fall within the jurisdiction of the federal government, and those that have not explicitly been given to lower tiers, shall be as determined by the federal government. Revenues received by the federal government from excise taxes and value added taxes (VAT) on domestic goods are deposited in a divisible pool and then shared among the federal, provincial and local governments. While spending by subnational entities was almost nonexistent before the new Constitution, provinces and local governments are

estimated to have spent over 20 percent of total budgeted expenditure for fiscal year 2018-19 (Figure 35).

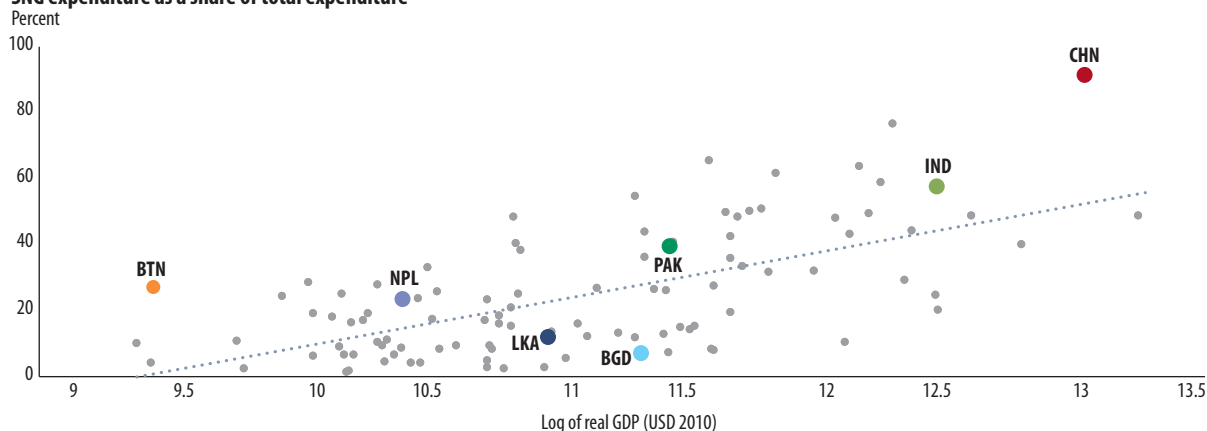
❖ **The 18th Amendment to Pakistan's Constitution, passed by Parliament in 2010, provided the four provinces with strong legislative and financial autonomy.** The provincial share in the divisible revenue pool has increased significantly under the 7th National Finance Commission award in FY10/11 (Figure 35). Local Governments saw their powers diminish once the Local Government Ordinance 2001 was rolled back in 2010. This coincided with the 18th Constitutional Amendment, resulting in a re-concentration of administrative and financial powers at the provincial level. Previously, local governments were responsible for education and health service delivery, but now their powers are mainly concentrated on municipal services. Their financing has been reduced as the Provincial Governments control most key service delivery aspects. However, different provinces have different approaches to local governments with some devolving services more than others.

## One size doesn't fit all

As countries develop and become more complex, a larger share of government spending becomes subnational. The further decentralization that is unfolding in South Asia is not unique to that region. Many countries have decentralized during the last three decades (Bardhan 2002). Data on the share of subnational spending in overall public spending suggest that the more complex a country becomes, the more difficult it is to manage it from a central government. The share of subnational government spending is positively correlated both with the size of the population and with GDP per capita, two proxies for the complexity of countries and economies. In cross-sectional analyses, both are statistically significant factors explaining a larger subnational spending share and the strength of these effects is very similar. The relationship can hence be shown relative to real GDP, which combines information on the population size and GDP per capita (Figure 36). In some countries, complexity is added by strong cultural and ethnic diversity. As

**Figure 36: The more complex a country, the more decentralized its spending.**

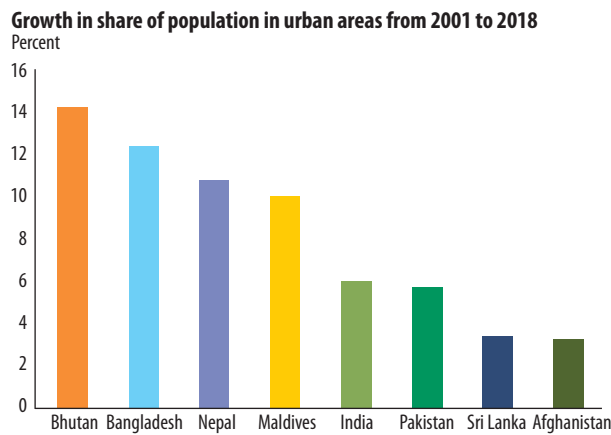
**SNG expenditure as a share of total expenditure**



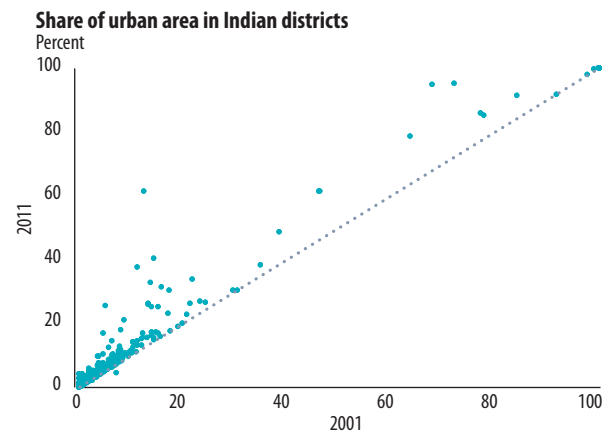
Sources: Reserve Bank of India; Ministry of Finance for Bangladesh, Pakistan, and Bhutan; Nepal Ministry of Finance (Budget speech 2018/19); and SNG-WOFI (World Observatory of Subnational Finance and Investment 2019) for all other countries. Population and per capita GDP are from the WDI.

Notes: AFG=Afghanistan, BGD=Bangladesh, BTN=Bhutan, IND=India, MDV=Maldives, NPL=Nepal, PAK=Pakistan, SLK=Sri Lanka. Data are for latest available year for each country. The vertical axis measures subnational government (SNG) expenditure as a percentage of total expenditure. In Nepal, the SNG expenditure as a share of total expenditure was calculated as the sum of provincial and local spending over total expenditure as budgeted for FY2018/19.

**Figure 37: The region experiences urbanization and spatial transformation.**



Sources: UN population projections and staff calculations.



Source: Spatial Database for South Asia.

countries and economies become more diverse, the need to adjust policies and spending to local conditions grows. Conditional on their size, spending in most South Asian countries is roughly as decentralized as in other countries. The two exceptions are Bangladesh, where the share of subnational spending is lower, and Bhutan, where it is higher. However, Bhutan's share of subnational spending overstates the level of decentralization of expenditure since it only considers budgeted expenditure and thus excludes the significant central spending on hydro investments. A notable outlier in the world is China, where 90 percent of the spending is subnational. It is often underappreciated that along with the opening of the economy and market reforms, China conducted a large-scale political decentralization and empowered sub-provincial governments, which contributed to its strong economic performance (Lin and Liu 2000; Singh 2009).

**The degree of decentralization is often the outcome of deep historical, political and cultural reasons and complex policy choices that involve many objectives.** In India, for example, many states feature a strong cultural and linguistic homogeneity, as well as a sense of belonging to one distinct polity. Policy objectives determining the degree of centralization can include improved service delivery, maintaining peace, local inclusion and engagement in decision making, addressing preference heterogeneity, and ensuring national unity. In addition, decentralization takes very different forms (Rondinelli 1990; Schneider 2003). Administrative decentralization in its weakest form, referred to as deconcentration, only shifts responsibilities from officials at the center to those based in subnational entities, without empowering them. Delegation goes a step further and transfers decision-making power, in addition to administrative functions. Devolution transfers authority over specific geographical territories, including fiscal responsibilities. Political decentralization usually goes hand in hand with devolution of responsibilities and often features elected local government. In federal countries, decentralization can either favor the second-tier of government (states or provinces) or local governments.

**One of the main objectives of decentralization is improved service delivery.** For the delivery of some services (for example education and health) a more decentralized provision is more appropriate than for others,

and there is a vast theoretical literature discussing which services should be decentralized under which circumstances (Hart, Shleifer, Vishny 1997; Aghion and Tirole 1997). In general, decentralization brings service delivery closer to citizens, which allows for adjusting policies and public spending to different needs and preferences. In addition, the expected strengthening of accountability and transparency, especially of local governments that are democratically elected, is likely to result in greater spending efficiency. Greater local spending could also reduce transaction costs. Ahmad and Brosio (2006 and 2009) provide rich overviews of the impact of decentralization on service delivery. The World Bank has also embraced decentralization as a major governance reform to improve service delivery (World Bank 2000). In a survey of economists in South Asia conducted for this report (see Box 2 in chapter 1), three quarters expect more decentralization to improve service delivery in their countries.

**In addition, urbanization in South Asia has increased the need for spatially differentiated policies and spending.** With manufacturing production and services becoming more important relative to agriculture, cities are becoming drivers of growth. Since 2000, the share of population living in urban areas increased by more than ten percent in Bhutan, Bangladesh, Nepal, and Maldives and by over 5 percent in India and Pakistan (Figure 37, left panel). This is an effect both of people migrating to cities and of rural areas becoming more urban (Figure 37, right panel). The 2011 Census in India, for example, recorded the emergence of 2500 additional cities since 2001.

## Partial decentralization

**Empirical evidence of the effectiveness of decentralization is mixed, and the limited benefits are often attributed to incomplete decentralization.** This holds both for decentralization efforts in the world (Prud'homme 1995; Bardhan 2002; Martinez-Vazquez, Lago-Peñas, and Sacchi 2017) as well as in South Asia (see Box 5). Despite decentralization efforts in South Asia, public service delivery remains disappointing. Nearly half of the people still lack access to basic sanitation services, low secondary school completion rates

## Box 5: The impact of decentralization on growth and service delivery in South Asia – a review of the literature

**The empirical evidence regarding the benefits of decentralization is mixed.** Martinez-Vazquez, Lagos-Peñas, and Sacchi (2017) provide a comprehensive and balanced overview of the academic literature on the impacts of decentralization in the world. Evidence on the impact of decentralization on service delivery in South Asia is limited, partly because major decentralization efforts are more recent than in other regions and because service delivery has often only been devolved to a limited extent (Robinson 2007). In addition, a lack of good data hampers such analyses.

**Cross-country analyses including some South Asian countries find benefits from decentralization only if certain conditions are met.** Sow and Razafimahefa (2018) show in a study covering 64 advanced, emerging and developing countries (including Bhutan, India, Maldives, and Pakistan) that fiscal decentralization can improve the efficiency of public service delivery but does so only under specific conditions. These conditions include autonomy of local governments, strong accountability, good governance, and strong capacity at the local level. In addition, a positive effect requires a sufficient degree of expenditure and revenue decentralization. If these conditions are not fulfilled, the efficiency of public service delivery can go down. In line with this argument, Iqbal and Ahmed (2015) using a sample of 46 developing and transitional economies (including Bangladesh, India, Nepal, Pakistan and Sri Lanka) for the period 1974-2004 find that political decentralization significantly reduces the number of total deaths due to natural disasters only if it is accompanied by fiscal decentralization.

**Studies for South Asia provide conflicting reports on the success of decentralization efforts regarding improved service delivery and growth:**

- Mahal et al. (2000) use survey data from 33,000 households in villages across India to show that the decentralization of public service delivery in primary healthcare and education services is positively correlated with improved child mortality and school enrolment. Similarly, Asfaw *et al.* (2007) find a significant role of fiscal decentralization in reducing rural infant mortality rates in India between 1990-1997. Crook and Sverrisson (2003) argue that decentralization of expenditures for basic services has taken place on a significant scale only in the states of West Bengal and Kerala, where substantial untied funds at the discretion of local village councils for developmental purposes have been introduced. In West Bengal, they find evidence for improved access to administrative and justice systems and water provision in some areas. On the other hand, Kalirajan and Otsuka (2012) make the case that decentralization to rural local bodies has been dismal and not achieved any significant results across Indian states. Similarly, Raghunandan et al. (2016) argue that local government functions are hampered in Karnataka, due to unfunded mandates which account for 25 of the 29 functions devolved to these local government units. Along the same lines, Kumar and Managi (2009) study the mechanisms to compensate local governments for the public provision of environmental services in India and confirm that simply assigning functions at appropriate levels does not ensure optimal provision of environmental services, but it needs to be backed with appropriate compensation as well. Aslam and Yilmaz (2011), using data from over 180 villages in Pakistan, show that the decentralization reforms implemented in 2001 increased the provision of street paving, water canals, sanitation sewer lines, and school facilities. Panta (2016) stresses obstacles to decentralized service delivery in Nepal, which are mainly related to low revenue raising power, unclear assignments, as well as poor accountability and transparency.
- Malik et al. (2006) find that fiscal decentralization has had a positive impact on economic growth in Pakistan but argue that in earlier stages of development decentralization may have a negative impact if the central government is in a better position to ensure fiscal sustainability. Khattak, Ahmad and Khan (2010) find a positive impact of fiscal decentralization on growth in Pakistan only in the short run, while the accumulated effect overtime is found to be negative. They attribute the negative long-run effect to poor provincial capacity to efficiently generate own resources and provincial dependence on federal transfers. Lamichhane (2016) finds a positive contribution of local government expenditures on economic growth in Nepal. Herath (2009) shows that in Sri Lanka the actual degree of decentralization after the establishment of provincial councils has been low and has not had any impact on per capita incomes.

For a summary of new research on subnational public finance and local service delivery presented at the 4th South Asia Economic Network Conference see Appendix A7.

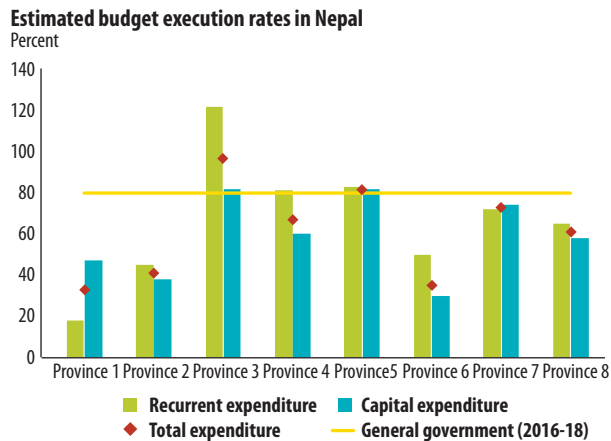
have resulted in a large and growing stock of uneducated adults, water is an acute problem for many in rural areas, and stunting is higher than in most parts of the world (World Bank 2018). These challenges underline the importance of policy reforms to improve service delivery.

**The explanation of the lack of results from decentralization is often that decentralization has not gone far enough.** Key decisions are still taken by higher levels of government. The allocation of resources to local

governments is unpredictable and heavily earmarked, limiting flexibility in resource utilization at the local level. Few opportunities exist for local governments to raise own revenues. For decentralization to improve service delivery, all three constituent components – fiscal decentralization, administrative decentralization, and political decentralization – need to go hand in hand and downward accountability has to be strong. In an environment of partial decentralization, however, local governments lack institutional capacity.

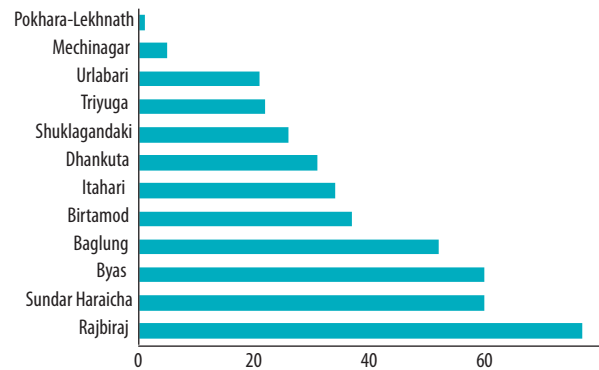


**Figure 38: In Nepal, a difficult transition to federalism and weak local government capacity exacerbates already low budget execution**



Source: Budget Speeches of Provincial Ministry of Economic Affairs and Planning.  
Note: The provincial data is for fiscal year 2018/19.

**Unused capital expenditure of selected local governments**  
Percent



Source: Strategic Assessment of Municipalities in Nepal (SAMN).

**Decentralization in South Asia indeed remains work in progress.** In Bhutan, the implementation of the decentralization pillar included in the 12th five-year (2018-2023) plan will take some time. In India, the 15th Financing Commission has the mandate to re-think competitive federalism and to re-balance responsibilities and revenue sharing. States and local governments remain highly dependent on devolved resources and underperform in direct tax collection (Jaitley 2018). More importantly, while states were given more resources and autonomy, neither the 73rd and 74th constitutional amendments providing for the empowerment of urban local bodies nor the recommendations by the 14th Financing Commission for devolution to local government bodies have been properly implemented. Devolution of funds remains very limited and state financing commissions are typically ineffectual and far behind schedule. In Nepal, the federal transition is difficult and capacity constraints at the subnational level remain severe. Three of the seven provinces spent less than half of the budgeted expenditure in fiscal year 2018-19 and some local governments seem still dysfunctional (Figure 38). One of the main challenges is to reassign capable civil servants from central agencies in Kathmandu to local governments across the country. In Pakistan, tax autonomy by provinces has resulted in a fragmentation of the market, the different economic size of provinces has resulted in power imbalances, and the empowerment of provinces has disempowered local governments. To address the latter, Punjab in Pakistan just enacted a local government reform that still has to be implemented.

**In Bangladesh, the current institutional arrangements lag the more decentralized system envisioned in the Constitution.** The first article of the Constitution defines Bangladesh as a unitary state. But the Constitution does support local government and allows local government to impose taxes, prepare their own budget and maintain funds. The envisioned devolution of responsibilities to districts, sub-districts, Union of Villages, Municipalities and city corporations include civil administration, fire protection, development and operation of markets, roads and infrastructure, traffic and urban transportation, local economic development,

environmental protection, water supply, street lighting and land use planning. However, many of these responsibilities have not been decentralized and despite considerable efforts in the past, no effective local government system emerged (Sarker 2003, 2006). Decentralization seemed to progress when the Upzilla (sub-district) level election took place in 2009. However, that transition was unsuccessful, partly because many Members of Parliament were unwilling to accept a weakening of their position. For example, the Upzilla level chairmen are required to take advice from their respective Members of Parliament in decision making, weakening this level of government. At Union Parishad level, elections are held regularly but very few effective steps have been taken to strengthen them. Bangladesh now has an administratively decentralized system with various levels of elected local governments institutions, but these local governments have very little decision-making and financial authority, in addition to a low level of resources and very weak governing capacities (Mansur and Ahsan 2019).

**In Afghanistan, the central state is too weak to preside over an efficient decentralization process and in Sri Lanka the decentralization process is still halted.** In Afghanistan, rebuilding a functioning central government has been the primary objective, but the Constitution entails the aspiration to move toward a state structure where some resources and authorities are shared with sub-national governments in the future. The centralized state structure coexists with a decentralized traditional society, and many areas outside of Kabul are dominated by regional and local commanders. Past attempts for decentralization or de-concentration may have partly been driven by political motives of regional elites rather than a desire for better service delivery. Sri Lanka, on the other hand, has a well-established legal system of local governments at the provincial and sub-provincial levels. The 13th amendment to the Constitution provided the constitutional provision to establish the Provincial Councils, which were given powers and functions. Yet, years of conflict halted the decentralization process in Sri Lanka. But despite the armed conflict being over for ten years, there has not been meaningful progress in decentralization in the last decade.



**While poor service delivery outcomes in South Asia are only partly related to imperfect decentralization, completing the implementation of decentralization in South Asia could support better service delivery.** Past decentralization efforts have often been half-hearted, and across the region the implementation of the decentralization agenda remains very incomplete. In the survey conducted for this report, nine out of ten economists in South Asia see a misalignment between the de facto decentralization in their country and the one envisioned de jure. To make decentralization work, local governments need a clear mandate, need to be both empowered and accountable, and need sufficient and reliable resources. Other challenges include insufficient auditing and performance measurement and a lack of coordination between different levels of governments. The latter can result in deadlocks between different levels of government, especially if governments belong to different parties and institutional arrangements allowing higher tiers to block lower tiers. But while these are all critical constraints, they are not a sufficient explanation of the disappointing contribution of decentralization to better service delivery in South Asia.

## Decentralization and centralization belong together

**Partial decentralization is not good enough, but full decentralization is not the solution.** The previous section has argued that partial decentralization or insufficient empowerment of local communities can prevent optimal service delivery. However, there is ample evidence that too much decentralization can impair efficiency. In Pakistan, for example, the existence of five independent tax jurisdictions has led to double taxation and hampers commerce between provinces (Box 6). Too much decentralization can lead to inefficient fragmentation. Like multiple tax systems, also multiple product or environmental standards would limit economic integration within a country. Moreover, decentralization does not necessarily reduce corruption (Bardhan and Mookherjee 2006). Decentralization has been found to decrease corruption in some cases (Fisman and Gatti 2002) and to increase it in others (Fan, Lin, Treisman 2009). More corruption is likely if the functional devolution is unclear and if accountability to communities is weak (Véron *et al.* 2006). In the survey conducted for this report, nearly nine out of ten South Asian economists agreed that unclear responsibilities of local governments foster corruption at the local level in their country. In unchecked, autonomous local communities the probability of corruption and elite capture can be higher than in larger, integrated communities.

**Efficient centralization can be the missing element.** Over the past 40 years, rapid decentralization in many countries has been accompanied by strong market integration (through opening up to the world market) and a consequent loss of some of their national sovereignty. This process requires strong central rules to facilitate market integration. The clearest example is Europe, where some national government responsibilities were entrusted to the European Union and some power was

devolved to municipalities. Such a simultaneous centralization and decentralization creates an environment in which autonomous local governments engage in beneficial competition in an integrated world. This encourages innovation, experimentation, and learning from rivals, while everybody has to comply with the same general rules and same general standards. Such a competitive environment cannot be created by decentralization alone.

**The academic literature provides some evidence that a strong central government is needed for successful decentralization.** Enikolopov and Zhuravskya (2007), using data from 95 countries (including Bangladesh, India, Pakistan, and Sri Lanka), show that the strength of national political parties improves the results of fiscal decentralization. Blanchard and Shleifer (2000) argue that decentralization was more successful in China than in Russia, because in China the central government was able to reward and to punish local administrations, which reduced both the risk of local capture and the scope of competition for rents. And Malik *et al.* (2006) find that too much decentralization can slow growth. Shah (2010) argues that the information revolution has led to a diminished economic relevance of intermediate levels of governments and enhanced the need for empowered local governments. He describes how conforming to federalism of provinces and states in countries like Australia, India, Mexico, and Pakistan has blocked local governments. Evidence from countries like China, Japan, Korea, and the Nordic countries, on the other hand, suggests that where local governments are given a proper role, they contribute to competitiveness and growth.

**If the central government has delegated service delivery to local governments, it still has the important task to provide the right incentives and to exercise quality control.** Decentralization is not a zero-sum game in which power is just re-distributed across different tiers of government. Instead, replacing central provision of services with decentralized provision by local governments introduces a new relationship of accountability between national and local policymakers (Ahmad, Devarajan, and Shah 2005). Roles change and designing a proper system of responsibilities and interactions between different tiers of government is crucial. Often the critical question is not whether a first, second, or third tier of government can best provide a service, but how to organize the joint production of services (Prud'homme 1995). In Europe, the subsidiarity principle, which became the general principle of European Union law, states that a central authority has a subsidiary function, performing only those tasks that cannot be performed at a more local level. But one key function of the highest level is ensuring a common market. That common market creates conditions under which local communities can provide services. Similarly, in India more decentralization to states in recent years went hand in hand with the introduction of the Goods and Services Tax (GST), which subsumed local and state taxes to foster the flow of goods and services within the country. Moreover, the highest level also plays a crucial role in redistributing resources, in setting standards to prevent a race to the bottom (for example in regulatory standards and taxes), and in providing quality control. In South Asia, creating competition between local entities

## Box 6: The case for a harmonized sales tax in Pakistan

The current sales tax regime fragments Pakistan into five competing tax jurisdictions resulting in potential double taxation and high compliance costs for businesses. Federal and Provincial Governments acknowledge that the current sales tax regime needs improvement. The base is broken up into goods and services with the federal government taxing the former and provincial governments the latter. The base is further broken up spatially, as each province has the power to tax services supplied within its jurisdiction and levy its own tax rates on these services. This fragmented nature of the base has caused inter-provincial and Federal-Provincial jurisdictional conflicts resulting in potential double taxation, exporting of taxes to other provinces, and consequently high costs of compliance for businesses. Unfortunately, no common legislative or administrative forum exists to address these issues. It is therefore important that a harmonized sales tax is introduced, along with a national forum that has the power to legislate and address these issues related to taxation.

The sales tax has always been a shared tax, but after the 18th Constitutional Amendment provinces have established their own tax collecting agencies to collect sales tax on services without systems or procedures to effectively coordinate with one another. Constitutionally, the Sales Tax on Goods (STG) is a Federal tax while the Sales Tax on Services (STS) is a Provincial tax. Until 2010, both taxes were collected by the Federal Government, through the Federal Board of Revenue (FBR) for a nominal fee, and the sales tax on services was remitted back to the provinces. After the 7th National Finance Commission award (2009) and the 18th Constitutional Amendment (2010), all provinces established their own revenue authorities to collect sales tax on services and claimed a substantial increase in collection. Yet, total sales tax collection by all provinces is still only 0.5 percent of GDP. On the other hand, the fragmentation of the base and resulting complexity and jurisdictional issues have significantly raised the costs of compliance for businesses.

With five different revenue collecting agencies on Sales Tax on Goods and Services, the following issues have emerged:

- **Fragmented bases:** With different tax collection agencies, and five different sales tax legislations, the tax bases are different in each province. Issues also arise between the Federal and Provincial governments on tax bases, as the definition of goods and services is not clear, and complaints have been raised by both the Federal and Provincial Governments that other agencies are impinging on their tax bases.
- **Different taxation principles:** Issues between provinces have also arisen concerning principles of taxation unrelated to the tax base, especially on sales tax on services. For example, Sindh province charges sales tax on many services on the origin principle, while the rest of the provinces charge the tax on the destination principle. Given the nature of Sindh as the province with a developed port, taxation at origin of services has led to substantial double taxation when other provinces levy the sales tax on the same service according to the destination principle. Retaliation by other provinces, either by also using the origin principle selectively or not providing an input tax credit on cross-border purchases, have also been reported.
- **High administrative and compliance costs:** With five different tax collecting agencies charging sales tax, businesses working across different geographical areas within Pakistan must file up to 60 different tax returns (one per month for each agency). This increases compliance costs for firms, hampering overall economic activity.

All these issues significantly reduce the incentive for businesses to purchase from other provinces or sell to other provinces, essentially fragmenting Pakistan into five markets. To address these issues, Pakistan could consider converting the current sales tax into a harmonized sales tax on goods and services that allows for effective revenue raising while not negatively impacting economic activity and investments in the country.

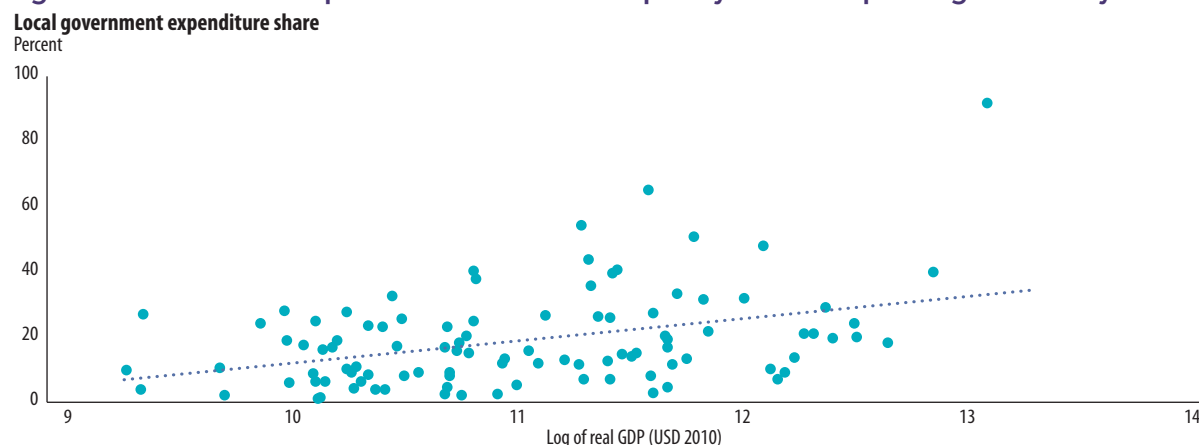
is not easy, as internal migration is low and firms and capital are not very mobile. Therefore, higher levels of government play a crucial role in stimulating innovation and in rewarding good performance. Creating competition between local governments is fostered by granting autonomy to generate own resources. In addition, higher levels of government have the role of providing incentives that promote accountability of local officials to citizens to ensure services provided match local preferences.

**Decentralization to states and provinces may complicate a further devolution of responsibilities to local governments.** The potential for improving basic service delivery is strongest when service delivery is localized. At the same time, only economic rules and standards set at the highest level ensure market integration. From a perspective of better service delivery in integrated markets, only limited decision-making power should

be devolved to the middle tier of government. However, past decentralization efforts in Pakistan and India have strengthened the second tier, not the third. In India, states were in turn expected to devolve functions to local governments, but even the most decentralized states are lagging in this respect. Interestingly, in Pakistan local government institutions have usually been strengthened by non-representative regimes that consolidated central power (Cheema, Khwaja, and Khan 2005). The 18th Constitutional Amendment agreed upon by democratically elected representatives, on the other hand, not only devolved powers from the central government to the provinces, but also centralized local responsibilities at the provincial level. Efforts to reverse some of the negative consequences of the weakening of local governments have led to new reforms in KP and Punjab in Pakistan to strengthen local governments again. In a survey among South Asian economists conducted for

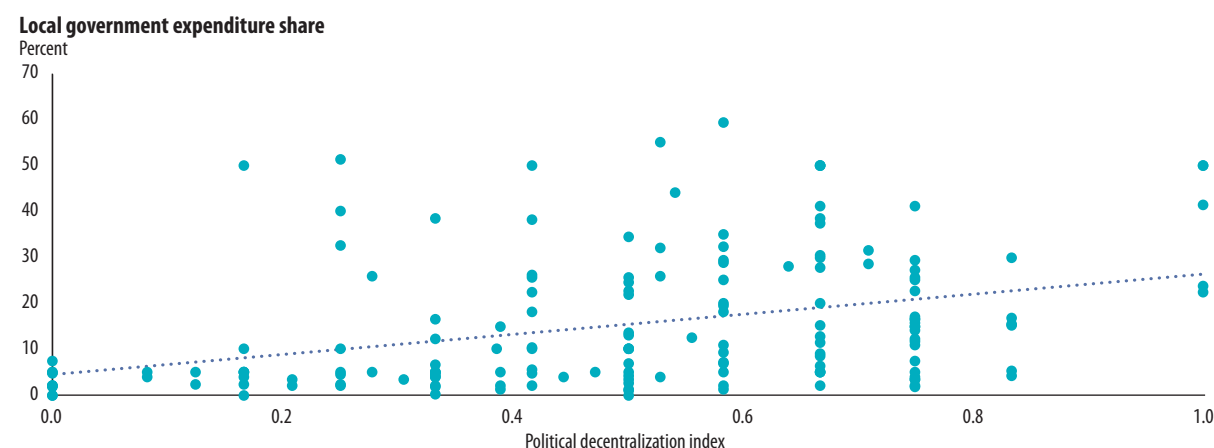


**Figure 39: The relationship between economic complexity and local spending is relatively weak.**



Sources: Reserve Bank of India; Ministry of Finance for Bangladesh, Pakistan, Nepal, and Bhutan; and SNG-WOFI and SNG-WOFI (World Observatory of Subnational Finance and Investment 2019) for all other countries. Population and per capita GDP are from the WDI.  
Notes: Data are for latest available year for each country. The vertical axis measures local government expenditure as a percentage of total expenditure. In Nepal, the local expenditure as a share of total expenditure is as budgeted for 2017/18.

**Figure 40: The share of local spending is correlated with political decentralization.**



Sources: Reserve Bank of India; Ministry of Finance for Bangladesh, Pakistan, Nepal, and Bhutan; and SNG-WOFI and SNG-WOFI (World Observatory of Subnational Finance and Investment 2019) for all other countries. The political decentralization index is from Ivanyna and Shah (2014).  
Notes: Data for local spending shares are for latest available year for each country. The vertical axis measures local government expenditure as a percentage of total expenditure. In Nepal, the local expenditure as a share of total expenditure is as budgeted for 2017/18.

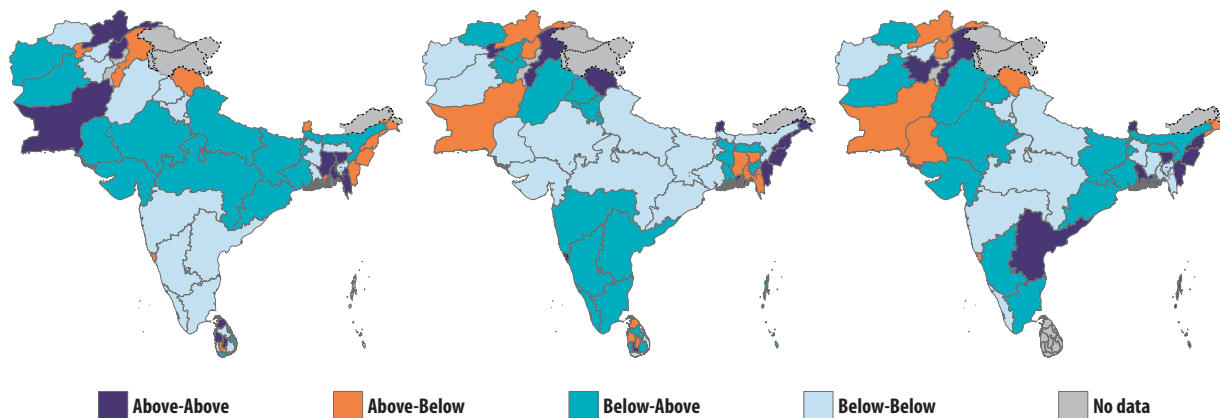
this report, a lack of political will to devolve power to lower levels was ranked the biggest challenge for efficient local government institutions.

**Insufficient devolution of power to local governments and consolidation of power at the second tier of government might well be a global phenomenon.** Figure 36 earlier in this chapter showed a strong correlation between economic complexity and total subnational spending. The level of local spending, however, is much lower than total subnational spending, and the relation with economic complexity is weaker (Figure 39). Especially the large federal states of South Asia tend to have limited empowerment of local governments, as the states and provinces control a relatively large part of public spending. The measure of local spending used even overestimates the decision-making power of local governments, as spending decentralization is purely administrative in some cases. However, the share of local government spending is highly correlated with political decentralization (Figure 40) and other indicators of closeness of government to its citizens (Ivanyna and Shah 2014).

## Optimal allocation of central resources is key to success

**Even with empowered local governments and a strong and effective central government, challenges remain.** The central challenge is how to allocate central resources over very diverse districts. Some areas experience faster development than others and living standards between rural areas and cities diverge. In South Asia, subsidiary farming nowadays takes place next to world-class IT programming and space engineering. In all countries the living standards in the most advanced cities are decoupled from the living standards in the most backward regions. Spatial variations in living standards within countries are often larger than the variation across countries. Each country in South Asia faces a geography of opportunity and of despair. Sustaining high growth rates and reducing poverty are both local challenges and require not only investing in people, but in people at the right place. Decentralization brings questions of the appropriate spatial distribution of public spending to the surface.

Figure 41: The appropriate distribution of resources depends on the perspective.



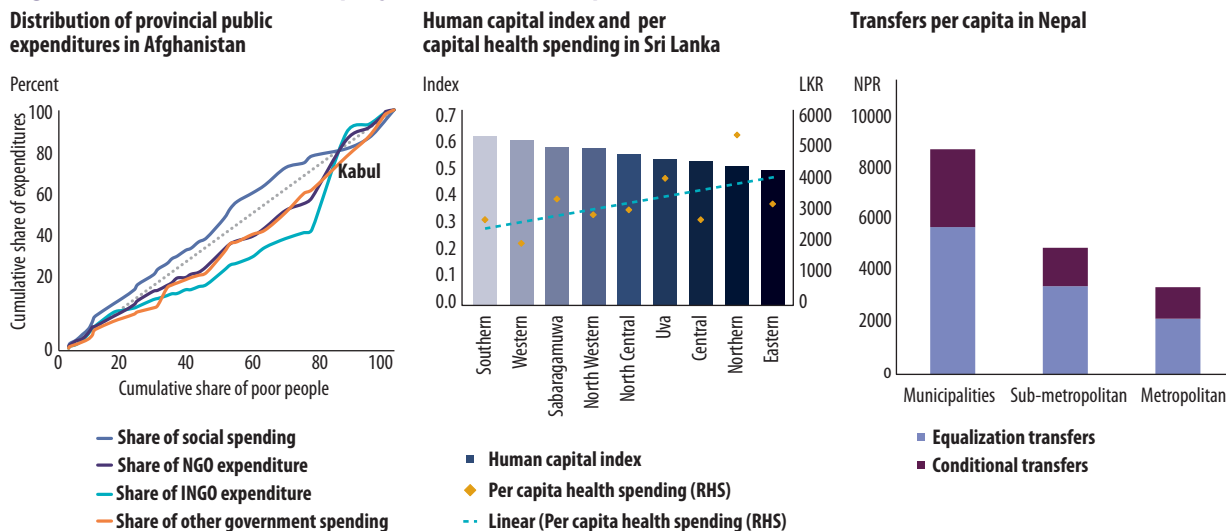
Sources: Global Data Lab, Reserve Bank of India, World Bank, and staff calculations.  
Notes: The need/outcome/performance refer to expected years of schooling and are compared to the corresponding country average. Spending on education per capita is also compared to country averages. Thus, for example, above-above means that the need/outcome/performance indicator is above average and per capita spending on education is above average. See Appendix A6 for details.

**Governments try to achieve several objectives with the spatial allocation of funds.** As countries decide where and on whom to spend their resources, they face potentially very difficult trade-offs between equity concerns and the return on their spending (Bardhan 2002). First, the amount of public resources needed to ensure an equal (or at least similar) level of basic service delivery for all citizens varies with local conditions. For example, providing basic education and health services is more expensive in sparsely populated areas. And a promise of universal basic service delivery can result in very high costs even for individuals. In Bangladesh, for example, the attempt to connect everyone to the grid meant high expenditure on those individuals living very far away from others, like isolated fishermen at the coast. Second, there are good reasons to provide lagging areas with additional resources to allow them to catch-up. All countries in South Asia are concerned about spatial inequalities and provide special funding for lagging areas, often in the form of equalization grants. On the other hand, even the most

prosperous cities in South Asia urgently need more public investment. The return on investments in cities can be a multiple of the return in rural areas. Third, rewarding good performance can improve incentives, but also results in higher spending for those areas improving their outcomes. Balancing the need for equity across the country, the need for investments in high-yielding projects, and the need for the right incentives to increase the efficiency of service delivery everywhere, is a daunting task (see Box 7 for a discussion of these trade-offs in India).

**Evaluating the spatial distribution of spending depends on the perspective.** All these different issues result in very different perspectives on the spatial distribution of public spending. In Balochistan, for example, the need for education spending (measured by low expected years of education) is higher than in other provinces in Pakistan, but so is per capita spending on education. Thus, spending is well targeted in terms of needs (Figure 41, left panel), but poor outcomes mean

Figure 42: In South Asia, equity concerns are important.



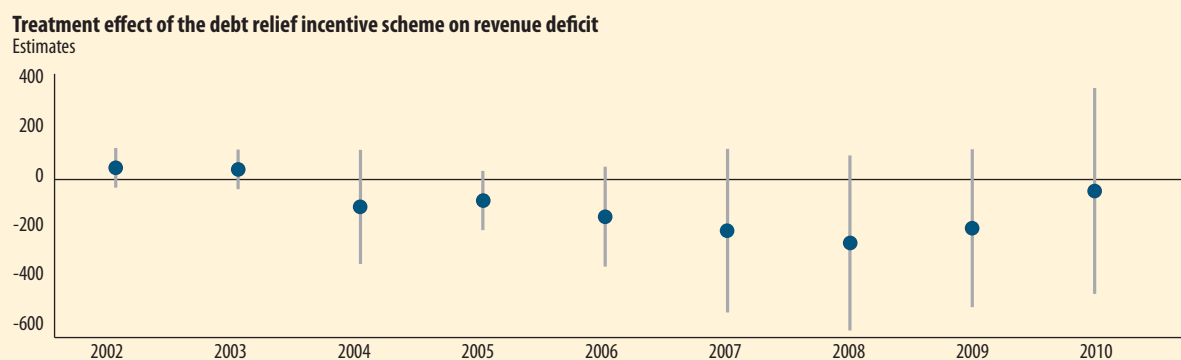
Sources: World Bank and staff calculations (left); Sri Lanka Human Capital Report (World Bank 2019a); Managing the federal transition to support sustainable urbanization in Nepal. World Bank (2019b). Data for Afghanistan is 2016, for Sri Lanka it is 2018, and for Nepal it is as budgeted for FY2017-18.  
Notes: For the left panel, provinces are ranked from low levels of economic activity to high levels measured by nightlight intensity and rural population (World Bank 2017). Social spending is defined as spending by the Ministry of Education, Ministry of Higher Education, Ministry of Public Health, Ministry of Refugees and Repatriates, Ministry of Women Affairs, Ministry of Martyrs, Disabled and Social Affairs and the Ministry of Counter Narcotics.



### Box 7: Design aspects of a fiscal transfer system – evidence from India

The design of a fiscal transfers’ system is a challenging task. On the one hand, the fundamental idea of decentralization is to increase subnational governments’ discretion over expenditure to allow subnational governments to deliver the services demanded by citizens, while assuring that service providers are held accountable if services do not meet citizens’ expectations. On the other hand, increasing subnational governments’ discretion over the allocation of expenditure can mean that services are not provided to a level deemed satisfactory by the central government. One option to resolve this trade-off is for the central government to impose conditions linked to transfers on subnational government. Two types of conditions are especially common: incentives grants, which tie the disbursement of a transfer to the achievement of an outcome, and earmarked grants, which tie funds to specific uses. This box presents two examples from India on when such instruments work, and when they do not. Other work investigating Finance Commission transfers in India includes Rajaraman and Gupta (2016), who investigate properties of transfers intended for devolution to the local level, and Rajaraman and Vasishtha (2000), who highlight that the transfer of unconditional grants can reduce local government tax effort.

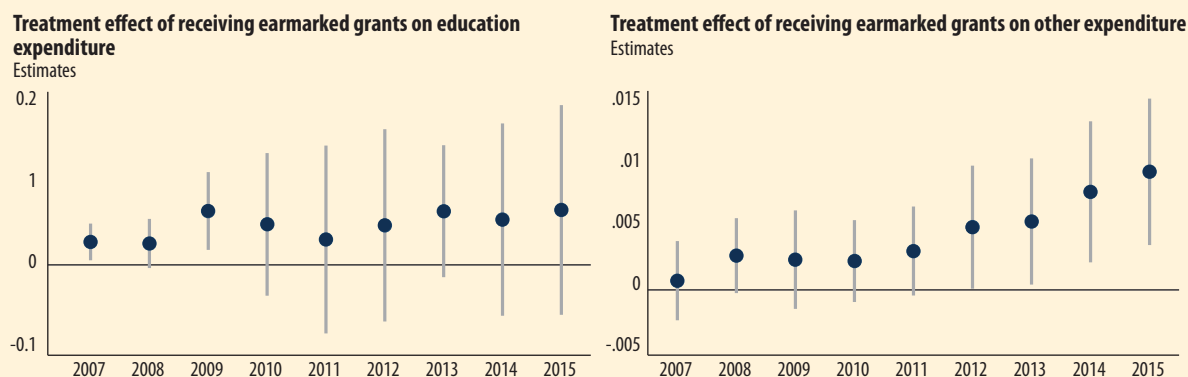
Figure 43: Incentive grants linking fiscal prudence to debt relief had the intended effect.



Sources: RBI, Finance Commission, and staff calculations.  
Notes: Estimates represent coefficient estimates based on empirical model explained in Appendix A5. Error bars represent 90 percent confidence intervals.

India’s 12th Finance Commission introduced a working incentive grant that linked fiscal prudence to debt relief. Starting in 2006, states that improved their revenue balance were eligible to write off repayments on central loans, effectively making federal assistance conditional on fiscal performance. Evidence suggests that the scheme has been effective at reducing revenue deficits at the state level (the detailed methodology to obtain these estimates is described in the appendix A5). Figure 43 plots the effect of the scheme on the revenue deficit by year, showing the reduction in the revenue deficit of states whose repayment obligations cover 1 percent of total expenditure compared to states with no repayment obligations. From 2006 onwards, revenue deficits dropped noticeably more in states with a 1 percent repayment obligation than in those without, peaking at a reduction of over INR 200 crore in 2008. Scaling these estimates through back of the envelope calculations implies that at the peak of its effectiveness, an increase in payment obligations to the center by 3 percentage points of total expenditure led to a reduction in the revenue deficit by 40 percent. The scheme was thus effective in inducing fiscal discipline. Once these incentives ceased to exist, deficits went back to previous levels.

Figure 44: Additional grants earmarked for education increased non-education spending more than education spending.



Sources: RBI, Finance Commission, and staff calculations.  
Notes: Estimates represent coefficient estimates based on empirical model explained in Appendix A5. Error bars represent 90 percent confidence intervals.





**Around ten percent of all grants in India are earmarked for a specific purpose, typically for spending in social sectors or on agriculture, but earmarking does not always achieve the intended results.** Evidence suggests that earmarking spending is effective in raising social sector spending: estimates highlight that a 5-percentage point increase in the share of earmarked grants between Finance Commissions increases the pass-through of one rupee transferred to total expenditure by 35 percent – of which about one third is accounted for by increased spending on education, health, and agriculture. Conditional grants, however, do not exclusively raise spending in targeted sectors. The 13th Finance Commission earmarked grants for primary education equivalent to approximately 8 percent of baseline education expenditure. These grants were inframarginal, which means that they did not exceed the amount that states would have spent on education anyway. As a result, states responded to the introduction of the grant in 2012 by expanding non-education expenditure. By contrast, the increase in education spending after 2012 was less steep and statistically not distinguishable from zero (Figure 44). This occurred because it was possible for states to use the funds from the grant to cover the spending on education they would have incurred anyway and divert the resulting savings to other uses. Taken together, these results suggest that conditional grants can work in raising targeted sector spending, but if the amounts distributed are too small, conditional grants have effects that are comparable to untied grants.

that spending is not well targeted in terms of efficiency (Figure 41, middle panel). And looking at changes over time results in yet another perspective. Since Balochistan improved education outcomes more than the average province in Pakistan, increases in resources that are higher than average may be reasonable (Figure 41, right panel). The appropriate distribution of resources is hence not straightforward. In South Asia, the distribution of revenue between the higher and lower levels of government is usually determined by financing commissions that design revenue sharing formulas. In addition to some standard variables like the population, they usually include a measure of backwardness. That can introduce some counter-intuitive incentives. For example, when a higher share of people living in poverty results in larger transfers, subnational governments that fight poverty successfully are penalized. Instead, it may be more useful to define needs and backwardness independent from the outcome policy makers target.

**In South Asia, equity concerns appear to be an important determinant of the spatial allocation of funds.** Available data suggests that equity concerns result in pro-poor social spending in South Asia (Figure 42). In Afghanistan, ranking provinces according to a measure of economic development based on night light intensity and rural population (World Bank 2017) and then comparing the cumulative share of poor people to the cumulative share of expenditure shows that social spending is benefiting lagging provinces more than others (Figure 42, left panel). Other government spending is not. Surprisingly, NGO spending and especially international NGO spending is going over-proportionally to Kabul and does not favor lagging provinces. A similar analysis is possible using income per capita for regions from the Global Data Lab. The results using the alternative measure and regions instead of provinces are very similar. In Sri Lanka, health spending is often ad hoc and largely driven by human resources, which accounts for around half of health spending. Yet, aggregating provincial health spending from different sources and contrasting it with human capital shows that per capita spending is higher in provinces with lower human capital (Figure 42, middle panel) providing evidence that the formula used to benefit lagging areas is working at least to some extent (World Bank 2019a). In Nepal, there is a clear pattern that larger metropolitan cities, as characterized by

larger population sizes, receive lower levels of grants per capita than sub-metropolitan or other smaller municipalities (Figure 42, right panel). The federal government allocates greater amounts of grants (in per capita terms) to those municipalities that are smaller in size and less urbanized (World Bank 2019b).

**Also globally, the allocation of resources to decentralized governments seems to reduce spatial differences.** In principle, more decentralization can both increase or decrease spatial variation within a country. If decentralization is driven by demands for more autonomy by the richest areas of a country, it is likely that these areas will be able to keep more of the resources generated by them after decentralization. And with more resources staying in the richest areas, spatial inequalities are likely to increase. On the other hand, if decentralization is driven by areas feeling left behind, and such forces are driving the decentralization process in Nepal, a more decentralized system can have an equalizing effect. Globally, fiscal decentralization has resulted in less spatial heterogeneity. Data on spending of 82 countries between 1990 and 2016 show that a higher share of spending by subnational governments was associated with a lower within-country variation of income, education outcomes (measured by the expected years of education) and health outcomes (measured by the life expectancy) (Table 6). The effect of decentralization on the spatial variation was not linear (Figure 45). For education and health outcomes, spatial variation only decreased if a substantial share was decentralized. In line with these results, a higher subnational spending share is argued to have increased the efficiency of spending as well (Sow and Razafimahefa 2015). Many countries experiencing convergence have succeeded by promoting an economic union and by ensuring minimum standards in basic services across the country (Shankar and Shah 2001).

## Better geospatial data can improve evidence-based policy designs

**Better geospatial data of public expenditure is fundamental.** Often fiscal incidence is analyzed across households, but spatial variation may account for a big

**Table 6: Globally, fiscal decentralization has reduced spatial variation...**

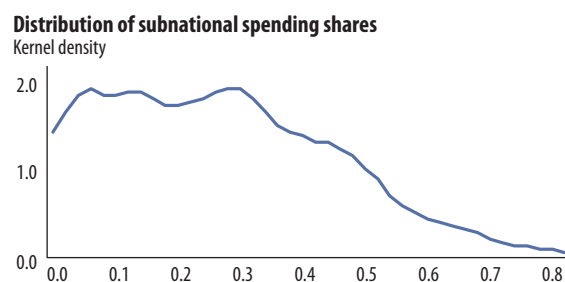
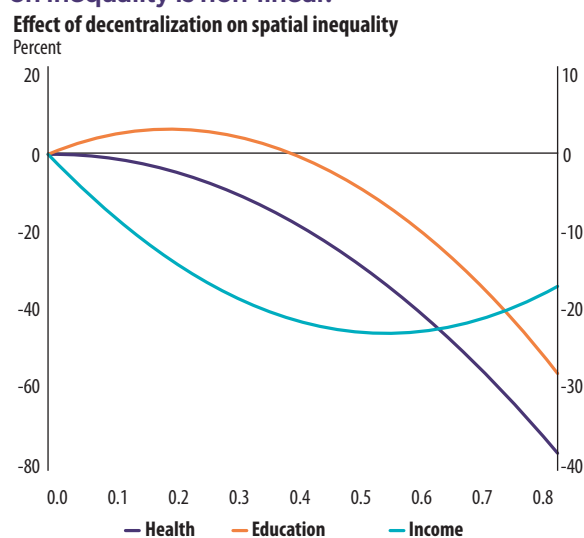
	Income	Health	Education
Subnational expenditure (lagged)	-0.87*** (0.21)	0.25 (0.42)	0.64*** (0.23)
Squared subnational expenditure (lagged)	0.82*** (0.30)	-1.20** (0.81)	-1.68*** (0.44)
Controls	YES	YES	YES
Observations	1332	1244	1298
R2 overall	0.95	0.86	0.96

Sources: IMF's Fiscal Decentralization Dataset, Global Data Lab, and staff calculations. Notes: The data covers 82 countries from 1990 to 2016. Spatial variation is measured as coefficient of variation (CV) within the country. GDP per capita is used as a control, and the fiscal decentralization variable is lagged to address endogeneity concerns. The analysis includes country fixed-effects. The figure shows the impact of changes in fiscal decentralization (subnational expenditure over total government expenditure) on the within-country inequality in the outcome variables of income (gross national income per capita in PPP), education (expected years of schooling) and health (life expectancy). The impact of moving from one level of fiscal decentralization to another is obtained by subtracting the corresponding inequality levels in the y-axis. For instance, doubling the level of fiscal decentralization from 20 to 40 percent leads to a 7.7 percent reduction in within-country income inequality, a 14.8 percent reduction in health inequality and a 7.4 percent in education inequality. See the Appendix A3 for details on the data and estimation method. Standard errors in parenthesis; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01.

portion of it. In addition, urbanization is arguably the most important transformation faced by developing countries, but urbanization is a spatial phenomenon, boosted or hindered by local public spending. And, finally, successful resource decentralization is critically important to attain development outcomes but requires accountability and performance measurement that only work with better data. Without subnational expenditure data, decentralization cannot be managed, policies cannot be evidence-based, spending cannot be targeted, and it is impossible to understand the effect of spending on outcomes. Investments in regularly published geospatial data would help track spatial development patterns and could guide policy designs. For that, authoritative administrative areas need to be defined and used across tiers of government. These allow for accurate data collection, aggregation, and subsequent communication.

**South Asia lags far behind in recording and publishing subnational fiscal data.** This is reflected in such data not being as easily available as that of other countries in data efforts by different international organizations. For example, the only South Asian countries covered by the IMF dataset on fiscal decentralization are Afghanistan, Maldives, and Sri Lanka. The World Observatory of Subnational Finance and Investment (2019), led by the OECD and the United Cities and Local Government, provides some general characterization of some South Asian countries but very limited data. The maps presented in Figure 41 are based on an attempt to provide a regional overview of subnational public spending. They combine data from different sources and build strongly on BOOST,

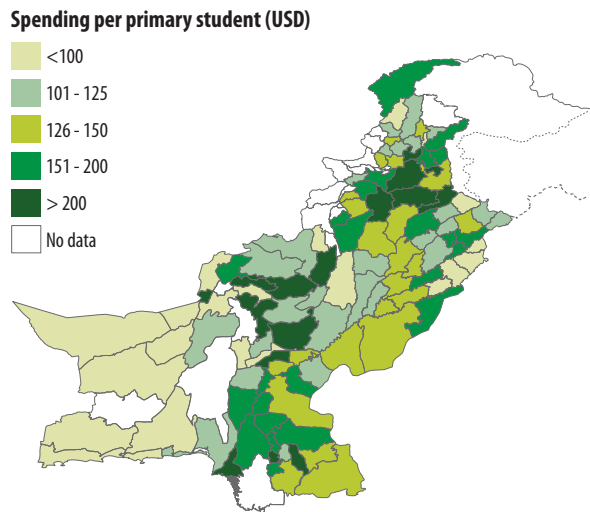
**Figure 45: ... and the effect of decentralization on inequality is non-linear.**



a World Bank initiative to facilitate access to budget data. BOOST data is available at different levels of detail and for different years for Afghanistan, Pakistan, and Bangladesh. Unfortunately, none of this data is publicly available yet. For India, state level spending is publicly available, but the distribution of local spending is not, and it is very cumbersome to collect. This is partly because the flows of public funds are not all available from treasuries but involve different schemes as well (see Box 8). The absence of district-level expenditure data in India is problematic given the large size of some of the states and the importance of local governments in providing services. Even recording and publishing all on-budget expenditures at a granular spatial level does not provide a full picture, since substantial public spending is undertaken by self-accounting entities like municipalities and state owned-enterprises (see Box 8 for an example in Pakistan).

**Linking subnational spending data with subnational outcome data deepens understanding of the relationship between the two.** Incentive structures and institutional arrangements are crucial for the efficiency of service delivery, and in many cases spending more will have a weaker effect than spending well (World Bank 2018). But better data is fundamental to better understand the relationship of spending and outcomes. For example, while the relationship between spending and learning outcomes is often weak, there is some evidence that higher spending is beneficial in Pakistan. Spending on pre-school and primary education per student in public schools varies a lot between districts in Pakistan (Figure 46). After controlling for different variables that may impact the costs and quality of education,

**Figure 46: Spending on primary education varies across districts in Pakistan...**



higher district spending raises the years students in public schools remain in school and the satisfaction of their parents with the schools. More importantly, with higher spending the probability of good learning outcomes increases (Table 7; see Appendix A4 for more details).

**Better data and more research can lead to better policy advice.** There has been more progress in generating spatially granular outcome data, compared to spatially granular expenditure and revenue data. Subnational outcome data for South Asian countries is, for example, available from the South Asia Spatial Database (Li *et al.* 2015) and from the Global Data Lab (Smits and Permanyer 2019). In addition, there are different initiatives at the country level. But more subnational public finance data is fundamental for a deeper understanding and well-functioning decentralized systems. Linking outcome and spending data results in useful insights, and better data will lead to more research on subnational public finance and local service delivery in the region. And since decentralization is work in progress across South Asia, more research will be valuable to further strengthen evidence-based policy advice.

## Conclusions

**Decentralization in South Asia has yet to deliver on its promises.** Despite a long history of decentralized systems, public service delivery in South Asia remains disappointing. To benefit from more decentralization, South Asian countries need to avoid that decentralization turns into fragmentation. It is crucial that effective central governments create integrated markets in which local communities compete and facilitate mobility across local boundaries. Central governments' role is also to address equity concerns and support disadvantaged regions to give all citizens equal opportunities, irrespective of where they are born. In addition, South Asian countries have specific priorities. In Bangladesh, urban management can be improved, and empowering local governments can improve service delivery. In

**Table 7: ... and higher spending has a positive impact.**

	(1)	(2)	(3)
	Years in school	School satisfaction	Learning outcomes
<b>ln(spending)</b>	<b>0.52***</b> (0.06)	<b>0.06***</b> (0.005)	<b>0.08***</b> (0.02)
<b>Controls</b>	YES	YES	YES
<b>Observations</b>	124607	206267	41310
<b>R2 overall</b>	0.77	0.22	0.20

Sources: PSLM 2012-13, PIFRA database, and staff calculations.  
Note: Controls are district fixed-effects, population density, GDP per capita, share of public students, agriculture employment, average years of schooling of the household head, and share of population with access to electricity. Standard errors in parenthesis; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01.

Bhutan, new decentralization efforts require building local capacity. In India, the 15th Financing Commission can properly balance responsibilities and revenue sharing and ensure fiscal prudence at the state level. Most importantly, India could benefit by giving some of the responsibilities accumulated at the state level to local governments. In Nepal, easing tensions between different levels of government and improving capacity at the local level would support a successful federal transition. In addition, the transition will need time to deliver better services and, in the meantime, managing the expectations can be helpful. In Pakistan, the power of provinces could be more balanced, and a new revenue sharing formula can create incentives better aligned with improved service delivery. In addition, reversing the market fragmentation between provinces would benefit economic growth.

**Transforming South Asia's cities into dynamic engines of growth requires increasing revenues for those cities, but that comes with the risk of widening spatial inequality.** South Asian countries would benefit from investing more in their cities (World Bank 2016) and to raise lagging places at the same time. Across South Asia, subnational entities depend on central government grants rather than on fees or own tax revenue. In India, municipal revenue is only one percent of GDP. Tariffs for many basic services, like water supply in India or solid waste collection in Sri Lanka, do not reflect cost recovery or are even free. Higher tariffs and fees could provide some additional resources to local governments. More importantly, however, South Asian cities are generating much less revenue from land than cities in other regions in the world. More autonomy in property and land taxation, and in re-zoning, could be crucial. In addition to funding city development, higher revenue generation from land in cities could also free resources to invest in lagging areas. Land policies touch upon vested interests and elite capture and are difficult to change. While decentralization can potentially reinforce local elites, democratically elected, empowered, and accountable mayors could bring about positive



## Box 8: Tracking on- and off-budget expenditure at the district level in Pakistan

A complete picture of public spending requires including self-accounting public entities. Across most countries there is a strong focus on public financial management information systems, which provide information on spending at local levels. And there is no doubt that strengthening these is important. However, some of the most important government agencies have their own accounts, and their expenditures are often not included in analyses of government expenditures. Expenditure tracking surveys have been conducted to address this issue, but these are costly and are mainly focused on education and thus are not well suited to track municipal spending or infrastructure investments.

The World Bank hence started a pilot for a comprehensive public expenditure database in Pakistan, where state-owned enterprises (SOEs) play a crucial role in service delivery. On-budget data has been collected from PIFRA, which tracks federal, provincial, and district expenditure at the district level and connects expenses to the thematic functions of the government using very detailed descriptions. Off-budget expenditures by SOEs and TMAs have been collected individually. These efforts built heavily on pre-existing personal relationships, substantial trust building, and were very time intensive. The SOEs included in the pilot, covering years 2012/13 and 2013/14, are the Electricity Distribution Companies (DISCOs), Oil and Gas Development Company Limited (OGDCL) and the National Highway Authority (NHA).

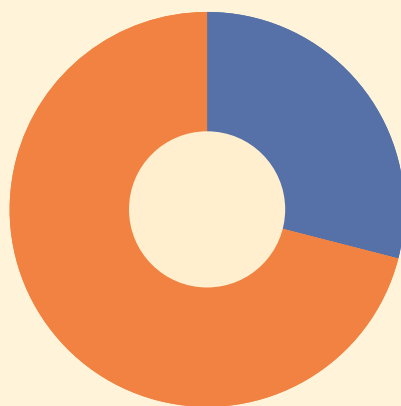
Merging data from the SOEs with the on-budget government data requires three key steps. First, the expenditures need to be made compatible across different accounting procedures. This requires using the Cash Flow Statement of the SOEs included in the accrual-based accounts, published as per the requirement of International Financial Reporting Standards, to convert their spending to a cash basis. Second, SOE expenditures need to be distributed at the district level. Road expenditure of the NHA, for example, has been distributed using kilometers of national roads per district and DISCO expenditure has partly been distributed using the number of consumers or users across districts. Third, SOE expenditure categories need to be merged with PIFRA categories.

PIFRA utilizes very detailed descriptions to connect expenses to thematic functions of the government, and some of the categories are opaque to economic and development questions. Hence, expenditures are re-categorized into eight categories: health, education, infrastructure, social protection, pensions, debt servicing, operational expenses, and others. However, the filter we use is easily adjustable and expenditures can be categorized differently. Development and current expenditures are considered separately, and population data from the 2017 Census is used to approximate per capita expenditures.

**Figure 47: Merged off-budget expenditure amounts to more than a quarter of total public spending.**

Public spending off- and on-budget  
Shares

■ Off-budget  
■ On-budget



**Table 8: Overall infrastructure spending is benefiting richer districts more than only on-budget expenditure.**

	(1)	(2)
	Infrastructure, total per capita	Infrastructure, PIFRA per capita
ln(GDP per capita)	1.12*** (0.25)	0.40** (0.20)
Controls	YES	YES
Observations	103	102
R2 overall	0.52	0.71

Sources: PIFRA, World Bank, and staff calculations.

Notes: GDP per capita is based on nightlights and rural population (World Bank 2017) and controls include dummies for Islamabad, provincial and division capitals. Standard errors in parenthesis; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01.



**Off-budget expenditure is substantial and matters.** The tracked off-budget expenditures amount to over a quarter of total spending. In addition, off-budget expenditure is important across all provinces and nearly all districts, in some of which more than half of the expenditure is not on-budget. Using a district level measure of GDP per capita based on nightlights and population (Beyer *et al.* 2018), it is possible to analyze the relationship between the level of development of a district and its spending patterns. Districts with higher per capita GDP spend significantly more per person on education but not on health. Richer districts also spend more on infrastructure. But considering only on-budget spending (column 2 in Table 8) suggests a much weaker relationship between per capita GDP and infrastructure spending than when off-budget expenditure is included. This is just one example of how providing the full picture of public spending can change our understanding.

change. Currently, even large and economically important cities across the region have no elected mayors, and where they exist, they are often weak. In India, even town planning is still at the state level. While the

empowerment of cities is crucial, without generating more revenue that can free resources to finance development in lagging regions, it may increase spatial heterogeneity.

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## Appendix

### Appendix A3: Global analysis of the distributional effect of decentralizing spending

This analysis covers 82 countries from 1990 to 2017 as a result of merging two different databases. Outcome data was collected from the Global Data Lab. Education outcomes were measured as the expected years of schooling, and health outcomes were approximated by life expectancy. Gross National Income per capita (PPP, 2011 USD) was used as the income variable. Fiscal decentralization is measured as subnational expenditure over total government expenditure. This variable comes from and the IMF's Fiscal Decentralization Database.

**Estimating the impact of fiscal decentralization on the spatial variation of income, education, and health.** The impact of fiscal decentralization on the three outcome variables is estimated using a global pooled regression (Sow and Razafimahefa 2015). To explain the spatial variation within a country we compute the year and country-specific coefficient of variation across regions and regress it on the fiscal decentralization variable of interest. To allow for possible non-linear effects of fiscal decentralization on the spatial variations of the outcomes, the squared term of fiscal decentralization was included. Country-fixed effects were added to control for time-invariant unexplained factors at the country level, and GDP per capita (WDI) was added to avoid omitted variable bias. Finally, fiscal decentralization has been lagged to address endogeneity concerns.

$$Spatial\ variation_{it} = \beta_0 + \beta_1 Lag.FD_{it} + \beta_2 Lag.FD_{it}^2 + \beta_3 Lag.GDPpc_{it} + \gamma_i + \varepsilon_{it}$$

Income, education, health
Variable of interest: fiscal decentralization with quadratic term
Country FEs

### Appendix A4: The effect of higher spending on education in Pakistan

This analysis covers 110 Pakistani districts during FY 2012/13. Data was collected from the Pakistan Social and Living Standards Measurement 2012/13 (PSLM); the Data for Pakistan initiative; the Annual Status of Education Report database 2012 (ASER); and spending data from the Project to Improve Financial Reporting and Auditing database 2012/13 (PIFRA).

**Estimating the effect of education spending on education outcomes.** To estimate the effect, the education outcome variables were defined as years of schooling, school satisfaction and learning outcomes in language and math. Two different specifications were used, and both models included district fixed effects, to control for unexplained factors at a district level, and other control variables related to education spending, as well as to individual and household characteristics.

$$educ_i = \alpha + \beta_1 \ln(spending\_std_d) + \beta_2 female_i + \beta_3 age_i + \beta_4 urban_{hh} + \beta_5 e\_agr_i + \sum_{n=6}^{10} \beta_n X_{hh} + \gamma_d + \varepsilon_i$$

Years of schooling, school satisfaction

$$scores_i = \alpha + \beta_1 \ln(spending\_std_d) + \beta_2 female_i + \beta_3 age_i + \beta_4 owned_{hh} + \beta_5 used_{computer}_i + \beta_6 electricity_{cnx}_i + \beta_7 toilet_i + \beta_8 mobile_i + \beta_9 popdensity_d + \gamma_d + \varepsilon_i$$

### Appendix A5: Estimating the impact of fiscal transfer design aspects in India

This analysis is based on a state-year panel that covers the fiscal years from 2001 to 2017 and a balanced sample of 25 states. Data was collated from different sources, including the Finance Commission reports the Reserve Bank of India's state reports database.

**Estimating the Effect of the Debt Relief Incentive Scheme under the 12<sup>th</sup> Finance Commission.** The effect of the debt relief scheme is estimated using a difference-in-difference approach. The temporal variation for this approach comes from the comparison of the 12<sup>th</sup> and 11<sup>th</sup> Finance Commission. The spatial variation is generated as states with a higher debt burden have a larger incentive to shoulder the cost of revenue deficit reductions in response to the incentive scheme. The regression we estimate is thus:

$$RD_{st} = \beta_0 + \beta_1 \frac{100 \cdot \text{Repayment to Center}_s^{2005}}{\text{Total Expenditure}_s^{2005}} \cdot FC_{12t} + \mu_s + \gamma_t + \varepsilon_{st}$$

The outcome is the revenue deficit in a given state  $s$  in year  $t$ .  $\frac{100 \cdot \text{Repayment to Center}_s^{2005}}{\text{Total Expenditure}_s^{2005}}$  measures the percentage of total expenditure allocated to repaying loans to the center in the baseline year 2005.  $FC_{12t}$  is a dummy variable for the 12<sup>th</sup> Finance Commission period and  $\mu_s$  and  $\gamma_t$  capture state and year fixed effects respectively. The coefficient of interest is  $\beta_1$ , which measures the differential change between the 12<sup>th</sup> and 11<sup>th</sup> Finance Commission between states with higher and lower repayments to center, relative to total expenditure.

**Estimating the Impact of Conditional Finance Commission Grants.** Estimates are obtained through a 2-SLS procedure which first predicts transfers received by whether a state has special category status and how this was treated under a given Finance Commission through the following equation:

$$FC\_Transfer_{st} = \alpha_0 + \alpha_1 SCS_s \cdot FC_t^{12} + \alpha_2 SCS_s \cdot FC_t^{13} + \alpha_3 SCS_s \cdot FC_t^{14} + \mu_s + \gamma_t + \varepsilon_{st}$$

The variable  $SCS_s$  denotes a dummy for a special category state, and the variable  $FC_t^i$  denotes an indicator that takes the value 1 if a given year falls under the  $i$ -th Finance Commission period, and 0 otherwise. The predicted values from this regression are then used to estimate the parameters of interest in the following specification:

$$y_{st} = \beta_0 + \beta_1 FC\_Transfer_{st} + \beta_2 Earmarked\_Share_{st} \cdot FC\_Transfer_{st} + \beta_3 Earmarked\_Share_{st} + \mu_s + \gamma_t + \varepsilon_{st}$$

The outcome variable,  $y_{st}$ , captures state-level expenditure normalized to represent expenditure in per capita terms and the term  $FC\_Transfer_{st}$  captures the share of transfers received in a given state and given year that were earmarked for a specific purpose. The coefficient of interest is  $\beta_2$ , which captures the difference in the effect of transfers on fiscal outcomes from marginally increasing the earmarked share.

**Estimating the Effect of Education Grants under the 13th Finance Commission.** The estimation of the effect of the tied education grants on spending under the 13<sup>th</sup> Finance Commission leverages a difference-in-difference design, where the temporal variation comes from the start of the 13<sup>th</sup> Finance Commission period and the pre-treatment period is the 12<sup>th</sup> Finance Commission period. To obtain special variation, we define a continuous treatment variable measured as the share of education grant allocation to baseline education expenditure in 2001. This series is scaled by a factor 0.2 to make the coefficient interpretable as the treatment effect of receiving a grant that covers 20 percent of baseline education expenditure (compared with receiving no grant):

$$y_{st} = \beta_0 + \beta_1 \frac{100 \cdot 0.2 \cdot \text{Education Grant}_s^{13FC}}{\text{Education Exp.}_{2001}} \cdot FC_{13t} + \mu_s + \gamma_t + \varepsilon_{st}$$

The primary outcome variables we consider are (log) education expenditure and (log) non-education expenditure.  $FC_{13}$  denotes a time dummy that takes the value 1 for all observations within the 13<sup>th</sup> Finance Commission period. The regression also includes state and year fixed effects. The coefficient of interest is  $\beta_1$ , which measures the differential change between the 13<sup>th</sup> and 12<sup>th</sup> Finance Commission between states with higher and lower education grant allocations.

## Appendix A6: Maps on subnational education expenditure and outcome variables

The analysis covers five South Asian countries: Afghanistan, India, Pakistan, and Sri Lanka for 2016 and Bangladesh for 2010. Data on education outcomes (expected years of schooling) was collected from the Global Data Lab for all countries except for Sri Lanka, for which it comes from the Household and Income Survey. The education expenditure data comes from the World Bank Boost Initiative (except for India and Sri Lanka) and makes use of the COFOG functional and economic classifications to identify what corresponds to education expenditure. In the case of India, expenditure data comes from the Reserve Bank of India and has been linked to the COFOG classification. For Sri Lanka, it comes from a recent World Bank (2019) report on human capital. Subnational education expenditure is put in per capita terms using population data from the Global Data Lab. Expenditure data disaggregation varies by country; for India it is at the state level but for other countries it is more disaggregated.

To carry out the analysis, three perspectives were adopted: need, outcome and performance. For each of them the regional expenditure per capita is identified to be either above or below the country average and the education needs, the education outcome and the change in the education outcome are identified as above or below the country average. This way we present three different perspectives with four categories that mix the situation in the expenditure and the need/outcome side. Needs and outcomes are exactly the opposite of each other.

## Appendix A7: New research on decentralization: A summary of the 4<sup>th</sup> South Asia Economic Network Conference

In preparation for this report, the World Bank co-organized a regional academic conference with the South Asia Network on Economic Modelling (SANEM). For this two-day event, young researchers, practitioners and experts from five South Asian countries came together to discuss challenges in subnational finance and local service delivery in their countries.

**The role of local governance institutions, their capacity to function and their fiscal autonomy are at the center of the discussion of fiscal decentralization and efficient service delivery in South Asia.** Monzur Hossain (Bangladesh Institute of Development Studies) does not find a strong impact of improved administrative governance on local economic development in Bangladesh. However, training programs for local government officials, the number of parishad meetings, and the total number of schemes implemented over the previous year positively affected perceived outcome indicators. Dr. Ahsan Mansur (Executive Director, Policy Research Institute Bangladesh) highlighted the strong centralization of power in Bangladesh and emphasized that local governments lack not just resources, but also authority to perform their assigned functions. The Minister of Planning for Bangladesh, MA Mannan, shared similar sentiments in the inaugural session and agreed that one of the biggest challenges hindering progress in Bangladesh is the absence of well-functioning local government institutions. But these challenges are not restricted to Bangladesh only. Manish Gupta (National Institute of Public Finance and Policy, India) concluded that India's State Finance Commissions have so far had very little impact on improving state-local fiscal relations, addressing vertical and horizontal fiscal imbalances, or increasing access to public amenities. Dr. Ishrat Husain (Advisor for Institutional Reforms and Austerity to the Prime Minister of Pakistan) presented Pakistan's efforts to bring decision making closer to the people in KP and Punjab in Pakistan, for example by establishing separate rural and urban governance bodies as well as municipal and town bodies with locally elected representatives. Historically, the empowerment of local governments in Pakistan was mostly done by military regimes. He also discussed the need to bring competition among districts for efficiency of service delivery and accountability of local governments.

**Even for access to local governments, social networks and personal access play an important role.** Atonu Rabbani (University of Dhaka, Bangladesh) finds that personal contacts and connections to local representatives have a significant impact on access to social pension benefits and other targeted programs. He confirms a strong mistargeting for social pensions, which is partly explained by representatives being unaware of eligibility criteria and allocating pensions to individuals with higher social capital, as well as higher income and assets. Similarly, Saheli Bose (Jadavpur University, India) shows that social connections, network strength and links with influential households matter for the allocation of household public goods through local governments in West Bengal. In addition to the location, a household's own network strength as well as those of its peers and neighbors play a significant role in obtaining a higher number of benefits from the local government. Panchali Banerjee (Jadavpur University, India) suggested that an increase in fiscal devolution to local governments led to a significant decrease in corruption in public service delivery, whereas an increase in tax devolution led to a significant increase in corruption in public service provisioning in India. Bushra Yasmin (Fatima Jinnah Women University, Pakistan) suggested that decentralization in Pakistan is not yet strong enough to reduce public corruption effectively and that the current system characterized by an absence of strict monitoring and evaluation of processes still allows for rent-seeking behavior.

**With continued urbanization in South Asia, the issues of urban planning and urban service delivery become more important.** Bilesha Weeraratne (Institute of Policy Studies, Sri Lanka) highlighted that solid waste management at the local level in Sri Lanka is punctured with financial issues intertwined with low integrity of elected officials, low transparency, and high corruption. Leena Bhattacharya (Indira Gandhi Institute of Development Research, India) argued that the inclusivity of slums in urban planning policies has done little to equalize living conditions and that the conditions in slums related to sanitation, water supply and housing remained dismal despite various initiatives for equitable sustainable development, such as the Jawaharlal Nehru National Urban Rural Mission (JNNURM) and Smart City Mission. In a special lecture, Dr. Isher Judge Ahluwalia (Chairperson, Indian Council for Research on International Economics) discussed underrepresentation of urban voters and an inadequate power devolution to urban governments reflected, for example, by town planning remaining at the state level. In addition, few majors in India are elected and even those are not sufficiently empowered.

**Two of the most decentralized function in South Asia are education and health, two areas crucial to development outcomes.** Mutawakkil Ahmad Abbasi (PIDE School of Public Policy, Pakistan) showed that devolution of education in Khyber Pakhtunkhwa resulted in better student performance, increased enrollment in government schools, and a significant move of students from private schools to public schools. Ashani Abayasekara (Institute of Policy Studies, Sri Lanka) found evidence that additional funds for schools to be spent at their discretion had some benefits for teaching and learning outcomes, but that the effective use of these funds was negatively affected by delays in receiving them, difficulties in following the rules of the Ministry of Education, issues in procurement of goods, and a lack of clarity on what the funds could be used for. Gopi Khanal (National Natural Resource and Fiscal Commission, Nepal) found no evidence that more own revenue generation, in contrast to more equalization funds, result in higher subnational spending on health and education. Megha Rao (Indian Institute of Management, India)







identified a strong variation in the degree of decentralization in different health subsectors within Karnataka, with high levels of local discretion over funds for nutrition but abysmal financial jurisdiction over most other spheres of public health. In addition, she provided evidence for poor allocative efficiency across districts.

Researchers and policy experts seemed to agree that a further empowerment of local governments can improve local service delivery. One important tool mentioned frequently was the need to expand the taxing power of local governments. Dr. Ahsan Mansur emphasized that tax revenues account for only a small share of total resources of local governments, and that the top priority should be to strengthen the system of property taxation through proper and computerized land records, proper land and property valuation, and sensible tax rates. Participants also seemed to agree that elected local government representatives should oversee public service delivery and resource management instead of professional civil servants, as elected officials are accountable to the community. Dr. Selim Raihan pointed to the lack of political will in Bangladesh to empower local governments and an inclination towards deal-based fiscal transfers as opposed to rule-based ones. Dr. Ishrat Husain and Dr. Isher Ahluwalia pointed to the need for a complementary relationship between the federal and the local governments instead of an adversary one to ensure efficient service delivery. And Dr. Hans Timmer emphasized the importance of competition for efficient service delivery, the need for structured land policies, and the issues of lacking data to assess progress effectively. Finally, everyone seemed concerned with growing elite capture in the region and many acknowledged that further decentralization may come into conflict with vested interests.

### Papers Presented:

**Ashani Abayasekara**, Nisha Arunatilake and Priyanka Jayewardena (all Institute for Policy Studies, Sri Lanka): Formula Based School Funding and Improving Education Service Delivery in Sri Lanka

**Atonu Rabbani** (University of Dhaka, Bangladesh), Viola Asri, Kumar Biswas, Sebastian Fehrer, Urs Fischbacher (all University of Konstanz) and Katharina Michaelowa (University of Zurich): Why contacts matter: Local governance and the targeting of social pensions in Bangladesh

**Bilesha Weeraratne** (Institute for Policy Studies, Sri Lanka): Subnational Financing and Local Service Delivery: The Case of Solid Waste Disposal in Sri Lanka

**Bushra Yasmin** (Fatima Jinnah Women University, Pakistan): Role of Fiscal Decentralization in Corruption: An Empirical Evidence from Pakistan

**Gopi K Khanal** (National Natural Resources and Fiscal Commission, Nepal) and Bishal K. Chalise (Niti Foundation, Nepal): Role of local government finance in improving public service delivery in Nepal

**Leena Bhattacharya** (Indira Gandhi Institute of Development Research, India): Has urban planning improved living conditions in slums? Evidence from million plus cities in India

**Manish Gupta and Pinaki Chakraborty** (both National Institute of Public Finance and Policy, India): Strengthening Local Government Finances and Service Delivery - Role of State Finance Commissions in India

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# SOUTH ASIA COUNTRY BRIEFS

58





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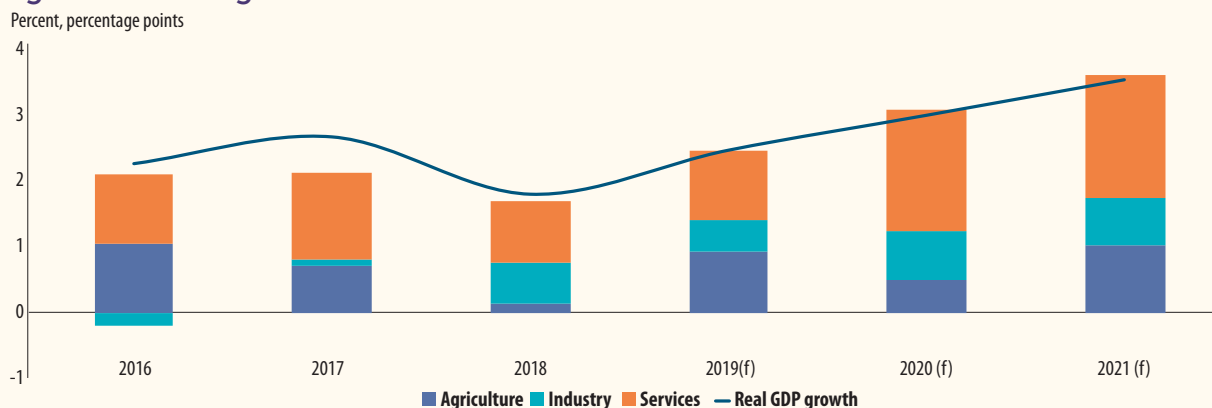
# Afghanistan

After a slowdown in 2018, growth is expected to slightly recover in 2019 with improved farming conditions. However, the economic outlook remains highly susceptible to elevated political and security risks from the presidential elections and the uncertain prospects of peace talks. Any rapid decline in aid flows would pose risks to fiscal and external sustainability, as well as the capacity to maintain basic services. Accelerated reform and improved security conditions are critical to accelerate growth, mobilize economic potential, and help alleviate poverty from its current high levels.

	2018
Population, million	36.4
GDP, current USD billion	19.5
GDP per capita, current USD	536.9
School enrollment, primary (percent gross) <sup>a</sup>	54.5
Life expectancy at birth, years <sup>a</sup>	64.0

Sources: WDI, World Bank, and official data.  
Note: (a) Most recent WDI value (2017)

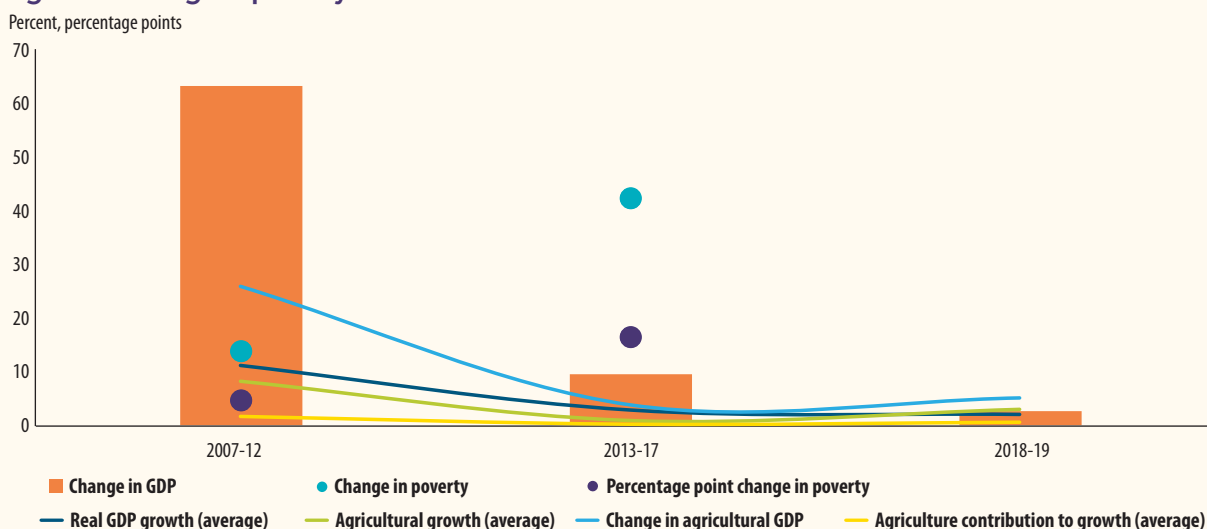
**Figure 1: Real GDP growth and contributions.**



Source: World Bank.

Notes: (f) = forecast. Afghanistan's fiscal year is the calendar year.

**Figure 2: Change in poverty rate.**



Source: World Bank.

Note: Afghanistan's fiscal year is the calendar year.

## Recent economic developments

Afghanistan faced severe economic headwinds in 2018, with the economy growing by an estimated 1.8 percent. Severe drought had a strong negative impact on agriculture. Confidence deteriorated significantly in the context of elevated uncertainty around: i) the level of international security assistance; ii) the outcome of upcoming presidential elections in September and the potential for election-related violence; and iii) uncertain prospects for peace negotiations with the Taliban.

Despite drought conditions, benign global food inflation and increased food imports kept inflation at a moderate 0.6 percent (period average). Inflation accelerated in 2019 to 4 percent y-o-y in July, reflecting higher prices of cereals and dry fruits.

The trade deficit widened in 2018 to 35.3 percent of GDP due to weaker export growth and a moderate increase in imports. As a result, the current account surplus narrowed to 0.6 percent of GDP. Grants, although lower than in 2017, financed almost all of the trade deficit. In the first quarter of 2019, export growth accelerated to 14 percent y-o-y while imports declined by 7 percent.

The exchange rate depreciated by nine percent against the USD during 2018, mainly driven by the strengthening of the USD against major currencies. However, the nominal appreciation of the afghani against other major trading partners' currencies contributed to lower imported inflation. Depreciation of the afghani against the USD further accelerated over the first half of 2019 amid continued strengthening of the USD in the region and declining confidence in the context of upcoming elections. Gross international reserves increased slightly to USD 8.3 billion, enough to cover around 12 months of imports.

Fiscal performance was strong in 2018, with a surplus of 0.7 percent of GDP. Domestic revenue collection grew by 12 percent in 2018, reaching a record high of Afs 189.6 billion (13.4 percent of GDP). Higher revenues were supported by improved tax administration, with estimated arrears collection of Afs 10.5 billion and a surge in non-tax revenues from state-owned enterprises. Revenue growth continued strong in the first half of 2019, with a 22 percent y-o-y increase over the first seven months. Budget execution also improved, to 92 percent in 2018 from 83 percent in 2017. Progress continued in 2019, as budget execution reached 47 percent (of the total year's expenditure) by end-July, largely because of improved development budget execution.

Poverty in 2018 is likely to have increased from an already high poverty headcount of 55 percent in 2016-17. The rate of economic growth substantially lagged population growth, leading to declining per capita income. The 2018 drought adversely affected rural livelihoods and increased food insecurity, especially since 40 percent of the population relies on agriculture as an income source. Reflecting widespread hardship, drought-induced displacement reached the record level of 298,582 individuals, mainly to urban areas in adjacent provinces.

## Outlook

Improved weather conditions are expected to help growth recover slightly in 2019, to around 2.5 percent. Performance of the industry and services sectors will likely remain subdued, given heightened political instability surrounding the upcoming presidential elections and elevated uncertainties over peace negotiations and international security support. Over the medium term, assuming a stable political transition following the presidential election and a subsequent improvement in investor confidence, growth is expected to accelerate to 3 percent in 2020 and 3.5 percent in 2021. Inflation is expected to increase to 3.1 percent in 2019 and stabilize at around five percent in the medium term.

The trade deficit is expected to improve slightly over the medium term but to remain at around 30 percent of GDP. The current account is however expected to deteriorate gradually due to declining international grants, resulting in a deficit of around two percent of GDP by 2021-22. International reserves will decline reflecting the deteriorating external position but will still stay at a comfortable level at slightly less than eight months of imports.

A small fiscal deficit is expected in 2019. Revenue mobilization is expected to slow during the second half of the year, reflecting: i) limited room for further revenue mobilization through measures such as the tax amnesty scheme implemented in 2018; and ii) declining customs revenues in the context of political uncertainty and weakened governance. Both security and civilian grants are expected to decline substantially, leading to increased fiscal pressures. With limited access to debt financing, the overall debt-to-GDP ratio is expected to remain low at around 7 percent.

Despite improved farming conditions and its potential for employment gains, poverty is unlikely to decline in 2019, as growth rates and incomes in agriculture would need to increase substantially to realize welfare gains. Stronger economic growth, accompanied by improved security conditions, would be needed to lift substantial numbers of Afghans out of poverty.

## Risks and challenges

Economic prospects are subject to substantial downside risks. In the short-term, election-related political instability and disruptions to revenue collections could further undermine growth and fiscal stability. Over the medium-term, any rapid decline in international aid flows would result in difficult fiscal and external adjustments and undermine the capacity of the government to maintain basic services.

Political and security risks will remain elevated in the context of the recent cancellation of peace negotiations in September. While the future course of peace negotiations is subject to substantial uncertainty, sustained and comprehensive improvement in security, achieved through political settlements, could boost confidence

and bring economic dividends. The impact of any political settlement, however, will depend on whether peace can be sustained and how the broader post-conflict institutional environment evolves.

Reforms are required to both improve general investment confidence and mobilize the country's economic

potential, especially in agriculture and extractives. Continued international assistance in security and development is critical to preserve development gains achieved over the last seventeen years. A clear commitment to sustained support from international partners would help to reduce current levels of uncertainty and raise confidence and investment.

**Table 2: Macro poverty outlook indicators (annual percent change unless indicated otherwise).**

	2016	2017	2018	2019 (f)	2020 (f)	2021 (f)
<b>Real GDP growth, at constant market prices</b>	2.4	2.7	1.8	2.5	3.0	3.5
Private consumption	-0.2	4.3	1.2	2.0	2.3	2.2
Government consumption	0.3	1.5	4.2	4.9	1.5	2.3
Gross fixed capital investment	-6.0	6.4	0.5	3.1	2.8	2.9
Exports, goods and services	-0.3	7.0	5.0	10.0	12.0	15.0
Imports, goods and services	25.8	8.0	1.0	3.6	2.5	2.4
<b>Real GDP growth, at constant factor prices</b>	2.0	2.2	1.8	2.5	3.0	3.5
Agriculture	6.0	3.8	0.8	4.5	3.0	5.5
Industry	-0.8	0.4	2.5	2.5	3.0	3.0
Services	2.0	2.5	1.8	1.9	3.1	3.1
<b>Inflation (consumer price index)</b>	4.3	4.7	0.6	3.1	5.0	5.0
<b>Current account balance (percent of GDP)</b>	5.6	1.0	0.6	-1.6	-2.7	-2.4
<b>Net foreign direct investment (percent of GDP)</b>	-0.1	-0.1	-0.1	-0.1	0.1	0.1
<b>Fiscal balance (percent of GDP)</b>	0.1	-0.5	0.6	-0.9	-0.6	-0.3
<b>Debt (percent of GDP)</b>	6.1	5.9	6.9	7.1	7.1	7.1
<b>Primary balance (percent of GDP)</b>	0.2	-0.4	1.7	0.0	0.3	0.6

Source: World Bank.  
Note: (f) = forecast.





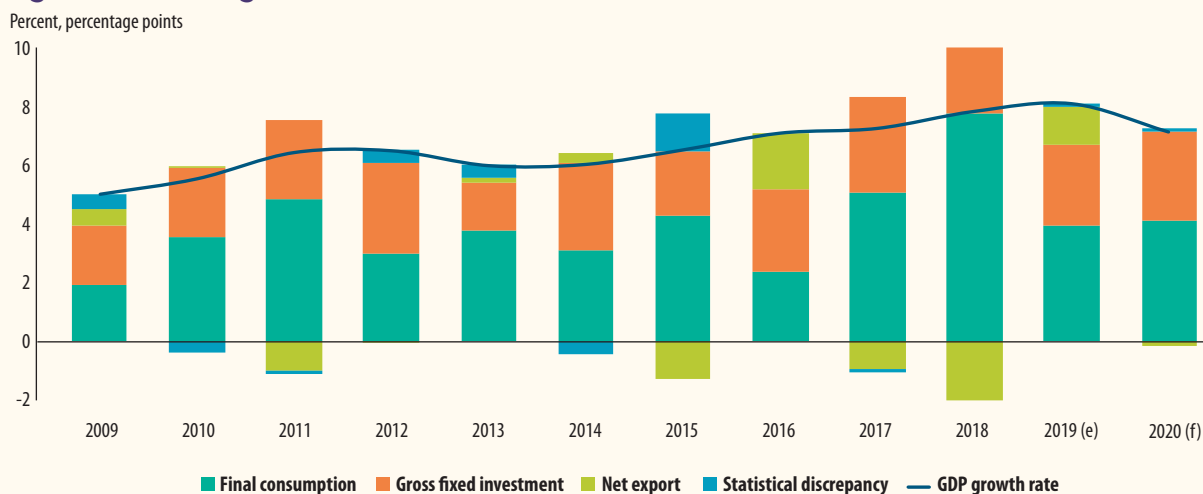
# Bangladesh

Rising exports and remittances underpinned manufacturing-led growth in FY19, thus reducing the current account deficit. Inflation, driven by growing domestic demand, was tempered by strong agricultural output. The fiscal deficit persisted as revenues continued to underperform. Over the medium-term, growth is expected to remain above 7 percent, supporting continued poverty reduction. Risks to the outlook include rising financial sector vulnerability, fiscal pressures, and loss of external competitiveness as the real exchange rate appreciates.

	2018
Population, million	166.9
GDP, current USD billion	274.1
GDP per capita, current USD	1642.0
International poverty rate (USD 1.9) <sup>a</sup>	14.8
Lower middle-income poverty rate (USD 3.2) <sup>a</sup>	52.9
Gini index <sup>a</sup>	32.4
School enrollment, primary (percent gross) <sup>b</sup>	111.1
Life expectancy at birth, years <sup>b</sup>	72.8

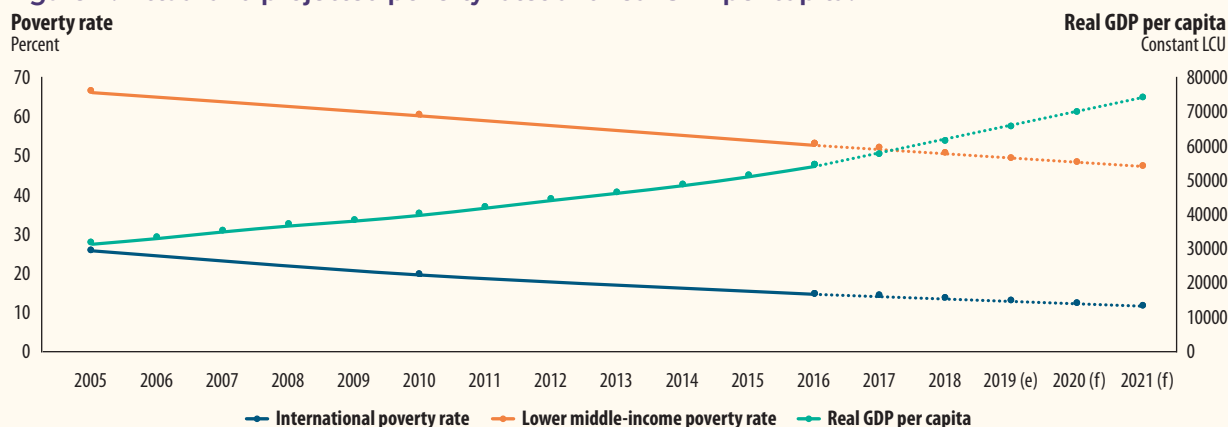
Sources: WDI, World Bank, and official data.  
Notes: (a) Most recent value (2016), 2011 PPPs; (b) Most recent WDI value (2017).

**Figure 1: Real GDP growth and contributions.**



Sources: Bangladesh Bureau of Statistics (BBS) and staff calculations.  
Notes: (e) = estimate; (f) = forecast.

**Figure 2: Actual and projected poverty rates and real GDP per capita.**



Source: World Bank.  
Notes: (e) = estimate; (f) = forecast. Calculations based on SAR-POV harmonization, using 2010-HIES and 2016-HIES. Actual data: 2016. Nowcast: 2017-2018. Forecast are from 2019 to 2021.

## Recent economic developments

Real GDP growth is estimated at 8.1 percent in FY2019, up from 7.9 percent in FY2018. On the demand side, growth was underpinned by higher net exports and increased consumption. Diversion of garment export orders from China boosted exports while record remittances of USD 16.4 billion in FY2019 boosted private consumption. On the supply side, growth was driven by industry and services. Manufacturing contributed 3.2 percentage points to growth while services contributed another 3.3 percentage points.

Inflation decreased to 5.5 percent in FY2019 from 5.8 percent the previous year, remaining within the Bangladesh Bank (BB) target. The decline was primarily driven by falling rice prices. The BB Monetary Policy announcement of July 2019 kept a 12.5 percent target for broad money growth. The main policy interest rate (repo rate) was unchanged at 6 percent, and the reverse repo rate remained at 4.75 percent.

Non-performing loans (NPLs), which rose to 11.9 percent of bank assets at end-March 2019 from 10.8 percent a year ago, have constrained financing for private investment. Recent policy changes have allowed defaulters to re-schedule loans on easy terms, while the easing of loan classification standards has obscured accurate measurement of NPLs. In addition, commercial lending rates have averaged 9.5 percent in FY2019 despite government efforts to reduce rates below 9 percent. As a result, private sector credit grew only by 11.3 percent during FY2019. In contrast, credit to the public sector grew by 19.1 percent, driven by the resumption of central government borrowing from domestic banks to finance the deficit.

The current account deficit (CAD) declined from 3.5 percent of GDP in FY2018 to 1.7 percent in FY2019, supported by higher net exports and record remittances. A lower CAD was coupled with increased foreign direct investment (FDI) resulting in a small balance of payment surplus. With a strengthening dollar, the BB sold USD 2.3 billion in the foreign exchange market in FY2019 to stabilize the taka-dollar exchange rate. As a result, the real effective exchange rate appreciated by 5.6 percent and gross foreign exchange reserves declined from 6.2 months equivalent of imports at the end of FY2018 to 5.8 months at end-June 2019.

The fiscal deficit remains high, estimated at 4.4 percent of GDP in FY2019. Both revenues and spending underperformed during the year. Revenues remained modest, at 10.3 percent of GDP due to a narrow tax base and limited implementation of administrative reforms. After a seven-year delay, the implementation of a new VAT law began in July 2019 but with multiple rates for different types of goods and services, the complexity of the VAT regime has increased. The Annual Development Program (ADP) execution rate improved in FY2019 and domestic financing of the deficit has shifted to bank borrowing, a departure from the practice of relying on expensive national savings certificates.

Strong growth in garment exports, buoyant remittances, faster growth in nominal wages relative to inflation, particularly in agriculture and services, and a decline in food inflation have sustained poverty reduction. The

Rohingya crisis, the July floods and recent fires in the slums of Dhaka underscore the continued vulnerability of large swathes of the population and demonstrate the case for a spatial approach to poverty reduction.

## Outlook

Bangladesh is likely to maintain GDP growth above 7 percent, supported by strong macroeconomic fundamentals, faster implementation of public investments in megaprojects, higher domestic demand aided by remittances and continued export growth as production shifts further from China. Private investment may also rise in response to the ongoing Doing Business reforms and operationalization of the new economic zones. Inflation is projected to rise due to an increase in natural gas prices and possible crop failures due to the recent floods.

A modest increase in the current account deficit is likely, as strong investment-driven import growth is likely to outweigh export and remittance growth. FDI is expected to rise due to regulatory reforms, infrastructure developments and stable political conditions. Increased investment will support job creation and contribute to poverty reduction. Revenue underperformance together with increased spending on subsidies (on exports, remittances and LNG) and megaprojects is likely to increase the fiscal deficit in FY2020. Public debt was 32.8 percent of GDP at the end of FY2019, with a low risk of debt distress.

## Risks and challenges

Downside risks include financial sector vulnerability, reform reversals, fiscal pressures and loss of external competitiveness. Increased NPLs, enforcement of a blanket ceiling on lending rates and increased government borrowing from banks could crowd out credit to the private sector. Lack of progress in modernizing tax administration may result in revenue shortfalls while higher spending and donor fatigue in response to the Rohingya crisis could add to fiscal pressures.

External risks are balanced. Tariff escalation by the US against China may provide a further boost to exports in the short run if Bangladesh can capture some of the trade diversion. However, recession in European and US export markets and appreciation of Bangladesh's real exchange rate would adversely impact export demand and remittances.

Moving forward, resolving fragile banks, accelerating ongoing business regulatory reforms, addressing exchange rate overvaluation and deepening fiscal reforms are immediate priorities. Key structural challenges that need to be addressed include reducing the infrastructure deficit, enhancing human capital, improving urban management, and managing climate change risks. Emerging spatial inequalities warrant greater attention. Progress in poverty reduction in the (north) west needs significant acceleration through improvements in human development and structural transformation outcomes.

**Table 2: Macro poverty outlook indicators (annual percent change unless indicated otherwise).**

	2016	2017	2018	2019 (e)	2020 (f)	2021 (f)
<b>Real GDP growth, at constant market prices</b>	7.1	7.3	7.9	8.1	7.2	7.3
Private consumption	3.0	7.4	11.0	5.4	6.2	6.4
Government consumption	8.4	7.8	15.4	8.0	8.1	10.6
Gross fixed capital investment	8.9	10.1	10.5	8.2	9.1	8.7
Exports, goods and services	2.2	-2.3	8.1	14.9	8.0	8.3
Imports, goods and services	-7.1	2.9	27.0	4.8	8.1	8.5
<b>Real GDP growth, at constant factor prices</b>	7.2	7.2	7.9	8.3	7.2	7.3
Agriculture	2.8	3.0	4.2	3.5	3.0	3.1
Industry	11.1	10.2	12.1	13.0	9.0	10.0
Services	6.2	6.7	6.4	6.5	7.0	6.5
<b>Inflation (consumer price index)</b>	5.9	5.4	5.8	5.5	5.9	5.7
<b>Current account balance (percent of GDP)</b>	1.9	-0.5	-3.5	-1.7	-2.0	-2.2
<b>Net foreign direct investment (percent of GDP)</b>	0.6	0.7	0.6	0.8	0.8	0.8
<b>Fiscal balance (percent of GDP)</b>	-3.7	-3.4	-4.7	-4.4	-4.8	-4.7
<b>Debt (percent of GDP)</b>	31.5	30.8	31.9	32.8	33.8	34.8
<b>Primary balance (percent of GDP)</b>	-1.8	-1.6	-2.8	-2.5	-2.6	-2.4
<b>International poverty rate (USD 1.9 in 2011 PPP)<sup>a,b</sup></b>	14.8	14.1	13.5	12.8	12.3	11.7
<b>Lower middle-income poverty rate (USD 3.2 in 2011 PPP)<sup>a,b</sup></b>	52.9	51.7	50.6	49.3	48.3	47.2

Source: World Bank.

Notes: (e) = estimate; (f) = forecast. (a) Calculations based on SAR-POV harmonization, using 2010-HIES and 2016-HIES. Actual data: 2016. Nowcast: 2017-2018. Forecast are from 2019 to 2021. (b) Projection using point-to-point elasticity (2010-2016) with pass-through = 1 based on GDP per capita in constant LCU.



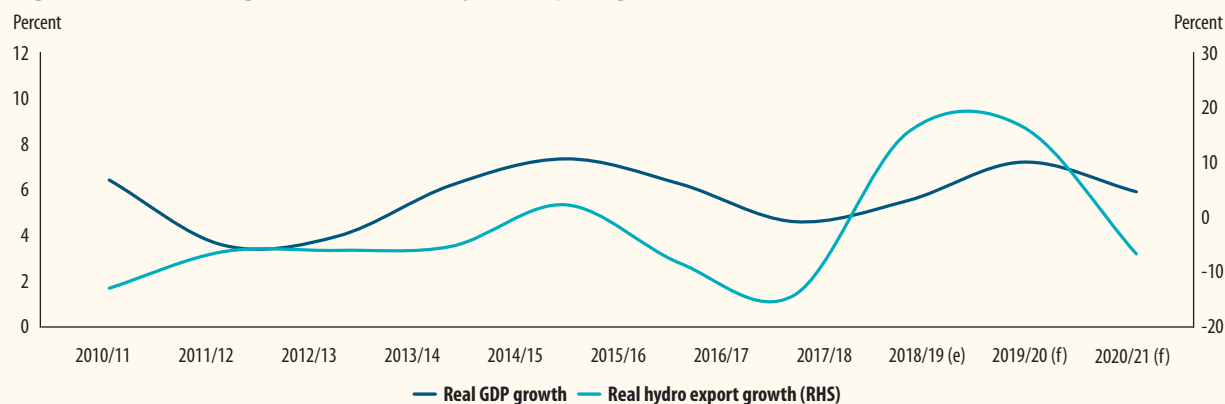
# Bhutan

Growth in Bhutan is forecast to accelerate to 7.4 percent in FY2020 with the commissioning of a new power plant and the completion of maintenance work in another. Tourism is emerging as a secondary driver of growth and, together with electricity exports, has contributed to a narrowing of the current account deficit. The primary risks to fiscal sustainability and growth stem from delays in completing hydro-megaprojects. Poverty measured using the USD 3.20 poverty line is projected to fall from 11.2 percent of the population in 2018 to 9.9 percent in 2019.

	2018
Population, million	0.7
GDP, current USD billion	2.5
GDP per capita, current USD	3397.8
International poverty rate (USD 1.9) <sup>a</sup>	1.5
Lower middle-income poverty rate (USD 3.2) <sup>a</sup>	12.0
Upper middle-income poverty rate (USD 5.5) <sup>a</sup>	38.6
Gini index <sup>a</sup>	37.4
School enrollment, primary (percent gross) <sup>b</sup>	92.6
Life expectancy at birth, years <sup>b</sup>	70.6

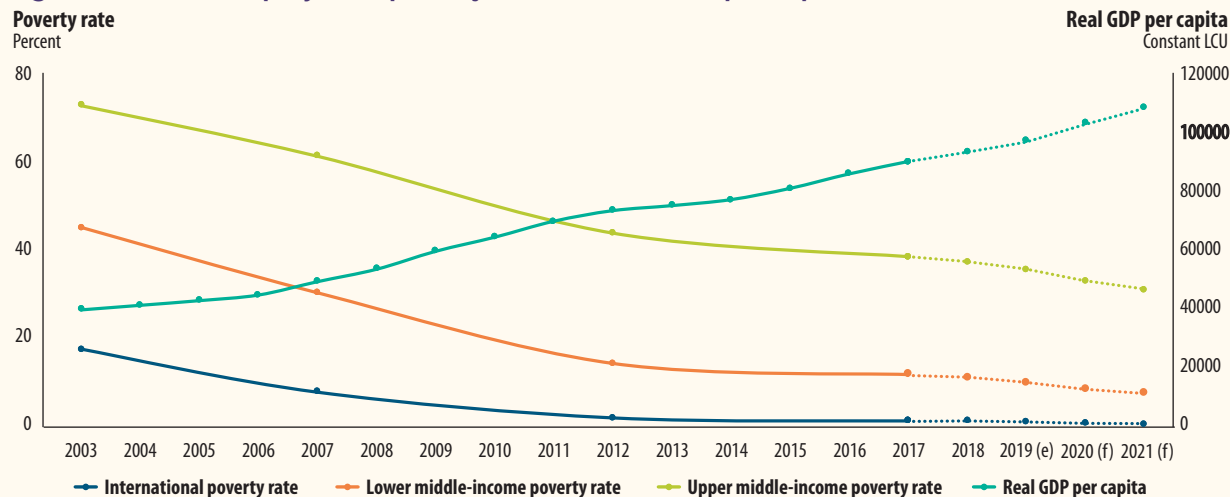
Sources: WDI, World Bank, and official data.  
Notes: (a) Most recent value (2017), 2011 PPPs; (b) Most recent WDI value (2017).

Figure 1: Real GDP growth and non-hydro export growth.



Sources: Government of Bhutan and staff calculations.  
Notes: (e) = estimate; (f) = forecast.

Figure 2: Actual and projected poverty rates and real GDP per capita.



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

## Recent economic developments

Bhutan's economy continues to be dominated by hydropower and its economic relationship with India. Growth is estimated to have rebounded to 5 percent in FY2019 after a deceleration to 4.6 percent in FY2018 due to maintenance and on-boarding delays on two major power plants (Tala and Mangdechhu). On the demand side, growth was underpinned by exports and consumption, reflecting the progress in hydro-power maintenance and a procyclical public demand response to the associated income inflows. Services remain the main driver of growth on the supply side, where wholesale and retail trade has emerged as the key contributing sub-sector.

Approximately 80 percent of Bhutan's imports are from India, and the Bhutanese Ngultrum is pegged to the Indian Rupee. Thus, inflation between the countries is closely linked. FY2019 began with a slowdown in inflation, hitting a low of just above 2 percent in July 2018 before gradually increasing to 3.1 percent in April 2019 due to food and oil price dynamics. The exchange rate has followed the appreciation of the Indian Rupee in recent months, decreasing from 70.78 BTN per USD to about 69 BTN per USD in August 2019.

Developments in the hydropower sector also contributed to a narrowing of the current account deficit to 16.3 percent of GDP in FY2019, as exports from the Tala plant expanded after the conclusion of maintenance work. At the same time, tourist arrivals increased by 8 percent in FY2019, contributing to the growth of service exports. The current account deficit was primarily financed through capital inflows from India. Foreign exchange reserves cover nearly 10.1 months of imports.

Bhutan has maintained its course of sustainable public finances, with the fiscal deficit estimated to have reduced to 2.1 percent of GDP in FY2019, from 4.6 percent two years prior. This reflects revenue growth from reforms that increased the corporate income tax base and changed the valuation rules for sales tax on vehicles in FY2018, and a slowdown in the initiation of new capital projects which limited spending growth. Government debt is estimated at 109.3 percent of GDP and is considered sustainable due to a special financing arrangement with India, which covers construction risks of hydropower plants and guarantees a return on surplus power purchases.

Little progress was observed in the labor market as labor force participation fell from 65.7 percent in 2017 to 62.6 percent in 2018. Agriculture contributes only 10 percent to GDP but accounts for 54 percent of employment. Working in agriculture is highly correlated with being poor: about 66 percent of poor household heads work in agriculture. Increases in agricultural exports and productivity helped reduce poverty in recent years. Extreme poverty at USD 1.90 per day is almost eliminated, a laudable achievement. The USD 3.20 poverty rate (in 2011 PPP) is estimated to have declined from 12 percent in 2017 to 11.2 percent in 2018. Hydropower is capital intensive and contributes little to job creation.

Overall unemployment is low, but high youth unemployment represents Bhutan's challenge to create more and better jobs.

## Outlook

Growth is expected to edge up to 7.4 percent in FY2020 on the back of increased hydropower exports from the newly on-boarded Mangdechhu plant. In the medium term, growth is expected to stabilize between 5 and 6 percent, supported by the initiation of new public investment projects under the 12th Five Year Plan and the construction of the Punatsangchhu I and II hydro plants.

Inflation is expected to increase moderately in the near term, following a strong growth outlook in India and firming food and fuel prices. Increased hydropower exports are expected to narrow the current account deficit further, to 10 and 7 percent of GDP in FY2020 and FY2021, respectively.

The fiscal outlook for Bhutan foresees a joint expansion of revenue and expenditure that will temporarily widen the fiscal deficit to 4.9 percent of GDP by FY2021. Revenue growth is expected due to increased hydro revenue from the Mangdechhu power plant and the introduction of a green tax on fuel and a goods and services tax (GST). Expenditure growth in the short-term is expected to outpace revenue growth due to increased investments in non-hydro projects as part of the 12th Five-Year-Plan and public sector wage increases.

Poverty reduction will continue at a modest pace in the near term. The USD 3.20 poverty rate is expected to decline to 9.9 percent in 2019 and 8.7 percent in 2020. Diversification into non-hydropower sectors remains the key challenge to accelerating job creation in non-farm sectors. Maximizing the growth potential of the tourism sector could significantly contribute to jobs and income growth, especially among the rural poor and low-skilled. As poverty is almost exclusively rural, efforts to develop agribusinesses and increase agricultural productivity will need to continue, by investing in the downstream value chain.

## Risks and challenges

Given its dependence on the hydropower sector, the main risks to Bhutan's growth and fiscal situation relate to delays and maintenance outages of planned and existing powerplants, which would delay the large expected export and revenue payoffs. Mitigating these risks requires reforms that support the development of a private sector that can complement growth from hydro, a diversification of public revenue sources towards domestic non-hydro tax bases, and a smoothing of the trajectory of public spending to reduce its responsiveness to contemporaneous revenue increases. The labor force is young and increasingly educated, presenting a unique opportunity to reap the demographic dividends, provided that job creation can keep pace.

**Table 2: Macro poverty outlook indicators (annual percent change unless indicated otherwise).**

	2016	2017	2018	2019 (e)	2020 (f)	2021 (f)
<b>Real GDP growth, at constant market prices</b>	<b>7.4</b>	<b>6.3</b>	<b>4.6</b>	<b>5.0</b>	<b>7.4</b>	<b>5.9</b>
Private consumption	3.0	-0.4	1.0	8.7	7.4	4.2
Government consumption	7.3	4.3	5.2	6.8	7.4	5.0
Gross fixed capital investment	11.5	5.5	-3.6	-3.9	-2.5	3.1
Exports, goods and services	-1.4	6.8	-2.0	10.9	19.3	0.3
Imports, goods and services	12.3	-7.1	-7.1	6.9	-6.9	-4.6
<b>Real GDP growth, at constant factor prices</b>	<b>7.8</b>	<b>6.0</b>	<b>4.2</b>	<b>5.9</b>	<b>8.8</b>	<b>6.2</b>
Agriculture	4.4	3.6	4.1	4.4	4.7	4.4
Industry	7.6	4.6	1.1	3.9	8.8	3.8
Services	9.2	8.2	7.4	8.4	9.9	9.0
<b>Inflation (consumer price index)</b>	<b>4.4</b>	<b>4.1</b>	<b>2.7</b>	<b>5.0</b>	<b>5.0</b>	<b>5.0</b>
<b>Current account balance (percent of GDP)</b>	<b>-30.5</b>	<b>-22.9</b>	<b>-19.6</b>	<b>-16.3</b>	<b>-9.6</b>	<b>-7.3</b>
<b>Fiscal balance (percent of GDP)</b>	<b>-1.9</b>	<b>-4.6</b>	<b>-3.1</b>	<b>-2.1</b>	<b>-2.7</b>	<b>-4.9</b>
<b>Debt (percent of GDP)</b>	<b>109.4</b>	<b>108.2</b>	<b>104.0</b>	<b>109.3</b>	<b>105.6</b>	<b>100.6</b>
<b>Primary balance (percent of GDP)</b>	<b>-0.4</b>	<b>-3.4</b>	<b>-1.9</b>	<b>-1.2</b>	<b>-1.8</b>	<b>-3.6</b>
<b>International poverty rate (USD 1.9 in 2011 PPP)<sup>a,b</sup></b>	<b>..</b>	<b>1.5</b>	<b>1.3</b>	<b>1.1</b>	<b>0.9</b>	<b>0.7</b>
<b>Lower middle-income poverty rate (USD 3.2 in 2011 PPP)<sup>a,b</sup></b>	<b>..</b>	<b>12.0</b>	<b>11.2</b>	<b>10.0</b>	<b>8.7</b>	<b>7.8</b>
<b>Upper middle-income poverty rate (USD 5.5 in 2011 PPP)<sup>a,b</sup></b>	<b>..</b>	<b>38.6</b>	<b>37.2</b>	<b>35.7</b>	<b>33.0</b>	<b>31.1</b>

Source: World Bank.

Notes: (e) = estimate; (f) = forecast. (a) Calculations based on SAR-POV harmonization, using 2017-BLSS. Actual data: 2017. Nowcast: 2018. Forecast are from 2019 to 2021. (b) Projection using neutral distribution (2017) with pass-through = 0.7 based on GDP per capita in constant LCU.



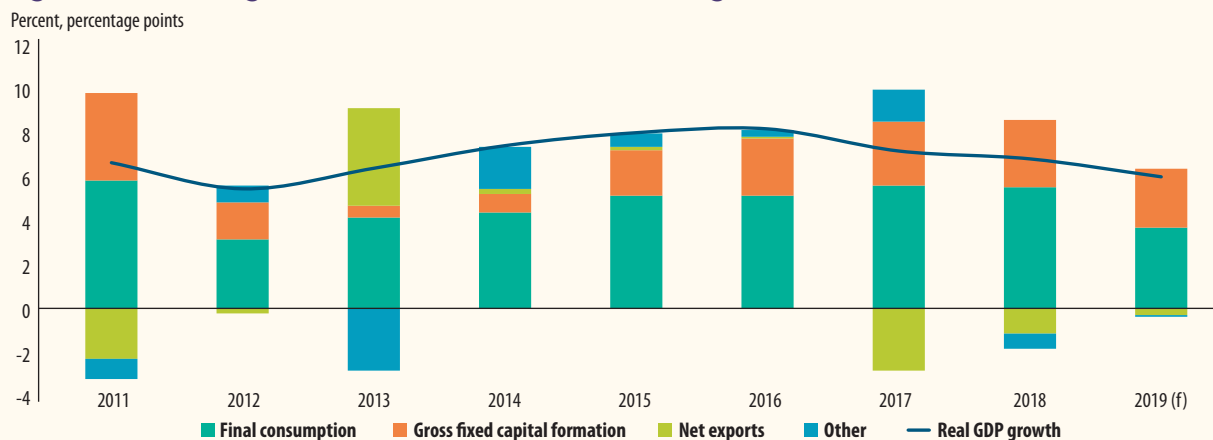
# India

Growth is estimated to have moderated to 6.8 per cent in FY18/19. A further deceleration is expected in FY19/20 and a gradual acceleration thereafter, subject to significant risks related to external developments and the possibility of renewed fiscal and financial sector stress. Poverty declined to an estimated 13.4 percent in FY15/16 at the USD 1.9 international poverty line. However, implementation challenges of indirect tax reforms, weaknesses in the rural economy and a high youth unemployment rate in urban areas may have moderated the pace of poverty reduction.

	2018
Population, million	1356.6
GDP, current USD billion	2716.6
GDP per capita, current USD	2002
International poverty rate (USD1.9) <sup>a</sup>	21.6
Lower middle-income poverty rate (USD3.2) <sup>a</sup>	61.1
Upper middle-income poverty rate (USD5.5) <sup>a</sup>	87.3
Gini index <sup>a</sup>	35.4
Life expectancy at birth, years <sup>b</sup>	68.8

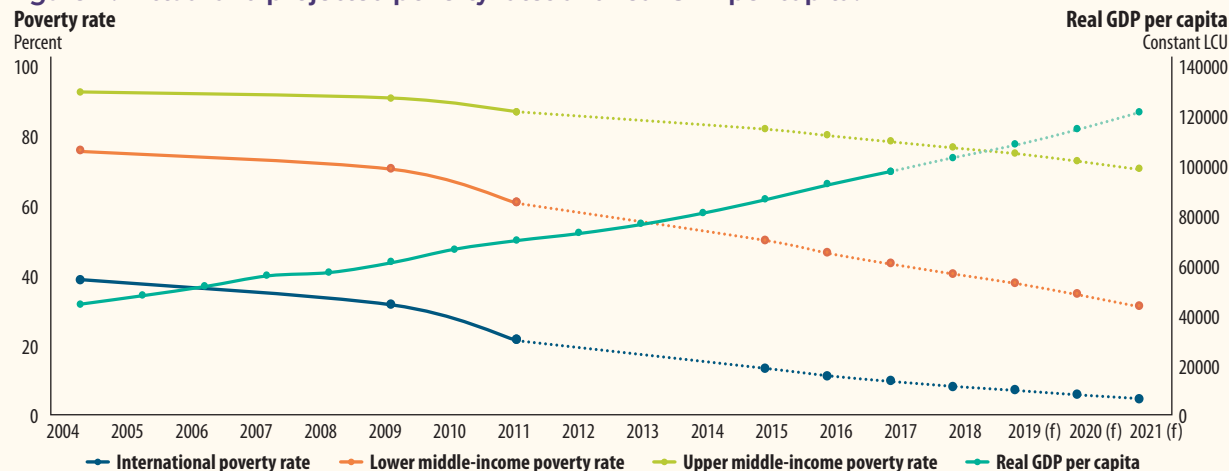
Sources: WDI, World Bank and official data.  
Notes: (a) Most recent value (2011), 2011 PPPs; (b) Most recent WDI value (2017).

**Figure 1: Real GDP growth and contributions to real GDP growth.**



Sources: Central Statistics Office and staff calculations.  
Note: (f) = forecast.

**Figure 2: Actual and projected poverty rates and real GDP per capita.**



Source: World Bank.  
Notes: (f) = forecast.

## Recent economic developments

Economic growth decelerated for the second consecutive year in FY18/19, to 6.8 percent (from 7.2 percent in FY17/18). While industrial output growth increased to 6.9 percent, driven by a pick-up in manufacturing and construction activity, growth in agriculture and services moderated to 2.9 and 7.5 percent, respectively. In the first quarter of FY19/20, the economy experienced a significant and broad-based growth deceleration (to a 25-quarter low of 5 percent y-o-y) with a particularly sharp deceleration in private consumption on the demand side, and a weakening of growth in both industry and services on the supply side.

Reflecting the below-trend economic momentum and persistently low food prices, headline inflation averaged 3.4 percent in FY18/19 and remained well below the RBI's mid-range target of 4 percent in the first half FY19/20. This allowed the RBI to ease monetary policy via a cumulative 135 basis point cut in the repo rate since January 2019 and a shift in the policy stance from “neutral” to “accommodative”.

The current account deficit widened to 2.1 percent of GDP in FY18/19 (from 1.8 percent in the previous year), mostly reflecting a deteriorating trade balance. On the financing side, significant capital outflows in the first half of the year (triggered by the tightening in global financial conditions) were followed by a sharp reversal from October 2018 onwards and a build-up of international reserves to USD 411.9 billion at the end of the fiscal year (equivalent to 10 months of imports). Likewise, while the rupee initially lost ground relative to the USD (12.1 percent depreciation between March and October 2018), it appreciated by about 7 percent up to March 2019.

The general government deficit is estimated to have widened by 0.2 percentage points, to 5.9 percent of GDP in FY18/19. This is despite the central government improving its balance by 0.2 percentage points over the previous year. General government debt remained stable and sustainable – being largely domestic and long term—at around 67 percent of GDP.

Poverty has continued to decline, albeit possibly at a slower pace than earlier. Between FY11/12 and FY15/16, the poverty rate declined from 21.6 to 13.4 percent (USD 1.9 PPP/day). Subsequently, disruptions brought about by the introduction of GST and demonetization, combined with stress in the rural economy and a high youth unemployment rate in urban areas, may have heightened the risks for the poorest households.

## Outlook

The significant slowdown in the first quarter of the fiscal year and high frequency indicators thereafter suggest that output growth will not exceed 6.0 percent for the full fiscal year. Consumption is likely to remain depressed by slow growth in rural incomes, domestic

demand (as reflected in a sharp drop in sales of automobiles), and credit from non-banking financial companies (NBFCs). Investment will benefit from the recent cut in the effective corporate tax rate for domestic companies in the medium term, but also will continue to reflect financial sector weaknesses. Growth is expected to gradually recover to 6.9 percent in FY20/21 and 7.2 percent in FY21/22, as the cycle bottoms-out, rural demand benefits from the effects of income support schemes, investment responds to tax incentives and credit growth resumes. However, exports growth is expected to remain modest, as trade wars and slow global growth depresses external demand.

Going forward, monetary policy is expected to remain a key channel of countercyclical intervention, given benign price dynamics. While the authorities have shown steadfast commitment to fiscal prudence, the significant growth deceleration as well as the corporate tax cuts undertaken to counter it come with heightened risks of fiscal slippage. If the center and the states hold on to their consolidation objectives, the general government deficit is expected to reach 5.8 percent in FY20/21, but reaching this target may prove challenging.

External balances are projected to remain stable and the current account deficit to decline marginally to 2.0 percent of GDP in FY19/20, as import demand weakens and oil prices remain benign.

If growth continues to be distribution-neutral, poverty measured at the USD 1.9 PPP/day line, is projected to decline to 4.6 percent by FY21/22. Poverty measured at the USD 3.2 PPP/day line, is expected to fall from 50.4 percent in FY14/15 to 31.2 percent in FY21/22. However, the recent contraction in several high-frequency consumption indicators, suggests that vulnerabilities for poorer households may have increased. By contrast, policy measures to reduce stress in the rural economy, such as the government's flagship income transfer scheme is likely to have a positive impact on reducing poverty.

## Risks and challenges

The main policy challenge is to address the sources of softening private consumption and the structural factors behind weak investment. This will require restoring the health of the financial sector through reforms of public sector banks' governance and a gradual strengthening of the regulatory framework for NBFCs, while ensuring that solvent NBFCs retain access to adequate liquidity. It will also require efforts to contain fiscal slippages, as higher-than-expected public borrowings could put upward pressure on interest rates and potentially crowd-out the private sector.

The main sources of risk include external shocks that result in tighter global financing conditions, and new NBFC defaults triggering a fresh round of financial sector stress. To mitigate these risks, the authorities will need to ensure that there is adequate liquidity in the financial system, while strengthening the regulatory framework for NBFCs.

Broad-based poverty reduction remains a major challenge, in particular with respect to (i) presently excluded groups (such as women and scheduled tribes), and (ii) extending gains to a broader range of human development outcomes related to health, nutrition, education and gender. The persistently low female labor

force participation rate and high youth unemployment present risks to sustaining the current rate of poverty reduction. Furthermore, outdated information on indicators of poverty and employment limit the scope of reliably correlating growth forecasts with projected rates of poverty reduction.

**Table 2: Macro poverty outlook indicators (annual percent change unless indicated otherwise).**

	2016	2017	2018	2019 (f)	2020 (f)	2021 (f)
<b>Real GDP growth, at constant market prices</b>	<b>8.2</b>	<b>7.2</b>	<b>6.8</b>	<b>6.0</b>	<b>6.9</b>	<b>7.2</b>
Private consumption	8.2	7.4	8.1	5.0	6.5	8.0
Government consumption	5.8	15.0	9.2	8.6	9.5	7.2
Gross fixed capital investment	8.3	9.3	10.0	8.5	8.2	8.5
Exports, goods and services	5.1	4.7	12.5	6.0	6.1	6.3
Imports, goods and services	4.4	17.6	15.4	5.9	8.1	8.9
<b>Real GDP growth, at constant factor prices</b>	<b>7.9</b>	<b>6.9</b>	<b>6.6</b>	<b>5.8</b>	<b>6.7</b>	<b>7.0</b>
Agriculture	6.3	5.0	2.9	2.5	3.3	3.3
Industry	7.7	5.9	6.9	5.2	6.7	7.3
Services	8.4	8.1	7.5	7.0	7.6	7.7
<b>Inflation (consumer price index)</b>	<b>4.5</b>	<b>3.6</b>	<b>3.4</b>	<b>3.5</b>	<b>4.0</b>	<b>4.0</b>
<b>Current account balance (percent of GDP)</b>	<b>-0.6</b>	<b>-1.8</b>	<b>-2.1</b>	<b>-2.0</b>	<b>-2.0</b>	<b>-2.3</b>
<b>Net foreign direct investment (percent of GDP)</b>	<b>1.6</b>	<b>1.1</b>	<b>1.1</b>	<b>1.2</b>	<b>1.4</b>	<b>1.6</b>
<b>Fiscal balance (percent of GDP)</b>	<b>-6.9</b>	<b>-5.7</b>	<b>-5.9</b>	<b>-6.0</b>	<b>-5.8</b>	<b>-5.6</b>
<b>Debt (percent of GDP)</b>	<b>67.5</b>	<b>67.6</b>	<b>67.3</b>	<b>66.9</b>	<b>66.5</b>	<b>66.1</b>
<b>Primary balance (percent of GDP)</b>	<b>-2.2</b>	<b>-0.9</b>	<b>-1.3</b>	<b>-1.3</b>	<b>-1.2</b>	<b>-0.9</b>
<b>International poverty rate (USD 1.9 in 2011 PPP)<sup>a,b</sup></b>	<b>11.3</b>	<b>9.6</b>	<b>8.2</b>	<b>7.0</b>	<b>5.7</b>	<b>4.6</b>
<b>Lower middle-income poverty rate (USD 3.2 in 2011 PPP)<sup>a,b</sup></b>	<b>46.6</b>	<b>43.6</b>	<b>40.7</b>	<b>38.0</b>	<b>34.7</b>	<b>31.2</b>
<b>Upper middle-income poverty rate (USD 5.5 in 2011 PPP)<sup>a,b</sup></b>	<b>80.4</b>	<b>78.7</b>	<b>76.9</b>	<b>75.3</b>	<b>73.1</b>	<b>70.7</b>

Source: World Bank.

Notes: (f) = forecast. Fiscal projections do not take into account the possible effects of changes to corporate taxes announced on September 20, 2019. (a) Calculations based on SAR-POV harmonization, using 2011-NSS-SCH1. Actual data: 2011. Nowcast: 2012-2016. Forecast are from 2017 to 2021; (b) Projection using neutral distribution (2011) with pass-through = 0.733 (rural) and 0.559 (urban) based on HFCE in constant LCU for nowcast and GDP per capita in constant LCU for forecast.



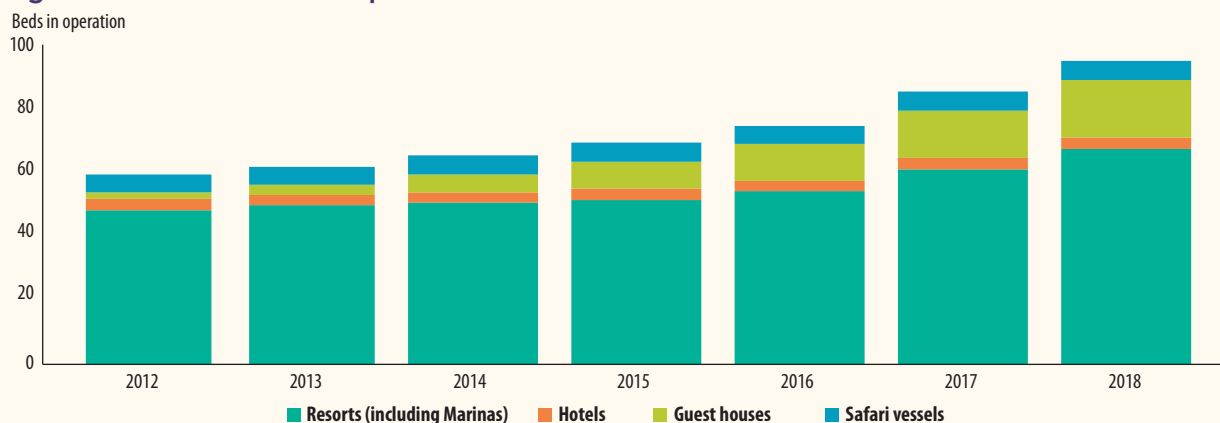
# Maldives

Real GDP growth is expected to decelerate from 6.7 percent in 2018 to 5.2 percent in 2019, due to a temporary slowdown in construction. Over the medium-term, infrastructure investment and expansion in the tourism sector will support growth. Efforts to rationalize recurrent spending are needed, especially related to subsidies and health spending. Poverty is low, but youths continue to face labor market challenges. Public debt is projected to rise further, and international reserves are low.

	2018
Population, million	0.4
GDP, current USD billion	5.3
GDP per capita, current USD	11890
School enrollment, primary (percent gross) <sup>a</sup>	101.5
Life expectancy at birth, years <sup>a</sup>	77.6

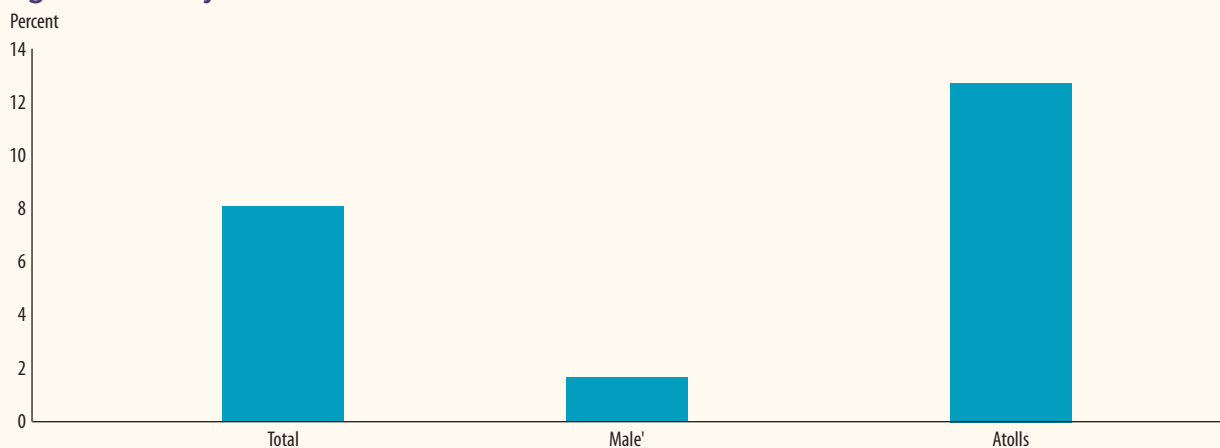
Sources: WDI, World Bank, and official data.  
Note: (a) Most recent WDI value (2017).

**Figure 1: Number of beds in operation.**



Source: Ministry of Tourism.

**Figure 2: Poverty headcount ratio.**



Source: National Bureau of Statistics.

## Recent economic developments

Real GDP grew by 6.7 percent in 2018, on the back of strong performance in tourism, construction, and trade. Preliminary estimates indicate that growth slowed down to 3.1 percent y-o-y in Q1 2019, compared to 13.1 percent in Q1 2018. Tourism contributed approximately 2.4 percentage points, followed by transportation and communication (0.7 percentage points) and financial services (0.4 percentage points). Construction declined by 23.1 percent. The opening of new resorts and infrastructure (the international airport and a connecting bridge) and housing projects have fueled the construction sector over the last 5 years, and the decline in construction reflects the completion of some large infrastructure projects. Tourist arrivals and bed nights increased by 18.7 percent and 14.7 percent y-o-y in H1 2019 respectively, supported by these investments and the expansion in the guest houses' sector.

The overall CPI remained unchanged in H1 2019. This was mainly driven by policy changes that led to a decrease in prices of staple food items and electricity. Price declines were more pronounced in the atolls, with the CPI falling on average by 1 percent in H1 2019, whereas the CPI for Male increased by 1.2 percent. Two major contributors to the decline in the Atolls were food and non-alcoholic beverages and housing and utilities.

The current account deficit is estimated to have widened to 25.3 percent of GDP in 2018, from 21.7 percent in 2017. The trade deficit increased with the rapid expansion of goods imports (24.0 percent y-o-y) linked to imports of building materials. Services exports performed strongly (11.4 percent y-o-y growth) thanks to strong tourism receipts. The current account deficit was financed mainly through debt flows and direct investment. The nominal exchange rate has remained at around 15.4 MVR/USD under a de facto stabilized arrangement, whereas the overnight deposit rate has been kept at 1.5 percent since 2014. Gross official reserves decreased to USD 677.4 million in June 2019 (2.9 months of imports), from USD 726.4 million a year before. Usable reserves stood at USD 276 million.

Preliminary estimates suggest that the fiscal deficit widened to 4.7 percent of GDP in 2018, from 3 percent in 2017. Public debt is estimated to have reached 59 percent of GDP in 2018. According to the World Bank-IMF debt sustainability analysis, Maldives remains at high risk of debt distress. The overall deficit narrowed y-o-y in H1 2019. Revenue and grants increased by 5.3 percent y-o-y in H1 2019, with tax revenues growing by 6.3 percent y-o-y, non-tax revenues falling by 8.3 percent y-o-y (driven partly by a decline in SOE dividends) and grants more than doubling. Total spending contracted by 8.0 percent y-o-y in H1 2019, largely due to under-execution of the public sector investment program (-61.2 percent y-o-y). Recurrent expenditures increased by 8.8 percent y-o-y.

The poverty headcount rate is low, at 8.2 percent using the national poverty line and 6.6 percent using the

international poverty line for upper middle-income countries of USD 5.50 a day. Large disparities in welfare and other socio-economic outcomes persist, with over 90 percent of poor Maldivians living in Atolls.

Labor market challenges prevail for youth and women. Over a quarter of women are either unemployed or not looking for a job. Youth unemployment is high at 15.3 percent. The government is the top employer among Maldivians. Tourism and construction, the main drivers of growth, rely mostly on foreign labor and male employment. About two thirds of Maldivians are employed in jobs not related to tourism, suggesting a misalignment between the drivers of growth and aspirations of jobseekers. Measures that foster private sector job creation can help reduce pressure on the public sector to create jobs. Public-private wage differentials and other benefits associated with public employment dis-incentivize young jobseekers from taking up private sector opportunities. The projected expansion in the young labor force means that private sector alternatives will be required.

## Outlook

Real GDP growth is expected to slow down to 5.2 percent in 2019, with the completion of large infrastructure projects and the slow transition to new ones. Tourism is expected to continue to be the main driver of growth, with recent infrastructure investment helping relieve supply bottlenecks in the sector. Growth is expected to rebound to 5.5 percent in 2020 as these new projects pick up pace. The current account deficit is projected to narrow over the medium-term, as investment-related imports gradually subside.

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

## Risks and challenges

Risks to the outlook are tilted to the downside. A downturn in the global economy or in China could impact Maldives' tourism industry. An increase in oil prices could affect the external account, given the country's heavy reliance on diesel imports.

One key challenge for the Maldives is to strike an appropriate balance between making large investments needed to close existing infrastructure gaps –potentially allowing to boost tourism, increase resilience to climate change and ease constraints in service delivery— and

managing the rapid accumulation of public debt. Containing recurrent spending and improving the efficiency of social spending are key areas that require attention. The overall level of indebtedness is high and reserves coverage is low. The large volume of external loans and guarantees on non-concessional terms to finance infrastructure projects represents significant risks.

Large disparities in welfare and other socio-economic outcomes across regions are a cause for concern. Poverty rates vary widely across geographic areas, and Maldivians in the Southern Atoll are particularly affected by poverty, with almost 1 in 5 being poor. These spatial disparities require a renewed effort in economic and social inclusion of all regions across the Maldives.

**Table 2: Macro poverty outlook indicators (annual percent change unless indicated otherwise).**

	2016	2017	2018	2019 (f)	2020 (f)	2021 (f)
Real GDP growth, at constant market prices	7.3	6.9	6.7	5.2	5.5	5.6
Real GDP growth, at constant factor prices	7.0	6.0	6.5	5.2	5.5	5.6
Agriculture	1.5	8.3	2.6	3.3	3.4	3.1
Industry	12.3	10.9	11.7	8.0	10.1	8.5
Services	6.7	5.2	6.0	5.0	5.0	5.3
Inflation (consumer price index)	0.5	2.8	-0.1	0.5	0.9	1.2
Current account balance (percent of GDP)	-23.4	-21.7	-25.3	-18.5	-15.8	-11.7
Fiscal balance (percent of GDP)	-9.9	-3.0	-4.7	-2.9	-4.9	-4.8
Debt (percent of GDP)	56.2	58.5	59.2	59.0	60.2	61.1
Primary balance (percent of GDP)	-8.1	-1.5	-3.0	-1.2	-3.1	-3.0

Source: World Bank.  
Note: (f) = forecast.



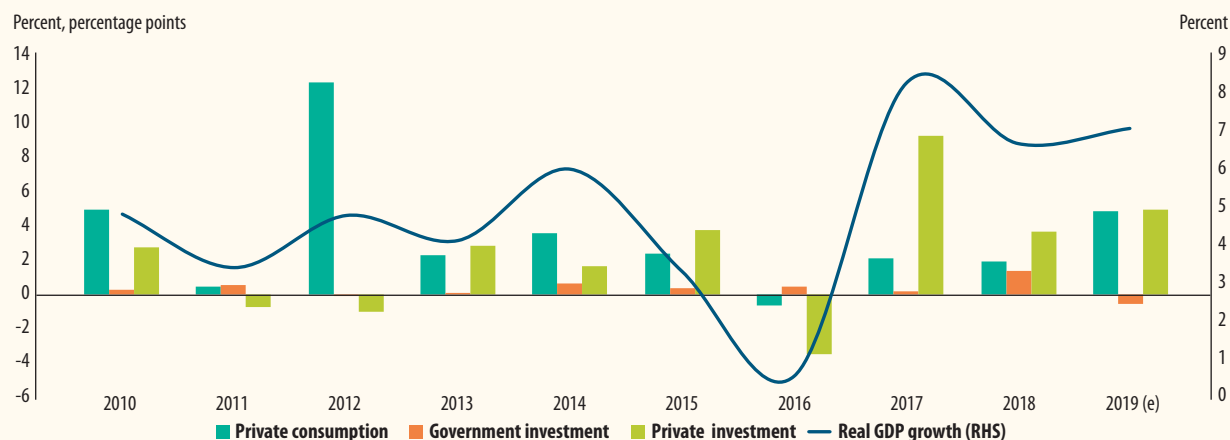
# Nepal

Growth in FY2019 is estimated to have increased to 7.1 percent, driven by private investment and consumption. With significant underspending of the budget, the fiscal deficit declined in FY2019 while the external deficit remained close to last year's level. Poverty is declining, but vulnerabilities remain. The medium-term outlook is supported by government consumption and investment. Risks to the outlook primarily arise from capacity constraints, especially at the subnational level, delays in reform implementation and vulnerability to natural disasters.

	2018
Population, million	29.6
GDP, current USD billion	29.0
GDP per capita, current USD	980
International poverty rate (USD 1.9) <sup>a</sup>	15.0
Lower middle-income poverty rate (USD 3.2) <sup>a</sup>	50.8
Upper middle-income poverty rate (USD 5.5) <sup>a</sup>	83.0
Gini index <sup>a</sup>	32.8
School enrollment, primary (percent gross) <sup>b</sup>	134.1
Life expectancy at birth, years <sup>b</sup>	70.6

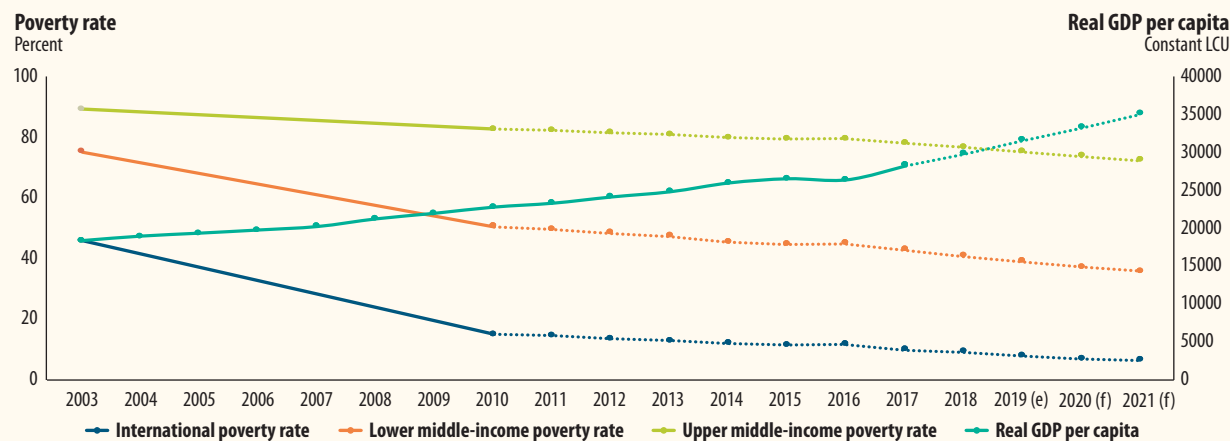
Sources: WDI, World Bank, and official data.  
Notes: (a) Most recent value (2010), 2011 PPPs.; (b) Most recent WDI value (2017).

**Figure 1: Investments continue to drive real GDP growth.**



Sources: Central Bureau of Statistics and staff calculations.  
Notes: (e) = estimate. Nepal's fiscal year runs from July 16th to July 15th.

**Figure 2: Actual and projected poverty rates and real GDP per capita.**



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

## Recent economic developments

GDP growth is estimated at 7.1 percent in FY2019, marking three consecutive years of over six percent growth. On the supply side, growth was driven by the services sector, particularly, retail, hotel, and restaurant subsectors, which received a boost from an uptick in tourist arrivals and remittance-fueled private consumption. The agricultural sector contributed an additional 1.6 percentage points to growth, supported by good monsoons and increased commercialization and availability of agricultural inputs. On the demand side, private investment and consumption were the main drivers, contributing 4.9 percentage points each to overall growth.

Given good agricultural production and the peg to the Indian rupee, inflation in FY2019 (4.5 percent) remained below target (5.5 percent). Credit growth reached 19.3 percent, exceeding deposits growth, and led to a rise in the banking sector's credit-to-core capital plus deposit ratio (which at 75.2 percent remained just below the 80 percent regulatory limit).

The current account deficit remained high at 7.7 percent of GDP in FY2019, driven by a persistent trade deficit. The latter narrowed marginally from 37.5 percent to 37.1 percent of GDP as goods import growth slowed down, reflecting lower import demand for industrial supplies (such as cement clinker) and capital goods. A part of the trade deficit was financed by remittances, which were sustained at the same level as last year (25 percent of GDP). Remittance inflows in FY2019 were supported by the depreciation of the Nepali rupee against the USD and the increased use of formal remittance channels. The remaining external deficit was financed through borrowings and by drawing down foreign exchange reserves, which fell to USD 9.5 billion in July 2019, equivalent to 7.8 months of imports.

Delays in the enactment of Federal, Provincial, and Local Civil Service Acts and in the establishment of provincial civil service commissions adversely impacted the hiring of new staff at the subnational levels. These delays together with the limited technical capacity of existing staff led to significant underspending of the budget, reducing the fiscal deficit from 6.7 percent of GDP in FY2018 to 1.9 percent in FY2019. With public debt at 30 percent of GDP, Nepal remains at low risk of debt distress.

The estimated poverty headcount ratio (at the USD 1.90 per person per day international poverty line) was 9.3 percent in 2018, down from 15 percent in 2010. At a higher line of USD 3.20 a day for Nepal, 41 percent of the population was poor in 2018, a 10 percentage-point decrease from 2010. Despite the declining poverty trend, vulnerability remains high in Nepal. Almost 10 million people, or close to 32 percent of the population, are estimated to live on incomes between USD 1.90 and USD 3.20 a day (2018). Climate related shocks, such as floods and earthquakes, further increase vulnerability.

## Outlook

GDP growth is projected to average 6.5 percent a year over the medium term. On the supply side, growth will be driven by services, underpinned by steady remittance inflows and high tourist arrivals. The latter will be supported by the Visit Nepal 2020 program, the completion of the second international airport, and the construction of big hotels. On the demand side, investment and government consumption are expected to be the main drivers of growth. Public consumption will be supported by increased spending on salary and goods and services. In addition, efforts aimed at building capacity at the subnational levels and the implementation of performance-based contracts at the central level will also result in higher overall public spending. The implementation of the 2019 national work plan to minimize the trade deficit along with investment-related initiatives, such as establishing a one-stop service center, will support private investment. However, increased import tariffs on selected agricultural products and consumer goods are expected to lower the growth of private consumption.

Inflation is expected to increase marginally with higher public sector wages, increases in import duties on agricultural and industrial goods, and the removal of value-added-tax exemptions on some intermediate goods and services. On the other hand, the regular supply of electricity at low cost and low inflation in India will offset some of the increase.

The current account deficit is likely to moderate to 5.9 percent of GDP by FY2021, as spending on federalism-related infrastructure and post-earthquake reconstruction tapers down and the government starts implementing a work plan for encouraging export-oriented and import-substituting industries. Some increase in exports, particularly of hydroelectricity, is anticipated in the next few years, but broader growth in exports will happen only in the longer term as structural reforms start yielding results. Remittances as a share of GDP are expected to stabilize at 25 percent over the medium term.

Government spending is expected to increase to 29.7 percent of GDP by FY2021 due to salary increases, higher social security spending, and a pick-up in capital investments. Revenues are also likely to increase with higher import duties but will lag expenditure growth. As a result, the fiscal deficit is projected to increase to 3.3 percent of GDP and public debt is likely to reach 31 percent of GDP by FY2021.

## Risks and challenges

The outlook is subject to significant risks and challenges. Persistently high trade deficits would raise the risks to the external sector, especially if remittance growth slows down due to geopolitical tensions in migrant receiving countries and uncertain oil prices. Lower remittances could also impact the liquidity in the financial system. Climate-related natural disasters could adversely impact

agricultural production and infrastructure, potentially reversing recent gains in poverty reduction. And capacity challenges, particularly at the subnational level, could manifest through the under execution of provincial and local budgets, impacting service delivery. Therefore, efforts are needed to: (a) raise export competitiveness and establish a legal framework for cross-border electricity

trade; (b) enforce the implementation of policies and regulations related to climate and disaster risk reduction and management; (c) strengthen the preparation of the medium-term expenditure framework at the subnational level; and (d) adopt a legal framework for hiring staff at the subnational level and build capacity of all staff.

**Table 2: Macro poverty outlook indicators (annual percent change unless indicated otherwise).**

	2016	2017	2018	2019 (e)	2020 (f)	2021 (f)
<b>Real GDP growth, at constant market prices</b>	<b>0.6</b>	<b>8.2</b>	<b>6.7</b>	<b>7.1</b>	<b>6.4</b>	<b>6.5</b>
Private consumption	-0.7	2.6	2.5	6.5	0.9	1.5
Government consumption	-0.4	10.5	13.4	8.3	44.4	7.2
Gross fixed capital investment	-12.3	44.3	18.1	14.3	7.2	11.4
Exports, goods and services	-13.7	11.3	7.8	7.9	8.4	15.0
Imports, goods and services	2.8	27.2	19.0	17.9	7.7	5.5
<b>Real GDP growth, at constant factor prices</b>	<b>0.3</b>	<b>7.7</b>	<b>6.1</b>	<b>6.7</b>	<b>6.4</b>	<b>6.5</b>
Agriculture	0.2	5.2	2.8	5.0	4.0	4.0
Industry	-6.4	12.4	9.6	8.1	8.3	8.8
Services	2.4	8.1	7.2	7.3	7.2	7.2
<b>Inflation (consumer price index)</b>	<b>9.9</b>	<b>4.5</b>	<b>4.2</b>	<b>4.5</b>	<b>5.0</b>	<b>5.0</b>
<b>Current account balance (percent of GDP)</b>	<b>6.2</b>	<b>-0.4</b>	<b>-8.2</b>	<b>-7.7</b>	<b>-6.8</b>	<b>-5.9</b>
<b>Fiscal balance (percent of GDP)</b>	<b>1.4</b>	<b>-3.1</b>	<b>-6.7</b>	<b>-1.9</b>	<b>-2.6</b>	<b>-3.3</b>
<b>Debt (percent of GDP)</b>	<b>27.9</b>	<b>26.1</b>	<b>30.2</b>	<b>30.1</b>	<b>30.3</b>	<b>31.4</b>
<b>Primary balance (percent of GDP)</b>	<b>1.8</b>	<b>-2.7</b>	<b>-6.1</b>	<b>-1.3</b>	<b>-1.8</b>	<b>-2.5</b>
<b>International poverty rate (USD 1.9 in 2011 PPP)<sup>a,b</sup></b>	<b>11.7</b>	<b>9.9</b>	<b>9.3</b>	<b>8.0</b>	<b>7.0</b>	<b>6.6</b>
<b>Lower middle-income poverty rate (USD 3.2 in 2011 PPP)<sup>a,b</sup></b>	<b>45.2</b>	<b>43.1</b>	<b>41.0</b>	<b>39.2</b>	<b>37.4</b>	<b>36.0</b>
<b>Upper middle-income poverty rate (USD 5.5 in 2011 PPP)<sup>a,b</sup></b>	<b>79.9</b>	<b>78.4</b>	<b>77.1</b>	<b>75.5</b>	<b>74.1</b>	<b>72.7</b>

Source: World Bank.

Notes: (e) = estimate; (f) = forecast. (a) Calculations based on SAR-POV harmonization, using 2010-LSS-III. Actual data: 2010. Nowcast: 2011-2018. Forecast are from 2019 to 2021; (b) Projection using neutral distribution (2010) with pass-through = 0.5 based on GDP per capita in constant LCU.



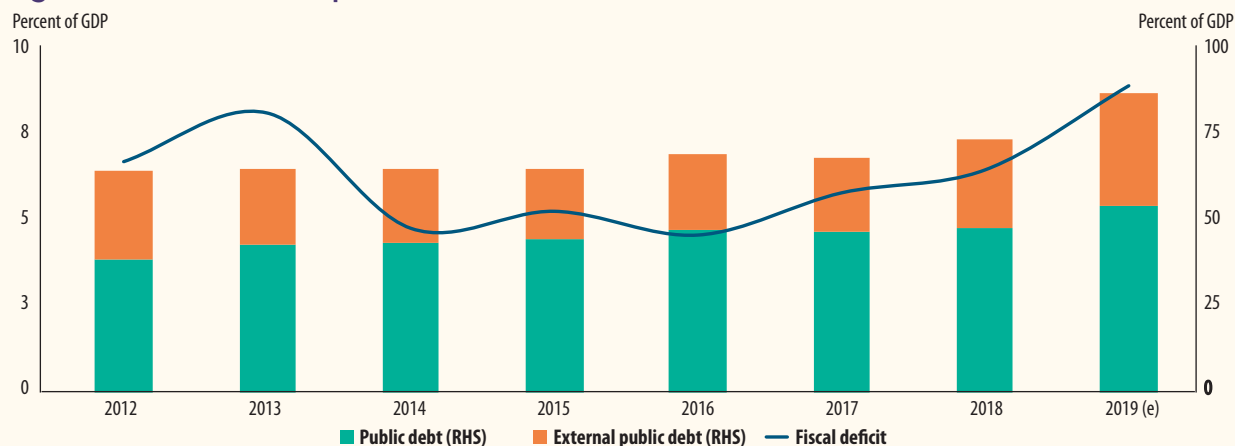
# Pakistan

Pakistan's economy is slowing as the country passes through yet another macroeconomic crisis with high twin deficits and low international reserves. With an IMF Extended Fund Facility supported stabilization program in place, growth is expected to remain low in the near-term. The medium-term growth outlook hinges upon the country's ability to implement necessary structural reforms to boost competitiveness and achieve sustained growth. Progress in poverty reduction is expected to be limited during the macroeconomic adjustment period.

	2018
Population, million	201.0
GDP, current USD billion	314.6
GDP per capita, current USD	1565
International poverty rate (USD 1.9) <sup>a</sup>	3.9
Lower middle-income poverty rate (USD 3.2) <sup>a</sup>	34.7
Upper middle-income poverty rate (USD 5.5) <sup>a</sup>	75.4
Gini index <sup>a</sup>	33.5
School enrollment, primary (percent gross) <sup>b</sup>	95.9
Life expectancy at birth, years <sup>b</sup>	66.629

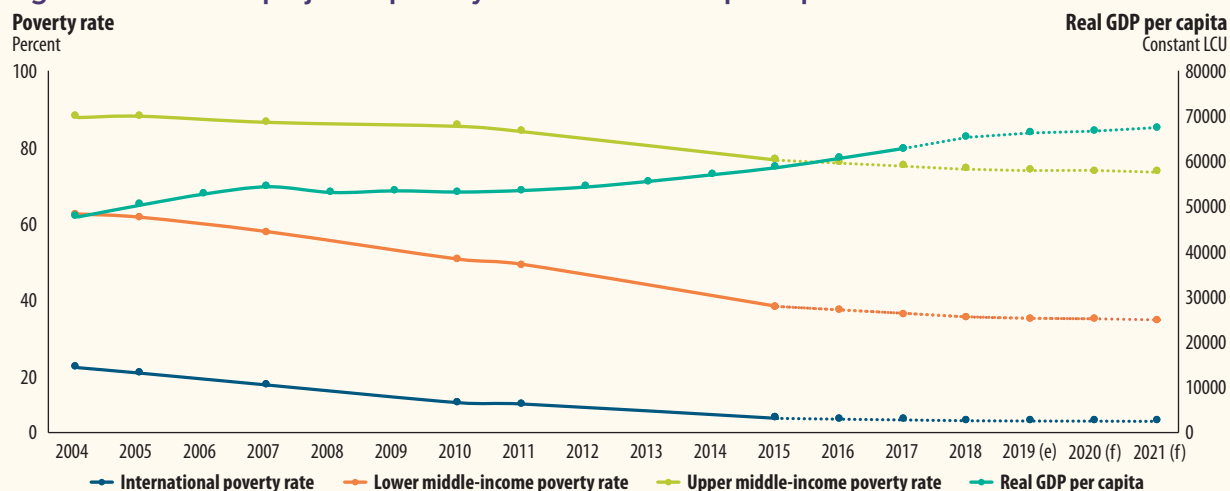
Sources: WDI, World Bank, and official data.  
Notes: (a) Most recent value (2015), 2011 PPPs.; (b) Most recent WDI value (2017).

**Figure 1: Fiscal deficit and public debt.**



Sources: Ministry of Finance and State Bank of Pakistan.  
Notes: (e)=estimate. Pakistan reports data on fiscal year (FY) basis. The fiscal year runs from July 1 through June 30 in Pakistan.

**Figure 2: Actual and projected poverty rates and real GDP per capita.**



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

## Recent economic developments

GDP growth (at factor cost) decelerated to 3.3 percent in FY19—2.2 percentage points lower than FY18—as gradual policy adjustments to tackle macroeconomic imbalances started to take effect. These adjustments included a tightened monetary stance, cuts in public sector development expenditures, and enhanced focus on higher tax collections. As a result, large scale manufacturing, which accounts for half of overall industrial output, contracted by 3.6 percent in FY19. The services sector, which contributes over 60 percent to total output, decelerated to 4.7 percent in FY19 compared to 6.2 percent last year. In agriculture, major crops registered a 6.6 percent decline in production due to adverse weather conditions. On the demand side, policy adjustments slowed private consumption growth from 6.8 percent in FY18 to 4.1 percent in FY19, while investment contracted by 8.9 percent in FY19 as compared to a growth of 7.1 percent in FY18. Headline inflation increased to 7.3 percent in FY19 compared with 3.9 percent in FY18, primarily because of a cumulative depreciation of 25.5 percent of the PKR against the USD during the fiscal year. To check these inflationary pressures, the State Bank of Pakistan (SBP) gradually raised its policy rate by 675 bps to 13.25 by July 2019.

The current account deficit (CAD) narrowed to USD 13.5 billion (4.8 percent of GDP) in FY19 compared to USD 19.9 billion (6.3 percent of GDP) in FY18. The decline in the CAD was primarily driven by a fall in imports (goods imports declined by 7.4 percent while services imports fell by 14.9 percent). Exports, however, did not respond to the depreciation in FY19, as regaining competitiveness after extended periods of an overvalued exchange rate will take time. Financial flows increased due to substantial liquidity injections from Saudi Arabia, UAE and China. However, these injections did not stem the declining (net) foreign reserves, which fell from USD 9.8 billion (1.7 months of import cover) in end-June 2018 to USD 7.3 billion in end-June 2019 (1.5 months of import cover).

Fiscal performance in FY19 deteriorated substantially due to revenue underperformance and higher interest payments. The consolidated fiscal deficit (including grants) stood at 8.8 percent of GDP—2.4 percentage points higher than FY18. Tax revenues almost stagnated at last year's level and non-tax revenues declined by 44 percent as the exchange rate depreciation reduced SBP profits, resulting in lower transfers to the government. As a result, overall revenues contracted by 6.3 percent. With fiscal slippages and the large exchange rate depreciation, Pakistan's public debt rose sharply to 86.5 percent of GDP by end-June 2019 compared to 73.0 percent in FY18.

To restore macroeconomic stability, the government signed a 39-month USD 6 billion Extended Fund Facility (EFF) program with the IMF in July 2019. Key steps initiated under the EFF include a shift towards a market-based exchange rate regime, expenditure consolidation, increased revenue collections, stronger

coordination between federating units, an upward adjustment in energy prices and tighter monetary policy.

## Outlook

Growth is projected to decelerate to 2.4 percent in FY20 with continued fiscal consolidation and a tight monetary policy stance. The IMF adjustment program entails a rebalancing from domestic to external demand. Growth is expected to recover slowly, to 3.0 percent in FY21, as macroeconomic conditions improve and external demand picks up on the back of structural reforms and increased competitiveness. This recovery is conditional on relatively stable global markets, a decline in international oil prices and reduced political and security risks. Inflation is expected to rise in FY20 to 13.0 percent, and afterwards start declining gradually. The increase in prices will be driven by the second-round impact of exchange-rate pass-through to domestic prices. Pakistan's commercial banks remain well capitalized. However, rising public sector demand for credit (mainly central government borrowing) and rising interest rates are expected to crowd out private credit in the near-term.

The current account deficit is expected to decline to 2.6 percent of GDP in FY20 and further to 2.2 percent of GDP in FY21, as increased exchange-rate flexibility will support a modest recovery in exports and rationalization of imports. The consolidated fiscal deficit (including grants) is projected to reach 7.5 percent of GDP in FY20 and remain elevated at 6.2 percent of GDP in FY21. The public debt-to-GDP ratio is expected to remain high in FY21 at 80.8 percent, increasing Pakistan's exposure to debt-related shocks. Fiscal consolidation across the federation will be needed for the public debt to decline, but the debt-to GDP ratio is not expected to fall below 70 percent of GDP - the debt burden benchmark for high risk emerging markets - over the medium term. Pakistan's debt vulnerabilities will remain high due to large foreign currency debt amortizations and sizeable refinancing of short-term domestic debt.

Progress in poverty reduction, which was uninterrupted since 2001, is expected to stall during the macroeconomic adjustment period, due to decelerating growth and higher inflation rates. The poverty headcount, measured using the USD 1.90 per person per day international poverty line, is projected to remain at the FY19 level (3.1 percent). Poverty measured using the USD 3.2 line is expected to decline from 31.4 percent last year to 31.2 percent in FY20, while poverty measured using the USD 5.5 poverty line is projected at 72.5 percent in FY20, compared to 72.6 in FY19.

## Risks and challenges

Economic policies over the past few years have resulted in increased debt levels and erosion of fiscal and external buffers, limiting the economy's ability to absorb shocks. The country needs to restore these buffers,

especially since (i) turbulence in global financial markets could affect Pakistan's access to private external financing; and (ii) the weakening global economy and rising trade tensions could dampen external demand. The main domestic risk emerges from potential difficulties in implementing the necessary adjustments and

structural reforms. Vulnerable households' ability to weather the economic impact of the crisis will depend critically on the inclusiveness of growth, food and non-food inflation, and the resilience of sectors relevant for their employment (agriculture, construction and wholesale/retail trade).

**Table 2: Macro poverty outlook indicators (annual percent change unless indicated otherwise).**

	2016	2017	2018	2019 (e)	2020 (f)	2021 (f)
<b>Real GDP growth, at constant market prices</b>	5.5	5.6	5.8	3.3	2.4	3.0
Private consumption	7.6	8.5	6.8	4.1	0.7	1.5
Government consumption	8.2	5.3	8.6	10.0	1.5	2.7
Gross fixed capital investment	7.5	10.3	7.1	-8.9	1.7	5.9
Exports, goods and services	-1.6	-0.6	10.4	13.2	10.8	8.7
Imports, goods and services	16.0	21.2	15.8	5.8	-1.2	1.5
<b>Real GDP growth, at constant factor prices</b>	4.6	5.2	5.5	3.3	2.4	3.0
Agriculture	0.2	2.2	3.9	0.8	1.8	2.0
Industry	5.7	4.6	4.9	1.4	1.2	2.1
Services	5.7	6.5	6.2	4.7	3.0	3.7
<b>Inflation (consumer price index)</b>	2.9	4.2	3.9	7.3	13.0	8.3
<b>Current account balance (percent of GDP)</b>	-1.7	-4.1	-6.3	-4.8	-2.6	-2.2
<b>Net Foreign Direct Investment (percent of GDP)</b>	0.8	0.9	1.1	0.6	0.8	1.0
<b>Fiscal balance (percent of GDP)</b>	-4.5	-5.8	-6.4	-8.8	-7.5	-6.2
<b>Debt (percent of GDP)</b>	68.7	68.0	73.0	86.5	82.9	80.8
<b>Primary balance (percent of GDP)</b>	-0.2	-1.5	-2.1	-3.4	-0.8	0.1
<b>International poverty rate (USD 1.9 in 2011 PPP)<sup>a,b</sup></b>	3.7	3.5	3.2	3.1	3.1	3.0
<b>Lower middle-income poverty rate (USD 3.2 in 2011 PPP)<sup>a,b</sup></b>	33.7	32.8	31.8	31.4	31.2	30.9
<b>Upper middle-income poverty rate (USD 5.5 in 2011 PPP)<sup>a,b</sup></b>	74.6	73.8	72.9	72.6	72.5	72.2

Source: World Bank.

Notes: (e) = estimate; (f) = forecast. (a) Calculations based on SAR-POV harmonization, using 2010-PSLM and 2015-PSLM. Actual data: 2015. Nowcast: 2016-2018. Forecast are from 2019 to 2021; (b) Projection using annualized elasticity (2010-2015) with pass-through = 0.25 based on GDP per capita in constant LCU.



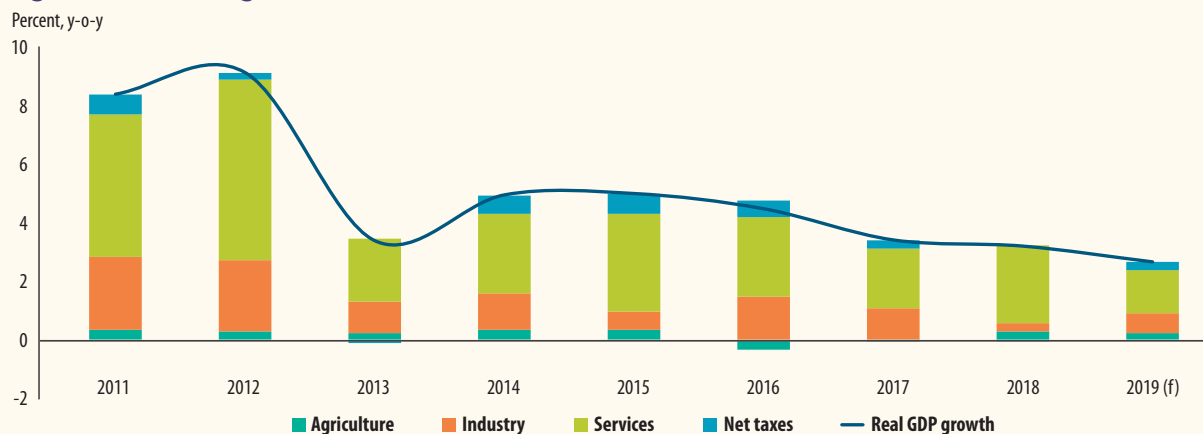
# Sri Lanka

The April terrorist attacks heightened macroeconomic challenges. Growth is expected to decelerate to 2.7 per cent in 2019. Reduced tourism receipts will exert pressure on external accounts, despite reduced import demand. Fiscal balances will deteriorate amid contracting revenues. Large refinancing needs, weak fiscal buffers and high debt make the country vulnerable to rollover risks. A slowdown in economic activity will constrain job creation and income growth, and the pace of poverty reduction. The USD 5.50 poverty rate is projected at 36.1 per cent in 2019.

	2018
Population, million	21.7
GDP, current USD billion	88.9
GDP per capita, current USD	4104
International poverty rate (USD 1.9) <sup>a</sup>	0.8
Lower middle-income poverty rate (USD 3.2) <sup>a</sup>	10.1
Upper middle-income poverty rate (USD 5.5) <sup>a</sup>	40.4
Gini index <sup>a</sup>	39.8
School enrollment, primary (percent gross) <sup>b</sup>	101.9
Life expectancy at birth, years <sup>b</sup>	75.5

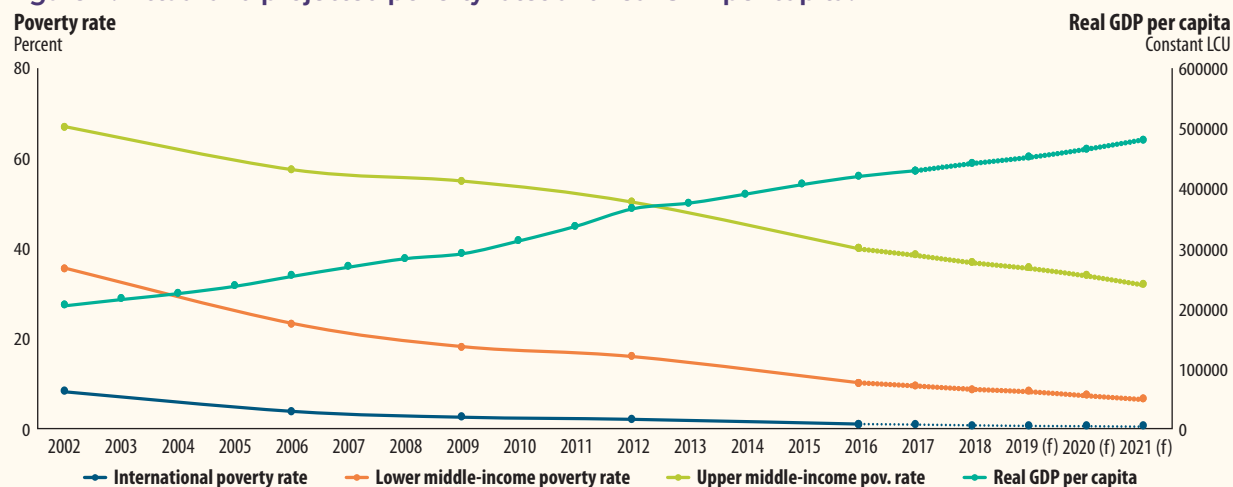
Sources: WDI, Macro Poverty Outlook, and official data.  
Notes: (a) Most recent value (2016), 2011 PPPs; (b) Most recent WDI value (2017).

**Figure 1: Real GDP growth and contributions.**



Source: Department of Census and Statistics and staff calculations.  
Note: (f) = forecast

**Figure 2: Actual and projected poverty rates and real GDP per capita.**



Source: World Bank.  
Note: (f) = forecast.

## Recent economic developments

Sri Lanka's economic growth continues to be adversely affected by shocks. An unprecedented political controversy last year led to a subdued growth of 3.2 percent for 2018. Growth rebounded in the first quarter of 2019 to 3.7 percent (year-on-year) thanks to relatively benign weather that revived agriculture and related industry sectors. However, the aftermath of the April terrorist attacks that killed over 250 people, including tourists, is expected to take a toll on the economy in the rest of 2019 with decelerating private consumption and investment. Annual average inflation remained low at 4.2 percent by end-June 2019, with the moderation of food prices owing to improved weather, despite the passthrough of currency depreciation in 2018. Citing sluggish growth and favorable inflation expectations, the Central Bank reduced the policy rate corridor by 100 basis points in the first eight months of 2019. Nevertheless, the demand for private credit has shown limited responsiveness amid sluggish economic activity.

On the external front, the trade deficit narrowed in the first half of 2019 due to a contraction of motor vehicles and gold imports, which experienced an import surge in the corresponding period of 2018, and increased garments exports. This is expected to have reduced the current account deficit for the first half of 2019 despite decelerating tourism receipts and remittances. Notwithstanding historically high debt repayments, official reserves increased thanks to the issuance of USD 4.4 billion in sovereign bonds. While reserve cover reached a 12-month high at 5.2 months of merchandise imports by end-June 2019, external vulnerability remains high with relatively high short-term liabilities. The rupee remained broadly stable against the USD, with a year-to-date appreciation of 3.4 percent by end-June.

Fiscal balances deteriorated in the first half of 2019. Tax revenues fell short of expectations due to weak collection of excise taxes from motor vehicles, petroleum products and import taxes, amid slow growth. Expenditures increased due to relief packages after the April attacks, settling of arrears and the implementation of budget proposals that increase recurrent expenditures in an election year. As a result, the annualized budget deficit is expected to have increased above 6.0 percent of GDP for the first half of 2019. Sri Lanka's debt to GDP ratio of 82.9 percent and annual gross financing needs of approximately 18 percent of GDP remain among the highest among middle-income countries. In addition, the debt portfolio is subject to important risks, with over 54 percent of the debt denominated in foreign exchange.

The USD 3.20 poverty rate (used for lower middle-income countries) declined from 9.5 percent in 2017 to 8.7 percent in 2018. The USD 5.50 poverty rate (used for upper middle-income countries) declined from 39 percent to 37.3 percent during the same period. Tourism and related service sectors have increasingly become a viable source of employment and income for the poor and low-skilled in rural areas in recent years, contributing

to poverty reduction. However, low female labor force participation and the low quality of private sector jobs, including high rates of informal employment, remain persistent issues. While overall unemployment was relatively low at 4.4 percent of the labor force in 2018, youth unemployment recorded 21.4 percent, indicating difficulties with entering the labor market.

## Outlook

The medium-term outlook is subject to the country's ability to ensure political stability and a return to normalcy. Growth for 2019 is expected at 2.7 percent, as many important economic sectors show relatively weak performance. In the medium-term, the economy is expected to recover from the disruptions in 2019, and growth is expected to accelerate towards 4.0 percent, gradually closing the output gap. The drivers of the recovery are anticipated to be investment and exports, as performance in the tourism sector improves and uncertainty is resolved after the elections are held.

The current account deficit is expected to narrow marginally in 2019 compared to 2018, thanks to weak import demand. Significantly large debt creating flows will be required to close the external financing gap when the impact of past one-off FDIs wane. Gross official reserves are expected to remain relatively low, as the country faces large debt repayments. Provided that the revenue-led fiscal consolidation continues, primary surpluses will return in 2020, which will help bring debt to a sustainable path. In the absence of currency depreciation, the debt-to-GDP ratio will stabilize in 2019. The successful completion of the IMF supported reform program and the continuation of the reform agenda beyond mid-2020 will be critical for macroeconomic stability and sustainability. The slowdown in economic activities, especially tourism, trade, transport, construction and other SME businesses, is expected to constrain jobs and wage growth in the near-term. The decrease in remittances will also lead to lower contributions to household income. As a result, the pace of poverty reduction is expected to slow down, with poverty measured using the USD 5.50 poverty line projected at 36.1 percent in 2019.

## Risks and challenges

Risks are tilted to the downside. On the domestic front, a challenging political environment, delays or reversals in efforts to strengthen revenues, and a slower than expected recovery of some key economic sectors represent important risks. Mitigating these risks will be key to creating private sector jobs and accelerating poverty reduction. Externally, while Sri Lanka has raised enough foreign currency funds to manage immediate debt repayments, continued large refinancing requirements, weak fiscal buffers and high indebtedness make the economy vulnerable to uncertain global financial conditions. Priority reforms include: (a) continuing fiscal consolidation by broadening the tax base and aligning

spending with priorities; (b) shifting to a private investment-tradable sector-led growth model by improving trade, investment, innovation and the business environment; (c) improving governance and SOE performance; (d) addressing the impact of an aging workforce by

increasing labor force participation, encouraging longer working lives and investing in skills to improve productivity; and (e) mitigating the impact of reforms on the poor and vulnerable with well-targeted social protection spending.

**Table 2: Macro poverty outlook indicators (annual percent change unless indicated otherwise).**

	2016	2017	2018	2019 (f)	2020 (f)	2021 (f)
<b>Real GDP growth, at constant market prices</b>	4.5	3.4	3.2	2.7	3.3	3.7
Private consumption	7.4	2.5	2.3	2.6	3.4	3.8
Government consumption	2.3	-5.4	-5.5	4.8	3.5	4.5
Gross fixed capital investment	7.8	5.9	-1.3	-2.4	3.3	4.9
Exports, goods and services	-0.7	7.6	0.5	1.1	7.7	4.8
Imports, goods and services	7.9	7.1	1.8	-3.3	4.9	4.5
<b>Real GDP growth, at constant factor prices</b>	4.3	3.4	3.6	2.7	3.3	3.7
Agriculture	-3.7	-0.4	4.8	3.4	3.4	3.4
Industry	5.7	4.1	0.9	2.6	3.2	3.5
Services	4.8	3.6	4.7	2.6	3.4	3.8
<b>Inflation (consumer price index)</b>	4.0	6.6	4.3	4.5	4.5	4.5
<b>Current account balance (percent of GDP)</b>	-2.1	-2.6	-3.2	-2.7	-2.6	-2.7
<b>Net Foreign Direct Investment (percent of GDP)</b>	0.8	1.5	1.7	1.1	1.3	1.3
<b>Fiscal balance (percent of GDP)</b>	-5.3	-5.5	-5.3	-6.5	-5.2	-4.7
<b>Debt (percent of GDP)</b>	78.3	76.9	82.9	82.7	83.6	83.5
<b>Primary balance (percent of GDP)</b>	-0.3	0.0	0.6	-0.5	0.7	1.3
<b>International poverty rate (USD 1.9 in 2011 PPP)<sup>a,b</sup></b>	0.8	0.7	0.6	0.5	0.4	0.3
<b>Lower middle-income poverty rate (USD 3.2 in 2011 PPP)<sup>a,b</sup></b>	10.1	9.5	8.7	8.2	7.4	6.5
<b>Upper middle-income poverty rate (USD 5.5 in 2011 PPP)<sup>a,b</sup></b>	40.4	39.0	37.3	36.1	34.4	32.3

Source: World Bank.

Notes: (f) = forecast. (a) Calculations based on SAR-POV harmonization, using 2016-HIES. Actual data: 2016. Nowcast: 2017-2018. Forecast are from 2019 to 2021; (b) Projection using neutral distribution (2016) with pass-through = 0.87 based on GDP per capita in constant LCU.



# South Asia at a glance

		Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka	South Asia	
OUTPUT and PRICES	Real GDP Growth	2016	2.4	7.1	7.4	8.2	7.3	0.6	4.6	4.5	7.7
		2017	2.7	7.3	6.3	7.2	6.9	8.2	5.2	3.4	7.2
		2018	1.8	7.9	4.6	6.8	6.7	6.7	5.5	3.2	6.6
		2019 (f)	2.5	8.1	5.0	6.0	5.2	7.1	3.3	2.7	5.9
		2019 Q1 (CY)	..	..	..	5.8	..	..	..	3.8	..
		2019 Q2 (CY)	..	..	..	5.0	..	..	..	1.6	..
	Inflation (Consumer Price Index)	2016	4.3	5.9	4.4	4.5	0.5	9.9	2.9	4.0	4.2
		2017	4.7	5.4	4.1	3.6	2.8	4.5	4.2	6.6	5.1
		2018	0.6	5.8	2.7	3.4	-0.1	4.2	3.9	4.3	3.9
		2019 (f)	3.1	5.5	5.0	3.5	0.5	4.5	7.3	4.5	4.0
		2019 June	3.1	5.5	2.7	3.2	1.7	6.1	8.9	2.1	..
		2019 July	1.8	5.6	..	3.1	0.5	6.3	10.4	2.2	..
	REER (CY)	2016	..	..	..	105.2	..	..	110.3	..	105.7
		2017	..	..	..	110.0	..	..	106.9	..	109.7
		2018	..	..	..	105.0	..	..	103.0	..	104.8
		2019 (f)	..	..	..	106.8	..	..	103.8	..	106.5
		2019 August	..	..	..	108.0	..	..	104.4	..	107.6
		2019 Sept.	..	..	..	108.7	..	..	104.8	..	108.3
BALANCE of PAYMENTS	Current Account Balance (percent of GDP)	2016	5.6	1.9	-30.5	-0.6	-23.4	-0.6	-1.7	-2.1	-0.7
		2017	1.0	-0.5	-22.9	-1.8	-21.7	-1.8	-4.1	-2.6	-2.0
		2018	0.6	-3.5	-19.6	-2.1	-25.3	-2.1	-6.3	-3.2	-2.5
		2019 (f)	-1.6	-1.7	-16.3	-2.0	-18.5	-2.0	-4.8	-2.7	-2.3
	Trade Balance (percent of GDP)	2016	-30.8	-32.2	-31.1	-1.2	..	-40.7	-14.9	-7.5	-5.0
		2017	-32.4	-42.6	-24.0	-2.3	..	-49.2	-18.7	-7.6	-6.9
		2018	-30.7	-53.7	-19.8	-3.0	..	-57.1	-19.6	-7.7	-8.3
		2019 (f)	-30.0	-52.8	-19.6	-2.8	..	-59.8	-15.8	-5.6	-7.8
	Import Growth (percent, y-0-y)	2016	25.8	-7.1	12.3	4.4	..	2.8	16.0	7.9	4.7
		2017	8.0	2.9	-7.1	17.6	..	27.2	21.2	7.1	16.6
		2018	1.0	27.0	-7.1	15.4	..	19.0	15.8	1.8	15.3
		2019 (f)	3.6	4.8	6.9	5.9	..	17.9	5.8	-3.3	5.7
Export Growth (percent, y-0-y)	2016	-0.3	2.2	-1.4	5.1	..	-13.7	-1.6	-0.7	4.4	
	2017	7.0	-2.3	6.8	4.7	..	11.3	-0.6	7.6	4.2	
	2018	5.0	8.1	-2.0	12.5	..	7.8	10.4	0.5	11.9	
	2019 (f)	10.0	14.9	10.9	6.0	..	7.9	13.2	1.1	6.5	

			Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka	South Asia
BALANCE of PAYMENTS	Foreign Reserves (months of goods import cover, CY)	2016	..	8.8	..	12.1	3.4	..	5.4	3.8	11.0
		2017	..	8.4	..	10.3	2.8	..	4.0	3.8	9.5
		2018	..	7.1	..	9.5	2.8	..	2.8	4.4	8.7
		2019 June	..	7.0	..	10.7	..	..	2.9	6.2	9.8
		2019 July	..	6.9	..	10.5	..	..	3.0	4.6	9.5
	Personal Remittances Received (USD million, CY)	2016	652	13,574	34	62,744	3.8	6,612	19,808	7,262	110,691
		2017	734	13,502	43	68,967	4.0	6,928	19,807	7,190	117,176
		2018	385	15,562	58	78,790	4.2	8,064	21,194	7,043	131,101
		2019 June	..	4,374	..	12,617	..	..	5,069	1,617	..
		2019 July	..	4,550	..	14,642	..	..	5,747	..	..
GOVERNMENT FINANCES	Fiscal Balance (percent of GDP, FY)	2016	0.1	-3.7	-1.9	-6.9	-9.9	1.4	-4.5	-5.3	-6.3
		2017	-0.5	-3.4	-4.6	-5.7	-3.0	-3.1	-5.8	-5.5	-5.4
		2018	0.6	-4.7	-3.1	-5.9	-4.7	-6.7	-6.4	-5.3	-5.8
		2019 (f)	-0.9	-4.4	-2.1	-6.0	-2.9	-1.9	-8.8	-6.5	-6.0
		2020 (f)	-0.6	-4.8	-2.7	-5.8	-4.9	-2.6	-7.5	-5.2	-5.8
	Public Debt (percent of GDP, FY)	2016	6.1	31.5	109.4	67.5	56.2	27.9	68.7	78.3	64.5
		2017	5.9	30.8	108.2	67.6	58.5	26.1	68.0	76.9	64.5
		2018	6.9	31.9	104.0	67.3	59.2	30.2	73.0	82.9	64.8
		2019 (f)	7.1	32.8	109.3	66.9	59.0	30.1	86.5	82.7	65.4
		2020 (f)	7.1	33.8	105.6	66.5	60.2	30.3	82.9	83.6	64.8
CONSUMPTION and INVESTMENT	Private Consumption Growth (percent, y-o-y)	2016	-0.2	5.2	3.0	8.1	..	0.9	8.2	7.4	7.7
		2017	4.3	9.2	-0.4	7.6	..	2.8	7.5	2.5	7.5
		2018	1.2	8.9	1.0	7.9	..	3.9	4.6	2.3	7.3
		2019 (f)	2.0	5.8	8.7	5.8	..	3.7	2.4	2.6	5.2
		2020 (f)	2.3	6.3	7.4	6.1	..	1.2	1.1	3.4	5.4
	Gross Fixed Capital Investment Growth (percent, y-o-y)	2016	-6.0	9.5	11.5	7.9	..	16.7	8.7	2.5	8.0
		2017	6.4	10.3	5.5	9.1	..	31.2	9.1	7.8	9.2
		2018	0.5	10.7	-3.6	9.8	..	15.9	2.0	5.0	9.3
		2019 (f)	3.1	8.6	-3.9	8.9	..	10.7	-3.6	5.8	8.1
		2020 (f)	2.8	8.9	-2.5	8.3	..	9.3	3.8	5.5	8.1
	Net Foreign Direct Investment (percent of GDP, FY)	2016	-0.1	0.6	0.5	1.6	10.3	0.5	0.8	0.8	1.4
		2017	-0.1	0.7	-0.7	1.1	10.1	0.8	0.9	1.5	1.1
		2018	-0.1	0.6	0.1	1.1	10.5	0.6	1.1	1.7	1.1
		2019 (f)	-0.1	0.8	..	1.2	..	..	0.6	1.1	1.1
		2020 (f)	0.1	0.8	..	1.4	..	..	0.8	1.3	1.3
Net Foreign Portfolio Investment (USD million)	2016	98.7	-42.1	..	4,725	132.3	..	-153	-993	..	
	2017	-29.1	178.8	..	-30,638	-328.7	..	-1,198	-1,772	..	
	2018	..	550.4	169.5	9,598	-98.2	..	288	-129	..	
	2019 Q1 (CY)	..	253.2	..	13,502	..	..	-1	1,418	..	
	2019 Q2 (CY)	..	253.2	..	13,502	..	..	-1,032	1,418	..	

## Notes:

(f)	Forecast
CY	Series for Calendar Year
FY	Series for Fiscal Year
	Afghanistan's fiscal year is the calendar year. Bangladesh's fiscal year runs from July 1st to June 30th. Bhutan's fiscal year runs from July 1st to June 30th. India's fiscal year runs from April 1st to March 31st. Maldives's fiscal year is the calendar year. Nepal's fiscal year runs from July 16th to July 15th. Pakistan's fiscal year runs from July 1st to June 30th. Sri Lanka's fiscal year is the calendar year.
Real GDP Growth	Source: Central Statistics Office of India, Sri Lanka Department of Census and Survey, and World Bank MTI. Note: Real GDP growth rates (percent change, y-o-y) at Market Prices; Pakistan is in factor prices.
Inflation (Consumer Price Index)	Source: World Bank DEC GEM and World Bank MTI. Note: Annual percent change in CPI inflation.
REER (CY)	Source: World Bank DEC GEM. Note: Real effective exchange rate is the nominal effective exchange rate (a measure of the value of a currency against a weighted average of several foreign currencies) divided by a price deflator or index of costs. An increase in REER implies that exports become more expensive and imports become cheaper.
Current Account Balance (percent of GDP)	Source: World Bank MTI. Note: Does not include grants unless otherwise stated.
Trade Balance (percent of GDP)	Source: World Bank WDI. Note: Trade balance in goods and services is derived by offsetting value of imports of goods and services against value of exports of goods and services as ratio to GDP.
Import Growth (percent, y-o-y)	Source: World Bank DEC GEM, World Bank MTI, and staff calculations. Note: Annual trade change is in (respective) fiscal year and covers goods and non-factor services (GNFS) imports. Monthly trade change is in calendar year and covers only merchandise.
Export Growth (percent, y-o-y)	Source: World Bank DEC GEM, World Bank MTI, and staff calculations. Note: Annual trade change is in (respective) fiscal year and covers goods and non-factor services (GNFS) exports. Monthly trade change is in calendar year and covers only merchandise.
Foreign Reserves (months of goods import cover, CY)	Source: World Bank DEC GEM. Note: Annual data for foreign reserves are 12-month averages.
Remittances (USD million, CY)	Source: Haver Analytics, World Bank WDI, Trading Economics, and staff calculations. Note: Personal remittances including personal transfers and compensation of employees in current USD.
Fiscal Balance (percent of GDP, FY)	Source: World Bank MTI. Note: Does not include grants unless otherwise stated.
Public Debt (percent of GDP, FY)	Source: World Bank MTI. Note: Gross public debt stock including domestic and foreign liabilities, end of Period.
Private Consumption Growth (percent, y-o-y)	Source: World Bank MTI. Note: Annual (respective) fiscal year percent change in gross consumption expenditure.
Gross Fixed Capital Investment Growth (percent, y-o-y)	Source: World Bank MTI. Note: Annual (respective) fiscal year percent change in gross fixed capital expenditure.
Net Foreign Direct Investment (percent of GDP, FY)	Source: Haver Analytics and World Bank MTI. Note: Net balance of Foreign Direct Investment assets and liabilities as ratio to GDP.
Net Portfolio Investment (USD million)	Source: Haver Analytics, IMF BoP database, and staff calculations. Note: Portfolio investment covers transactions in equity securities and debt securities. Balances are calculated as net assets minus net liabilities. Data is in current USD.







