SOUTH ASIA

South Asia remains the world's fastest growing region. India's domestic demand is strengthening as the country reaps the benefits of structural reforms and of a revival of credit growth. Growth in the region is projected to accelerate to 7.1 percent in 2019 from 6.9 in the previous year. Over the medium term, robust domestic demand will continue to underpin growth, which is expected to average 7.1 percent. However, risks to the outlook are tilted down. On the domestic side, vulnerabilities are being exacerbated by fiscal slippages and rising inflation, and the possibility of delays in needed structural reforms to address weaknesses in the balance sheets of banks and non-financial corporates. Key external risks include a further deterioration in current accounts and a faster-than-expected tightening of global financing conditions.

Recent developments

Growth in South Asia accelerated to an estimated 6.9 percent in 2018 from 6.2 percent the previous year, with domestic demand strengthening in India as temporary disruptions fade and the benefits from ongoing structural reforms start to materialize. The recovery was in line with expectations, and recent high frequency data–including purchasing managers' indices and industrial production–have broadly remained solid (Figure 2.5.1).

Throughout the region, private consumption picked up in 2018 while investment remained solid. The solid investment was supported by the fading of a number of temporary disruptions, a revival of credit growth, and ongoing infrastructure projects. Strong domestic demand boosted imports, while exports remained subdued amid weak global trade sentiment, causing current account deficits to widen (World Bank 2018s).

India's growth accelerated to an estimated 7.3 percent in FY2018/19 (April to March) as economic activity continued to recover with strong domestic demand. While investment continued to strengthen amid GST harmonization and a rebound of credit growth, consumption remained the major contributor to growth (Ahmad et al. 2018).

Excluding India, regional growth moderated slightly in 2018. Pakistan's GDP (factor cost) is estimated to have grown 5.8 percent in FY2017/18 (July 16 to July 15), with solid contributions from consumption and investment. Activity was supported by strengthening in the agricultural and industrial sectors, and a sustained acceleration in services.

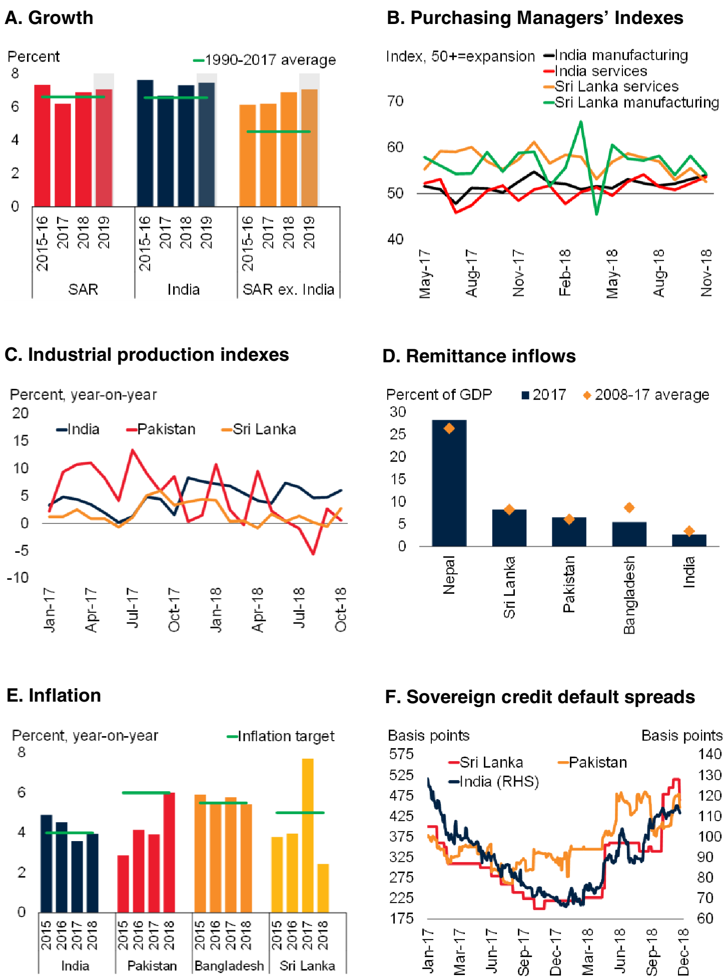
In Bangladesh, growth was broad-based, remaining strong at an estimated 7.9 percent in FY2017/18 (July 1 to June 30). Private consumption was the main driver of growth, supported by strong remittance inflows. Net exports turned negative because of rising food and capital machinery imports and weak exports (World Bank 2018t).

In Sri Lanka, activity accelerated to an estimated 3.9 percent in 2018 on the back of a recovery in the agriculture and services sectors. In Nepal, economic activity remained solid with a 6.3 percent growth in FY2017/18 (July 16 to July 15). Less favorable monsoons led to weakness in agricultural activity, but this was offset by a recovery in remittances and robust industrial

Note: This section was prepared by Temel Taskin. Research assistance was provided by Ishita Dugar and Brent Harrison.

FIGURE 2.5.1 SAR: Recent developments

South Asia remains the fastest growing EMDE region. High frequency indicators of economic activity are mixed across the region but are broadly consistent with the recovery underway. Remittance inflows are an important source of income in the region. Inflation is below official targets in general despite a recent acceleration in some countries. Sovereign credit default spreads have been rising as the Federal Reserve continues to tighten monetary policy and U.S. dollar appreciates.



Source: Haver Analytics, International Monetary Fund, World Bank.
A. SAR = South Asia Region. Aggregate growth rates are calculated using constant 2010 U.S. dollar GDP-weights. Data for 2018 are estimates. Shaded areas indicate forecasts.
B. PMI readings above 50 indicate expansion in economic activity; readings below 50 show contraction. Last observation is November 2018.
C. Last observation is October 2018.
D. Data present the workers' remittances and compensation received by countries. Last observation is 2017.
E. Last observation is October 2018.
F. Data present five-year U.S. dollar credit default swap (mid-rate). Last observation is December 2018.
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sector growth, particularly for manufacturing activities (World Bank 2018u).

Investment and services remained the major contributor to economic activity in Bhutan and the Maldives. In Bhutan, hydropower and other infrastructure projects supported investment, and GDP expanded by an estimated 4.6 percent in FY2017/18 (July 1 to June 30). Maldives' GDP accelerated to an estimated 8.0 percent in 2018, reflecting strength in tourism and construction. Growth in Afghanistan is estimated to have edged down to 2.4 percent. Although activity was supported by agriculture and services, subdued business confidence and security challenges continued to weigh on growth.

There were some signs of rising inflation pressure across the region, and both India and Pakistan raised rates in 2018 to counter the effects of currency depreciation, rising energy prices, and domestic capacity constraints.

Sovereign bond yields surged in the region last year. Fiscal consolidation stalled owing to elections in several countries, contributing further to the region's high levels of government debt. In India, the government deficit was higher than planned, reflecting lower-than-expected revenues from telecom spectrum auctions and low dividends from public sector enterprises (World Bank 2018v). The central government is budgeting a reduction in the fiscal deficit for next fiscal year. Pakistan's fiscal deficit rose to 6.6 percent of GDP last year, well above the government's target of 4.1 percent, as tax collection fell short of expectations.

External vulnerabilities are also rising in the region. In Sri Lanka and to some extent in Pakistan, external debt is sizable and current account deficits have deteriorated considerably. Recent currency pressures have eroded Pakistan's foreign exchange reserves significantly—they currently amount to only around two months of imports.

Outlook

The outlook for South Asia is robust, despite the financial stress that has affected a number of EMDEs and continued trade disputes. Regional growth is expected to accelerate in 2019, to 7.1 percent (Figure 2.5.2). Economic activity will be underpinned by solid investment and robust consumption. While exports and imports will be held back owing to slowing global trade, the region's relatively low exposure to international trade will mitigate the impact of this slowdown on the regional outlook.

India's GDP is forecast to grow by 7.3 percent in FY2018/19 and 7.5 percent thereafter, in line with June forecasts. Private consumption is projected to remain robust and investment growth is expected to continue as the benefits of recent policy reforms begin to materialize and credit rebounds. Strong domestic demand is envisioned to widen the current account deficit to 2.6 percent of GDP next year. Inflation is projected to rise somewhat above the midpoint of the Reserve Bank of India's target range of 2 to 6 percent, mainly owing to energy and food prices.

In the rest of the region, economic activity will average 5.6 percent over the forecast horizon. In Pakistan, macroeconomic imbalances weigh on growth outlook. Pakistan is expected to face financing needs due to large current account and fiscal deficits combined with low international reserves. GDP growth is projected to decelerate to 3.7 percent in FY2018/19, with financial conditions tightening to help counter rising inflation and external vulnerabilities. Activity is projected to rebound and average 4.6 percent over the medium term with support from stabilizing macroeconomic conditions (World Bank 2018u).

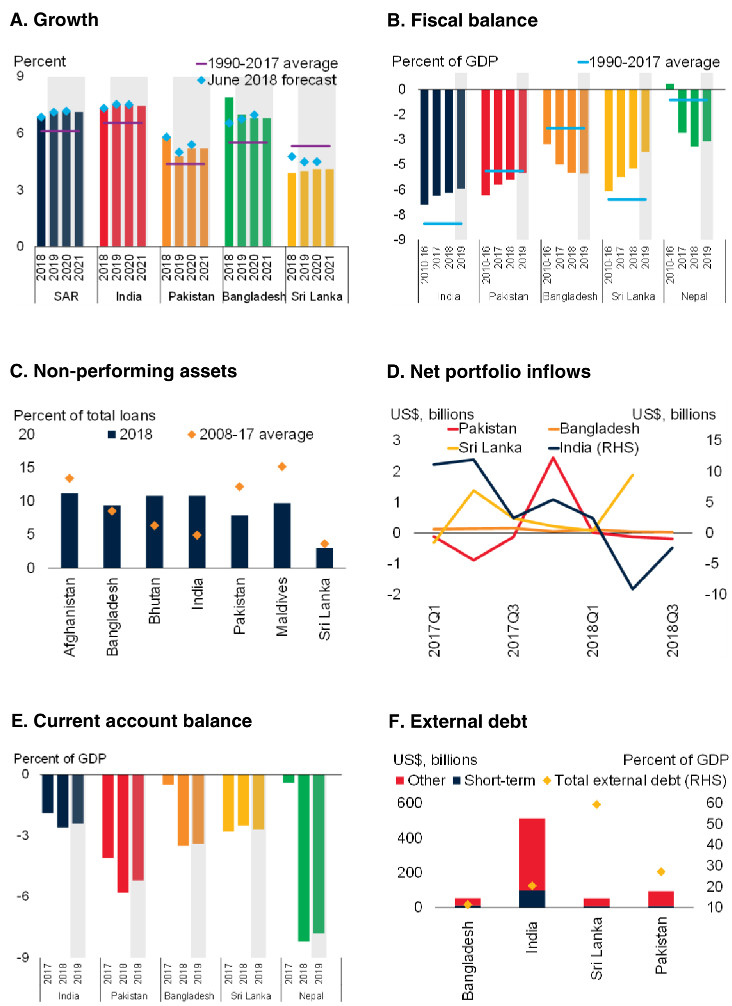
In Bangladesh, robust economic activity is expected to be sustained. GDP growth is forecast at 7.0 percent in FY2018/19 and is expected to decelerate only slightly over the forecast horizon. Activity will be supported by strong private consumption and investment on the back of infrastructure projects. Net exports are projected to contribute negatively to GDP growth as imports outpace exports in response to strong domestic demand.

In Sri Lanka, last year's recovery from adverse weather conditions is expected to continue in 2019, with 4.0 percent GDP growth. Activity will be supported by robust domestic demand as consumption rebounds following natural disasters, and investment is boosted by infrastructure projects. Nepal's strong post-earthquake momentum is expected to moderate—GDP growth is forecast to decelerate to 5.9 percent in FY2018/19. Activity will be underpinned by strong infrastructure investment and consumption.

In Bhutan and the Maldives, activity will remain reliant on construction and tourism. Bhutan's

FIGURE 2.5.2 SAR: Outlook and risks

Economic activity is projected to remain strong. Possible fiscal slippages could further worsen already-high public debt positions. Non-performing assets remain high despite recent efforts to improve the quality of financial sector balance sheets. External imbalances pose a risk to the outlook. Major economies in the region have tightened their monetary stance to stabilize inflation and mitigate external risks.



Source: Haver Analytics, World Bank.

A. SAR = South Asia Region. Aggregate growth rates are calculated using constant 2010 U.S. dollar GDP-weights. 2018 data are estimates. Shaded areas indicate forecasts.

B.E. 2018 data are estimates. Shaded areas indicate forecasts. The data represent fiscal years of countries except for Sri Lanka, as described in Table 2.5.1.

C. Data present the ratio of bank non-performing loans to total gross loans. Last observation is 2017.

D. Last observation is 2018 Q3 for Bangladesh and Pakistan, and 2018 Q2 for India and Sri Lanka.

F. Gross external debt position including both public and private sectors, as of 2018 Q2.

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growth is projected to accelerate to 7.6 percent 2018/19, supported by ongoing infrastructure projects and rising tourism. In the Maldives, growth is expected to moderate to 6.3 percent in 2019 as construction activity returns to long-term averages, and capital investment projects gradually slow down. Afghanistan's economy is expected to remain subdued, expanding 2.7 percent in 2019, as a result of security challenges ahead of elections, declining business confidence, and worsening drought conditions.

In South Asia, a large proportion of activity is informal, which may constrain productivity, wages, and access to social protection systems (Kanbur 2017). Investing in education and skills, improving the business environment by enhancing regulatory frameworks and boosting the quality of government services provided to formal firms are among the policy measures which can encourage formal activity (Box 2).

Risks

The risks to the outlook are tilted downside. Domestic vulnerabilities are being exacerbated by fiscal slippages and rising inflation, escalation in political uncertainty, and the possibility of delays in the needed structural reforms to address weaknesses in balance sheets of banks and non-financial corporates. Key external risks include a further deterioration in current accounts and a faster-than-expected tightening of global financing conditions.

South Asian economies have high levels of public debt in general. Fiscal slippages could further worsen already-precarious public debt positions and result in a costly rise in already- elevated interest payments.

The upcoming election cycle next year elevates political uncertainty in the region. The challenging political environment could adversely affect the ongoing reform agenda and economic activity in some countries (e.g. Afghanistan, Sri Lanka).

In South Asia, non-performing assets (NPAs) are still high despite recent measures taken to improve the recognition of these assets (Figure 2.5.2). Especially, public sector banks in India, which represent roughly 70 percent of the banking sector assets, still report low profitability and high NPAs. Credit expansion could be limited in some major South Asia economies unless further steps are taken to deal with financial and corporate balance sheets.

On the external front, the region has relatively low exposure to international trade, which limits the benefits from trade over the long term. However, the low exposure also suggests that that it could be more insulated from the effects rising trade protectionism than other regions. Moreover, the region may even benefit from trade diversion amid the recent dispute between some major economies (World Bank 2017b).

Persistent current account deficits and high levels of external debt make the region more vulnerable to a faster-than-expected tightening of global financial conditions.

South Asia is one of the most vulnerable regions to natural disasters (World Bank 2017c). In recent years, the number of affected people and geographical areas from natural disasters such as drought, floods, and earthquakes have risen in the region. Increasingly common natural disasters could disrupt infrastructure, agricultural output, and economic activity in general. The realization of these domestic or external risks could weaken investor confidence and result in capital outflows, currency depreciation leading to rising external debt, a tightening of domestic financing conditions, and a slowdown in regional growth (Eichengreen and Gupta 2015; Kose et al. 2017).

TABLE 2.5.1 South Asia forecast summary

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from June 2018 projections: 2018e	2019f	2020f
EMDE South Asia, GDP[1, 2]	**7.5**	**6.2**	**6.9**	**7.1**	**7.1**	**7.1**	**0.0**	**0.0**	**-0.1**
(Average including countries with full national accounts and balance of payments data only)[3]									
EMDE South Asia, GDP[3]	7.6	6.2	6.9	7.1	7.2	7.1	0.0	-0.1	0.0
GDP per capita (U.S. dollars)	6.2	4.9	5.7	5.9	6.0	6.0	0.1	0.0	0.0
PPP GDP	7.6	6.2	6.9	7.1	7.2	7.1	0.0	0.0	0.0
Private consumption	7.6	6.0	6.9	7.0	7.0	7.0	0.3	0.1	0.0
Public consumption	8.5	11.1	10.7	9.1	8.5	8.5	1.0	0.3	0.0
Fixed investment	9.4	8.0	8.2	8.0	7.8	7.5	0.6	0.3	0.1
Exports, GNFS[4]	1.9	6.2	5.6	5.6	5.9	6.0	-0.1	-0.5	-0.2
Imports, GNFS[4]	2.6	14.6	8.5	6.3	6.7	6.8	1.0	-0.2	0.6
Net exports, contribution to growth	-0.3	-2.3	-1.1	-0.6	-0.6	-0.6	-0.4	-0.2	-0.3
Memo items: GDP[2]	**16/17**	**17/18**	**18/19e**	**19/20f**	**20/21f**	**21/22f**	**18/19e**	**19/20f**	**20/21f**
South Asia excluding India	5.8	5.9	5.7	5.5	5.6	5.6	0.1	-0.1	-0.1
India	7.1	6.7	7.3	7.5	7.5	7.5	0.0	0.0	0.0
Pakistan (factor cost)	5.4	5.8	3.7	4.2	4.8	4.8	-1.3	-1.2	-0.6
Bangladesh	7.3	7.9	7.0	6.8	6.8	6.8	0.3	-0.2	-0.2

Source: World Bank.

Note: e = estimate; f = forecast. EMDE = emerging market and developing economy. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time.

1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.
2. National income and product account data refer to fiscal years (FY) for the South Asian countries, while aggregates are presented in calendar year (CY) terms. The fiscal year runs from July 1 through June 30 in Bangladesh, Bhutan, and Pakistan, from July 16 through July 15 in Nepal, and April 1 through March 31 in India.
3. Sub-region aggregate excludes Afghanistan, Bhutan, and Maldives, for which data limitations prevent the forecasting of GDP components.
4. Exports and imports of goods and non-factor services (GNFS).

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TABLE 2.5.2 South Asia country forecasts

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from June 2018 projections: 2018e	2019f	2020f
Calendar year basis[1]									
Afghanistan	2.4	2.7	2.4	2.7	3.2	3.2	0.2	0.2	-0.1
Maldives	6.2	7.1	8.0	6.3	5.6	5.6	2.5	1.8	0.7
Sri Lanka	4.5	3.3	3.9	4.0	4.1	4.1	-0.9	-0.5	-0.4
Fiscal year basis[1]	**16/17**	**17/18**	**18/19e**	**19/20f**	**20/21f**	**21/22f**	**18/19e**	**19/20f**	**20/21f**
Bangladesh	7.3	7.9	7.0	6.8	6.8	6.8	0.3	-0.2	-0.2
Bhutan	5.8	4.6	7.6	6.4	6.4	6.4	2.2	0.4	-2.3
India	7.1	6.7	7.3	7.5	7.5	7.5	0.0	0.0	0.0
Nepal	7.9	6.3	5.9	6.0	6.0	6.0	1.4	1.8	1.8
Pakistan (factor cost)	5.4	5.8	3.7	4.2	4.8	4.8	-1.3	-1.2	-0.6

Source: World Bank.

Note: e = estimate; f = forecast. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time.

1. Historical data is reported on a market price basis. National income and product account data refer to fiscal years (FY) for the South Asian countries with the exception of Afghanistan, Maldives, and Sri Lanka, which report in calendar year (CY). The fiscal year runs from July 1 through June 30 in Bangladesh, Bhutan, and Pakistan, from July 16 through July 15 in Nepal, and April 1 through March 31 in India.

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BOX 2.5.1 Informality in South Asia

South Asia's share of informal employment is the largest among EMDE regions, despite a below-average share of informal output. Heavy tax burdens, above-average corruption, and low government effectiveness have contributed to high employment informality. Informal employment is concentrated among low-skilled, young, female and rural workers. The sizable informal sector is associated with lower productivity, lower government revenues, and higher poverty in the region. Policy options to address these challenges include investing in human capital in the form of training programs and improving access to finance.

Introduction

South Asia (SAR) is the EMDE region with the highest average share of informal employment among EMDE regions, despite a below-median and declining share of informal output. Nonetheless, there is significant heterogeneity in the share of employment as well as output informality among South Asian countries.

Against this backdrop, this Box examines the following questions:

- How has informality evolved in South Asia?
- What have been the macroeconomic and social correlates of informality?
- What policy options are available to address challenges associated with informality?

Evolution of informality

Informality in SAR. In aggregate, output informality in the SAR region is below the average of other EMDE regions—the size of informal sector relative to official GDP was on average 30 percent in South Asia compared with 35 percent in average EMDE during 2008-2016 (Figure 2.5.1.1). During the same period, 96 percent of workers lacked pension coverage and 63 percent were self-employed.

Evolution of informality in SAR. Output informality declined from 37 percent in 1990s to 32 percent in the 2010s, broadly in line with the decline in informality in other EMDEs. However, labor informality over the same period persisted or rose depending on the measure of informality. For example, the share of the labor force without pension coverage rose from 88 percent to 96 and self-employment remained around 63 percent.

Regional heterogeneity. The extent of informality varies substantially across countries in South Asia. Sri Lanka had the highest degree of informality (output in the informal sector is about 40 percent of total output) in 2016 and India had the lowest share (below 20 percent). However, this ranking is reversed using labor market indicators of informality: Sri Lanka has the lowest share of self-employment (42 percent) and India the highest (76 percent) as of 2016. These differences are reflected in lower labor productivity in the informal sector (relative to the formal sector) in India than in Sri Lanka.

Correlates of informality

Business climates. Costs to doing business—such as tax burdens, labor regulation, and cost of starting business—are among the main drivers of informality identified in the empirical literature (FICCI 2017; Goldar and Aggarwal 2012). Over the past decade, SAR has suffered from greater corruption and weaker government effectiveness than other EMDE regions (Figure 2.5.1.2). Tax burdens and indicators of ease of doing business have also been less favorable than in the average EMDE (World Bank 2017c). Among costs to doing business, heavy tax burdens were particularly strongly associated in India and Pakistan with a larger fraction of firms operating unregistered (Ghani, Kerr, O'Connell 2013; Waseem 2013).

Worker characteristics. South Asia's informal labor force consists predominantly of low-skilled, female, rural, and young workers (Bahadur and Parajuli 2014; Goldar and Agarwal 2012; Gunatikala 2008; Williams, Shahid, and Martinez 2015). The intensity of informal employment in South Asia reflects a lack of formal jobs and skills, as well as a preference towards self-employment (Arby, Malik, and Hanif 2010; Williams, Shahid, and Martinez 2015). This means that informal firms are usually small, agricultural, and consist mostly of self-employed workers (FICCI 2017).

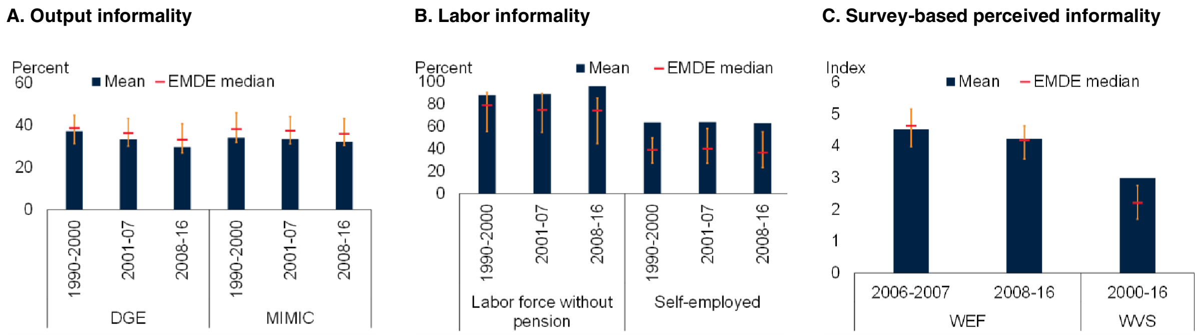
Lower productivity and incomes. In South Asia, informal workers have had lower earnings, fewer skills, and less access to social protection systems; this has been reflected in lower productivity and higher poverty (Kanbur 2017; Likhi 2013). Informal employment among underrepresented groups in labor markets, such as women and the young, has grown over the past decade and

Note: This box was prepared by Temel Taskin. Research assistance was provided by Brent Harrison and Jinxin Wu.

BOX 2.5.1 Informality in South Asia (*continued*)

FIGURE 2.5.1.1 Informality in South Asia

South Asia's share of informal employment is the largest among EMDE regions, despite a below-average share of informal output.



Source: Elgin et al. (forthcoming); World Bank.

A. DGE = dynamic general equilibrium model. MIMIC = multiple indicators multiple causes model. Both DGE and MIMIC estimates measure the informal output in percent of official GDP.

B. Labor force without pension is the fraction of the labor force that doesn't contribute to a retirement pension scheme, which is derived from the original data on pension coverage obtained from WDI. Self-employed is the share of self-employment in total employment.

C. WEF = World Economic Forum. WVS = World Values Survey. WEF index is the average responses at the country-year level to the following question (surveyed by World Economic Forum): "In your country, how much economic activity do you estimate to be undeclared or unregistered? (1=Most economic activity is undeclared or unregistered; 7 = Most economic activity is declared or registered)." WEF indices are re-ordered (i.e. 1= Most economic activity is declared or registered; 7= Most economic activity is undeclared or unregistered) so that a higher average at the country level indicates a larger informal economy. The index does not use data for year 2004-2005 due to inconsistency in survey methods. The World Value Survey asks whether respondents can justify cheating on taxes, with responses ranging from 1 (never justifiable) to 10 (always justifiable). The average responses at the country-year level are used as a measure for attitudes towards informality (or tax morality, Oveido et al. 2009), labeled as WVS. A higher average at the country level implies that people find cheating on taxes more justifiable.

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constrained these groups' income security. Low earnings and limited options available to informal workers constrain their benefit from economic growth, which means that growth has been less inclusive than otherwise (ADB 2016; Heintz 2012). Conversely, in India, an easing of labor market restrictions and measures to foster gender equality—such as increasing female education and strengthening law enforcement against gender discrimination—have been associated with stronger growth as well as larger formal employment (Goldar and Aggarwal 2012; Khera 2016).

Lower government revenues. Large informal sectors—in addition to other factors such as inefficient tax administration and narrow tax base—weigh on tax revenues in South Asian economies (Cevik 2016; Ilzetzki and Lagakos 2017). On average, tax revenues as a percent in GDP have historically been below the EMDE average. The lack of tax revenues ultimately affects the ability of governments to fund its infrastructure investment, social programs, etc., and therefore limiting their ability to tackle poverty and inequality (Chapter 3).

Policy challenges

In South Asia, informal employment is concentrated among young, low-skilled, female, and rural workers. Policies targeting training and education of these groups, especially in rural areas, could help their transition to formal employment (Khera 2016).

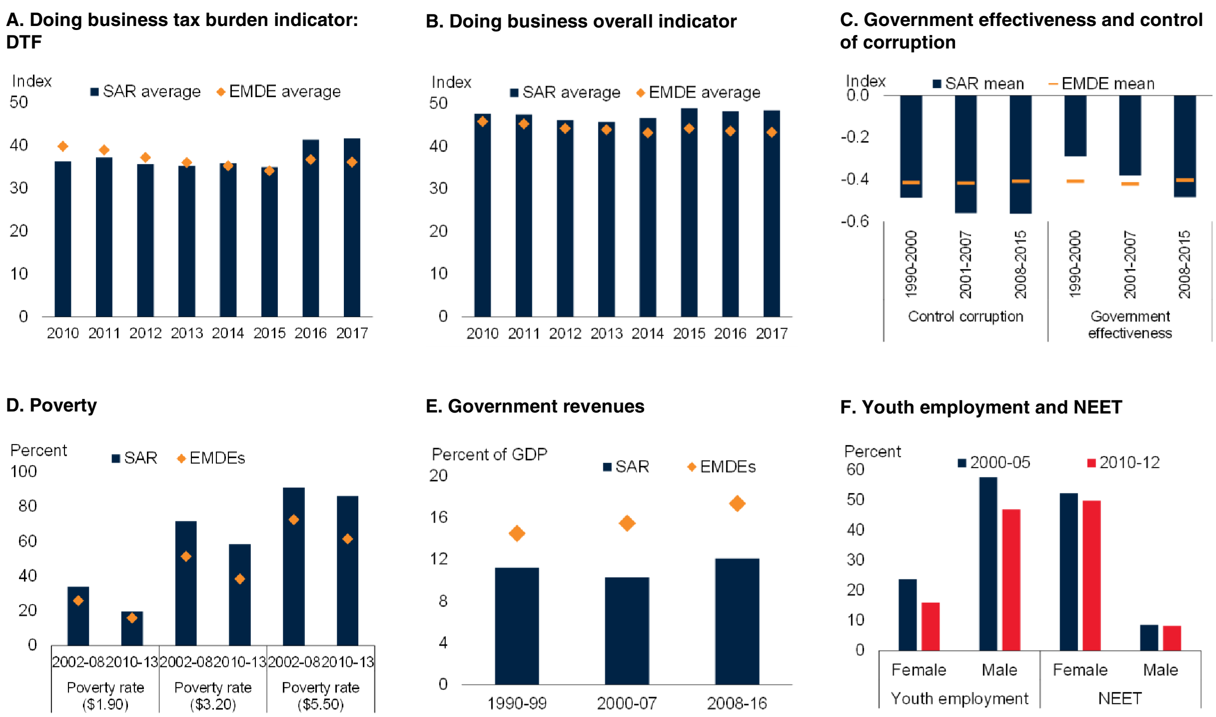
There is significant room to improve the ease of doing business in South Asia. This could reduce informality by reducing the cost of entry and cost of operating in formal sector. Measures to reduce the time, cost, and complexity of registration would also improve the business climate and foster growth (FICCI 2017).

High quality public services can also provide an incentive for informal firms to become formal in order to access these services. Enhanced monitoring and enforcement, including of tax regulations, could help discourage informality (Ilzetzki and Lagakos 2017). Also, in India the recent introduction of a Goods and Services Tax and steps toward demonetization are expected to encourage a shift from the informal to the formal sector.

BOX 2.5.1 Informality in South Asia *(continued)*

FIGURE 2.5.1.2 Drivers of informality in South Asia

Heavy tax burdens, above-average corruption, and low government effectiveness likely have contributed to high employment informality. The sizable informal sector is associated with weaker government revenues and higher poverty in the region. Youth unemployment is much higher among women who represent a higher share of informal workers than men.



Source: World Bank, World Development Indicators.

A.B. Index denotes Distance to Frontier Score (100-regional score), where 100 equals international best practices. Greater distance indicates further below best practice score.

D.E. Episodes are determined based on data availability.

F. NEET stands for the share of youth Not in Employment, Education, or Training. Youth is defined as the population between ages of 15 and 24.

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South Asia's self-employed, which account for about 80 percent of informally employed, have limited access to financial resources that could finance growth- or productivity-enhancing investment (Ghani, Kerr, and O'Connell 2013). Greater access to credit for the self-employed and household enterprises could help them grow into formality (Beck and Hoseini 2014). Microfinance can be an effective instrument for providing financial access to informal firms, as many of them are self-employed enterprises (ILO 2013; Likhi 2013).

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