BOX 2.5.1 Potential growth in South Asia

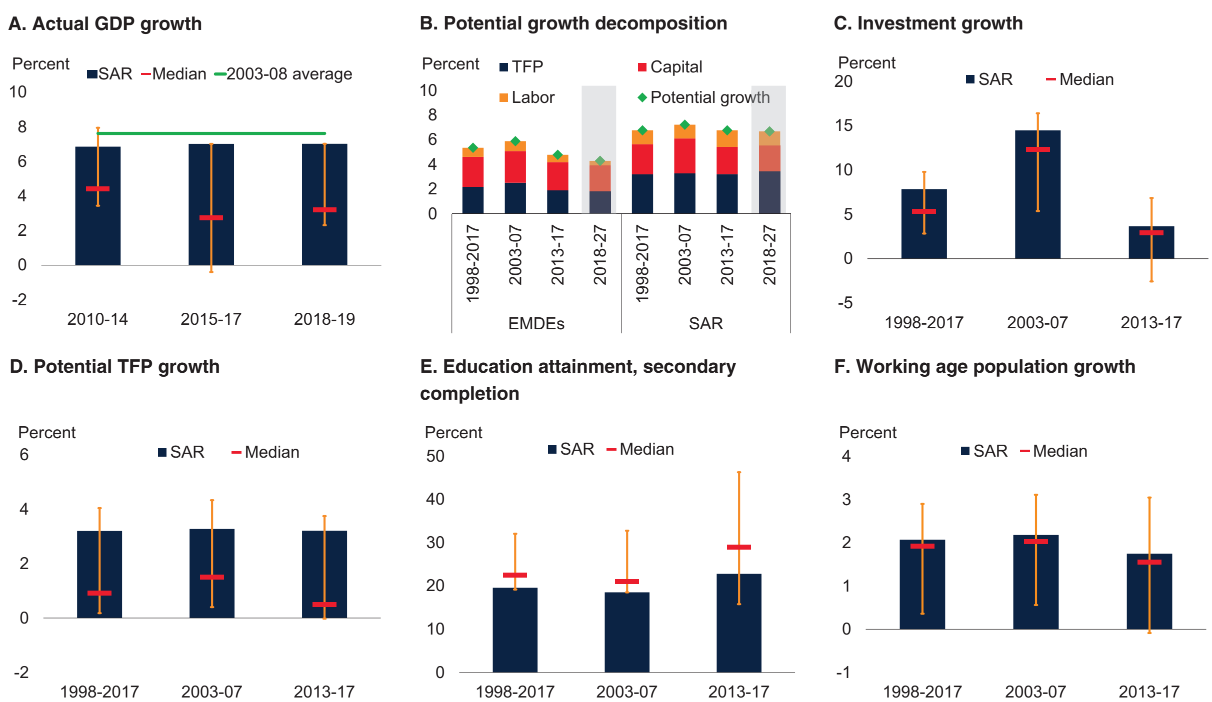
Potential growth in South Asia has slowed from around 7.2 percent just prior to the global financial crisis to an average of 6.8 percent in recent years, reflecting the effects of a sharp investment slowdown. Over the medium-term, South Asia's potential growth is expected to stabilize around 6.7 percent. Achieving faster sustained growth will require structural reforms such as improving human capital, enhancing female labor force participation, strengthening corporate and banking sector balance sheets, and promoting greater integration of the region into global and regional value chains.

Introduction

Although South Asia was the fastest growing emerging market and developing economy (EMDE) region in recent years, it still slowed compared with the rapid pace set prior to the global financial crisis (Figure 2.5.1.1). This slowdown was mainly driven by stalled investment in India, and it appears also to reflect a more broad-based easing of potential growth within the region, from 7.2 percent pre-crisis to around 6.8 percent. Other studies have estimated potential growth in the region. In the case of India, potential growth is estimated within the range of 6-8 percent in the post-crisis period (Bhoi and Behera 2016; Mishra 2013; Blagrave et al. 2015). Similarly, Ding et al. (2014) estimate Sri Lanka's potential growth between 6 and 8 percent after the global financial crisis.[1] Looking forward, achieving faster sustained growth in the region, with a corresponding improvement in living standards,

FIGURE 2.5.1.1 Regional growth

The slowdown of regional GDP growth in recent years has coincided with a decline in potential growth, which has mainly reflected weak investment.



Sources: Haver Analytics, Penn World Tables, World Bank Estimates, and World Development Indicators.
A. C.-F. Blue bars show GDP-weighted average of SAR countries. Markers show median GDP-weighted averages of the six EMDE regions and vertical lines denote range of regional GDP-weighted averages.
B. Potential growth estimates based on production function approach for India and Sri Lanka. See Annex 3.1 for more details.

Note: This box was prepared by Temel Taskin, Sinem Kilic Celik, and Yirbehogre Modeste Some. Anh Mai Bui, Jinxin Wu, and Ishita Dugar provided research assistance.

[1] This estimate does not reflect the GDP revision of 2015, and might be biased upward.

BOX 2.5.1 Potential growth in South Asia *(continued)*

will require identifying and addressing the structural factors that are constraining the region's potential.

Against this backdrop, this Box will discuss the following questions:

- How has potential growth evolved in South Asia and what were its main drivers?
- What are prospects for potential growth?
- What are the policy options to lift potential growth?

This Box concludes that, in the absence of policy action, South Asia's potential growth is likely to remain broadly steady at its current rate. However, there is scope to boost the region's potential growth significantly through product and labor market reforms as well as through investment in human capital.

Evolution of potential growth and its drivers

Estimates based on the analysis in Chapter 3 suggest that the decline in potential growth in South Asia reflected slowing capital accumulation which outweighed the acceleration in TFP growth and improved educational attainment. A number of factors appear to have been at work, including heightened regulatory and policy uncertainties, delayed project approvals and implementation, continued bottlenecks in the energy sector, as well as reform setbacks (Anand et al. 2014). Large corporate debt overhang and non-performing assets in the banking sector further weighed on credit growth and investment within the region.

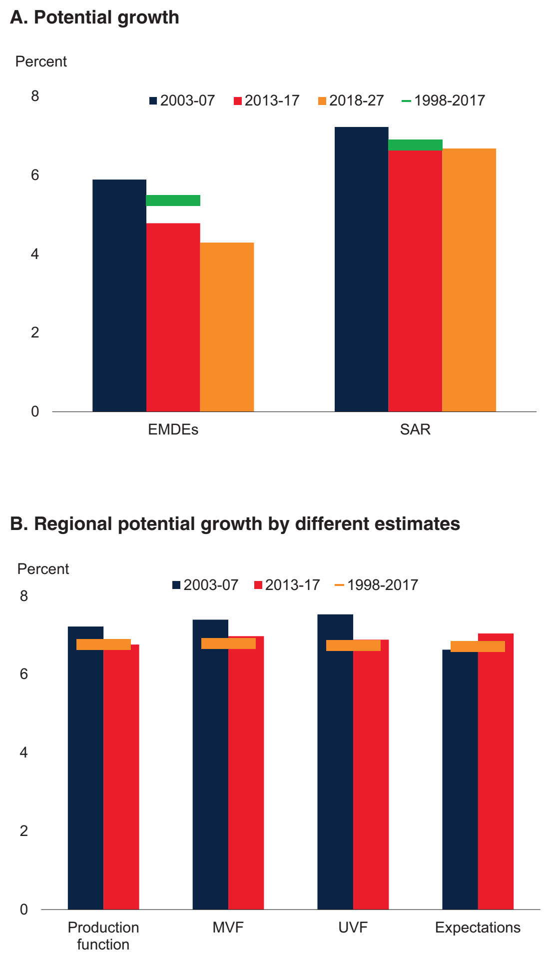
Potential growth prospects

Over the medium-term, potential growth in South Asia is expected to average around 6.7 percent in the next decade. Although this would be well below the high rates achieved just before the global financial crisis, it compares favorably with other EMDEs, where potential growth is expected to slow even further (Figure 2.5.1.2).

Potential growth in South Asia will be underpinned mainly by a recovery in Total Factor Productivity (TFP)—in part owing to the effects of improvements in educational attainment, which will help offset a moderation in the growth of the working age population, similar to other EMDEs where aging already weighs heavily on potential growth.

FIGURE 2.5.1.2 Regional potential growth estimates

South Asia's potential growth has slowed from around 7.2 percent just prior to the global financial crisis to an average of 6.8 percent in recent years, according to the baseline measure (production function).



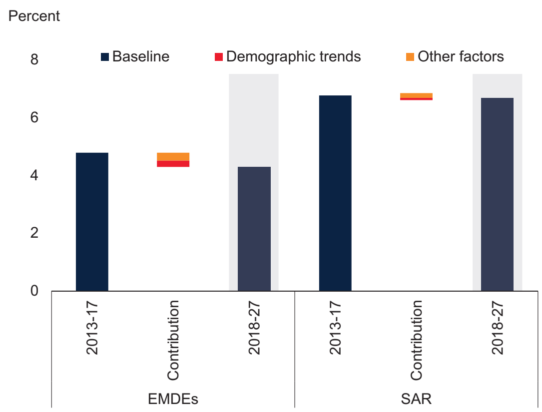
Source: World Bank estimates.
Notes: Lines and bars denote averages of different periods.
A. Based on the production function approach for India and Sri Lanka, as defined in Annex 3.1.
B. MVF stands for multivariate filter-based potential growth estimates; UVF stands for univariate filter-based potential growth estimates (specifically, the Hodrick-Prescott filter); Expectations stands for potential growth proxied by five-year-ahead *World Economic Outlook* growth forecasts. Sample includes India and Sri Lanka in the PF estimates, India in the MVF and UVF estimates and India, Pakistan, Bangladesh, Sri Lanka, Nepal, Maldives, Bhutan, and Afghanistan in the Expectations.

BOX 2.5.1 Potential growth in South Asia *(continued)*

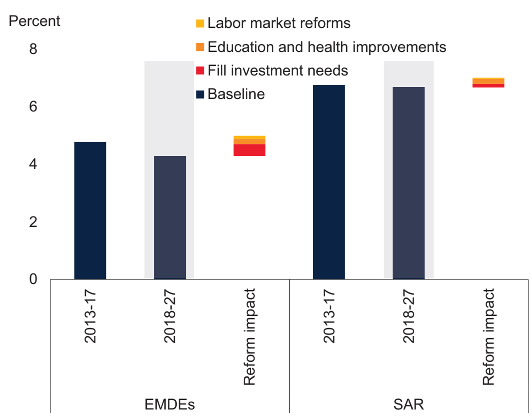
FIGURE 2.5.1.3 Policies to stem declining potential growth

Potential growth in South Asia is expected to average around 6.7 percent between 2018-27, slightly below its recent average rate. Labor market, education, and health reforms, along with investment, could boost the region's potential growth by 0.4 percentage points.

A. Baseline potential growth



B. Potential growth under reform scenarios



Source: World Bank estimates.
Notes: GDP weighted averages. Derived using the production function approach for India and Sri Lanka. Details are described in Annex 3.1.
A. "Other factors" reflects declining population growth, trend improvements in human capital, and a slowdown in investment growth to output growth.
B. Policy scenarios are described in Annex 3.1.

India's recent reforms, such as the "Make in India" initiative and demonetization, are expected to encourage formal sector activity, broaden the tax base, and improve long-term growth prospects despite short term disruptions in the case of demonetization. For instance, the "Make in India" initiative, which began in late-2014, aims to improve investment and innovation as well as develop skills to meet the demand for skilled labor. To achieve these goals, the government has taken various steps to improve the business climate, such as shortening approval times for trademarks and patents to enhance property right protection, lowering restrictions on foreign direct investment (including foreign ownership restrictions) in various sectors, and accelerating investment in energy and transport infrastructure, which helped improve the ease of doing business (World Bank 2017l).

The July 2017 introduction of the Goods and Services Tax (GST) in India has caused temporary disruptions in manufacturing, and is linked to the recent weakness in the Purchasing Managers' Index and industrial production growth. However, eventually, it is expected to simplify tax compliance, deepen economic linkages between Indian states, broaden the tax base and improve revenue collections. In turn, this is expected to enhance the broader business environment and help foster investment and employment (IMF 2017).

Significant vulnerabilities have been recognized in the Indian banking and corporate sectors that may weigh on medium-to-long-term growth prospects unless they are addressed. Encouragingly, several steps have been taken on this front. For example, the Asset Quality Review initiated by the RBI in 2015 has led to an increase in the recognition of non-performing assets on financial sector balance sheets. More recently, the government announced a large recapitalization package ($ 32 billion) for public sector banks to be implemented over two years. Over the medium to long term, these measures are expected to help resolve private sector balance sheet weaknesses and unlock lending for private investment. Infrastructure spending in recent years partly addressed supply side bottlenecks. However, weaknesses on corporate balance sheets remain as firms are highly indebted. As corporate lending still accounts for a significant part of banks' assets, their ability to finance future business investments will require the restructuring of this debt, as well as a broader deleveraging in the corporate sector.

Sri Lanka's economic reform agenda, supported by World Bank and IMF programs, is expected to sustain

BOX 2.5.1 Potential growth in South Asia *(concluded)*

macroeconomic stability and support potential growth over the medium term (World Bank 2017ab). Public debt is expected to decline amid ongoing fiscal consolidation, which will open fiscal space and enable the country to allocate public spending toward human capital investments that support potential growth. The government recently adopted the new Inland Revenue Act, which aims to simplify tax compliance, but which could also mobilize additional revenue that could support growth-enhancing spending, including infrastructure investment.

Policy options to lift potential growth

As illustrated in Chapter 3, structural reforms can provide a significant boost to productivity, employment, and potential growth. Indeed, this analysis illustrates that steps to reform labor markets, as well as education and health systems, and policies to encourage private sector investment could boost potential growth. (Figure 2.5.1.3).

One area that could encourage higher private investment in South Asia would be steps to enhance its integration in global value chains. Studies show that this has been associated with higher growth, but South Asia region lags behind other EMDE regions in terms of the integration of its trade and investment flows, both globally and within the region (Farole and Pathikonda 2016). Closer trade and investment ties could be supported by closing infrastructure gaps, removing regulatory and other impediments to businesses, as well as by promoting a shift towards higher-value added manufacturing industries (Lopez Acevedo and Robertson 2016).

Addressing corporate and banking sector balance sheet issues could lift investment and potential growth prospects in the region. Recent steps taken by the government such as the recapitalization package for public sector banks are expected to support credit growth and investment.

Investment in human capital may also help lift productivity, labor incomes, and potential output, including by fostering a shift toward higher-value added and innovative industries (Aturupane et al. 2014). Policies that can help facilitate this shift include steps to improve the share the participation of women in the workforce, increase access to higher and better education, and investing in vocational training programs (World Bank 2017p).