|  |
| --- |
| **South Asian Economies: Future Challenges**Dr Ishrat Husain |

The first decade of the 21st Century is bringing about several fundamental structural changes in the economies around the world. South Asian economies have to accelerate the pace of internal transformation of their 'economies' if they choose to benefit from the opportunities the structural changes present. There is a need to shift from the old paradigm of dependence on official aid and putting blame on the unjust international economic order for their woes to the new paradigm of becoming an active participant in the emerging globalised economy.

What are the key characteristics of this new globalised economy? First is an open trading environment 'in which low cost and reliable producers of quality goods and services are able to deliver them just in time will derive maximum gains. The countries in this environment will have to compete for market shares in their quest for selling goods and services to the rest of the world.

Second, the integration of financial markets and liberal flows of cross border capital, particularly foreign direct investment, provide ample scope for supplementing domestic savings and raising investment levels to accelerate the pace of growth and poverty reduction. In South Asia, the earnings and remittances of workers employed overseas do play a key role in accumulation of net foreign assets. Third, rapid changes in information technology and communications can lead to improving efficiency in the utilization of capital and labour and thereby to total productivity increase. But, at the same time, it places a severe burden on the prospects of employment for unskilled labour. Fourth, a silent revolution in expectations of the so far voiceless voters is taking place due to a perceptible impact of electronic media and skilful management of these expectations and delivery of tangible results against promises is assuming a new dimension in good governance.

This paper addresses the following issues: To what extent are the South Asian Economies prepared to face these four major challenges and what is the agenda they should follow in the next 10 years? Before analyzing this issue a few thoughts need to be considered on the process of decision-making that should be followed by the leaders of South Asia in order to bring about the paradigm shift.

Each country must begin by preparing a long-term vision and the roadmap to translate this vision into action with milestones and time-lines. This vision and road map must have a non-partisan and national consensus and all political parties must agree and commit to the broad thrust and the direction of the economy. Of course, there will be many nuances and approaches to implementation and the roadmap will be altered in the light of experience gained but, at least, the investors and economic actors will be assured that there will be no abrupt reversals and significant derailments. China offers an excellent example of this process where the vision and the road map adopted by Deng Xia Ping has been followed, with some modifications and alterations, by successive governments. The skeptics may contest this conclusion by arguing that the same political party has remained in power since 1978. While this is true, but the point to consider is that in plural democratic societies when even contesting political parties have a broad agreement on the vision and direction of the economy, the voters will judge the performance by their relative success in implementing the programs, policies and projects and bringing about an improvement in the living standards of their electorate during their respective tenures. It is the differentiation in their relative performance that will distinguish the record of one political party from the other and win and lose the support of the electorate.

**Past Achievements and Current Status**

What is the state of South Asian economies in meeting he challenges mentioned earlier? South Asia has grown at 5.6 per cent in the 1990s -- faster than the low income countries as a group but slower than the East Asian countries. The wide-ranging reforms implemented in this region during the last 10 years or so have brought about some fundamental changes in the economic landscape and removed some of the major constraints retarding the progress of this region. The changes that have come are noteworthy:

1. There is now a broad political consensus about the objectives and content of economic policies in almost all the countries. The defeat of the Bharatiya Janata Party (BJP)-led Government in the recent Indian elections should not be construed as an indictment of reforms but a manifestation of the growing impatience of the electorate that these reforms have not been deep and fast enough to touch the lives of the majority of the population. This political consensus has survived many changes of the governments in India since 1991 and the alternating shift of power in Pakistan, Bangladesh and Sri Lanka. South Asian countries did not blindly and relentlessly follow the Washington consensus but selected only those elements which suited them thus avoiding the kind of crisis faced by East Asian countries.
2. Reliance on private sector as the main investor, producer and distributor of goods and services has replaced the old notion of the commanding heights model of the economy in which state and state-owned enterprises were the main tools of industrial development. The demise of License Raj has given rise to a healthy competitive environment in which market mechanism is used for allocation of resources. This shift has improved the efficiency of resource allocation and utilization in South Asia. State intervention has been limited to provision of physical infrastructure, social services and other public goods in support of private investment and making markets function efficiently.
3. Unilateral trade liberalization has been quite rapid in the 1990s in the region. Average tariff rates have declined from 90-100 per cent in 1980s to 13-32 per cent. Sri Lanka leads the way followed by Pakistan. India and Bangladesh are considered laggards in trade liberalization according to a World Bank study, but are in much better shape than what they were in the 1970s and 1980s. Export promotion has finally been accepted the new gospel in contrast to the past five decades of obsession with inward looking import substitution and protection of domestic industry.
4. Domestic financial and capital market reforms have made the financial sector sound and healthy. In Sri Lanka and Pakistan the strides made are quite advanced. India is slowly and gradually opening up to foreign competition and introducing new legislation to improve the performance of the banks and upgrade the quality of assets. Bangladesh has begun the process more recently but is committed to moving forward in the same direction. But directed credit and credit ceilings, administered and subsidized interest rates, have gradually given way to market-based allocation of credit and determination of prices.
5. Macroeconomic stability i.e., low inflation, low domestic interest rates and stable but realistic exchange rates, has become the hallmark of these economies. Exchange rate regimes in all the countries have switched from fixed to managed float. Bi-directional movement i.e. both, depreciation or appreciation of domestic currency, takes place according to market supply and demand conditions. There is no longer a hang-up to defend a particular level of exchange rate and preserving competitiveness of exports and smoothing volatility are the main policy considerations. Large foreign exchange reserves are piling up in all the countries with India's coverage more than 15 months imports followed by Pakistan about 12 months and Bangladesh 4 months.
6. Fiscal consolidation and discipline are the furthest in Pakistan with fiscal deficit down to 4 per cent of GDP compared to average 7 per cent and domestic resource mobilisation stepped. up in the last five years by almost 70 per cent. India's budget (2004-2005) aims at 4.4 per cent deficit of GDP for the Central Government but the consolidated deficit is still uncomfortably high. Tax-GDP ratios are low by comparison to other countries at the similar income levels. Therefore, domestic savings and investment ratios have not matched those of China and other fast growing East Asian countries.
7. India has clearly taken advantage of the low wage, English speaking, highly educated technical manpower to become a leader among the recipients of outsourcing of IT related services. The same trend is beginning to emerge in other services such as drug clinical trials, health care, biotechnology, research and development. Although the immediate employment impact of the exports of these services is likely to be limited in the medium and long-term, the expansion of burgeoning middle class and the demonstration effect on the younger generation to acquire higher scientific and technical education will help India in the transformation of its economy. Other countries in South Asia are latecomers to the scene and have a lot of catching up to do. This Indian strategy of export of services does make much sense as the services sector accounts for 60 per cent of the output of developed economies and many services are becoming mobile across borders due to breakthroughs in technology and communication.

These improvements in macroeconomic fundamentals have led to up gradation of credit worthiness of India and, more recently, Pakistan. Both the countries have established access to international bond market at fine pricing. It will, therefore, be fair to surmise that economic fundamentals have improved to a very large extent in all the South Asian countries in the last decade or so. Broad political consensus on the content and direction of economic policies and their credible and consistent pursuit should provide some signal to the markets that the South Asian economies can be relied upon in the exchange of goods and services and inflow of capital.

**Agenda for the Future**

However, the challenges and tasks ahead for economic managers in the region are simply daunting. Sri Lanka and India have almost one quarter of their population living below the poverty line. The estimates for Bangladesh are in the mid 40 per cent, while Pakistan has one-third of its population living below the poverty line. Unemployment rates are quite high and Human Development indicators are dismally low. Moreover, these tasks have to be pursued in the context of a more volatile economic environment -- both domestic, as well as, international. Capital inflows and outflows have much greater potential to destabilise markets, exchange rate and interest rates.

Technological, communication and media revolution, especially the satellite television and cable channels, have raised people's expectations through the demonstration effect of conspicuous consumption by powerful and affluent classes. These expectations are placing enormous pressures on the ruling classes for providing access to basic necessities of life to the majority of the population. At the same time, the state apparatus for delivery of these services in most South Asian countries has become largely dysfunctional due to induction of poor quality personnel, corruption, inertia, waste and institutional decay. How to narrow this widening gap between the rising expectations of the common man and the declining capacity of state institutions is one of the most difficult tasks for the leaders of South Asia.

South Asia is lagging behind the East Asian economies and has a lot of catching up to do, that too, in the shortest period of time. We are way behind China, Indonesia, Malaysia, Thailand and the Philippines both in level as well as the rate of improvement. What can be done to reduce poverty and unemployment and catch up with East Asia? We should recognise this region as the benchmark against which we should evaluate our performance, although it is our biggest competitor in the global market, particularly China, which is becoming an industrial giant. A few points are worth consideration, although not exhaustive, to initiate a debate in the region:

1. Between 1980 and 2001, South Asia received US$ 17 billion as Official Development Assistance (ODA). However, between 1990 and 2001, ODA inflows had declined both per capita and as percentage of GDP. There was a change in the composition of external capital inflows with a declining share of aid in relation to other types of inflows. This change in composition suggests that the influence of the official donors and particularly the International Financial Institutions (IFIs) is thus likely to wane while that of the fund managers, rating agencies, equity research houses, investment banks and multinational companies is likely to grow. Thus credibility of economic policies pursued by the countries assumes a much important role than the relationships nurtured with donors and the IFIs. The market's power to penalise imprudent policies and breach of commitment is more damaging to the economy than the slippages in the observance of IMF or World Bank conditionalities. Mexico had to suffer heavily when the Zedillo regime reversed the commitment made by the Salinas regime to the markets on the exchange rate. The country witnessed huge and sudden capital outflows, depreciation of currency, inflation and economic recession. To keep access to the international financial markets, the South Asian countries will have to maintain not only open and liberal foreign exchange regimes, sound and robust financial sector, but also pursue consistent, credible and transparent economic policies.
2. Along with sound economic policies, there is growing evidence about the critical role of good governance and institutional quality in the growth-poverty reduction nexus. Weak governance normally associated with South Asia breeds corruption, political patronage, lack of transparency, low observance of rule of law, absence of level playing field, heavy tilt in the delivery of public goods and services towards the privileged and elite classes.

Political leaders are now beginning to realise that the disenchantment of the electorate with these poor governance practices increases the burden of incumbency and risks their survival. Thus, improved governance should be on the top of the agenda of all political parties in South Asia.

Bureaucratic hassles, long drawn procedures, un-even application of rules and regulations, excessive discretionary powers in the hands of lower level bureaucracy, shortages of essential infrastructure facilities and low productivity of labor force have made the region not such an attractive place for foreign investors. Consequently, Foreign Direct Investment (FDI) has not yet made any significant impact on the economies of the region. FDI accounts for 0.5 per cent of GDP with India receiving US$ 3-4 billion annually and Pakistan about US$ 1 billion. Portfolio investment to India had taken an upward trend but suffered a setback after the recent elections. A major overhaul of the structure of civil service, judiciary, police and local government institutions, re-engineering of business process and inculcation of modern management practices will be required in all the countries of the region.
3. Political and geopolitical risks are still quite elevated in the region. The long-standing hostility between India and Pakistan; the acquisition of nuclear and missile capability by the two countries and the consequential sanctions imposed on them, the active frontline status of Pakistan in the war against terrorism, the prolonged civil war between Tamil Tigers and the government in Sri Lanka, and the frequent strikes called by the opposition parties against the government in power in Bangladesh have added risks to doing business and locating investment in these countries. The external perceptions about our region are, therefore, heavily biased due to these risks. The sooner we can overcome these problems, the sooner the better the region will be as a reliable trading partner, active participant in the international capital markets and a choice location for foreign investment.
4. Investment in education and human development in countries, other than Sri Lanka, has been inadequate in volume, deficient in quality and lacking in relevance. The most recent census data for 2001 shows that India's literacy rate has gone up to 64 per cent but female literacy rate is less than 50 per cent. It also shows that at least one third of its population and labor force is not equipped to take up the ever changing and more complex tasks of the economy trying to outclass other competing countries. In Pakistan and Bangladesh almost half of their population and two-third of female population is illiterate. This large proportion of women among illiterates is a cause for serious concern.

Sri Lanka is the only country in the region with almost a hundred per cent literacy. But this literacy level shows the growing imbalance between the demand for skills imposed by market economic forces and the supply of skills produced by our educational institutions. There is a surfeit of highly educated graduates who are not employable and there is a shortage of workers who can carry out routine technical jobs in production and service. India produces good quality science and engineering graduates every year who can cater to the high end of the job market but lack of attention to non-university technical education and its quality have created wide gaps at the middle end of the job market. This situation is aggravated in Pakistan and Bangladesh where the issues of quality, relevance and numbers are all intertwined. Sri Lanka has no problem with the numbers, but high level of unemployment among university graduates testifies to this mismatch in the skills. The widespread frustration among the parents and graduates and a high level of dissatisfaction among the employers in finding the right persons for the right jobs are further evidence of the imbalance in labor market.
5. This skill imbalance and lack of employability has serious repercussions for the composition and growth of the basket of goods that can be exported: The most dynamic and rapid growing sectors of exports in the world market today in the medium term are those associated with high technology and to some extent medium technology. While India is making some headway in increasing high technology exports, the record of other countries in the region is not very promising. They are still stuck in the low technology exports particularly textiles and clothing which have declining share in the world trade. Thus the need to overcome the skill obsolescence and turn towards medium and high technology exports was never as apparent as it is now. A change in the composition of exports can be achieved by removing the barriers and constraints in the way of foreign investors and Multinational Corporations (MNCs). FDI is an important force for integration for this as MNCs have set up supply chains and integrated production networks that tend to locate each stage of production in the country with the lowest cost. Affiliates of a MNC in one country often export to another for eventual sales in a third country market. These affiliates act as the on-the-job training grounds for the acquisition and dissemination of the skills needed for production and minimising costs. These skills are then disseminated and multiplied throughout other firms in the country.
6. Very little intra-regional trade is taking place in South Asia. Intra-regional trade has remained stagnant at less than 2 per cent of the total trade in the last 25 years. A study carried out by the Pakistan Ministry of Commerce in 1996 concluded that due to low transportation costs, cultural similarities which influence taste and cause profitable complementarities to emerge and low transaction costs, the economic benefits of liberalising trade with India outweigh costs. Despite this, the trade between the two neighbouring countries has remained negligible. Regional trading arrangements have made a huge difference in North America, Europe and East Asia, but they have not, so far, been successful in South Asia. The recent attempt to revitalise SAARC will stimulate trade and growth but only to the extent that it unleashes competition' that lowers domestic prices, enables achieving economies of scale and acquiring new technology.

SAFTA arrangements can be successful the coming years but they some important preparatory measures, such as:

|  |
| --- |
| * + Trade facilitation through expeditious border crossings, quick custom clearance, efficient port facilities and improved transport links should precede or take place simultaneously with the expansion of volume in cross border trade.
	+ Domestic tax, tariff and subsidy policies that affect production. and trade incentives should be harmonised to avoid recurrence of trade disputes and frequent use of anti-dumping laws. As India provides a lot of subsidies to its producers, in various forms an shapes, the smaller countries are hesitant to allow MFN status to India. The recourse to a long negative list that restricts the volume of trade should be avoided at all costs.
	+ Macroeconomic policies, in fiscal and monetary spheres, should be harmonised to achieve a stable, non-discriminating macroeconomic environment for all the countries in the region.
	+ Supporting institutions to manage and facilitate integration, for example, setting standards, establishing regional development funds and for dispute resolution should be created.
	+ Communication and transport infrastructure between the bordering countries should be improved and upgraded to facilitate increased trade and factor mobility.
	+ Legal regulations for investor protection, intellectual property rights enforcement, anti-trust law, commercial law, labor relations and financial institutions should be harmonised.
	+ Financial markets should be widened and regulatory changes introduced to promote cross-border investment, listings, syndication, bond issues, etc.
 |

1. South Asian countries should tap the enormous potential of their large expatriate population in mobilising investment capital, foreign exchange earnings, skilled manpower and exports of ethnic products and services. India, Pakistan, Bangladesh and Sri Lanka together receive about US$ 20 billion of remittances from their workers annually but their contribution in domestic capital formation is insignificant. Unlike the overseas Chinese community that has played a substantial role in foreign direct investment, non-resident Indians have been a source, to some extent, of professional, technical and managerial skills but not much in terms of large financial outlays. The non-resident deposits transferred to India account for only a miniscule proportion of their wealth holdings abroad. These flows are quite stable and should augment domestic savings for accelerating the pace of investment without creating future debt obligations. Innovative products and investment vehicles to attract the savings of non-resident South Asians should be encouraged with the help of regulatory agencies.

South Asian countries have not become a part of global value chain nor participated in international supplier chain arrangements. There is no single business model for participating in this chain and there can be many phases of transition and many modes of involvement. For example, joint ventures, franchising, purchasing by international firms, licensing, sub-contracting, fully owned firm, original equipment, original design and manufacturing, strategic partnerships for technology, overseas acquisition of equity are the diverse means whereby developing country enterprises can gain wide access to international markets at their own level of capability, climb the technology ladder and benefit from globalisation. East Asia is a major participant in this global supply chain and produces parts and components for a variety of manufactures. It is time the South Asian countries got engaged in this value chain.

**The Impact of WTO**

The prevailing confusion needs to be cleared that something drastic or unexpected is going to hit us in the near future due to WTO. All the countries in the region are already members of this organisation since 1995 and have made binding commitments to maximum tariffs. In some cases the applied tariffs are lower than the bound tariffs. The South Asian countries have already liberalised their imports and have been flooded with cheaper imports from China in the recent years. There could be no greater threat to the survival of domestic industry than competition from Chinese goods. Some industrial firms could not face the onslaught and have been wiped out. Others have taken up the challenge by cutting the fat, taking up the slack, becoming cost efficient and improving quality, and are competing with the new entrants. Thus the process of restructuring and transition is going on and should not pose any systematic threat to the industries of the region.

What we are focusing upon is the abolition of the textile quotas under the Multi-Fiber Agreement and the adoption of the new agreement on clothing and textiles in January 2005. The impact of this new pattern of textile trade on the economies of South Asia region is highly varied. Most simulation studies and modeling exercises carried out by the World Bank, USITC and independent consulting firms confirm the view that China, followed by India and Pakistan, will be the main beneficiaries of the abolition of quotas. These countries are all vertically integrated i.e., from producing cotton all the way to finishing, dyeing, stitching, etc., and enjoy low wage costs and low raw material costs. Pakistan, for example, has invested US$ 3-4 billion in the past five years in modernising and acquiring state-of-the-art machinery that can produce quality goods according to the changing demand patterns of the buyers. However, it is not clear if all the ready-made garment exporting firms in Bangladesh and Sri Lanka will survive in the post-2005 markets. Both countries are seized of this problem and are taking measures to assist their firms and their workers.

Whatever the benefits of regional trading blocks, they are no substitute for participation in multilateral trade arrangements. Multilateral arrangements provide a much larger market, several times the size of any regional block, enlarge the market access substantially and permit wider competition, larger scale of operation and greater specialisation, all of which increase productivity and growth. Thus the successful completion of the Doha Development Round is in keeping with the interests of South Asian countries. However, the deferential impact on the countries of the region has to be handled carefully, imaginatively and expeditiously. Short-term adjustment costs to the workers and business have to be absorbed in the long-run interest of expansion in activities these countries have dynamic advantage in.

Conclusion
South Asian countries improved their economic landscape in the last 10 years or so and despite many vicissitudes and shocks have bee able to maintain positive growth momentum. In the coming decade, while the policy reform and will help the internal transformation of these economies, the task facing the leaders of these countries are formidable. To maximise the benefits from globalisation and thus help reduce poverty, the future agenda should focus on good governance and institutional reform, investment in skilled manpower, shifting away from low-technology exports, aligning with international value chain of production, attracting foreign private capital flows including that from expatiate nationals, promoting intra-regional trade and mitigating political and geopolitical risks.

(Dr Ishrat Husain is the Governor of the State Bank of Pakistan)