FUTURE CHALLENGES FACING SOUTH ASIAN ECONOMIES

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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 presented by these structural changes. There is a need to shift from the old paradigm of dependence upon 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 globalized economy.

What are the key characteristics of this new globalized economy? First and foremost 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 efficiency improvement in the utilization of capital and labour and thereby to total productivity increase. But, at the same time, it places 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.

Speech delivered at Central Bank Anniversary Lecture 2004 at Colombo, Sri Lanka on August 26, 2004.

This evening I would like to address the following question: To what extent are the South Asian Economies prepared to face these four major challenges and what is the agenda that they should follow in the next ten years or so? Before I share my views on this question, let me offer a few thoughts on the process of decision-making that should be followed by the leaders of South Asia in order to bring about the paradigm shift I have talked about.

Each country must begin by preparing a long-term vision and the road map to translate this vision into action with milestones and timelines. This vision and road map must have a non-partisan and national consensus and all political parties must be agreed and committed to the broad thrust and the direction of the economy. Of course, there will be many nuances and approaches to implementation and the road map will be altered in 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 XaoPing 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 I wish to underscore is that in plural democratic societies when even the contesting political parties have a broad agreement on the vision and direction of the economy, the voters will judge their 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.

Let me now turn to the substantive question that I have raised, i.e. the state of preparedness of the South Asian economies in meeting these future challenges.

South Asia has shown a remarkable growth about at 5.6 percent in the last ten years which is above the average of developing countries. Most countries have been able to achieve and maintained macroeconomic stability i.e. low inflation, low domestic interest rates, stable and flexible exchange rates. They have built up foreign exchange reserves to cushion themselves against external shocks. Fiscal consolidation and discipline have begun to set in with fiscal deficits being brought down to manageable levels.

Private sector has become the main vehicle for investment, production and distribution of goods and services while 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.

Trade liberalization has proceeded quite rapidly and average tariff rates have declined drastically. Export promotion is being actively pursued and inward looking import substitution and protection of domestic industry have been abandoned as principles of public policy.

Financial sector and capital market reforms have been stepped up in almost all the countries and are at various stages of implementation. New laws and regulatory mechanisms have been adopted to strengthen the banking sector and securities markets. Directed credit and credit ceilings, administered and subsidized interest rates have gradually given way to market-based allocation of credit and determination of prices.

India has become a leader in outsourcing of information technology enabled services. Low wages, large English speaking technical manpower, availability of venture capital and networking with the U.S. firms have brought about a major expansion in I.T. exports. Pharmaceuticals, health care, biotechnology, research and development are also beginning to attract attention from multinational companies. Indian firms are also beginning to acquire firms abroad and are integrating themselves in the global economy. However, other countries in the region are still way behind and have a lot of catching up to do. Services sectors account for 60 percent of the output of developed countries and many services are becoming mobile across border due to breakthrough in technology and communication. Thus the outsourcing of services is a sensible strategy.

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 ahead and tasks 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 percent, 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 task 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 destabilize markets, exchange rate and interest rates.

Technological, communication and media revolution especially the satellite television and cable channels have raised the expectations of the common man 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 have a lot of catching up to do and, that too, in the shortest period of time. I do not wish to go into the details of all the comparative indicators of the two regions which are well known to all of us, but suffice to say that we are way behind China, Indonesia, Malaysia, Thailand and the Philippines both in levels as well as the rate of improvement.

What can be done to reduce poverty and unemployment and catch up with the East Asia? We should recognize this region is our benchmark against which we should evaluate our performance although it is our biggest competitor in the global markets, particularly China, which is becoming an industrial giant. Let me offer some thoughts on this issue but also hasten to add that these are by no mean exhaustive and are being presented only in the spirit of provoking a broader debate and discussion in our countries on this important subject.

(a) Between 1980 and 2001, South Asia received $17 billion as Official Development Assistance (ODA). However, between 1990 and 2001 ODA inflows have declined both in per capita terms as well as percent 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 in the future while that of the fund managers, rating agencies, equity research houses, investment banks and multinational companies is likely to gain ascendancy. 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 penalize imprudent policies and breach of commitment is more damaging to the economy than the slippages in the observance of IMF or World Bank conditionalities. If we recall Mexico had to suffer heavily when the incoming Zedillo regime reversed the pre-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 pursue consistent, credible and transparent economic policies.

(b) 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. The features of weak governance that is normally associated with South Asia are corruption, political patronage, lack of transparency, low observance of rule of law, absence of level playing field, heavy tilt in delivery of scarce of public goods and services towards the privileged and elite classes.

The political leaders are now beginning to realize that the disenchantment of the electorate with these poor governance practices increases the burden of incumbency and puts their survival at serious risk. Thus, improved governance should be on the top of the agenda of all political parties in South Asia if they are interested in assuring their electoral sustenance.

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% of GDP with India receiving $3-4 billion annually and Pakistan about $1 billion. Portfolio investment to India had taken an upward trend but suffered a set back in the aftermath of the recent elections.

A major overhaul of the structure of Civil Service, Judiciary, Police and Local Government Institutions, Business process re-engineering and inculcation of modern management practices will be required in all the countries of the region.

(c) Political and geopolitical risks in the region are still quite elevated. The long standing hostility between India and Pakistan, the acquisition of nuclear and missile capability by the two countries and the consequential sanctions imposed upon 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 better off the region will be a reliable trading partner, active participant in the international capital markets and a choice location for foreign investment.

(d) 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 percent but female literacy rate is less than 50 percent. It also demonstrates that at least one third of its population and labor force is not fully 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 are 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 one hundred percent literacy. But this full literacy level raises another stark fact in our face i.e., 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 much 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 on one hand 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.

(e) 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 and in the medium term are those associated with high technology and to some extent medium technology. While India is making some headway in increasing its penetration of 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 a declining shares 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 today.

One particular means through which this change in the composition of exports can be accelerated is 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 minimizing costs. These skills are then disseminated and multiplied throughout other firms in the country.

(f) There is a very little intra-regional trade-taking place in South Asia. Intra-regional trade has remained stagnant at less than 2% of the total trade in the last twenty-five 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 liberalizing 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 been unsuccessful in South Asia. The recent attempt to revitalize SAARC is in the right direction and 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 in the coming year but they require a number of important preparatory measures. These are described below:

- Trade facilitation through expeditious border crossings, quick custom clearance, efficient port facilities, improved transport links should precede or take place simultaneously with the expansion of volume of cross border trade.

- Domestic tax, tariff and subsidy policies that affect production and trade incentives should be harmonized 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 and 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 such as fiscal and monetary policies should be harmonized 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, financial institutions should be harmonized.

- Financial markets should be widened and regulatory changes introduced to promote cross-border investment, listings, syndication, bond issues, etc.

(g) South Asian countries should tap the enormous potential of their large expatriate population in mobilizing investment capital, foreign exchange earnings, skilled manpower and exports of ethnic products and services. India, Pakistan, Bangladesh and Sri Lanka together receive about $20 billion of remittances from their workers annually but their contribution in domestic capital formation is insignificant. Unlike 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 in nature and should be able to 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 so far missed the boat by not becoming a part of global value chain and participating 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, manufacturing, 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 globalization. East Asia is a major participant in this global supply chain and produces parts and components for a variety of manufactures. It is time that South Asian countries do make an attempt to get engaged in this value chain.

Finally, I turn to the impact of WTO. I wish to clear the confusion that as if something drastic or unexpected or unknown is going to hit us in the near future due to WTO. All the countries in the region are already members of this organization since 1995 and have made binding commitments to maximum tariffs. In some cases the applied tariffs are lower than the bound tariffs. In actual practice, the South Asian countries have liberalized 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 of this invasion and have died. Others have taken up by the challenge by cutting the fat, taking up the slack, becoming cost efficient, improving quality are competing with the new entrants. Thus the process of restructuring and transition is ongoing and should not pose any systematic threat to the industries of the region.

What we all seem to be focusing upon is the abolition of the textile quotas under the Multi-fiber agreement and the adoption of 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 and differentiated. Most simulation studies and modeling exercises carried by the World Bank, USITC and independent consulting firms give credence to 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 $3 to 4 billion during the past five years to modernize and acquire state-of-the-art machinery that can produce quality goods according to the varying specifications and changing demand patterns of the buyers. On the other hand it is not obvious if all the ready made garment exporting firms in Bangladesh and Sri Lanka will be able to 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 to exploit which is several times the size of any regional block, enlarge the market access substantially and permit wider competition, larger scale of operation and greater specialization all of which increase productivity and growth. Thus the successful completion of Doha Development Round is very much in the interests of South Asian countries but the deferential impact on the various countries in 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 those activities in which these countries have dynamic comparative advantage.

Conclusion

South Asian countries have undergone remarkable improvement in their economic landscape during the last ten years or so and despite many vicissitudes and shocks have been able to maintain positive growth momentum. The challenges for the coming decade are however, of different nature. While the policy reform and good management of the past will certainly help the internal transformation of these economies the task facing the leaders of these countries are formidable. To maximize the benefits from globalisation and thus help reduce the incidence of poverty the future agenda should focus on good governance and institutional reform, investment in skilled manpower, shift 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.