**SOUTHASIA: POTTENTIAL FOR DEVELOPMENT [[1]](#footnote-2)**

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South Asian economies have grown rapidly during the last two decades recording an average growth rate of 6 percent annually. The rate had accelerated in the early 2000s to 7 percent before coming down in 2008, and 2009. Before the global financial crisis in 2008, India’s growth rate was a staggering 9 percent and Pakistan, Bangladesh and Sri Lanka around 7 percent. Consequently, the Incidence of poverty declined to 10 percentage points or more in India, Pakistan and Bangladesh. With rising incomes, household consumption has soared and a new middle class has emerged in all South Asian Countries. The exact numbers vary depending on the definition but there is a visible change that can be discerned through the explosion in shopping malls, restaurants and cafés, international travel, entertainment business etc. This expanded market can further grow through economies of scale in production, trade facilitation and communications, ease in movement of people and ideas across the countries in South Asia region. The potential for development and improvement in living standards is enormous but the question is as to how this potential can be translated into actual gains.

 First and foremost, all the countries have to maintain high growth rate. There is no option but to bring these rates back to their recent record. With an average growth rate of 7 percent annually South Asian income levels can triple over the next 20 years lifting 300 to 350 people out of poverty and creating a strong middle class of 1.2 billion in terms of purchasing power party. Korea reached an income level of $4,600 in 1986 and Japan in 1965. At this income level both the countries had 55 percent of population in middle class. The middle class is the key driver of economic growth because of its demand for goods and services and because it is the source of savings and of the entrepreneurship that drives new products and processes. This growth rate of 7 percent is attainable as long as the policy framework remains favorable. Why is this high growth rate possible? Let me recapitulate the reasons for this assertion.

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. 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.
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 Licence 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 utilisation 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 liberalisation has been quite rapid in the 1990s in the region. Sri Lanka leads the way followed by Pakistan, India and Bangladesh and all of these countries 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 subsidised 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. Preserving competitiveness of exports and smoothing volatility are the main policy considerations. Large foreign exchange reserves have been accumulated in all the countries with India's coverage more than 12 months imports.
6. Fiscal consolidation and discipline are beginning to be recognized as the new imperative in all South Asian countries although the actual progress is slow. Tax-GDP ratios are low by comparison to other countries at the similar income levels. Domestic savings and investment ratios have risen from their historical trends but needs to match 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 achievements are quite impressive but given the expectations of the people, the entrepreneurial energies of the businessmen, the quality of professional and managerial skills, the enormous natural and latent human resources the expanding middle class with rising purchasing power, South Asia is underperforming relative to its potential . There is hardly any reason as to why these countries are still hovering around $1500 per capita income and more than 400 million people are still living below the poverty line. How can this potential be harnessed for development, growth and poverty reduction? Although the specific applicability of the reforms will vary according to the country circumstances, there are many common elements that need to be implemented.

South Asia enjoys an advantage in the area of Demographics. South Asia will be the only region with sizeable population with more than 50 percent of its population in productive employable age bracket. This region can ease its unemployment problem by supplying young workers to the rest of the world in an environment of ageing population and the rise in dependence ratios. Whether this challenge can be transformed into a dividend will depend upon the priorities, policies, and programs that the Governments of these countries are able to conceptualize and implement.To the extent that South Asian countries are able to invest in education particularly technical and vocational education, expand access to higher and professional education, upgrade the quality and relevance of instruction there is a strong likelihood of this demographic transition paying dividend. But this dividend may dissipate if South Asia fails to meet this goal of educating growing younger population, equipping them with marketable skills and facilitating their mobility across the borders. The challenge is quite daunting as two thirds of the world’s illiterate population resides in South Asia and the addition of new entrants to the labor force every year equals the entire population of a mid-size country.

Next, technological, communication and media revolution, especially the satellite television and cable channels and social media, 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. 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 .These reforms will minimize corruption, political patronage, lack of transparency, low observance of rule of law, absence of level playing field and reverse the heavy tilt in the delivery of public goods and services towards the privileged and elite classes and thus narrow the widening gap between the rising expectations of the common man and the eroding capacity of the state institution to deliver. 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 also constrained the entrepreneurial spirits in the region. 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.

South Asia has not benefitted as much from the external capital flows in the form of Foreign Direct Investment, access to Equity and Debt capital markets as other regions. The influence of the fund managers, rating agencies, equity research houses, investment banks and multinational companies has become important. Thus credibility of economic policies pursued by the countries thus assumes a critical role. The market's power to penalise imprudent policies and breach of commitment is more damaging to the economy. 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.

Political and geopolitical risks remain quite elevated in the region. The long-standing hostility between India and Pakistan the possession of nuclear and missile capability by the two countries and the active frontline status of Pakistan in the war against terrorism, the tension between India and Sri Lankan governments, 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.

Human Development Indicators of South Asia are something we are not proud of. 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 shows that India's literacy rate has gone up to 74 per cent but the differential between female and male literacy rate is still wide. 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 is illiterate.

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.

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.

The most disturbing feature of South Asian economy is that unlike other regions,very little intra-regional trade is taking place. Intra-regional trade has remained stagnant at less than 2 per cent of the total trade in the last 25 years. Studies have 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 between India and Pakistan outweigh costs. Despite this, the trade between the two neighboring 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 attempts to revitalise SAARC will stimulate trade and growth as it unleashes competition' that lowers domestic prices, enables achieving economies of scale and acquiring new technology.

South Asia region historically had high intra-regional trade. In 1948 as much as one fifth of the trade took place within the region but at 6 percent today it is the least integrated region in the world. In contrast, East Asia and the Pacific’s intra-regional trade has risen to 52 percent. Even Sub-Saharan Africa carries out twice as much intra-regional trade as South Asia. Cross-border investment is negligible and while there is an overall liberal environment for foreign investment flows, there are a lot of formal and informal restrictions for flows originating from within the region. Common historical and cultural heritage would have, in other parts of the world, induced ease in the movement of the people, educational exchanges, access to each other’s media and cultural resources, sharing of scientific and technological knowledge and other forms of cooperation but none of this has happened. For example, Punjab in India and Punjab in Pakistan, Assam, and Sylhet, Northern Sri Lanka, and Tamil Nadu being geographically so contiguous have not derived any benefits from the proximity to each other and drifted apart during the last six decades since independence.

Trade facilitation across the borders within the region has been hindered by issues of Phyto-Sanitary, health, environmental standards, quality testing, considerable delays in custom clearance, lengthened travel times and higher transaction costs. Truck crossings, where they are even allowed, take several days and allegations of unnecessary harassment by the border officials are rampant. Non-tariff barriers on India-Pakistan trade have therefore diverted normal trade flows to informal or border trade or routing through third countries such as Dubai and Singapore raising costs to end-users.

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South Asian countries should also 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 received about US$ 109 billion of remittances from their workers in 2012 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.

A beginning can be made in IT and Software industry. India has shown a highly remarkable performance in terms of growth of modern export oriented services activity. Software production starting at $1.1 billion in 1996-97 has increased exponentially to US$ 75 billion in 2011-12. India now accounts for 60 percent of global outsourcing. Other countries in the region are lagging far behind. They can take advantage of India’s market leader role and enter into sub-contracting arrangements with the Indian software and IT companies. As Indian wages at low-end of the value chain are on an incline and this line of business is no longer as attractive the lower wagesin Pakistan, Bangladesh and Sri Lanka for similar skills will maintain profitability for the Indian Companies while the other countries will get business which they otherwise won’t be able to fetch as they are unknown and untested. Over the medium term as some of them gain experience and expertise the economies of scale and agglomeration effects will help them in positioning in the global outsourcing market.

**Conclusion**

South Asian countries improved their economic landscape in the last 10 years or so and despite many vicissitudes and shocks have been 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.

1. Address delivered at the South Asia Rotary Summit held at Hyderabad, India on May 3, 2013 [↑](#footnote-ref-2)