

BOX 2.5.1 Recent investment slowdown: South Asia

Investment growth slowed from 11 percent in 2011 to 6 percent in 2015, and is expected to weaken further in 2016. While subsiding political tensions and sharply lower oil prices have supported investment, long-standing structural bottlenecks continue to pose an obstacle to investment growth. Sizable investment needs remain in transport and energy, as well as in human resources, especially health and education.

South Asia (SAR) accounted for 4 percent of global investment, on average, over 2010-15. Despite an uptick in public investment spending, a deceleration in the private sector resulted in a substantial decline in overall investment growth, from 11 percent in 2011 to 3 percent in 2014. A rebound, to 6 percent in 2015, still left the growth rate below the long-term (1990-2008) average of 8 percent.

This box discusses the following questions:

- How has investment growth in the region evolved?
- What were the main sources of the investment slowdown?
- What are the remaining investment needs?
- Which policies can help address investment needs?

Recent investment weakness in South Asia reflects the legacy of weak output growth during 2010-13, excess manufacturing capacity in the face of sluggish external demand, and some uncertainty about government policy. These factors have compounded the long-term problems of structural bottlenecks, weak banking systems, and bouts of political tension. Needs for capital formation remain sizable, especially in the energy and transport sectors; the region also lags in the provision of health and education services. Governments can help directly, and by encouraging private sector participation. More broadly, improvements to the general business environment (e.g., through more streamlined regulations and reduced corruption) would enhance incentives for productive investment.

How has investment growth in the region evolved?

Weak investment has been a drag on South Asia's recent, consumption-driven expansion (World Bank 2016u). Across the region, investment growth slowed sharply from 11 percent in 2011 to 3 percent in 2014, with only a modest rebound to 6 percent in 2015—barely half its 2011 pace and well below the long-term (1990-2008) average of 8 percent (Figure 2.5.1.1). The downward trend

reflects a slackening in *India*, (which accounts for more than three-quarters of the region's total investment), offsetting a pickup in *Bhutan*, *Nepal*, and *Pakistan*. Preliminary data suggests continued investment weakness in 2016.

In *India*, gross fixed capital formation has been on a downward trend since 2011, with a shift in the composition from private to public. While public investment rose by 21 percent in FY2016, private investment (which accounts for two-thirds of the total) contracted by 1.4 percent, reducing overall investment growth to 4 percent. Infrastructure demand is expected to go up to \$1 trillion under the 12th Five-Year Plan (2012-2017). Going forward, public and private investment should be supported by higher allocations in the FY2017 federal government budget to build and upgrade infrastructure, and the setup of a \$3 billion National Investment and Infrastructure Fund.

In *Pakistan*, investment surged in 2015, mainly reflecting the China-Pakistan Economic Partnership (CPEC) infrastructure project (worth \$45 billion). This has more than compensated for sluggishness in private investment. The project is part of *China's* "One Belt, One Road" initiative, and consists of a network of highways, railways, and pipelines to connect Western China to the Arabian Sea through the Gwadar Port in Pakistan. The *Islamic Republic of Iran* expressed interest in early 2016 to join the CPEC project. Combined with the ongoing gas pipeline project from the Islamic Republic of Iran, Pakistan should be able to maintain robust public investment growth in the near-term, while private investment is expected to pickup in the medium-term.

In *Bangladesh*, capital formation is estimated to remain weak in 2016, partly as a result of heightened political tensions and security concerns. *Sri Lanka's* investment contracted by 2 percent in 2016, following the suspension of the \$1.4 billion Colombo Port City real estate project for over one year in 2015. In the near-term, investment growth in Sri Lanka is expected to continue on a downward trend, following the tightening of monetary policy in mid-2016 that raised financing costs. Fiscal consolidation, aimed at reducing the fiscal deficit to 3.5 percent of GDP by 2020 under the IMF's \$1.5 billion

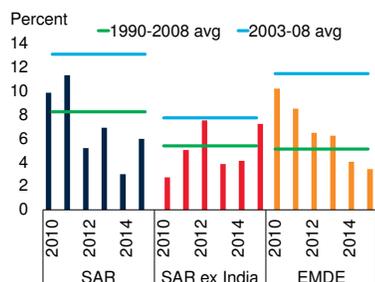
Note: This box was prepared by Boaz Nandwa.

BOX 2.5.1 Recent investment slowdown: South Asia (continued)

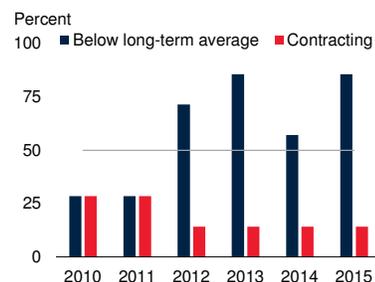
FIGURE 2.5.1.1 Investment growth slowdown in South Asia

Investment growth has been below the long-term average in more than half of SAR economies since 2012. Its composition has shifted away from private sector-driven investment growth during 2013-14 towards public sector-driven investment growth in 2015. While lower oil prices and easing political tensions supported investment, weak activity during 2010-12 and long-standing structural bottlenecks constrained investment.

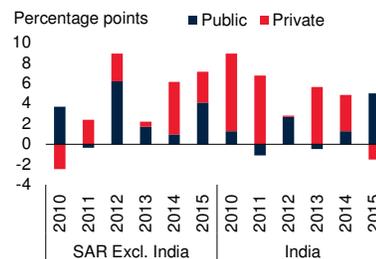
A. Investment growth



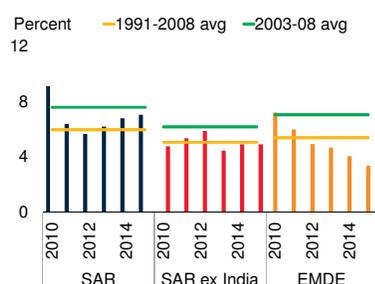
B. Share of SAR countries with weak investment growth



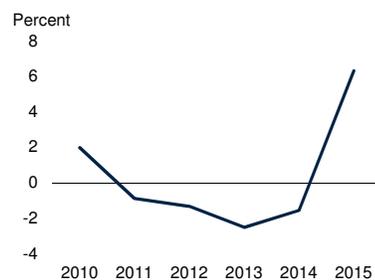
C. Contribution to investment growth



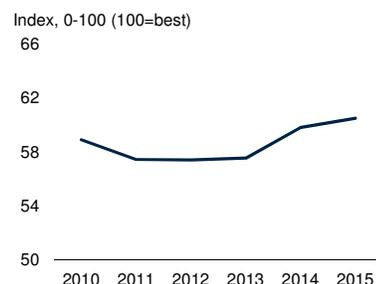
D. GDP growth



E. Terms of trade change



F. Political stability



Sources: Haver Analytics, International Country Risk Guide (ICRG), Ministry of Finance of Sri Lanka, Reserve Bank of India, World Bank.
 A. Weighted averages. Includes annual data for Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.
 B. Share of SAR economies with investment growth below its long-term average or with negative investment growth.
 C. Weighted average for Bangladesh, Bhutan, India, Nepal, Pakistan, and Sri Lanka.
 D. GDP-weighted averages.
 E. Investment-weighted averages. An increase denotes terms of trade improvements.
 F. Investment-weighted averages of ICRG index of Political Risk. An increase denotes greater political stability.

Extended Fund Facility program, will weigh on infrastructure spending (IMF 2016q).

What were the main sources of the investment slowdown?

During 2010-13, weak economic activity weighed on investment and business confidence. Since 2014, however, investor sentiment in the region has benefited from sharply lower oil prices, easing political tensions, and revived reform agendas in *India*, *Pakistan*, and *Sri Lanka*, as well as easing vulnerabilities in *Bangladesh*, *India*, and *Pakistan*. This uptick has yet to translate into a robust rebound in private investment. Structural bottlenecks (e.g., power shortages, poor road and rail networks) and administrative

requirements constitute barriers to investment, and weak banking sectors constrain investment finance.

India's steep private investment slowdown has been attributed to several factors (World Bank 2016u; Anand and Tulin 2014; Tokuoka 2012). First, the need to unwind excess capacity built during the pre-financial crisis growth boom amid weak external demand (e.g., in the manufacturing sector) has discouraged new projects and caused investors to shelve existing projects. Second, policy uncertainty has been a factor. For example, the stalled Land Acquisition Bill has extended project development timelines. Lack of federal and state government coordination, on compensation for land acquisition and environmental clearances, has contributed to cost and time

BOX 2.5.1 Recent investment slowdown: South Asia (continued)

overruns. Third, lenders have been less willing to finance overleveraged corporates, especially in infrastructure-related sectors (e.g., power and other utilities, steel, and cement firms). In particular, the Reserve Bank of India's 2015 corporate governance reforms in state-owned banks (which represent two-thirds of the total banking sector lending) has adversely affected lending to leveraged corporates and conglomerates.

What are the remaining investment needs?

South Asia is the second most densely populated region in the world, behind East Asia and Pacific, with large and pressing investment needs for infrastructure improvement (Bloom and Rosenberg 2011; Figure 2.5.1.2). Metrics of human capital provision (e.g., expenditure on education and healthcare, teacher-pupil ratios, doctor-patient ratios, water and sanitation in rural areas), fall below the EMDEs average (World Bank 2016w). This suggests that sizable additional outlays on human capital could effectively alleviate poverty (Romer 2016; Estache and Garsous 2012). Rapid urbanization and the maintenance of growth momentum, call especially for improvement of energy and transport infrastructure (Ellis and Roberts 2016; Inderst 2016; Battacharya 2012; ADB 2009, 2012; Andres, Biller, and Dappe 2014).

South Asia is one of the least integrated regions in the world (World Bank 2016e). This has been attributed to inadequacies in transport and power infrastructure (ADB 2009). Coverage differs within countries and across the region, with *India* and *Pakistan* somewhat better positioned than other countries.

Energy shortages (electricity, diesel) remain a critical constraint to activity in the region. Underdeveloped within-country and cross-border electricity grid network connectivity and, in some cases, geopolitical tensions have contributed to significant energy shortfalls, compounding regular electricity outages. In *India*, dependence on imported fuels for power generation, and low electricity tariffs have hampered power generation capacity, which now requires significant expansion to meet energy shortfalls (McKinsey 2011).

Bangladesh's infrastructure quality lags behind other countries in the region: power shortages and poor transport infrastructure have affected investment and productivity (World Bank 2015t). The 7th Five Year Plan estimates that about \$410 billion in financing—twice the size of 2015 GDP—is needed for developing Bangladesh's infrastructure. Investment is also needed in public health care, where expenditure has declined from 1.1 percent of

GDP in 2010 to 0.7 percent of GDP in 2014 (World Bank 2015f, 2016t).

In *Sri Lanka*, fiscal consolidation, coupled with priority spending to rebuild infrastructure after a 25-year civil war, has crowded out expenditure for human capital-building purposes. Government spending on education fell from 2.7 to 1.8 percent of GDP during 2006–2013, while spending on health declined from 2.0 to 1.4 percent of GDP over the same period (World Bank 2016x).

Which policies can help address infrastructure needs?

The alleviation of some longstanding obstacles to growth would help increase the level and productivity of investment of all forms. A more targeted, multi-pronged, policy strategy could also encourage investment by increasing returns to investment, and by expanding the financing envelope (Henckel and Mckibbin, 2010; Nataraj 2007).

Private investment. Under the right conditions, public investment can crowd-in private investment (World Bank 2016u; Chapter 3).¹ For example, private firms may be able to reap the benefits of large scale, if public infrastructure facilitates market access (Calderón, Moral-Benitob, and Servéna 2010). However, in the SAR, only *India* appears to have experienced a positive crowding-in effect (Jesintha and Sathanapriya 2011; World Bank 2006).

Financing. Financing for public and private investment can be expanded in a number of ways to narrow the investment financing gap (Deutsche Bank 2016; Andres, Biller, and Dappe 2014; McKinsey 2013; ADB 2012, 2009). First, public-private partnership may offer efficiency gains and cost-effectiveness (e.g., infrastructure funds), and at the same time alleviate fiscal pressures (Anadon and Surana 2015; Nataraj 2007). This can help reallocate government spending to socially desirable projects that cannot, in practice, be undertaken by the private sector, for instance, because of an unduly low private rate of return (e.g., water supply and sanitation projects). Second, domestic savings can be mobilized by improving access to the financial system (e.g., encouraging pension funds) and by broadening and raising government revenue collection. Third, banks' lending capacities can be increased by strengthening their balance sheets, and the

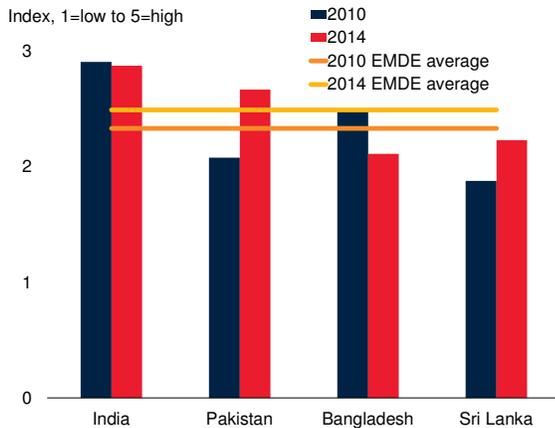
¹Public investment could also lead to crowding-out of private investment, e.g. Pakistan (World Bank 2016s).

BOX 2.5.1 Recent investment slowdown: South Asia (continued)

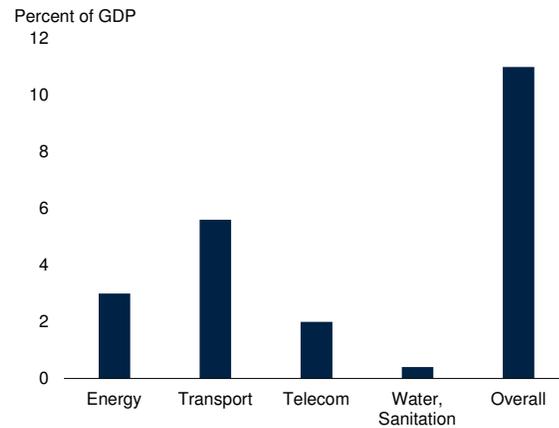
FIGURE 2.5.1.2 Investment needs in South Asia

Despite improvements since 2010, sizable investment needs remain in public infrastructure (energy, transport) and human capital development.

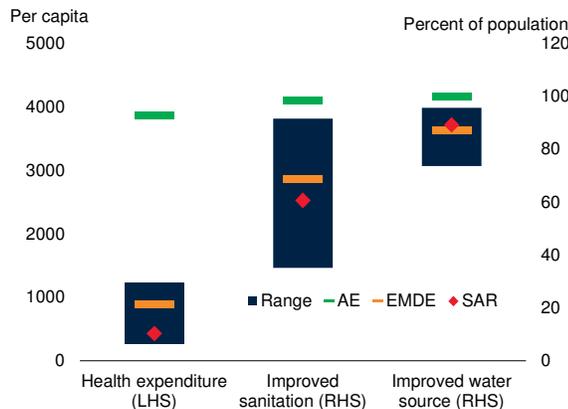
A. Quality of infrastructure



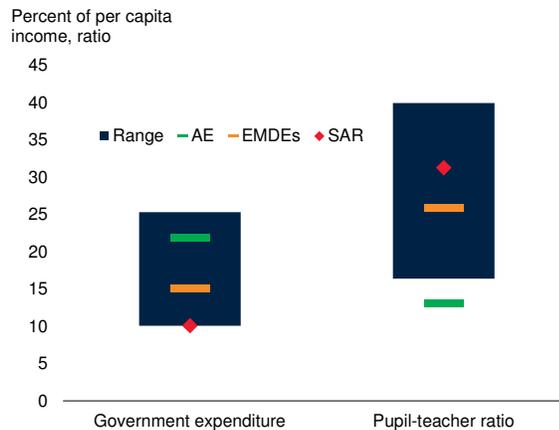
B. Infrastructure investment needs



C. Selected health indicators



D. Selected education indicators



Sources: Battacharya (2012), Haver Analytics, Inderst (2016), World Bank.
 B. This represents investment as a share of GDP required every year during 2010-2012 to meet investment needs. The authors use "bottom-up" approach based on identified pipeline regional infrastructure projects across SAR.
 C. Latest available data available during 2011-15. Blue bars denote range of unweighted regional averages across EMDE regions. Health expenditure per capita in purchasing power parity terms, unweighted averages of 199 EMDEs, 34 AEs, and 6 SAR economies. Access to improved sanitation facilities (in percent of population), unweighted averages for 150 EMDEs, 33 AEs, and 8 SAR economies. Access to improved water sources (in percent of population), unweighted averages for 148 EMDEs, 34 AEs, and 8 SAR economies.
 D. Latest available data available during 2011-15. Blue bars denote range of unweighted regional averages across EMDE regions. Government expenditure per primary student (in percent of per capita income), unweighted averages of 87 EMDEs, 32 AEs, and 5 SAR economies. Pupil-teacher ratio in primary education (headcount basis), unweighted averages for 165 EMDEs, 31 AEs, and 8 SAR economies.

efficiency of capital allocation may be improved by increasing the commercial orientation of banks, including through privatization and governance reforms. Fourth, greater commercial orientation (through privatizations or concessions to private investors) of state-owned enterprises

could raise efficiency and increase investment. Fifth, reducing asset-liability mismatches through greater use of funding through capital markets (e.g., infrastructure bonds), can be an alternative to heavy reliance on bank lending for infrastructure-related projects. Finally, foreign

BOX 2.5.1 Recent investment slowdown: South Asia (continued)

direct investment in infrastructure can be encouraged by removing regulatory obstacles to doing business in restricted sectors (Kirkpatrick, Parker, and Zhang 2006; World Bank 2000).

Reforms to foster an enabling environment. South Asia is just ahead of Sub-Saharan Africa, but behind the other regions in terms of a conducive business climate (World Bank 2016p; Lopez-Acevedo, Medvedev, and Palmade 2016). Entry and administrative barriers in many sectors (construction, finance, retail and wholesale, telecommunication, and health care) in *Bangladesh*, *India*, and *Pakistan* have hampered investment in these sectors. The burden of regulatory compliance, delays in utility connections, difficulties in obtaining permits to start and operate business, higher taxes, and rigid labor markets raise the cost of doing business and discourage investment (Pachouri and Sharma 2016; Shirke and Srija 2014). Compared to an average of 103 days in EMDE, obtaining services from utilities (e.g., electricity) can take four times as long in *Bangladesh* and almost twice as long in *Pakistan* (World Bank 2016p). In *India*, investors point to restrictive labor laws as contributing to lower productivity in the manufacturing sector, restricting employment opportunities for women, and discouraging the adoption of new technologies.

Reforms that promote competitiveness and reduce barriers to trade can encourage investment in the tradable export-oriented sectors (e.g., services and manufacturing). This can also level the playing field and increase profitability of exporting, or of competing with imports in hitherto

protected industries (Alfaro and Chari 2014). More generally, reforms to reduce regulatory burdens (e.g., land acquisition, environmental impact assessment) and to strengthen public-private partnerships legislation (e.g., consistent regulations, transparent bidding procedures) can foster investment. Strengthening public investment management processes, integrating infrastructure projects in budget cycles, and curbing corruption in infrastructure projects will not only improve quality of the infrastructure, but also improve the efficiency of government spending (KPMG 2011; Ali 2009).

Stability. Policy and political uncertainty represents a deterrent to investment in parts of the region (Chapter 3). Security challenges (Afghanistan, Pakistan) and geopolitical tensions (India, Pakistan) remain a formidable obstacle to creating a more conducive investment climate (Dash, Nafaraj, and Sahoo 2014) especially for cross-border projects that could increase regional economic integration. Stalled reforms on land (acquisition, compensation, and environmental clearances) remain a drawback on infrastructure-related private investment. Reforms to enhance efficiency of labor market—encouraging greater female labor market participation, facilitating hiring and redundancy procedures, and reducing taxes on low-paid workers—would increase the mobility and flexibility of the work force (Shirke and Srija 2014). In turn, the resulting increase in profitability, as well as the improvement in household incomes, would provide incentives for the expansion of businesses, including small and medium-size enterprises.