



Centre for Air Power Studies (CAPS)

Forum for National Security Studies (FNSS)

## Neighbourhood Insights

Wrap - Up 5

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# Assessment of Economies in India's Neighbourhood



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Edited by

**Dr. Shalini Chawla**

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Edited by Dr. Shalini Chawla

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## Preface

# Assessment of Economies in India's Neighbourhood

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The South Asia region presents a complex web of interrelated traditional and non-traditional challenges, including border disputes, cross-border terrorism, the proliferation of extremist ideologies, illegal migration and trade, narcotics, and climate change. The region's unique geography is marked by significant asymmetry in size and resources. India is the largest country in South Asia by size and shares land borders with all other countries in the region, except for the island nations of Sri Lanka and Maldives. In contrast, the other states in the region do not share borders with each other. One potential advantage of this phenomenon is that India could evolve as a connector for regional trade and economic integration. Also, India's economic progress could be an engine of growth for the other regional nations. However, the disadvantage of India's geographical proximity to its neighbours is that India variably or invariably bears the fallout from challenges arising in the neighbouring countries and cannot escape the repercussions of instability in its regional neighbourhood.

While the regional countries continue to fight multiple challenges, one common issue that they face is their struggle with economic crises, with India as an exception. India is on track to become the third-largest economy in the world and is the fastest-growing economy, with a GDP growth rate of 8.32 per cent in the last fiscal year. India's economic growth is critical to its position in global affairs and its ability to take an autonomous stance prioritising its national interests.

The economies in South Asia are struggling with fiscal deficits, high debt burdens, inflation, and a lack of opportunities for the youth. China has made inroads in the region through investments and debt diplomacy. Beijing's debt has led Sri Lanka to an economic default, and Pakistan consistently finds itself on the verge of financial default due to high

interest payments.

Afghanistan has shown some signs of recovery, but its economy remains in flux and will continue to rely heavily on international aid and assistance. The Taliban have been desperate for international recognition but are not ready to compromise on their position on women's rights and freedom. Bangladesh's economy has shown remarkable progress in the last 10 years. But the ouster of former Prime Minister Sheikh Hasina in August 2024 following the student protests and the complete disruption of law and order in the country poses a serious challenge to its economic prospects. It remains to be seen how Dhaka will shape up in the coming months. Bhutan has been cherishing its economic comfort zone, but there is a serious need for Bhutan to diversify its revenue generation sectors, which are currently tourism and hydropower. The Maldives is economically vulnerable and needs to be cautious with the overwhelming Chinese interest and inflow of investments. In Nepal, frequent changes in the regime led to inconsistent policies, posing a challenge to the economy. The country's trade deficit remains significant, and there has been a noticeable decline in foreign investment. Pakistan's economy is facing severe challenges of high debt servicing and low revenue. The country remains highly dependent on borrowing, and the debt remains unsustainable. Sri Lanka defaulted economically and went bankrupt in April 2022. This was followed by massive protests, intensifying the political and economic crisis. The structural reforms outlined by the International Monetary Fund are expected to lead to some stability in the future.

As India's Neighbourhood First Policy continues to remain a focus area for the Modi 3.0 government, India is gradually moving towards increasing economic assistance and cooperation with the neighbouring states, sans Pakistan. India's humanitarian assistance during the COVID-19 pandemic was received well in the region. India has revived its humanitarian aid to Afghanistan and continues to stand on its commitment to support the Afghans. Bangladesh remains India's largest trade partner in the region. Dhaka exported US\$1.97 billion in goods to India in 2023-24. Ongoing instability in Bangladesh and anti-India sentiments have generated ample uncertainty about the future of India-Bangladesh economic cooperation. India remains the main destination for Bhutan's exports and also the largest source of Bhutan's imports. Trade between India and Bhutan has grown significantly, from US\$484 million in 2014-15 to US\$1,615 million in 2022-23. This makes up about 80 per cent of Bhutan's total trade.

India's approach towards Maldives has been consistent and patient in the last few years. India's cooperation with the Maldives has been diversified in the economic, military, health, education, and infrastructure sectors. With respect to Nepal, India has been consistently

extending economic and technical support and has played a crucial role in supporting Nepal's economic initiatives. India proactively responded to the financial crisis in Sri Lanka and provided the country with nearly US\$4 billion in life-saving multi-pronged assistance.

The criticality of India's neighbourhood was evident from the statement made by Dr. S.Jaishankar at the Jasjit Singh Memorial lecture at the Centre for Air Power Studies (August 2024) when he said, "What we have tried to do in the last 10 years is actually to economically bring our neighbours much closer ...there will be political ups and down... these are realities we have to accept...but...we today have more resources, more capabilities, we are geographically at the centre, our size is so much bigger, ... we need to drive the process, we will set the pace, and we will go the extra mile." India's neighbourhood policy needs a push, and it cannot achieve its objective of being a US\$5 trillion economy without focusing on regional economic integration.

The CAPS wrap-up by the Neighbourhood Studies Vertical studies the economies of South Asia to understand the region's economic challenges. I wish to thank Director General CAPS, AVM Anil Golani, for his consistent support in all our endeavours. Additional Director, AVM Ashish Vohra has always been encouraging. I am thankful to all the contributors for their comprehensive analysis. The wrap-up could not have taken this shape without Niti Jha's impeccable copy editing and Rohit Singh's consistent technical help in formatting the wrap-up. I am grateful to Radhey Tambi and Anadi from the Neighbourhood Studies Vertical for going through the drafts multiple times to rule out any errors.



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# AFGHANISTAN

## Navigating Uncertainty under the Taliban 2.0 Rule

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### Introduction

In the wake of significant political changes and the withdrawal of international forces in 2021, Afghanistan stands at a critical juncture in its economic trajectory. The sudden political transition, coupled with international sanctions and the withdrawal of foreign aid, has profoundly impacted the country's already fragile economy. In addition, the return of Afghan refugees from Pakistan and Iran and the climate-induced vulnerabilities, including frequent floods, drought, and earthquakes, have exacerbated these challenges. At present, the country, a victim of decades of conflict and instability, faces daunting challenges as it navigates its future path toward economic recovery and sustainability.

### Overview of Afghanistan's Economy under the Taliban 2.0 Regime

Afghanistan's economy, heavily reliant on foreign aid and international support, experienced a sharp decline following the Afghan Taliban's takeover of Kabul in mid-2021. According to SIGAR, for approximately 20 years (until mid-2021), foreign assistance to support Afghanistan totalled almost US\$8 billion per year, which accounted for nearly 40 per cent of the country's gross domestic product (GDP) and financed three-quarters of the former Afghan Republican government's public expenditures<sup>1</sup> (i.e. 75 per cent of its total public expenditures).<sup>2</sup> However, the immediate cessation of international financial assistance after the fall of Kabul led to a severe fiscal crisis. A United Nations Development Programme report stated that "...the Afghan economy lost US\$5 billion after August 2021, wiping out in 10 months what had taken it 10 years to accumulate."<sup>3</sup> As a result, the country's economy collapsed, and Afghanistan was drawn towards a severe economic and humanitarian crisis. According to World Bank,

“after a severe 20.7 per cent GDP contraction in 2021, the Afghan economy further contracted by 6.2 per cent in 2022.”<sup>4</sup> The freezing of Afghanistan’s foreign reserves by the US further contributed to the economic downturn, triggering a liquidity crisis. But as foreign assistance to Afghanistan resumed by 2022, albeit on a smaller scale,<sup>5</sup> the rapid deterioration of economic conditions slowed down by the summer of 2022.<sup>6</sup> According to an August 2023 World Bank Afghanistan Economic Monitor report, the UN has purchased, transported, and transferred more than \$2.9 billion in US currency to Afghanistan since August 2021,<sup>7</sup> delivered primarily under the coordination of the UN Assistance Mission in Afghanistan (UNAMA). It helped in preventing a greater humanitarian disaster in the country to a considerable extent.

Nevertheless, according to the 2024 Humanitarian Needs and Response Plan for Afghanistan, approximately 23.7 million people, more than half of the country’s population, are in need of humanitarian assistance in 2024.<sup>8</sup> The 2024 reports by the UN Office for the Coordination of Humanitarian Affairs (OCHA) and the US Agency for International Development (USAID) stated that an estimated 15.8 million people are experiencing acute crisis and emergency levels of food insecurity<sup>9</sup> in Afghanistan, with 22.1 million requiring protection assistance, and 8.7 million children needing education support this year.<sup>10</sup> It is reported that in reality, 69 per cent of Afghans are “subsistence insecure,” i.e., lacking basic resources for livelihood.<sup>11</sup>

Recently, the United Nations has also cautioned that it has received only 6 per cent of the requested humanitarian aid (just US\$290 million of the US\$3.06 billion required) from its donors, which is directed towards assisting the millions of people in Afghanistan for the year 2024. These statistics provide a grim picture of this war-torn country. Furthermore, the World Bank has stated that Afghanistan’s economic stagnation will continue until at least 2025, which is a worrying sign for its population.

By May 2024, headline inflation had plummeted to -7.5 per cent year-over-year (YoY), propelled primarily by substantial reductions in food (-11.5 per cent YoY) and non-food (-3.1 per cent YoY) prices.<sup>12</sup> According to World Bank, core inflation, excluding volatile food and energy prices, was also negative at -2.5 per cent YoY, reflecting sluggish demand.<sup>13</sup> The same report further illustrated that in the first five months of 2024, Afghanistan’s exports declined by 16 per cent, totalling US\$613.5 million compared to US\$731.6 million in the same period in 2023.<sup>14</sup> On the other hand, Afghanistan’s imports surged by 22 per cent in the first five months of 2024, reaching US\$3.8 billion, up from US\$3.1 billion in the same period the previous year.<sup>15</sup>

Pakistan remained Afghanistan's primary export source, accounting for 48 per cent of exports, followed by India at 28 per cent during January-May 2024; while Iran is the most significant import destination, constituting 30 per cent of Afghanistan's imports.<sup>16</sup> After achieving the revenue target of AFN 210 billion in FY 2023-24, Afghanistan's total revenue reached AFN 31.2 billion in the first two months of FY 2024-25.<sup>17</sup> It is reported that in the first half of 2024, the currency Afghani remained stable, "depreciating slightly by 1.3 percent against the US dollar with Afghanistan's foreign exchange market appeared balanced, as remittances and unidentified sources of foreign exchange inflow counterpoise the growing trade deficit and reduced aid inflows."<sup>18</sup>

In Afghanistan, remittances play a critical role in the country's wider national economy. But international sanctions and the freezing of foreign reserves have crippled Afghanistan's banking sector, making it difficult for Afghans abroad to send money home through formal channels. Therefore, remittances and international transactions at the current juncture flow mostly through the informal funds transfer (IFT) system, generally referred to as '*hawala*'. Nevertheless, the *hawala* system has always been an important money transfer system in Afghanistan—a country where reportedly only 15 per cent<sup>19</sup> of the people have bank accounts.<sup>20</sup> At present, rural households in the country are highly dependent on the remittance sent to them by their family members living abroad. With the current economic challenges faced by the country, the reliance on remittances has grown even more pronounced, and these remittances play a vital role in sustaining Afghanistan's economy under the Taliban regime.

According to United Nation's Office on Drugs and Crime (UNODC), under the Taliban interim administration, the opiate informal economy's value has contracted by 90 per cent, the area under opium poppy cultivation declined by 95 per cent, and this has cost Afghans 450,000 jobs at the farm level alone.<sup>21</sup> No doubt the opium trade continues to thrive with the majority of benefits/profits enjoyed by the drug traders, processors, and exporters.<sup>22</sup> All in all, the ban on opium cultivation resulted in a staggering US\$1.3 billion loss in farmers' incomes, equivalent to approximately 8 per cent of the GDP.<sup>23</sup> According to the World Bank's Afghanistan Welfare Monitoring Survey, the unemployment rate among surveyed households was close to 20 per cent as of April-June 2023,<sup>24</sup> which is expected to rise rather than decline in the coming days.

## Current Economic Policies of the Regime and their Sources of Revenue

But despite these challenges and unfavourable circumstances, the Taliban Interim Administration has sought to revive domestic revenue, which reached US\$2.2 billion or 15 per cent of GDP in 2022, mainly through imposing taxation and levying customs duties.<sup>25</sup><sup>26</sup> According to analysts, the interim government is performing much better in the economic domain than expected by the international community. They have also managed to reduce some forms of corruption and streamline the revenue collection processes. The regime is trying its best to restart stalled infrastructure projects, especially in the transportation and energy sectors, to create more job opportunities for the locals and thus aiming to stimulate economic activity. Since their takeover of Kabul, time and again, the acting commerce minister of the Taliban has emphasised economic self-sufficiency/reliance and increasing domestic production.<sup>26</sup> In addition, the interim government is trying to attract international investors from different countries, especially regional countries like China, the Central Asia countries, and the Gulf states, to invest in the country's economy. The new rulers of Kabul have announced more than 200 mining deals worth billions of dollars with local Afghans as well as investors from China, Iran, Russia, Turkey, and beyond.<sup>27</sup> It is estimated that Afghanistan's domestic revenue increased 22 per cent (YoY) in April and May this year due to the auction of mines and resources such as nephrite, emeralds, oil, etc.<sup>28</sup> Furthermore, Afghanistan under the Taliban regime also participated in Belt and Road forum meeting held in China in October 2023 and expressed their interest in joining the BRI—a massive infrastructure investment project undertaken by Beijing. However, for China, much of the investment under the Belt and Road framework will depend on the security scenario in Kabul.

In May 2022, the interim government unveiled the country's first annual budget, totalling 231.4 billion Afghanis (about US\$2.6 billion), with a deficit of around 44 billion Afghanis, or nearly US\$500 million.<sup>29</sup> In the same month this year, the Taliban-run Finance Ministry announced that the budget document for the 2024-25 fiscal year (1403 solar fiscal year) had been ratified by the Taliban's Supreme Leader, without revealing the amount of budget approved to be spent until March 2025.<sup>30</sup><sup>30</sup> According to a leaked document, the Taliban's Ministry of Defence has requested a budget for 2024 that is “double in value than that of the previous year.”<sup>31</sup> Sources cited that in 2023, the Taliban's defence budget was close to 40 billion Afghanis, but this year's request has surpassed 80 billion Afghanis.<sup>32</sup> However, a significantly huge portion of the budget being given to the security sector in a war-torn/poverty-ridden country like Afghanistan has been severely criticised by different groups. While the document

outlines their priorities and aspirations, it also represents the Afghan Taliban's quest for governance and legitimacy.

## Notes:

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<sup>5</sup> SIGAR, n. 1.

<sup>6</sup> World Bank Group, n. 4.

<sup>7</sup> World Bank, “Afghanistan Economic Monitor”, August 31, 2023.

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<sup>13</sup> Ibid.

<sup>14</sup> Ibid.

<sup>15</sup> World Bank Group, n. 12.

<sup>16</sup> Ibid.

<sup>17</sup> Ibid.

<sup>18</sup> Ibid.

<sup>19</sup> World Bank Group, “The Global Findex Database 2021: Financial Inclusion, Digital Payments, and Resilience in the Age of COVID-19”, <https://www.worldbank.org/en/publication/globalindex>. Accessed on July 10, 2024.

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- <sup>24</sup> William Byrd, “Despite Daunting Economic Headwinds, Afghan Private Sector Shows Signs of Life”, United States Institute of Peace (USIP), May 02, 2024, <https://www.usip.org/publications/2024/05/despite-daunting-economic-headwinds-afghan-private-sector-shows-signs-life>. Accessed on July 10, 2024.
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- <sup>26</sup> Mohammad Yunus Yawar, “Taliban seeks economic self-sufficiency and foreign investment for Afghanistan, minister says”, Reuters, January 03, 2023, <https://www.reuters.com/world/asia-pacific/taliban-seeks-economic-self-sufficiency-foreign-investment-afghanistan-minister-2023-01-02/>. Accessed on July 10, 2024.
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- <sup>28</sup> Ibid.
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- <sup>33</sup> “Afghan-Pakistan Trade Surpasses \$800 Million in First Quarter of 2024”, Tolo News, May 12, 2024, <https://tolonews.com/business-188748>. Accessed on July 10, 2024.
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# BANGLADESH

## Stumbling Through Crises

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### Introduction

After a wave of student protests over a controversial quota system that spiralled into a larger political storm, Bangladesh's former Prime Minister, Sheikh Hasina, resigned in August 2024 and sought refuge in India. As a result, Bangladesh's economy, once hailed as a poster boy of successful economic transformation in South Asia, stands at a critical juncture, especially as the country is being led not by an elected government but a military-backed caretaker government. Despite Hasina's heavy-handedness in dealing with political opposition, one of the significant achievements of her governance was a rising economy. However, Hasina's track record of maintaining a healthy Gross Domestic Product (GDP) growth rate of about 7 per cent reached its climax in 2022.<sup>1</sup> The three R's—Rice (agriculture), Ready-Made Garments (RMG) and Remittances—that once propelled Bangladesh's growth<sup>2</sup> started reeling under the accumulated weight of several structural problems.

### Piling Loans and Shrinking Forex

Although Bangladesh fared comparatively well in the South Asian region during the COVID-19 pandemic, its RMG sector, which is a mainstay of its economy and vulnerable to external shocks, was affected as a result of disturbed supply chains across the globe.<sup>3</sup> In 2022, Bangladesh reached out to the International Monetary Fund (IMF) and other international lenders to prevent a meltdown.<sup>4</sup> The government did secure new loans, but these were added to existing external loans. In late 2023, external debt surpassed one hundred billion dollars for the first time, which resulted in very high debt service costs.<sup>5</sup>

During the initial eight months of the current fiscal year, Bangladesh disbursed

US\$2.03 billion in debt repayments.<sup>6</sup> According to Mustafizur Rahman, an economist, “The debt servicing, not only of foreign but domestic sources as well, forced the Hasina government to borrow to repay a large part of its PPG (Public and Publicly Guaranteed) debt obligations”.<sup>7</sup> This has put a serious dent in Bangladesh’s foreign exchange reserves, which experienced a huge slip. As of early April 2024, they were below the IMF’s recommended US\$19.26 billion.<sup>8</sup>

## **Chinese Debt**

Another issue plaguing the Bangladeshi economy is the rising Chinese debt, which accounts for about 24 per cent of its bilateral debt. Bangladesh’s debt stocks owed to China have rapidly increased from US\$0.97 billion to US\$6 billion in 2022.<sup>9</sup> To address this issue, Bangladesh has sought support from international financial institutions such as the International Monetary Fund (IMF), and the Asian Development Bank (ADB), which have provided financial assistance in the form of loans and grants to help stabilise the economy in 2023.<sup>10</sup> According to a January 2024 Daily Star News report, Abdul Hassan Mahmood Ali, the finance minister of Bangladesh, stated that both the World Bank and the ADB have agreed to provide financial assistance to Bangladeshi government when needed.<sup>11</sup> ADB’s Country Director, Edimon Ginting, stated that the ADB has long been extending budget support to Bangladesh. Last year, the ADB provided US\$800 million in budgetary support, which directly contributed to the foreign exchange reserve.<sup>12</sup>

On one hand, Beijing’s foothold in the country is widening; on the other, the money that China provides comes with strings attached. Chinese loans are opaque and loaded with high interest rates that often go beyond the paying capacities of countries. Additionally, they are mostly cornered around strategic projects in recipient nations. For instance, the tints of China’s ‘Debt Trap Diplomacy’ were clearly visible in acquiring strategically located Hambantota Port in Sri Lanka after the latter defaulted on its Chinese loans. So far, Bangladesh has avoided such an undesirable scenario, but given the history of Chinese credit, it faces increased pressure to repay loans, as well as issues of corruption.<sup>13</sup> Bangladesh must continue to carefully evaluate the loans granted by China and develop its economy to maintain the leverage to have a stronger say on the negotiating table and avoid potential economic dependency.<sup>14</sup>

It is expected that the current interim Yunus government will carefully navigate its ties with India and China instead of leaning on one side. In this context, it is expected that the projects discussed during Hasina’s last visit to India are likely to stay, including the energy connectivity projects with Nepal and Bhutan through India

that will reduce Bangladesh's reliance on fossil fuels.<sup>15</sup>

## **Social Indicators**

As most of the government spending went into servicing debt, social welfare schemes saw a cut in funding. The first casualty of government austerity was the decline in life expectancy. Bangladesh has seen a rise in life expectancy for several decades. In 2020, it reached 72.8 years, the highest recorded to date.<sup>16</sup> However, since then, the trajectory of population growth has been disrupted. There was a decline to 72.3 years as of 2021, and then in 2022, the Bangladesh Bureau of Statistics (BBS) reported a modest increase to 72.4.<sup>17</sup> However, in March 2024, the BBS released the Bangladesh Sample Vital Statistics-2023 (BSVS-2023), indicating a rise in the death rate for children under five years age, newborns and children under the age of one.<sup>18</sup> Given the rise in food insecurity over the past year, it is reasonable to assert that insufficient social spending has contributed to a health crisis.<sup>19</sup>

## **Climate Change**

One of the key structural challenges to Bangladesh is the impact of climate change. Bangladesh is among those countries that have been significantly impacted by climate change, being ranked 7th on the 2021 Global Climate Risk Index.<sup>20</sup> For instance, the devastating impact of 'Cyclone Amphan' in 2020 serves as a significant reminder of the country's vulnerability to extreme weather events, wherein the Bangladesh economy faced a loss of approximately US\$130 million.<sup>21</sup> Integrating climate adaptation measures within the social protection system, as emphasised in the ADB loan agreement of December 11, 2023, is an essential action in developing resilience and protecting the country's economic advancement.<sup>22</sup>

## **The India Factor**

The India-Bangladesh relations are historically, culturally, and linguistically deeply rooted in one another. Both countries have engaged in several bilateral talks, high-level visits, and various defence and security collaborations. They have also worked extensively to enhance people-to-people ties and connectivity projects via rail and waterways and have signed MoUs on digital payments and agriculture, focused on power, energy and development projects. Bangladesh remains India's largest development partner, benefiting from extensive trade, infrastructure, and human resource initiatives.<sup>23</sup> These robust ties exemplify a strong regional partnership

fostering economic, defence, and cultural cooperation.

Under the fourth consecutive government of Sheikh Hasina, Bangladesh aimed to elevate itself from the category of the ‘Least Developed Country (LDC)’ category by 2026.<sup>24</sup> By 2031, the same government wanted to achieve the goal of moving Bangladesh to upper-middle-income economy, i.e., per capita income between US\$4,466 and US\$13,845.<sup>25</sup> However, the overall turmoil in the country following Hasina’s ouster is likely to hinder its economic progress of the country, particularly the attainment of the 2031 goal. The structural problems created during Hasina’s reign are now staring at the forthcoming governments of Bangladesh. Only a democratic government can navigate the delicate balance between political continuity and responsive governance, address pressing macroeconomic concerns, and build resilience to the impacts of climate change, all the while carefully managing its regional ties.

As for India, the stakes are very high, as changes in Bangladesh’s political environment may threaten the security of India’s North Eastern states and impact cross-border security, trade, migration, and regional geopolitics. It is essential to note that India is Bangladesh’s second-largest trading partner in South Asia, and Bangladesh remains India’s largest trade partner in the region. Bangladesh exported USD 1.97 billion in goods to India in the Financial Year (FY) 2023-24. As per the Ministry of External Affairs’ India-Bangladesh Bilateral Relations 2024 report, the total bilateral trade has been reported as USD 14.01 billion for the FY 2023-2024.<sup>26</sup>

However, the rise of Islamist factions or a potential realignment of Bangladesh’s foreign policy towards China or Pakistan under the interim regime may pose a challenge to India’s strategic interests in Bangladesh and, by extension, South Asia. Hence, it is the need of the hour for India to reassess its approach toward its eastern neighbour.

## Notes:

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# BHUTAN

## Economic Progress and Challenges



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### Bhutan's Economic Profile

Bhutan is the most peaceful country in South Asia, with little upheavals until now. It has not recorded any terrorist incidents in the past five years and is the only state in the region with a zero score on the Global Terrorism Index.<sup>1</sup> Although it is the most peaceful country in the South Asian region, it has faced its own share of challenges posed by global disruptions like the COVID-19 pandemic and the Russia-Ukraine dispute. Besides maintaining internal security, Bhutan's economic recovery shows its resilience in the face of external shocks. The nation has been able to maintain an annual real economic growth of nearly 5 per cent since the fiscal year 2021-22 after facing economic contraction due to the pandemic.<sup>2</sup> As tourism increased after the pandemic, the real GDP of Bhutan has increased by 4.5 per cent in fiscal year 2022-23.<sup>3</sup> Moreover, with the rise of revenue and fall in expenditure, the fiscal deficit has declined to 4.1 per cent of GDP in fiscal year 2022-23 from 7.0 per cent of GDP in fiscal year 2021-22.<sup>4</sup> Furthermore, Bhutan has also graduated from the United Nations' least Developed Country status in December 2023.<sup>5</sup> This achievement shows the remarkable development journey that Bhutan has undertaken over the past five decades and, furthermore, acknowledges its progress in reducing poverty and promoting sustainable development.

Bhutan, being a landlocked country as well as one of the smallest economies in the world, has shown an average annual real GDP growth of 7.5 per cent since the 1980s.<sup>6</sup> This significant economic growth has contributed immensely to reducing poverty over the last two decades. By 2022, Bhutan had successfully eliminated extreme poverty, defined as living on less than US\$2.15 per day.<sup>7</sup> The Gini index, which measures income inequality, has also shown a decline from 37 in 2017 to 28 in 2022.<sup>8</sup>

## Drivers of Growth

The economic growth has largely been driven by the ‘hydropower’ and ‘tourism’ sectors. For instance, the development of projects like Tala Hydroelectric Power station in the mid-2000s helped Bhutan’s economy grow a lot.<sup>9</sup> Hydropower projects ensure that Bhutan’s economy has access to clean and sustainable sources of power as well as help in enhancing their foreign reserve by exporting power to other countries. For instance, Bhutan exports hydropower to India, guided by the 2006 bilateral agreement and its 2009 Protocol.<sup>10</sup> In addition to being the main destination for Bhutan’s exports, India is also the country from where most of Bhutan’s import comes. In fact, the trade between India and Bhutan has increased tremendously in the last few years, starting from US\$484 million in 2014-15 to US\$1,615 million in 2022-23, which makes up about 80 per cent of Bhutan’s total trade.<sup>11</sup> There are four hydro-electric projects (HEPs) amounting to 2,136 MW operating in Bhutan, providing electricity to India.<sup>12</sup> The 720 MW Mangdechhu began functioning in August 2019 and was transferred to Bhutan in December 2022.<sup>13</sup> In fact, as per Government of Bhutan, India’s import of electricity from Bhutan was around INR 2,448 crores in 2022.<sup>14</sup>

Bhutan’s economy has also seen growth in other sectors like agriculture, tourism, and a budding industrial base. Though there is less arable land (2.7 per cent of the country’s total area) in Bhutan, the agricultural productivity has been on the rise over the years.<sup>15</sup> The contribution of agriculture, forestry and livestock to the GDP has increased from 14.78 per cent in 2010 to 19.23 per cent in 2020.<sup>16</sup>

The tourism industry has played a significant role in driving economic activity in Bhutan. The tourism sector has been the biggest source of foreign exchange as well as the second-largest revenue generator after hydropower. In 2017, the tourism sector generated USD 79.8 million, which is a big leap from the late 1980s when tourism contributed only around USD 2 million to the government.<sup>17</sup> Bhutan’s Prime Minister, Tshering Tobgay, while visiting India, urged Indian industries to utilise business opportunities available in the tourism sector of Bhutan.<sup>18</sup> He emphasised that investors can establish hotels, restaurants and wellness centres in Bhutan. Furthermore, the Bhutanese PM has also requested India to assist with Rs 100 billion for the 13th Five-Year Plan and an additional Rs 15 billion for the economic stimulus package.<sup>19</sup> These initiatives will help Bhutan revive its economy and improve its infrastructure.

## **Gross National Happiness (GNH)**

Bhutan's economic development has been inspired by the idea of Gross National Happiness (GNH), which laid greater emphasis on sustainable and equitable growth.<sup>20</sup> Due to the greater emphasis on GNH, Bhutan has been able to significantly improve its living standard and reduce poverty from 25 per cent in 2003 to just 2 per cent in 2012, based on the international poverty line of US\$1.90 per day.<sup>21</sup> The GNH driven approach has improved the accessibility to healthcare, education, and other social services in the country.<sup>22</sup> This has further resulted in reduced poverty and overall better living standards. The concept of GNH has influenced Bhutan's development policy since its articulation and has been mooted on the global stage. Bhutan's application of the concept of the GNH index has introduced a practical measurement tool in policymaking. The GNH index serves as an incentive to the government of Bhutan, NGOs, and businesses to bring societal well-being and happiness. This includes the comprehensive reflection of the general welfare of the Bhutanese people, surpassing 'happiness' as a subjective psychological ranking.<sup>23</sup>

## **Key Economic Challenges in Bhutan**

Despite sustained economic growth, Bhutan's economy is facing significant economic challenges today. The major issue is the growing gap between the trade revenue and the money being spent on imports, which carries the potential to adversely affect the country's financial health. The global economic slump and country-wide COVID shutdowns further disrupted the supply chains in the landlocked nation, worsening the trade gap. As a result, the cost of everyday goods went up, making life tough for small and mid-sized businesses.<sup>24</sup>

Another key challenge that Bhutan is facing is with the manufacturing sector, which has been stagnant for over a decade, mostly relying on construction, mining, and electricity to drive the industrial sector. This has limited the country's economic diversification.<sup>25</sup> Also, the nation's growth is slowed down by higher oil prices, rising costs, and an overall global economic downturn, leading to fewer jobs. So, it's been a rough mix of issues hitting Bhutan's economy.

Further, youth unemployment has surged to over 28.9 per cent in 2022, making the young people virtually flee to foreign countries in search of better job opportunities.<sup>26</sup> Bhutan's economy is particularly challenged in the area of finance, where access to well-priced financing is reportedly considered a major obstacle to growth in the private sector.<sup>27</sup>

Moreover, Bhutan's interest rate spread has remained high over the years, reflecting inefficiency in the financial services sector. The result of financial reforms done in the late 1990s and late 2000s to restore competition and better manage credit or liquidity risks in loan pricing has been mixed, with Bhutan's interest rate spread not improving consistently. Furthermore, Bhutan has not yet been assigned a sovereign credit rating by major global credit rating agencies; however, an approximation based on interest payments on external debt suggests it would likely be rated BB-, which is normally considered a below-average and speculative level.<sup>28</sup> The macroeconomic factors influencing interest rates are tied to Bhutan's deep negative current account balance, which has been closely linked to its overall economic growth since 2006, presenting a broader financial challenge to the economy. These problems could altogether hold back the growth of the private sector, which is highly significant for diversifying and developing Bhutan's economy.

## **Conclusion**

Bhutan's economy has undergone significant growth and transformation in recent decades. It moved from an economy that was a traditional, subsistence-based system to one that's more diversified and strong. This shift was mainly due to its hydropower sector. Hydropower has not just made the country's GDP climb but also ensured Bhutan's energy security and earned it remittances through exports. All this has really pushed Bhutan forward in both its social and economic growth. Also, people's standard of living has improved significantly, and the nation has made great strides in cutting down poverty, all thanks to Bhutan's focus on Gross National Happiness. However, Bhutan faces challenges and has vulnerabilities that hurt its economy: a large trade gap, over-reliance on hydropower and tourism, a lack of sectoral diversification for revenue generation, and a slow manufacturing sector. These problems got worse during the pandemic phase, clearly highlighting growing unemployment and inefficiencies in the financial sectors. Going ahead, Bhutan must focus on economic diversification, strengthening the private sector and improving access to affordable financing to ensure sustainable and equitable growth. Handling these issues well is crucial for Bhutan's future economic growth and strength.

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# MALDIVES

## State of Economy and Prospects



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Having won both the presidential election in October 2023 and the parliamentary elections in April 2024, the road ahead now seems to be cleared for President Muizzu of the Maldives to implement his domestic plans and external policies. The scheme of things will include undertaking reforms to improve the finances of the state and bring debt to sustainable levels by focusing on improving tourism and mobilising large investments in the Maldives.<sup>1</sup> The success of this largely depends on a strong and stable economic foundation. However, the optics and reports from global economic institutions suggest otherwise due to low forex reserves, increased public debt, widening current account deficit, and fiscal challenges.

Forex reserves in the first six months of 2024 have been the lowest since 2018, except in April, when it reached US\$614.79 million, crossing the benchmark of US\$500 million for the first time this year.<sup>2</sup> But this is still lower than the same month last year, when it was US\$748.21 million. The International Monetary Fund (IMF) has called for an urgent policy adjustment and has put the Maldives in the high category of overall debt distress, which continues to hover around 115 per cent of the GDP.<sup>3</sup> In another report of the IMF executive board, the current account deficit of the Maldives for 2023 was 22.8 per cent. However, it is likely to reduce in the medium term.<sup>4</sup> All this indicates that the grammar of economics is not right to chart a prosperous future for the smallest South Asian country, the Maldives. Simultaneously, its closest neighbour and the largest country in South Asia, India, has emerged as one of the fastest growing economies post-COVID-19, according to the World Bank, largely due to accommodative monetary and fiscal policies, and recorded a growth rate of 6.9 per cent in 2022-23.<sup>5</sup> The forecasts suggest that India is likely to continue on this path. According to the IMF's latest World Economic Outlook, the GDP forecast for India in 2023-24 has been revised and increased by 20 basis points, taking the forecasted GDP growth to seven per cent.<sup>6</sup> What and how can Malé gain from New Delhi's economic ascendancy

and support remains to be seen under the newly elected pro-Chinese President of the Maldives.

### **Maldives' Economy: An Insight**

Made up of nearly 1,190 coral islands, grouped in a double chain of 27 atolls, the Maldives is an upper middle-income country located in the Central Indian Ocean Basin. Despite the ripples of the pandemic, which caused a global economic slowdown, Maldives has not only surpassed the pre-pandemic levels in terms of economic indicators but has also scaled new heights. In 2019, the GDP of the Maldives was US\$5.73 billion, with a GDP per capita of US\$11,350 and an economic growth rate of 7.30 per cent. By 2022, these figures had increased to US\$6.17 billion in GDP, US\$11,781 in GDP per capita (the highest in South Asia), and a growth rate of 13.91 per cent. This was mainly due to the revival of tourism and expansion of activities in other sectors like construction, transportation, and communication.<sup>7</sup> Despite all of this, the real GDP growth rate of the Maldives in 2023, according to the IMF, was 4.4 per cent—much lower than in yesteryears.<sup>8</sup> The projection for 2024 is 5.2 per cent, but it remains to be seen how well the Maldives can maintain this rate amid the ongoing Ukraine war, which has increased the prices of food, fuel, and fertilisers. All of this becomes more relevant for the Maldives as it is a net importer of agricultural products and fossil fuels.

According to the Human Development Index published by the United Nations Development Programme (UNDP), along with Sri Lanka, Maldives is the only country in South Asia categorised under high human development. Its growth from 0.753 in 2019 to 0.762 in 2022 is laudable.<sup>9</sup> Though the overall loss in human development due to inequality, according to the Inequality-adjusted HDI, has come down from 22.6 per cent in 2019 to 21.7 per cent in 2022. But a closer look at the above numbers shows that even this level of inequality is higher for a population of 5,30,000. More so, being an island country that is scattered between the equator and the eight-degree channel, the population is spread across different islands that have limited communication and transportation facilities, which has added to this gap. This has been confirmed in a report titled 'National Multidimensional Poverty in Maldives 2020', a result of the joint effort of the National Bureau of Statistics (Maldives), Oxford Poverty and Human Development Initiative, and UNICEF Maldives Country Office that compares the multidimensional poverty index of Malé, the economic and political hub, with that of the other atolls.<sup>10</sup> The report concludes that poverty is much higher in the surrounding

atolls than in the capital city of Malé, due to imbalanced allocation of resources and limited connectivity.

Another critical issue that is plaguing the Maldivian economy is the high and rising internal and external debt (Table 1), which has led to an acceleration in the total debt-to-GDP ratio. This issue did not originate with the current Muizzu administration or the previous Solih administration; rather, it stems from increased borrowings from China during the second half of the Yameen administration (2013-2018) (Table 2). The after-effects of these borrowings have continued to blot the economics of successive governments.

**Table 1**

**Comparison of the Internal and the External Debt of Maldives**

(Data is presented in MVR million)

		<b>Internal Debt</b>	<b>External Debt</b>
2020	S1	35	22
	S2	42	25
2021	S1	45	27
	S2	48	32
2022	S1	54	32
	S2	58	33
2023	S1	67.0	33.9

Source: This table has been created by the author based on data compiled from various Debt Bulletins released semiannually by the Ministry of Finance, Republic of Maldives.

Table 2 reflects that the rise in borrowing from China was continuously increasing each year, concomitantly followed by a sharp decline in borrowing from India. In fact, in 2019, when the borrowing from Beijing was the highest, simultaneously, it was the lowest from New Delhi. These were also the years when the Maldives had approved many Chinese infrastructure and connectivity projects in Malé. All of this has proved to be a deadly cocktail for the growth of the Maldives today. The two most prominent global economic institutions, the IMF and World Bank, have now cautioned the Maldives about getting too close to China. The IMF has speculated the need for urgent policy adjustments, which, if not done, could spell trouble for its overall debt.<sup>11</sup> The World Bank has advised the Maldives to exercise caution when borrowing from China for its infrastructural development. According to the Debt Bulletin released by

the Maldivian government, Maldives owes more than a quarter of the external debt to the EXIM Bank of China.<sup>12</sup>

**Table 2**

**Comparison of Borrowing from India and China during Yameen’s Administration**

(Data is presented in MVR million)

	June 2016	December 2016	June 2017	December 2017	June 2018	December 2018	June 2019	December 2019
<b>EXIM China</b>	2,778	4,708	4,777	5,935	7,219	8,093	8,896	8,892
<b>EXIM India</b>	221	220	221	201	181	162	142	122

Source: Data is compiled by the author from various Public Debt Bulletins released by the Ministry of Finance and Treasury, Malé, Republic of Maldives.

The current Muizzu government must heed these warnings, as it has been sending strong signals of bending toward China to support its economy. At the same time, it has adopted an economic policy focused on the construction of airports, international bunkering facilities, trade port, and other economic gateway projects.<sup>13</sup> All this requires a colossal amount of finances generated both from within the country and borrowed from outside in the form of cheap loans, lines of credit, and budgetary support. However, the challenge is that finances from within are limited due to extensive reliance on tourism and fisheries. This necessitates its dependence on outside sources which will be guided by its robust bilateral partnerships and global stance.

**Key Challenges**

Being one of the maritime South Asian country, Maldives’ economy is highly dependent on twin pillars of tourism and fisheries. One-third of the country’s GDP comes from tourism and related sectors. Despite the significant decline experienced during the pandemic, which took down its contribution by 62.7 per cent, the sector bounced back in 2021 and grew by 152.8 per cent.<sup>14</sup> Though the number of tourist arrivals has been increasing, however, the foreign exchange earned from this is not enough to service the large debt the country is facing (In 2023, it was 118 per cent of the GDP).

Simultaneously, the tourists from India, which were one of the Maldives largest sources of visitors till 2023, have been sharply dropping, especially after the social media outrage over the derogatory remarks made by the Maldivian ministers on PM Modi's visit to the Indian territory of Lakshadweep. This has affected the tourism campaign, and its impact is evident in the declining share of the Indian tourist market share from 10 per cent to 6 per cent.<sup>15</sup>

The second quintessential pillar of the Maldives' economy is fisheries, naturally due to its large maritime boundary. The fisheries sector, which apart from being a source of nutrition and livelihood, also has huge export potential, is suffering from staggering challenges of Illegal, Unreported, and Unregulated fishing thereby declining its contribution by five percent per annum.<sup>16</sup> Other challenges affecting the growth of this sector include the limitation of advanced fish processing, banking facilities, delayed payments, difficulties in acquiring ice and fuel, and challenges to the use of satellite phones.<sup>17</sup> Another sector that has picked up momentum is construction, but even that is completely dependent on the import of construction materials.

These are the two main engines of growth and prosperity in the Maldives. A commonality between them is their vulnerability to climate change. As the temperature of the Indian Ocean increases, this will, in all circumstances, impact the fish catch; at the same time, the increase in water levels will seriously impact the infrastructure and, consequentially, the tourism sector. Secondly, both sectors are highly vulnerable to external shocks, as was seen during the pandemic, which affected both the influx of tourists and the export of fisheries. The penultimate takeaway from the Maldivian economy is its low diversification and heavy reliance on imports.

## **What the Future Holds for Maldives and India**

A brief look at Malé's economic indicators suggests that it would potentially be vulnerable both due to internal as well as external factors if the right steps are not taken now. Domestically, the demand for several infrastructure projects will increase, and so will the borrowings and the import of construction materials, fossil fuels, and even agricultural products to feed the rising population. However, in pursuing development, it is crucial to consider the cost. Development should not come at the expense of political gains that offer short-term benefits but have long-term implications.

Getting the grammar of economics right in the Maldives will require not only domestic reforms like a tighter fiscal consolidation strategy, a mechanism to draw

in private investment, and a focus on green and sustainable growth, but also a wise borrowing strategy. One of the prime creditors of Malé is China. However, looking at the economic vulnerability in Sri Lanka suggests that Chinese borrowings not only come with higher interest rates but also at the cost of sovereignty. On the other hand, apart from the cheap EXIM Bank loan, New Delhi also provides budgetary support that Beijing does not provide. Budget support plays a key role in addressing critical economic reforms, supporting structural transformation in debt-stressed countries, and also facilitates the leveraging of private capital for institutional reforms.<sup>18</sup> India has done fantastically well in this regard, and in 2023-24, the budget support has seen an increase of 300 per cent compared to last year.

Cooperation with India and Indian leadership in the past in various sectors ranging from economic to military, health, education and infrastructure has uplifted not only local Maldivians, but also the nation as a whole. New Delhi's outstanding support in dealing with the coup of 1988, providing defence equipment, training and conducting joint exercises has strengthened and enhanced the security of the Maldives, which has ultimately contributed to its economic security. Recently, at the request of the Maldivian government to avert the risks of a debt crisis<sup>19</sup> and the fear of its first-ever Islamic sovereign bond default,<sup>20</sup> New Delhi has assisted the Maldives by buying their treasury bills worth US\$50 million twice,<sup>21</sup> first in May and again in September 2024.

However, no economic policy can succeed if the politics behind it does not make the right calls at the right time. And in this case, it all depends on the newly appointed President of Maldives, Dr Mohamed Muizzu, to take the road not taken. Despite the difficult choices made by Muizzu since he took over as the President in November 2023, which has deeply impacted its ties with India at the cost of China,<sup>22</sup> New Delhi has been neutral and gracious towards Malé. The importance of the Maldives for India was seen when PM Modi invited Muizzu for his oath-taking ceremony in June 2024. Despite everything, Malé must know how to balance its relations with different countries as it continues to diversify its diplomatic engagements. Testing the threshold of a benign neighbour like India can cost the ties in the present and the future.

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# NEPAL

## Economy in Disarray: Challenges and Concerns



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### Introduction

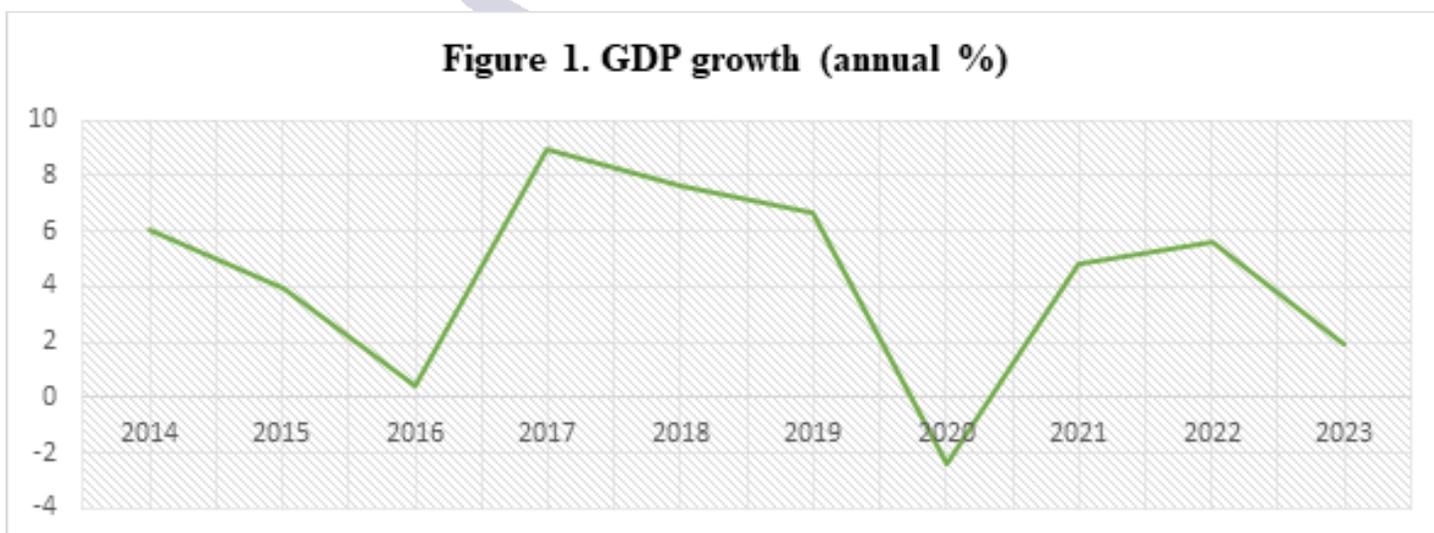
Nepal, influenced by domestic imperatives and global trends, underwent significant transformations towards democratisation and economic liberalisation in the 1990s. It marked the beginning of a transition that has spanned over three decades.<sup>1</sup> Over the course of the past 34 years, Nepal has experienced frequent changes in government, characterised by numerous coalition shifts and short-term cabinets. Additionally, the nation has grappled with social unrest, including ethnic agitations, and endured natural disasters such as floods, earthquakes, and the recent global pandemic COVID-19. Despite pursuing economic liberalisation and reforms, Nepal has struggled to achieve sustained progress due to persistent social and political instability. In recent years, Nepal's economy has shown signs of distress and potential disarray. This write-up aims to explore the challenges and concerns surrounding Nepal's economic situation and the underlying factors contributing to the current state of the economy.

### Nepal's Economy and the Major Sectors of Growth

Nepal's economy has historically been reliant on agriculture, with approximately 90 per cent of its population engaged in the agricultural sector during the 1950s. According to the Agriculture Census of 2021/22, at present, around 67 per cent of Nepal's population is dependent on agriculture.<sup>2</sup> However, despite this high level of engagement, the agricultural sector's contribution to the GDP stands at a modest 24.12 per cent, while the industry and service sectors contributed 13.45 per cent and 62.43 per cent respectively in the fiscal year (FY) 2022/23.<sup>3</sup> Nepal's economy underwent a gradual shift towards services, particularly remittances and tourism, following accelerated economic liberalisation since the 1990s.<sup>4</sup> The industrial sector, however, has not played a significant role in the country's economy in terms of its GDP contribution. This stagnation in the agricultural sector and slow growth

in the industrial sector can be attributed to persistent political instability, leading to policy volatility in Nepal.

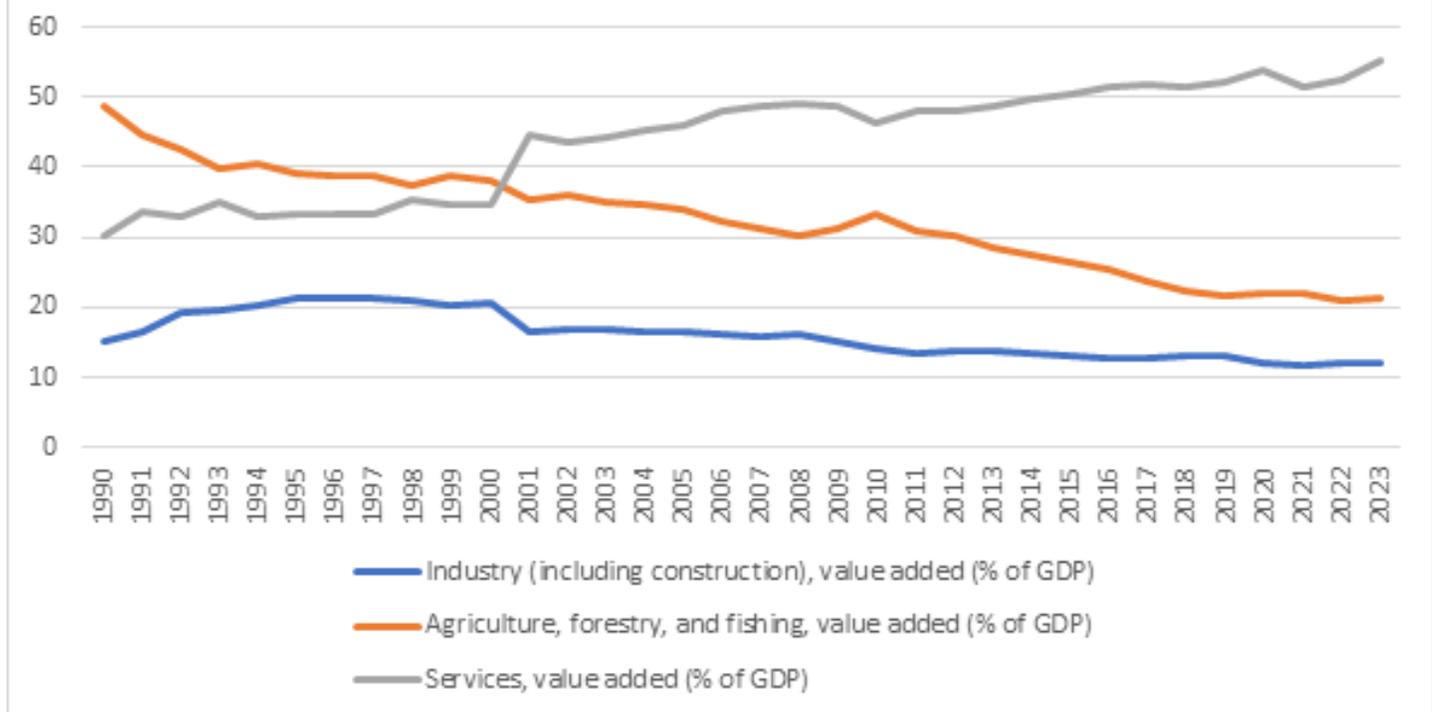
In the recent past, Nepal has encountered fluctuating GDP growth rates. This is evidenced by data obtained from the World Bank (see Figure 1). Over the past ten years, the Nepalese economy has been significantly impacted by various events, including persistent political instabilities leading to policy volatility, the April 2015 earthquake, the September 2015 ethnic uprising and economic blockade, and the unprecedented challenges stemming from the COVID-19 pandemic. These occurrences have notably disrupted trade, tourism, and Nepal's overall economic environment, resulting in a noticeable decline in the GDP growth rate, as depicted in Figure 1.



Source: Prepared by the Author based on the data retrieved from the World Development Indicators, The World Bank., n.d.

According to data retrieved from the World Bank, over the past 34 years, there has been a noticeable decline in the contribution of the agricultural sector to Nepal's GDP, accompanied by a significant rise in the services sector. Concurrently, the industrial sector has experienced fluctuations, declines, and stagnation in its growth, as depicted in Figure 2.

**Figure 2. GDP % Share of Agriculture, Industry, and Services Sectors of Nepal**



Source: Prepared by the Author based on the data retrieved from the World Development Indicators, The World Bank., n.d.

The Asian Development Bank (ADB) forecasts an acceleration in Nepal’s economic growth for the fiscal years 2024 and 2025. This growth is expected to be driven by increased domestic demand, amplified hydroelectric output, and a sustained recovery in the tourism sector.<sup>5</sup> However, the outcome is contingent upon political and policy stability, as well as Nepal’s capacity to capitalise on the hydropower and tourism sectors.

### **Understanding the Economic Challenges and Concerns in Nepal**

In the recent past, Nepal has encountered an array of daunting challenges and issues within its political economy, contributing to a state of disarray. These challenges encompass persistent political instability, leading to policy fluctuations due to frequent changes in governance and leadership. The resultant instability has effectively impeded long-term economic planning and development.

## *Financial Sector*

According to the International Monetary Fund (IMF) report, the potential weaknesses in the Nepalese financial sector are growing as banks experience capital challenges caused by the surge in post-pandemic borrowing. Lending practices are evolving, leading to a shift towards term lending and a review of client connections, but also resulting in a rise in gross Non-Performing Loans (NPLs). The decline in the real estate market has affected loan performance and the banks' ability to sell repossessed assets, contributing to higher NPLs and decreased bank profitability.<sup>6</sup> In addition, according to the IMF report, despite some recovery, tax collection remains below pre-pandemic levels, limiting fiscal space for development spending.<sup>7</sup>

Furthermore, in recent years, Nepal has witnessed a sustained escalation in its external debt, particularly since 2018. As of mid-July 2023, Nepal's external debt amounted to NPR 1170.25 billion, signifying approximately 22 per cent of the GDP.<sup>8</sup> This presents another concern for the Nepalese economy.

## *Remittances*

Nepal's heavy dependence on remittances from Nepali workers abroad plays a significant role in supporting many households. However, this reliance reflects a potentially unstable and unsustainable dependency. Notably, Nepal's GDP has seen a marked increase in the proportion of remittances, accounting for approximately 26 per cent of the total GDP.<sup>9</sup> The increase in migration from Nepal presents initial benefits but raises concerns regarding the country's growing reliance on remittances. This reliance is not conducive to long-term sustainability and makes the country vulnerable to external shocks. It has also contributed to a phenomenon known as brain drain, where numerous young individuals are departing the nation in pursuit of opportunities overseas. Additionally, educated and highly skilled individuals are increasingly seeking work abroad.<sup>10</sup> The negative impact of losing skilled individuals is a real concern. This trend could create a dangerous cycle where a poor domestic business and investment climate drive high-skilled people abroad, while the lack of high-skilled workers contributes to the poor climate, limiting the potential for reform and growth.<sup>11</sup>

The substantial dependence on remittances has steered Nepal towards a consumer-driven economy, leaving it vulnerable to abrupt crises, as demonstrated during the challenging period of the COVID-19 pandemic, when the Nepalese economy exhibited signs of strain.

## *Trade*

Nepal's trade is crucial to its economy, accounting for around 49 per cent of the GDP in 2022. However, the country's trade deficit remains significant due to political instability and policy inefficiency. This has led to a lack of investment and weak implementation of export-oriented policies in key sectors.<sup>12</sup> Recently, concerns have been raised about Nepal's declining exports compared to imports in recent decades, attributed to a 'collapse in its top export products.'<sup>13</sup> According to the Nepal Rastra Bank (NRB) report, in the fiscal year 2022-23, Nepal's exports decreased by 21.4 per cent to NPR 157.14 billion.<sup>14</sup>

The fluctuations in Nepal's exports suggest historical trade policy challenges. Nepal faces a significant trade deficit and has yet to fully leverage its expertise in products such as woollen carpets, pashmina, and medicinal plants. The country's size and limited resources are key factors contributing to its trade deficit in goods. However, there exists potential for expansion in the services sector, which could help mitigate the trade imbalance.<sup>15</sup>

Notably, Nepal's primary export destinations include India, the USA, Germany, Turkey, and the UK, while the country mainly imports from India, China, Indonesia, the United Arab Emirates, and Argentina.<sup>16</sup>

## *Foreign Direct Investment*

The Foreign Direct Investment (FDI) data of the past decade indicates that despite the liberal reforms in the investment sector of Nepal, it could not achieve the desired goal of attracting foreign investments. FDI's GDP share could not even cross 1 per cent of the total GDP of Nepal ever.<sup>17</sup> The latest FDI survey report published by the NRB points to a significant gap between FDI commitments and actual net inflows. As per the NRB data, between fiscal years 1995–96 and 2021–22, the total actual net FDI inflow stood at around 36.2 per cent of the total approval.<sup>18</sup> The FDI environment in Nepal is unfavourable due to a lengthy approval process, time-consuming profit repatriation, and weak copyright laws. Additionally, and most importantly, the everlasting political instability has majorly hampered foreign investors from investing in Nepal.<sup>19</sup>

According to data spanning fiscal years 2012/13 to 2020/21, the primary source countries of foreign investment in Nepal were China, India, the USA, South Korea, Japan, the UK, the Netherlands, Bangladesh, Australia, and Russia. However, a notable downturn in foreign investment has occurred due to the global impact of the COVID-19 pandemic<sup>20</sup> and the uncertainty created by the constant political jolts in Nepal.

## *Other Challenges and Concerns*

Corruption is a major concern in Nepal, eroding trust in institutions, distorting economic decision-making, and obstructing development efforts. The integrity of political and social institutions has been significantly impacted, leading to an increase in dishonest practices. Media reports have revealed numerous scandals and financial irregularities over the past decade, including substantial kickbacks linking diplomats, political leaders, and individuals to the financial support of corrupt politicians and parties. Prominent figures, such as Prime Ministers, cabinet ministers, bureaucrats and businessmen, have frequently been implicated in these improper activities.

Additionally, Nepal is susceptible to natural disasters such as earthquakes, landslides, and floods, which have the potential to devastate communities and disrupt economic activities. Nepal has experienced numerous catastrophic natural events, such as the 2015 earthquake, annual heavy flooding in the southern plains, and ensuing landslides in the hills. These events have caused significant damage to infrastructure, loss of human lives, and depletion of resources, consequently hindering Nepal's development. The need to build resilience against these disasters remains a formidable challenge. Substantial disparities in income, access to services, and opportunities persist among different segments of Nepali society, highlighting the imperative to address these inequalities for sustainable development.

Moreover, Nepal's geopolitical position between India and China exerts influence on its economic and political dynamics, presenting the delicate challenge of balancing relations with these major powers while asserting its sovereignty. Nepal's endorsement of China's ambitious and strategic Belt and Road Initiative (BRI) framework agreement in 2017 has strengthened China's influence in Nepal concerning political and strategic objectives. The implementation plan for the BRI is pending ratification. Nepal has expressed hesitancy in participating in BRI projects that require funding through loans<sup>21</sup> due to apprehensions about accumulating unsustainable debt. The current unease is supported by challenges encountered in Sri Lanka, an economic crisis in Lao PDR, and concurrent studies and reports indicating that Pakistan may confront similar issues.

Likewise, more recently, there has been an increase in the United States' engagement with Nepal, partly influenced by China's expanding presence in the South Asian region. The endorsement of the Millennium Challenge Corporation (MCC) serves as a manifestation of this heightened engagement. Additionally, there are some prevalent political perspectives in Nepal suggesting that the US is actively pursuing Nepal as a key component of its 'Indo-Pacific Strategy' and aims to establish military engagement.<sup>22</sup>

Lastly, Nepal is making strides towards its projected graduation from the Least Developed Country (LDC) category in 2026. This transition has been a key focus for the government since 2010. Currently, Nepal is in the transition period spanning from 2021 to 2026 and retains its status as an LDC and is entitled to receive all associated benefits. However, after graduation, Nepal will no longer be eligible for the preferential treatment and privileges accorded to LDCs, such as lower or zero tariffs on exports, concessional loans, and grants.

## **Economic Relations with India**

India plays a crucial role in the economic initiatives of Nepal, helping as a key partner in development cooperation across diverse sectors. Since the late 1940s, Nepal has actively sought economic and technical support from India.<sup>23</sup> In addition, it has also been seeking assistance from India in its' planned development.<sup>24</sup> India's development cooperation in Nepal largely encompasses manufacturing, infrastructure, hydropower, and tourism.<sup>25</sup> Furthermore, India represents a significant market for Nepalese agricultural and manufacturing goods and serves as a destination for labour migration.<sup>26</sup> Notably, a burgeoning partnership in the hydropower sector has emerged between the two countries in recent times. Nepal's developmental collaboration with India is distinct from its engagement with other nations due to its particular nature.<sup>27</sup> The pegging of the Nepalese currency to the Indian currency has brought stability to the value of Nepal's currency, acting as a protection against fluctuations.<sup>28</sup> Besides, Nepal's proposed hydropower export to Bangladesh necessitates a transmission line through Indian territory. There is a trilateral power exchange agreement in the pipeline.<sup>29</sup> The signing of the trilateral agreement will facilitate cross-border energy trade in the South Asia and Bangladesh-Bhutan-India-Nepal Initiative (BBIN) subregions, making it a unique, first-of-its-kind initiative.

In addition, India does provide duty-free, quota-free access to its market for almost all Nepalese goods and also provides access to its two seaports, Haldia (Kolkata) and Vishakhapatnam, to Nepalese overseas trade.<sup>30</sup> The majority of Nepal's third-country trade passes through Indian land, with access via Kolkata (Haldia) port and Vishakhapatnam port.

Besides, India is Nepal's largest trading partner, accounting for more than 60 per cent of Nepal's trade. The recent commencement of hydropower exports to India, as well as its potential for growth, could help alleviate Nepal's trade deficit with India. India's developmental collaboration with Nepal plays a pivotal role in Nepal's efforts to attract foreign investment and expand its foreign trade and commerce. Given that foreign investors typically seek accessible markets for their investment ventures, India appears to be the

largest market and transit provider to most of Nepal's overseas trade. Significant aspects of Nepal's economic development, including trade, investment, tourism, hydropower, agriculture, and services, are reliant on its relationship with India and the infrastructure connecting the two countries.

India's commitment to its 'Neighbourhood First Policy' underscores Nepal's paramount importance in its diplomatic and strategic pursuits, positioning it as a key priority in the region. This approach seeks to establish harmonious, stable, and forward-looking environments that foster mutual prosperity and development. India has consistently extended support to Nepal in its development endeavours, providing aid and assistance as needed and being the first to respond in times of necessity.

Amidst the frequent coalition changes and political instability, all the governments formed in Kathmandu have consistently underscored India's significance for Nepal's economic growth and overall development. Consequently, they have made concerted efforts to maintain positive relations and seek developmental support. Given the new coalition government formed in July 2024, the recent high-level visit of Nepalese Foreign Minister Arzu Rana Deuba to India in August 2024 underscores Nepal's dedication to enhancing its ties with India. The visit particularly emphasised the pursuit of development cooperation and an eagerness to broaden the scope of collaboration.<sup>31</sup>

## **Conclusion**

Nepal's economy is confronted with a multitude of challenges and issues that have contributed to its current state of disarray. The ongoing and protracted transitions have significantly impacted the nation. Addressing these challenges necessitates a concerted focus on governance and policy reforms, infrastructure development, anti-corruption measures, promotion of inclusive growth, and building resilience against natural disasters. Political stability and effective leadership are imperative for navigating these intricacies and guiding Nepal towards sustainable development. Further, Nepal must strategically realign and actively engage with its' reliable international development partners. Doing so is crucial to mitigate further adverse effects of economic challenges.

## Notes:

<sup>1</sup> Nepal has navigated multiple shifts, including the restoration of multiparty democracy in 1990, accelerated economic liberalisation during the 1990s and 2000s, the Maoist insurgency from 1996 to 2006, the abolition of the monarchy and the establishment of a federal republic in 2008, constituent assembly elections in 2008 and 2013 along with constitution-making processes. This culminated in the establishment of a federal parliament and seven provincial governments in 2018 after the federal elections in 2017-2018.

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<sup>12</sup> Bharti, n. 4, pp. 125, 171.

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- <sup>27</sup> Ibid.
- <sup>28</sup> Jha, n. 26.
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# PAKISTAN

## Persistent Economic Crises

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### Introduction

In September 2024, the International Monetary Fund (IMF) granted final approval for the loan to Pakistan. The international financial body has approved a 37-month extended arrangement under the Extended Fund Facility (EFF) for (around) US\$7 billion.<sup>1</sup> The Pakistan government has approached the IMF for the 25th time and is its fifth largest debtor. Turning to the IMF has been inevitable for Pakistan due to its unresolved balance of payments crisis. Under the new EFF-supported program, the key priorities include – “(i) rebuilding policy making credibility and entrenching macroeconomic sustainability through consistent implementation of sound macro policies and a broadening of the tax base; (ii) advancing reforms to strengthen competition, and raise productivity and competitiveness; (iii) reforming SOEs [state-owned enterprises] and improving public service provision and energy sector viability; and (iv) building climate resilience.”<sup>2</sup>

In an unusual move, the IMF held unscheduled talks with Pakistan in the second week of November, ahead of the stipulated time. The IMF issued a press release with recommendations for Pakistan:

“The need to continue prudent fiscal and monetary policies, revenue mobilization from untapped tax bases, while transferring greater social and development responsibilities to provinces. In addition, structural energy reforms and constructive efforts are critical to restore the sector’s viability, and Pakistan should take steps to decrease state intervention in the economy and enhance competition, which will help foster the development of a dynamic private sector.”<sup>3</sup>

Pakistan's revenue shortfall stood at Rs 190 billion in the first four months (July to October) of the current fiscal year, and according to the financial body, Pakistan had time till February next year (2025) to recover the shortfall.<sup>4</sup>

Perhaps the most critical challenge for the Shehbaz Sharif government has been to address the country's economic crisis. The government has indicated that it would want this to be the last loan from the financial institution. In the last two years, Pakistan has experienced compounding financial challenges, including an alarming decline in foreign reserves at the Central Bank, which dropped to as low as US\$2.9 billion in February 2023—just enough to cover three weeks of imports. The country faced a high debt burden, hard-hitting inflation that peaked at almost 30 per cent, and a desperate need for external assistance from the IMF and Pakistan's traditional donors, who have stepped in to provide relief in the past. Without delving into the details of Pakistan's history of economic mismanagement, it would not be incorrect to state that the persistent economic crises in the country is the result of a mix of factors: frequent phases of political uncertainty, the military's expanding stakes in the economy, economic mismanagement, unattended fiscal deficit, excessive reliance on debt, lack of focus on investment in the social sector, and very importantly, consistent high investment in the conventional military and nuclear buildup.

After the exit of Imran Khan and the controversial general elections in February 2024, there have been some positive shifts in the figures of foreign reserves and inflation, but the critical question is whether these shifts indicate changes in the economic dynamics or are a fallout of foreign assistance which Pakistan managed to receive from IMF and its 'friends in need'.

## **Economic Indicators**

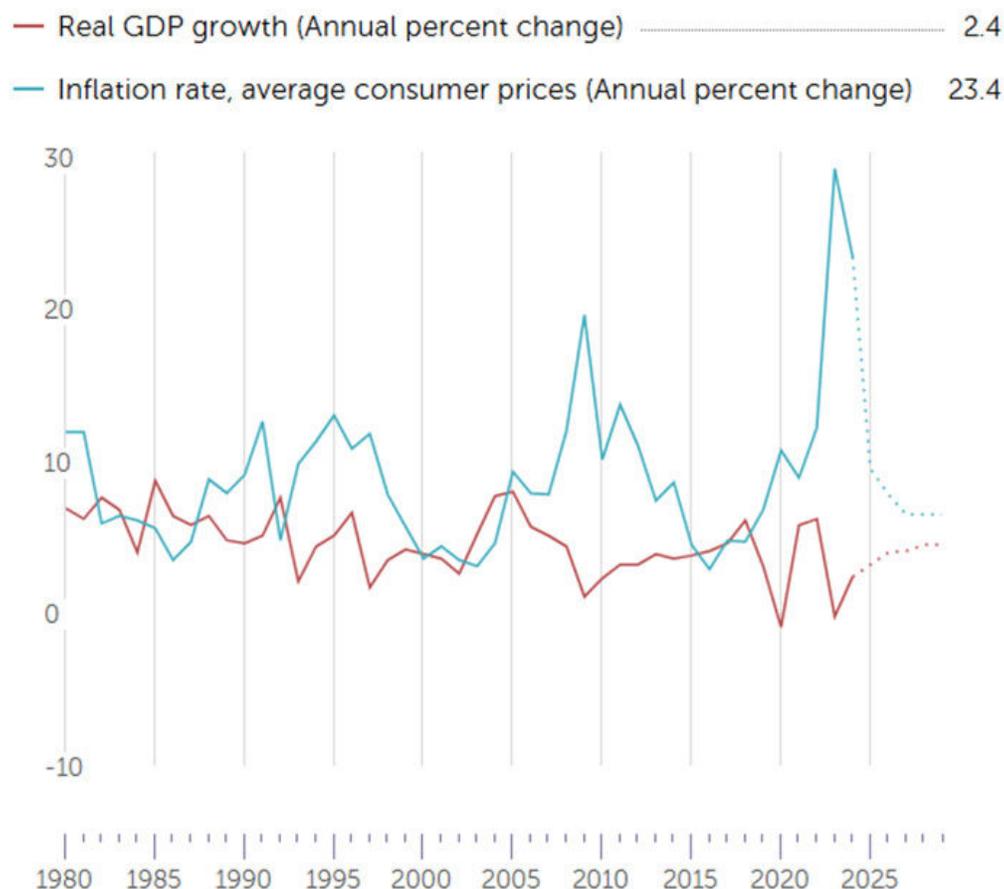
According to the *Pakistan Economic Survey*, in FY 2023-2024, "the government confronted four critical challenges that threatened Pakistan's socioeconomic growth: achieving sustainable macroeconomic stability, reducing poverty, ensuring fiscal consolidation, and addressing external account vulnerabilities."<sup>5</sup>

Some of the critical economic indicators which project some stability are as follows:

- Compared to 2023, Pakistan has shown some stability with general elections (February 2024) and stable external factors in 2024 and this reflected in the

GDP growth. The IMF standby agreement was approved in 2023, and weather conditions have been more favourable. The GDP growth rate has shown a slow improvement, with FY 2024 projected at 2.4 per cent, compared to -0.2 per cent in FY 2023. Inflation, which stood at 29.2 per cent in 2023, has reduced to 23.4 per cent in 2024 (Figure 1).

**Figure 1: Pakistan's GDP and Inflation**



Source: International Monetary Fund, Pakistan, <https://www.imf.org/en/Countries/PAK>. Accessed on October 21, 2024.

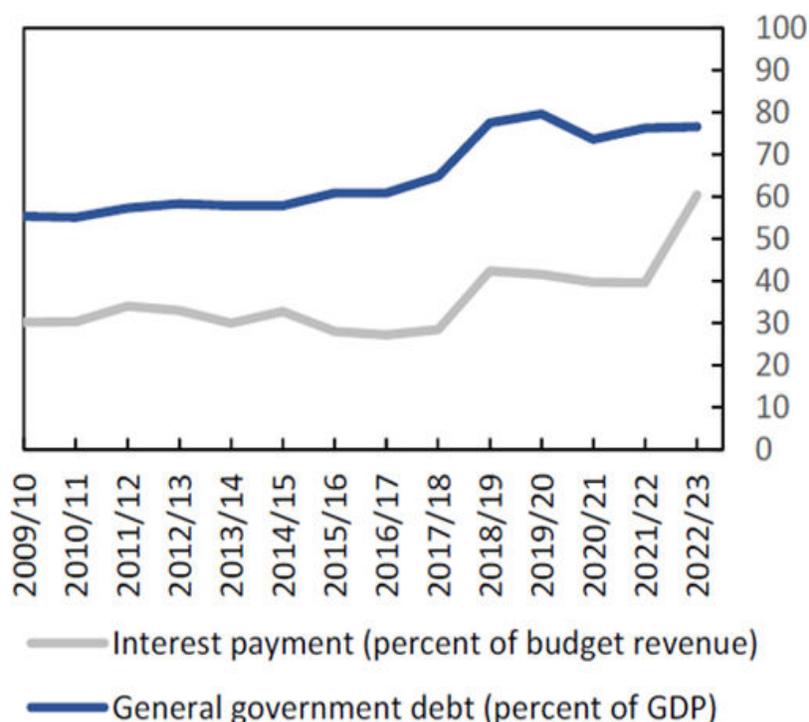
- Robust growth in the agriculture sector was the key driver of the GDP growth in FY 2024.<sup>6</sup> The growth of the agriculture sector was estimated at 6.25 per cent in FY 2024. Main crops contributing to growth include wheat, rice and cotton.<sup>7</sup>
- The GDP at current market prices is projected to grow by 26.4 per cent over last year's US\$302 billion, increasing to US\$382 billion in FY 2024.<sup>8</sup>
- The industrial sector and the service sector witnessed positive growth of 1.21 per cent in FY 2024.<sup>9</sup>

The growth figures are a temporary relief, but unfortunately do not represent a shift in economic mismanagement. Even though the economic indicators have shown some positive growth, high debt numbers and the persistent dependence on borrowing remain prime challenges for Pakistan. The economy has always remained aid-dependent, and for decades, the nation has been in a vicious cycle of taking new loans to repay the old ones.

## The Fiscal Crisis

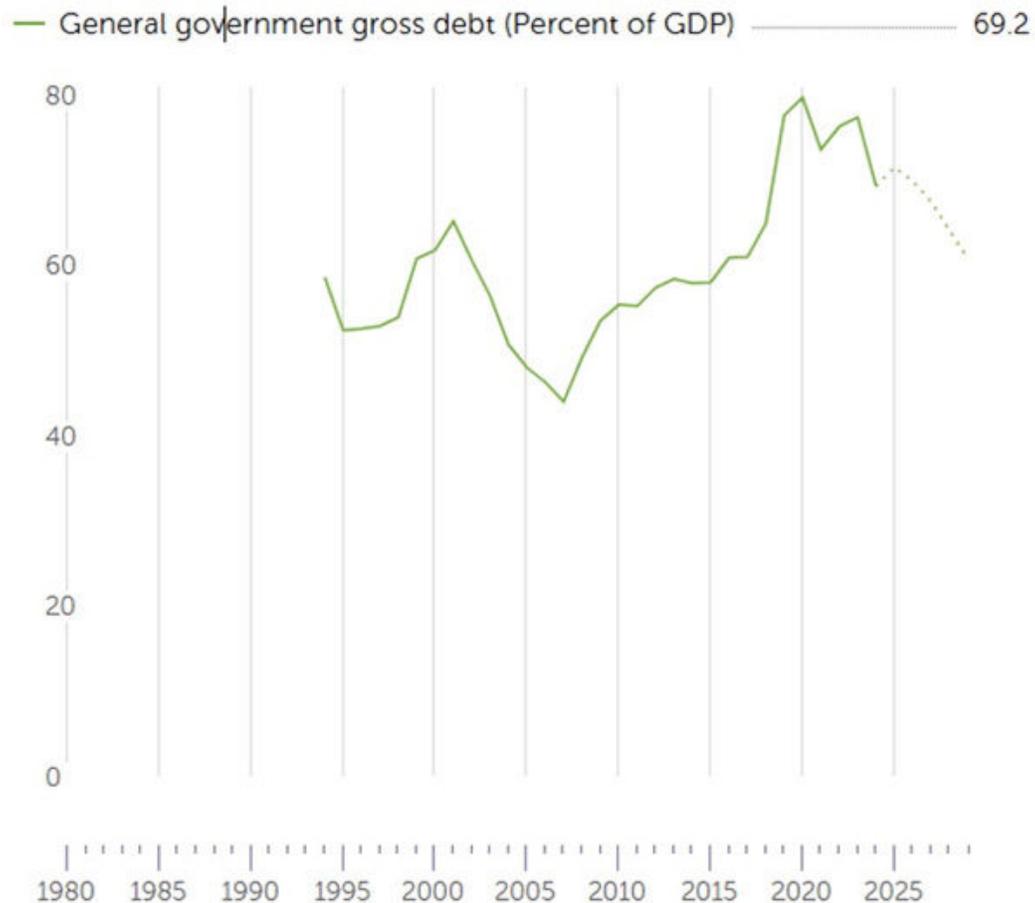
Pakistan does face an acute fiscal crisis. The ratio of public debt-to-GDP has increased significantly in recent years (Figure 2), growing by approximately 16 percentage points of GDP between FY 17 and FY 23.<sup>10</sup> The IMF report outlines multiple factors contributing to the fiscal deficit, including sluggish GDP growth, depreciation of the Rupee, under-performing SOEs, natural disasters, and lack of planned fiscal consolidation.<sup>11</sup> To deal with the fiscal deficit, Pakistan needs to increase the revenue base, increase the taxation, cut down on unproductive expenditure and invest in social and development sector.<sup>12</sup> Along with the chronic issues which need to be addressed, phases of prolonged political uncertainty have not allowed the economy to settle down.

**Figure 2: Debt and Debt Service**



Source: Fazeer Rahim, Richard Allen, Sybi Hida, and Soren Langhoff, *Technical Assistance Report: Pakistan Improving Budget Practices*, International Monetary Fund, August 2024, p11

**Figure 3 General Government Gross Debt**



Source: International Monetary Fund, Pakistan, <https://www.imf.org/en/Countries/PAK>. Accessed on October 21, 2024.

Pakistan struggles with a chronic debt problem (Figure3), primarily due to a deficiency of resources. Pakistan has not managed to resolve the issue of expanding its revenue base. The country struggles with a low level of tax-to-GDP ratio. Despite being the sixth most populous country in South Asia, the tax-to-GDP ratio stood at 10.0 per cent in 2022, which was 9.3 percentage points below the Asia and Pacific average of 19.3 per cent.<sup>13</sup> This issue has been debated at length in the studies by the financial bodies, and a decade ago, a World Bank report outlined the key issues behind Pakistan’s narrow tax base, which remain still remain unchanged:

“Pakistan’s tax system underperforms because of a complicated and unfriendly taxpayer system, a narrow tax base, low compliance, weak and inefficient tax administration, and inadequate subnational taxation.”<sup>14</sup>

The IMF has asked Pakistan to increase its tax base by bringing the real estate, agriculture and service sectors into the tax net. Some measures have been adopted and some are supposedly in the pipeline.

Pakistan's debt has grown at an alarming rate since 2010. Although Pakistan has been an aid-dependent economy for a long time, the nation borrowed significantly after 2010 to survive the impact of the global economic crisis. Pakistan's external debt stood at PKR 4,756 billion in 2011 and increased to PKR 24,093 billion in 2024.<sup>15</sup> According to a think-tank report, in FY 2024, Pakistan will need to pay back around US\$49.5 billion in debt maturities (30 per cent of which is interest).<sup>16</sup> The IMF recommendations and other inputs of the financial experts indicate debt restructuring as a solution. But, within the external debt, around 40 per cent is multilateral creditors, and this is not up for restructuring. Also, this component does not weigh too much in terms of interest cost. The bilateral component of the debt has grown significantly since 2010, and among the bilateral lenders, Pakistan owes the most significant component, around 58 per cent, to China.

Debt servicing in Pakistan does surpass the gross revenue and this has been a major issue. To control the deficit, Pakistan needs to increase the revenue base and cut costs. The most important sector, which consumes a large chunk of national resources, is defence. This has been a matter of discussion for decades within Pakistan and with the financial institutions. Although the *Pakistan Economic Survey 2023-2024* indicates the defence spending at 1.2 per cent of the GDP in 2023, the actual spending, which includes pensions and defence acquisitions, is much more and does divert resources from the development expenditure. Pakistan's defence modernisation has been maintained with the inflow of lavish Chinese equipment despite the acute economic crisis.

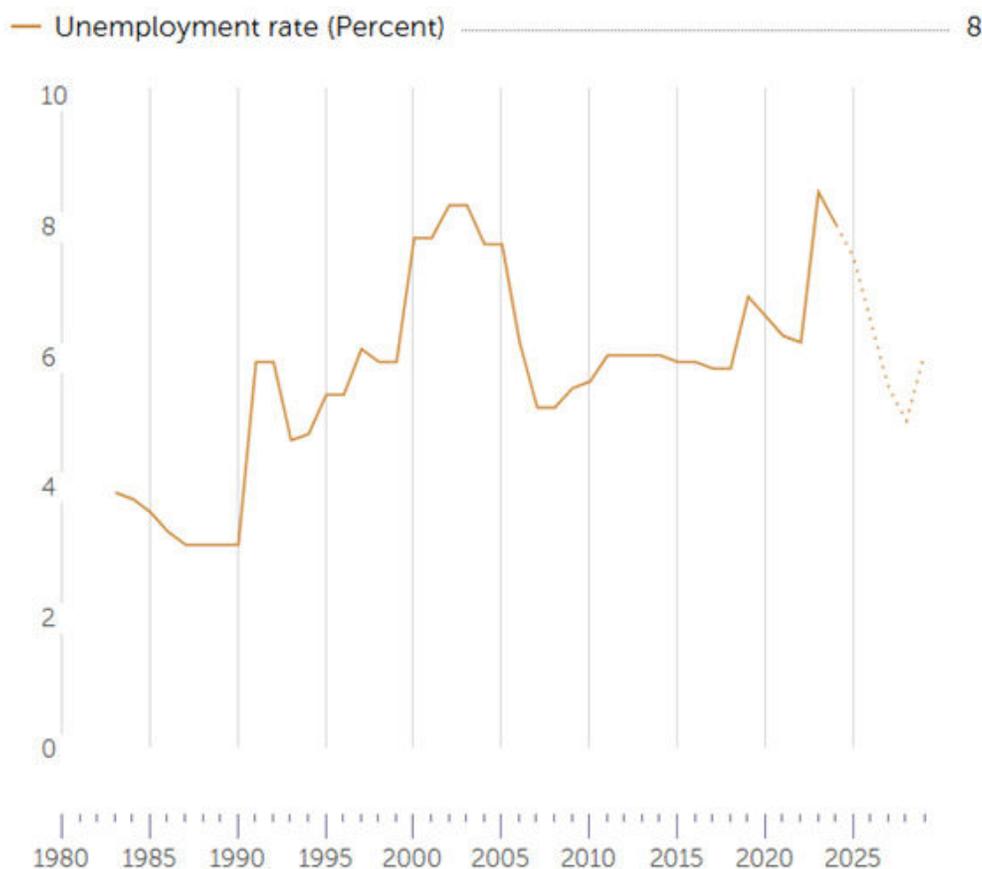
### **Is the Economy Improving?**

Pakistan did manage to dodge the risk of economic default in 2022 and in 2023 with assistance from its friends and traditional donors. China, Saudi Arabia and the UAE extended approximately US\$5 billion assistance through debt rollovers, which helped Pakistan stabilise its foreign reserves. Some positive signs in growth rate can be seen. The IMF loan, which the Sharif government is cherishing and projecting as a feather in its diplomatic cap, carries strict conditionalities, including a hike in taxation, high interest and an increase in energy prices. These measures further add to the financial burden on individuals already within the tax net, who are already struggling with high inflation and economic uncertainty in their day-to-day lives.

There has been reduction in inflation but the cost of living has gone up, unemployment rate has escalated (Figure 4), and the standard of living has been drastically challenged. Pakistan's popular daily reported:

“The pace of increase in prices may have come down but the cost of living remains steep. The nominal earnings of middle-income homes have not risen as much as prices in the last couple of years. They are worse off because their purchasing power or inflation-adjusted real income has fallen drastically, forcing most people to downgrade their standard of living.”<sup>17</sup>

**Figure 4: Unemployment Rate in Pakistan**



Source: International Monetary Fund, Pakistan, <https://www.imf.org/en/Countries/PAK>. Accessed on October 2024. Accessed on October 21, 2024.

The World Bank report eloquently highlighted the risks of the Pakistan economy:<sup>18</sup>

- “1. In the absence of international capital market access, Pakistan has been heavily reliant on expensive domestic borrowing for fiscal financing, leading to an intensifying sovereign bank nexus.
2. In the absence of a strong national political consensus on an ambitious and credible economic reforms plan, policy slippages and delays in implementation of critical structural reforms (such as fiscal consolidation or energy reforms) are likely.

3. With limited fiscal space and foreign reserves amounting to only US\$9.1 billion at end-February 2024 (equivalent to 1.7 months of FY25 imports), any delays in the disbursement of planned external financing could pose substantial liquidity risks.
4. Global inflationary pressures,... amid potential extensions of production cuts by oil producing countries, continuation of export bans on food items by large global exporters, and the continued war in Ukraine. Any escalation of the conflict in the Middle East and the associated disruptions in the energy supply chain would pose additional risks.”

The Foreign Direct Investments which need a push are now handled by the newly created Special Investment Facilitation Council (SIFC). The military’s role in the economy has further expanded with the Council, and it remains to be seen whether the SIFC will serve the country’s economic interests.

The IMF loan, debt rollovers from ‘friends’, rise in foreign reserves and inflation control have facilitated some indicators of economic stability. But the bigger question is: Does this lead to economic growth for Pakistan? To stabilise economic indicators and achieve growth, Pakistan needs well-considered structural fiscal reforms, a reduction in non-developmental expenditure and focused investment in developmental expenditure. In the wake of increasing population, Islamabad requires enhanced expenditure on health, education, climate change related disasters and green transition.<sup>19</sup> High defence spending certainly needs serious consideration. Pakistan needs policy reforms that ensure growth without depleting its foreign reserves or impacting inflation.

There has been an aggressive debate in Pakistan on the viability of the (SOEs), the majority of which have been loss-making. A World Bank report (April 2024) offered recommendations for Pakistan to reform the SOEs and suggested that Pakistan needs:

“A performance improvement roadmap for SOEs..., resizing and improving the SOE portfolio by closing insolvent SOEs and restructuring inefficient but economically viable SOEs, while assessing the potential for divestment, where possible...The Government should eliminate the longstanding practice of covering commercial SOE operating losses with transfers from the federal budget.”<sup>20</sup>

The overall economic situation is alarming for Pakistan, and political uncertainty and serious security challenges raise questions about the sustenance of the ongoing economic efforts. Consistent political instability and uncertainty shrink the prospects of investments and collaborations. Pakistan is working aggressively to attract investments and the military is taking the lead in that direction.

There have been occasional talks about resuming trade ties with India, which were suspended completely by the former Prime Minister Imran Khan post abrogation of Article 370. Diplomatic relations between the two nuclear neighbours have been suspended since 2016, following the Pakistan-sponsored terror attack on the Indian air base at Pathankot. India's economic growth has been remarkable in the last decade, and the GDP growth is at more than 8 per cent, but Pakistan's continued reliance on proxy war as part of its India strategy does not provide any space for diplomatic or economic collaboration.

## Notes:

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<sup>2</sup> Ibid.

<sup>3</sup> International Monetary Fund, "IMF Staff Concludes Visit to Pakistan," Press Release 24/423, November 15, 2024, <https://www.imf.org/en/News/Articles/2024/11/15/pr-24423-pakistan-imf-staff-concludes-visit-to-pakistan>. Accessed on November 17, 2024.

<sup>4</sup> Khaleeq Kiani, "Govt, IMF wrap up talks after rare revision of fiscal data," *DAWN*, November 16, 2024, <https://www.dawn.com/news/1872730>. Accessed on November 17, 2024.

<sup>5</sup> Government of Pakistan, "Pakistan Economic Survey 2023-24"; p. iii, [https://www.finance.gov.pk/survey/chapter\\_24/overview%202023-24.pdf](https://www.finance.gov.pk/survey/chapter_24/overview%202023-24.pdf). Accessed on October 2, 2024.

<sup>6</sup> Government of Pakistan, "Pakistan Economic Survey 2023-24"; p. 3, [https://www.finance.gov.pk/survey/chapter\\_24/Highlights.pdf](https://www.finance.gov.pk/survey/chapter_24/Highlights.pdf). Accessed on October 2, 2024.

<sup>7</sup> Ibid, p. 4.

<sup>8</sup> Ibid, p. 3.

<sup>9</sup> Ibid, p. 4.

<sup>10</sup> Fazeer Rahim, Richard Allen, Sybi Hida, and Soren Langhoff, *Technical Assistance Report: Pakistan Improving Budget Practices*, August 2024, p. 11, <https://www.elibrary.imf.org/view/journals/019/2024/099/article-A000-en.xml>. Accessed on October 20, 2024.

<sup>11</sup> Ibid.

<sup>12</sup> Ibid.

<sup>13</sup> OECD, “Revenue Statistics in Asia and the Pacific 2024- Pakistan”, <https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/global-tax-revenues/revenue-statistics-asia-and-pacific-pakistan.pdf>. Accessed on November 10, 2024.

<sup>14</sup> Jose R Lopez-Calix and Irum Touqeer, “Pakistan Policy Note 16,” June 2013, p. 3, <https://documents1.worldbank.org/curated/ar/378401468074335833/pdf/795830BRI0SASE0Box0377381B00PUBLIC0.pdf>. Accessed on September 16, 2024.

<sup>15</sup> Government of Pakistan, “Pakistan Economic Survey 2023-24”, Chapter 9, “Public Debt”, p 150, [https://www.finance.gov.pk/survey\\_2024.html](https://www.finance.gov.pk/survey_2024.html). Accessed on October 11, 2024.

<sup>16</sup> Ammar Habib Khan and Zeeshan Salahuddin, “A Raging Fire: Pakistan’s Debt Crisis,” Tabadlab, February 18, 2024, <https://tabadlab.com/a-raging-fire/>. Accessed on October 18, 2024.

<sup>17</sup> “Little Relief for Public”, *DAWN*, November 29, 2024, <https://www.dawn.com/news/1875475/little-relief-for-public>. Accessed on November 30, 2024.

<sup>18</sup> The World Bank, “Pakistan Development Update,” April 2024, p. 17, <https://thedocs.worldbank.org/en/doc/140b30353b40dbb294cca42bcb86529a-0310062024/original/Pakistan-Development-Update-April-2024.pdf>. Accessed on October 1, 2024.

<sup>19</sup> Khan, n. 16.

<sup>20</sup> World Bank, n. 18, p. 29.

# SRI LANKA

## Road to Economic Recovery

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### Introduction

In September 2024, the left-leaning Anura Kumara Dissanayake was elected as the President of Sri Lanka in a watershed election—the first since the country declared bankruptcy in April 2022. Sri Lanka had plunged into an economic crisis, arguably the worst in the annals of its history, due to years of mismanagement, corruption, and weak governance. A number of internal and exogenous shocks compounded this crisis: residual effects of the civil war that ended in 2009, the Easter bombings and sweeping tax cuts in 2019, the COVID-19 pandemic’s severe impact on tourism, an abrupt shift to organic farming in 2021, and the Russia-Ukraine war, among other things.

In the immediate aftermath of the 2022 economic crisis, violent protests, known as *‘Aragalaya’* or the people’s revolution, were triggered in response to shortages of food, fuel and other essential commodities, which resulted in the resignation of then-president Gotabaya Rajapaksa, with a fresh political crisis gripping the country. In June 2022, the United Nations warned that the dire situation in Sri Lanka could escalate into a “full-blown humanitarian emergency”, launching a US\$47.2 billion aid program to assist 1.7 million of the country’s most affected citizens.<sup>1</sup> In July 2022, Rajapaksa fled the country to the Maldives, with Ranil Wickremesinghe, the six-time Prime Minister, taking up the reins. He had since brought some measure of stability through implementing the necessary austerity measures, but given the painful nature of such reforms, Wickremesinghe was riding on a wave of unpopularity that ultimately cost him the coveted presidency.

In April 2024, the Asian Development Bank warned that Sri Lanka’s economy could face a potential decline, citing the “uncertainty” surrounding its upcoming

elections, which could put a downer on its fiscal policy and reform implementation, as seen in the run-up to previous election cycles.<sup>2</sup> As the dust settles, the new premier has much to live up to, especially since the elections were predominantly fought on economic issues, and Sri Lanka continues to face several challenges even as it is on the road to recovery. The Central Bank of Sri Lanka (CBSL) has forecast 4 per cent growth for 2024, marking a significant recovery from the -7.8 per cent GDP contraction in 2022.<sup>3</sup> On the other hand, the World Bank’s latest bi-annual report titled “South Asia Development Update” projected an expected growth rate of 2.2 per cent in 2024 and an anticipated 2.5 per cent in 2025.<sup>4</sup> The report attributes this improvement to: an increase in remittances, recovery in tourism, declining inflation, accumulation of foreign reserves, and an improvement in the current account balance. The economy, however, still remains plagued by elevated poverty levels, income inequality, a decline in labour force participation—particularly among women—and an increase in household debt for sustenance.

## **The Interplay of Foreign and Economic Policies**

The elections were held amidst Sri Lanka’s ongoing 17th agreement with the International Monetary Fund (IMF)—a 48-month Extended Fund Facility (EFF) program worth US\$2.9 billion, aimed at stabilising its economy. Upon its approval in March 2023, the first tranche of US\$333 million was immediately disbursed, while the second tranche of US\$337 million was cleared in December 2023, followed by the third instalment of US\$336 million in June 2024. The IMF’s Executive Board approved the program after receiving assurances from Sri Lanka’s key bilateral creditors and sovereign bondholders that they would restructure its debt. Among them, China, as Sri Lanka’s largest bilateral creditor, reached an agreement in October 2023 through its Export-Import Bank to restructure US\$4.2 billion of its outstanding debt.<sup>5</sup> In November 2023, Sri Lanka signed an ‘agreement-in-principle’ with the Official Creditor Committee (OCC) of the Paris Club, formed in May 2023 by 17 countries to restructure its debt.<sup>6</sup> Formalising this provisional arrangement, Sri Lanka sealed a final restructuring deal for US\$5.8 billion of its debt with the OCC on June 26, 2024.<sup>7</sup> Similarly, in early July 2024, close on the heels of the OCC agreement, Sri Lanka secured a debt restructuring deal with its international sovereign bondholders, which accounts for US\$12.5 billion of the country’s total external debt of US\$37 billion.<sup>8</sup>

It is worth noting that the OCC is co-chaired by India, Japan and France, alongside other Paris Club creditors, with China deciding to maintain an observer status on this platform despite being Sri Lanka’s biggest bilateral lender. It was then speculated that

China would cut a surreptitious bilateral deal with Sri Lanka on favourable terms for itself while exposing the latter to its ‘debt trap diplomacy’. However, Sri Lanka sought to placate these fears by stating that no creditor would get preferential treatment. Notably, Sri Lanka received its largest single investment from China in November 2023, when Sinopec, a Chinese state-owned oil giant, was granted permission to build a US\$4.5 billion refinery in Hambantota.<sup>9</sup> As such, Chinese investments in this island nation have often been subjected to scrutiny, since they are seen as attempts to acquire strategic assets in the event of Sri Lanka defaulting on its debt repayments to China. The 2017 Hambantota Port deal, in which Beijing obtained an 85 per cent stake in the port through a 99-year lease, is a case in point.

### **India’s Role: Regaining Ground**

When China seemed to distance itself from Sri Lanka at a critical juncture, New Delhi stepped in as the first responder, providing nearly US\$4 billion in multi-pronged assistance and becoming the first to assure the IMF on debt restructuring, all of which earned India appreciation across party lines.<sup>10</sup> In addition to being a lender of last resort, India has complemented its assistance by facilitating investments from Indian firms in the country. In 2023, India’s Adani Group secured approval to develop two wind power plants in Sri Lanka’s Mannar and Pooneryn regions and received a US\$553 million investment from the US to aid the development of the Colombo Port’s West Container Terminal.<sup>11</sup> This provided a fillip to Sri Lanka’s historically low Foreign Direct Investment (FDI), which saw a further decline in 2022 but reportedly rebounded in 2023, due in large part to Indian investments.<sup>12</sup> This also speaks well for the country’s investment stability that could attract more investors in the future.

Moreover, initiatives in connectivity, tourism, and culture, such as air links between Chennai and Jaffna, the resumption of ferry services, grants to promote Buddhist ties, and solar electrification of religious places, etc., have played a pivotal role in reversing Sri Lanka’s economic downturn.<sup>13</sup> The launch of Unified Payment Interface (UPI) services in Sri Lanka in February 2024, followed by a tie-up between PhonePe and LankaPay in May, is poised to enhance the overall travel experience for Indian tourists by making their payments quicker and more seamless.<sup>14</sup>

These initiatives demonstrate India’s credentials as a reliable regional partner in consonance with its Neighbourhood First Policy and Security and Growth for All in the Region (SAGAR) outlook. India’s Foreign Minister S Jaishankar visited Sri Lanka in early October 2024, the first foreign ministerial visit to Colombo following

the recently concluded elections, and discussed a range of collaborative opportunities. This visit underscores continuity in India-Sri Lanka relations, despite qualms about an otherwise scenario, considering Dissanayake's Marxist-leaning party is ideologically closer to China and has historically been anti-India. It also indicates that the new government will seek to pragmatically balance its ties between India and China.

On a broader scale, Sri Lanka has signalled its interest in strengthening ties with regional economies to augment its own economic growth, particularly by signing Free Trade Agreements (FTAs) with ASEAN countries. In February 2024, Colombo signed an FTA with Thailand, making it the second FTA with an ASEAN nation, the first one being with Singapore back in 2018. The then foreign minister, Ali Sabry, had noted that FTAs with India, Indonesia, Malaysia, Vietnam and China are in the works and will be consummated by this year's end.<sup>15</sup> Sri Lanka has also submitted a letter of intent to join the Regional Comprehensive Economic Partnership (RCEP), which constitutes the world's largest trading bloc. These are steps in the right direction, given that Sri Lanka, with a population of 22 million, remains one of the most protected economies in the world.

## **Domestic Reforms and Developments**

In July 2023, to curb deep-rooted corruption and tax-related evasions, Sri Lanka passed an Anti-Corruption Bill in tandem with the IMF's governance diagnostic exercise, making Sri Lanka the first Asian country to undergo this process. In the same month, the cash-strapped nation passed the Central Bank Act, bestowing a higher degree of independence and accountability on the CBSL so that it can ensure price stability and depoliticisation of monetary policies.<sup>16</sup> In October 2023, Sri Lanka approved a hike in its Value Added Tax (VAT) from 15 per cent to 18 per cent, which took effect from January 2024, to broaden its tax base and subsequently increase its tax revenue.<sup>17</sup> Although this is a requisite measure, it still risks constraining the purchasing power of households, particularly among the poor and vulnerable, which, in turn, will force their hands to take debt to meet day-to-day requirements. Furthermore, in 2024, the parliament approved two key pieces of legislation—the Public Financial Management Act and the Public Debt Management Act—which are expected to improve fiscal discipline and promote better debt management.

There has been an expansion of agricultural productivity, which is a refreshing turnaround, especially after Rajapaksa's ban on the use and importation of chemical fertilisers in 2021 proved disastrous for the agricultural sector. Though the ban was

lifted in November 2021, it thrust the traditionally rice-self-sufficient nation into spending millions on rice imports.<sup>18</sup> For instance, in the second quarter of 2023, while the industry and services sectors declined, agriculture registered an expansion, albeit by the second quarter of 2024, the former two sectors picked up the pace.<sup>19</sup> Meanwhile, Sri Lanka's promising economic recovery is manifest in its real GDP growth. The first quarter of 2024 saw a 5.3 per cent growth, as opposed to a -10.7 contraction in the first quarter of 2023, and in the second quarter of 2024, the economy grew by 4.7 per cent compared to a -3.0 contraction in Q2 2023.<sup>20</sup>

Evidently, then, the raft of measures, consistent with the IMF bailout conditions, have resulted in relative macroeconomic stabilisation, best exemplified by the drop in inflation rates. Inflation had peaked at 70 per cent in September 2022 but in March 2024, it fell to 0.9 per cent and is expected to remain within the 5 per cent target set out by the CBSL.<sup>21</sup> In July 2024, inflation witnessed a tangential increase, standing at 2.4 per cent, but dropped to 0.5 per cent in August and further declined to -0.5 per cent in September, marking the first deflation since September 2015, as per the Colombo Consumer Price Index. While deflation means a general decline in the price of goods and services—a phenomenon that could boost the purchasing power of citizens, thus providing some measure of reprieve—prolonged deflation is equally unfavourable as high inflation. It may indicate reduced economic growth, which would undoubtedly bode ill for the Sri Lankan economy.

## **Going Forward**

Dissanayake primarily seized votes by capitalising on reform-induced grievances, vowing to reverse steep tax hikes, promote transparency, root out corruption, and, most importantly, renegotiate the IMF agreement to ease the burden on citizens. In reality, however, tough austerity measures prescribed by the IMF are what will keep Sri Lanka on the road to recovery, as the agreement not only provides Sri Lanka financial credibility but also helps in securing external financing.<sup>22</sup> And, in any case, the IMF is unlikely to budge on the core elements of the agreement, given its importance in sustaining the country's hard-won economic recovery. In the meantime, the newly elected government must sustain the momentum of structural reforms while providing targeted concessions to the most vulnerable through various social assistance programs.

Additionally, ratcheting up and diversifying engagement with regional countries while maintaining a neutral stance between its two key economic partners, India and

China—both of whom Sri Lanka needs—becomes crucial to maximise the benefits of the seeds of economic integration it has already sown and to avoid becoming a geopolitical battleground at the expense of its economy. Ultimately, to sustain signs of stabilisation amid debt restructuring for short-term recovery and long-term growth, Sri Lanka must cater to its domestic interests while also addressing the concerns of its international creditors.

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<sup>2</sup> “Uncertainty about forthcoming elections may jeopardise Sri Lanka’s economic recovery: ADB”, *Business Today*, April 13, 2024, <https://www.businesstoday.in/latest/world/story/uncertainty-about-forthcoming-elections-may-jeopardise-sri-lankas-economic-recovery-adb-425388-2024-04-13>. Accessed on May 02, 2024.

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<sup>6</sup> “Agreement in Principle Between The Official Creditor Committee and Sri Lanka”, Paris Club, November 29, 2023, <https://clubdeparis.org/en/communications/press-release/agreement-in-principle-between-the-official-creditor-committee-and-sri>. Accessed on May 04, 2024.

<sup>7</sup> Meera Srinivasan, “Sri Lanka seals debt deal with Official Creditor Committee after financial crisis”, *The Hindu*, June 26, 2024, <https://www.thehindu.com/news/international/sri-lanka-finalises-debt-restructuring-agreement-after-financial-crisis/article68335968.ece>. Accessed on July 10, 2024.

<sup>8</sup> “Sri Lanka strikes private debt restructuring deal with bondholders”, *The Hindu*, July 04, 2024, <https://www.thehindu.com/news/international/sri-lanka-strikes-private-debt-restructuring-deal-with-bondholders/article68366151.ece>. Accessed on July 10, 2024.

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