Introduction: South Asian economic development: impressive achievements but continuing challenges

Wahiduddin Mahmud and Anis Chowdhury

Setting the context

South Asia comprises Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka and is home to almost 1.5 billion people, nearly a third of them very poor, having less than US$1 (in purchasing power parity terms) a day to consume.[1] Only Sri Lanka and the Maldives belong to the category of 'low-middle'-income countries as defined by the World Bank; the rest are all low-income countries. Not least because of its large population size, South Asia has more poor people than any other region in the world.

South Asia also holds the key to a significant reduction of global poverty. The region has been next only to East Asia in its economic growth performance since the beginning of the 1980s. Its average annual growth rate of real GDP at 5.6 per cent in the 1980s and 5.5 per cent during 1990–2001 exceeded that of low-income countries, at 4.5 per cent and 3.4 per cent respectively, during the same periods.[2] More recent growth performance in some of the economies of the region, especially India, is even more promising. The success of the Four Little Dragons (Hong Kong, Singapore, South Korea and Taiwan) in East Asia is now said to be followed by that of the Two Giants – China and India – which together are now leading the ascendancy of Asia in the global stage (Radelet and Sachs, 1997). However, whether the economic fundamentals in the South Asian countries have changed enough to put them on a higher growth trajectory matching that of their East Asian counterparts still remains doubtful.

South Asia's economic performance is all the more impressive and may have come as a surprise, since the countries in the subcontinent are alleged to suffer in varying degrees from many growth-retarding factors, such as corruption, conflict, high fiscal deficits, poor infrastructure and an overall adverse investment environment (Devarajan, 2005). Under similar adverse conditions, economies in other regions, especially in Sub-Saharan Africa, have done far worse. Moreover, unlike in other regions, economic development has been widely shared among the countries in South Asia.[3] This raises the question regarding whether the South Asian economic model has some unique inherent strength and resilience, or whether such a distinct model can be identified in the first place.

In spite of diverse sociopolitical cultures, there are important commonalities in development experience among the countries of the region. While a shared colonial legacy influenced the attitudes towards development thinking in the early years after independence, many institutional structures inherited from the colonial period still continue to exist. Despite apparently contrasting patterns of political development – such as democracy in India and authoritarianism in Pakistan – the social structures and political processes in South Asia can hardly be distinguished by the existing state boundaries; across the subcontinent, these are shaped in varying degrees by such factors as language, religion, ethnicity, class and caste (Jalal, 1995). Looking at the development experience of not only the individual countries, but also regions within the countries, can thus throw light on how responses to economic policies can vary under a variety of sociocultural settings. At the same time, examining the South Asian development experience as a whole can also be useful, particularly in revisiting some of the prevailing development paradigms, encompassing the role of history, culture, geography, politics and economic policies in determining development outcomes.

The development strategies and the subsequent policy shifts have been more or less similar in the major economies of the region. Compared with their East Asian counterparts, these countries pursued inward-looking policies with tight controls on foreign trade and an emphasis on import-substituting industrialization for a longer period. The state ownership was extensive, covering many manufacturing and service enterprises. Banks and other financial institutions were either publicly owned or tightly controlled and the government also intervened in the commodity markets, particularly those for agricultural inputs and outputs.

Interestingly, the South Asian policy-makers tended either to dismiss the East Asian economic success as irrelevant for drawing any policy lessons applicable to their countries or attribute it to idiosyncratic features of East Asia. However, once the rapid growth of China became evident by the late 1980s following the opening up of its economy, it clearly indicated to South Asian policy-makers that there was something amiss in their development strategy and that economic reforms had to be undertaken. Systematic reforms towards economic liberalization gathered momentum in the region only in the 1990s, except in Sri Lanka, where such reforms were started in 1977. The basic thrusts of the reform process in all the countries of the region were similar, in line with the so-called 'Washington Consensus' as advocated by the IMF and the World Bank, though the relative emphasis on components of the reform agenda naturally differed. These reforms, which have generally followed a gradualist approach, are regarded as still incomplete, but there are ongoing debates about how to proceed further with the reforms. It may be true that South Asia's overall record of economic performance has been impressive following the reforms, but without a closer look at the drivers of economic growth, it would be unwise to attribute the improvements entirely to reforms.[4]

South Asia's experience with market-oriented liberalizing reforms may indeed be useful in informing the ongoing debates surrounding the 'Washington Consensus'. The Consensus, which grew out of the experience of the so-called structural adjustment policies of the late 1980s, emphasized fiscal discipline, deregulation and privatization, openness to trade, market-determined exchange and interest rates, protection of property rights and redirection of public spending towards social sectors.[5] The Consensus has subsequently undergone many modifications as its initial formulation was found deficient in several important respects as a development framework (Stiglitz, 2004). The problem is less what the Consensus contains than what it leaves out – the issues of governance and institutions, the role of empowerment and social mobilization, the need for giving more attention to poverty reduction, the costs and pace of transformation and an appropriate state–market mix based on the context–specific evidence on what works and what does not. Much of the debates regarding the effectiveness of economic reforms have to do with the above dimensions of economic development that vary from one region to another. That is why looking at the outcomes of economic reforms in South Asia's specific circumstances may be particularly rewarding.

Growth performance: robust and promising?

The overall growth of GDP per capita of South Asia was 1.9 per cent annually during the 1960s and declined to 0.6 per cent in the 1970s (coinciding with the first oil shock); then it accelerated to 3.3 per cent in the 1980s and 3.4 per cent during 1990–2003.[6] These accelerated growth rates of the later periods still lagged far behind those of East Asia, but represented a superior growth performance compared with other developing regions. The contrast is most striking with Sub-Saharan Africa, which experienced decline or stagnation in per capita GNP during the 1980s and 1990s.

India has led South Asia's growth acceleration since the beginning of the 1980s, not only because of its size (80 per cent of the region's GDP and of the total population) but also because of its superior growth performance. Its GDP growth in the most recent years (three years up to the fiscal year 2005/06) has averaged about 8 per cent annually, and even conservative analysts put the country's current 'trend' annual GDP growth to be at least 6 per cent – the rate it has achieved since 1991. The growth acceleration in India had started even earlier, with the growth rate of GDP averaging 5.5 per cent per year in the 1980s, compared with the infamous 'Hindu rate of growth' of about 3.5 per cent per year during the three previous decades.

In spite of India's leading role, economic growth has been broadly based among the South Asian economies. In terms of long-term growth, Sri Lanka has performed best, and Nepal worst, but even Nepal's per capita GDP growth at an average of 1.8 per cent per annum over the decades of the 1970s, 1980s and 1990s represents significant progress.[7] In the recent years, the growth performance of the economies has withstood many adverse factors – natural disasters, internal conflict and external economic shocks – and this speaks to the resilience and robustness of the growth that has been taking place (Devarajan, 2005).[8]

This overall assessment of the region's growth performance should not, however, detract attention from important variations across the countries and over time within countries. For example, Pakistan's annual GDP growth rate declined significantly from 6.3 per cent in the 1980s to 3.6 per cent during 1990–2001, but there has been a recent turnaround with an average growth rate near 6 per cent. India's impressive growth performance in the 1990s hides the fact that the economy grew at an impressive 6.7 per cent in the first five years after the reforms and then it slowed down to 5.4 per cent in the next five years. Sri Lanka's average annual growth rate accelerated from 4 per cent in the 1980s to 6 per cent in the 1990s, but then declined to less than 5 per cent in the following five-year period. Nepal's GDP growth rate in the 1990s was the same as in the 1980s; there was a significant acceleration in manufacturing growth, which was offset by a decline in agricultural growth. Among the major South Asian countries, only Bangladesh has had a steady increase in the average growth rate over the successive five-year periods, from 3.7 per cent in the first half of the 1980s to 5.5 per cent during 2001–05.

Because of these uneven trends, it is not easy to relate economic performance to the reforms. There are the usual controversies regarding the effect of extraneous factors (the problem of the counterfactual) and also regarding the short-run and long-run effects of reforms, given the uncertain time-lags between reforms and their outcomes (Nayyar, 2001). The changes in the political regimes, with the associated changes in the governance environment, are also likely to have affected both the implementation of reforms and their effectiveness. It is also possible that some aspects of the reforms have propelled growth by removing the binding constraints at certain times, and not at other times. Critics of reforms have often blamed the slowdowns or lack of acceleration in growth on the ineffectiveness of such reforms, while the opposite view is that it is the failure to implement the reforms fast enough that resulted in less-than-expected outcomes. The latter view, in turn, is derived from South Asia's gradualist approach to reforms, which has meant a slow pace of implementation.[9]

Pakistan's growth failure in the 1990s is often attributed to the dysfunctional and corruption-ridden democratic system of that time that resulted in weak governance and financial indiscipline. In contrast, Bangladesh's improved growth performance during the same period took place in spite of weak democratic governance. India's growth accelerated in the 1980s when there was only a hesitant and piecemeal attempt towards economic liberalization. It may, however, be argued that this growth acceleration was in part due to the soaring public sector deficits financed by both domestic and external borrowings that were unsustainable (Srinivasan, 2000).[10] Another plausible hypothesis is that, in a highly controlled economy such as was India, even a piecemeal approach of doing away with the more irksome controls can unleash considerable growth momentum.

India's growth in manufacturing actually declined in the post-reform period after having peaked during the 1980s.[11] However, this decline was compensated by acceleration in the growth of the tertiary sector. Another contentious issue regarding the effectiveness of reforms in India is the growth slowdown during the late 1990s. One explanation is that the country's investment climate turned poor after perking up during the initial years of the reform. If so, uneven outcomes from reforms may be explained in part by the variability of investor mood – or the so-called 'desire-to-invest' factors – that have assumed greater importance in the post-reform period because of the redefining of the role of public investment.

External economic factors like the East Asian financial crisis in the late 1990s and the global economic recession around 2000 and 2001 are also alleged to have had an adverse impact on the region's growth performance. The smaller and more export-dependent economies such as Sri Lanka and Bangladesh are likely to have been affected by the global recession to a greater extent than the less open and larger economies such as India and Pakistan. In any case, the decline in growth in India in the late 1990s preceded the onset of the global recession and Pakistan's poor performance was of even longer duration.

South Asia's economic growth has passed through different phases, with growth impulses coming from varying sources. Both in India and Pakistan, the Green Revolution farm technology provided the early growth impetus. The rapid growth in agricultural production, combined with import-substituting industrialization, made the 1960s the period of most rapid growth in GDP in Pakistan's entire history.[12] India's Green Revolution led to a period of rural-led development in the 1970s and 1980s, with the Green Revolution state of Punjab becoming the country's fastest-growing and richest state. However, since the 1980s, and especially since the 1990s, urban-based manufacturing and services have led the way. An important part of this shift in the drivers of growth is the phenomenal rise of the IT-based industries. India's ability to take advantage of the new possibilities in high-tech information services largely resulted from its long-standing investments in higher education, especially in the Indian Institutes of Technology.[13]

Bangladesh has over the years made the transition from being primarily a jute-exporting country to a garment-exporting one. This transition has been dictated by the country's resource endowment, characterized by extreme land scarcity and abundant labour, which makes economic growth dependent on the export of labour-intensive manufactures. In both Bangladesh and Nepal, rapid growth in remittances of migrant workers since the 1990s has had a significant impact on economic growth and poverty reduction.

In spite of the structural transformation that has been taking place in the South Asian economies, their manufacturing base still remains narrow and undiversified, especially relative to their counterparts in the Pacific Rim. Only India's recent manufacturing trends seem to be powerful enough to spread into relatively high-tech industries such as electronics, pharmaceuticals and automotive components. Agricultural growth declined across most of South Asia in the 1990s, which is blamed by some authors on the fact that agricultural markets have been kept out of reforms, as in India and Sri Lanka.[14] In other countries, where reforms towards privatization and deregulation have included the agricultural sector, as in Bangladesh and Nepal, there are concerns about how to redefine the government's role in providing support for agriculture in a liberalized market-oriented environment.[15] Another common feature among these economies, including India, is that the share of manufacturing in GDP has not increased much over the years; instead, the decline in the share of agriculture has been largely offset by the increased share of the tertiary sector. This, again, is in contrast to the experience of the East Asian economies.

Poverty reduction despite increasing inequality

South Asia has achieved significant poverty reduction since the 1980s, but not as fast as in East Asia. During this time, Sub-Saharan Africa has in fact seen a rise in its poverty incidence, which is now higher than that of South Asia – a reversal of its initial position.[16] The pattern of changes in poverty across the regions thus broadly reflects the pattern of growth in per capita income.

More progress against poverty would have been made in South Asia had income distribution not worsened in both rural and urban areas. There is also increasing regional and rural–urban disparities. The national level estimates show that income inequality, as measured by Gini coefficient of the distribution of household consumption, has worsened in all the major South Asian countries, particularly since the 1990s.[17] Although this inequality is not still high by the standards of developing countries, its worsening trends have compromised in varying degrees the impact of economic growth on poverty reduction across the countries of the region.

Poverty is not just endemic, but increasingly concentrated in particular lagging regions (Devarajan and Nabi, 2006). Not only are these regions poorer, but their growth rates are substantially slower than the better-off regions. The difference in regional development outcomes is exemplified by the discussion about the 'two Indias', one inexorably falling behind the other. Estimates for 2002–03 show that per capita GDP in the poorest seven states (accounting for 55 per cent of the population) was nearly half of that in the richest seven states (with 33 per cent of the population). In the two largest and poorest northern states of India, Bihar and Uttar Pradesh (accounting for 25 per cent of the country's population), per capita GDP was less than half the national average and only a third of the richest states. Furthermore, in terms of GDP growth, the richer southern states like Andhra Pradesh, Karnataka and Tamil Nadu are galloping ahead of the poorest but populous northern states, thus threatening to increase the already existing poverty gap between the two regions. There is also evidence that interstate inequality has been increasing more rapidly since the 1990s, as many low-income states saw a fall in their GDP growth compared with the 1980s.[18]

Regional disparity in income and poverty is not peculiar to a large country like India. For example, most of Sri Lanka's economic growth has been concentrated in the Western Province led by Colombo. As a result, this province, accounting for 30 per cent of the country's population, has increased its share of national GDP from 40 to 47 per cent over the past decade. Even within sub-regions, there is significant inequality. In Pakistan's Punjab province, central and northern districts are much better off than the southern districts. With higher educational standards and better infrastructure, the better-off districts can attract more investment and can thus grow more rapidly.

Despite increasing inequality, the trends in the national headcount estimates of poverty incidence in the South Asian countries show the positive impact of economic growth on poverty reduction. There are, of course, considerable controversies surrounding these poverty estimates, arising from data problems and the sensitivity of the estimates to the particular 'poverty line' used.[19] The national poverty estimates are also not comparable across countries, or in some cases even within countries over time. In India, the data on poverty based on household expenditure surveys show that until 1977–78, the proportion of the poor in the population had fluctuated around 50 per cent with no downward trend, but with the acceleration in the growth of per capita GDP during the 1980s and 1990s, poverty declined to nearly 25 per cent in 2000. There is, however, a great deal of controversy regarding the extent of decline in rural poverty in the post-reform period of 1993–2000, the estimates ranging between ten and three percentage points (Deaton and Dreze, 2002; Sen and Himanshu, 2004). In Pakistan, the poverty ratio fell from around 45 per cent in 1985–86 to 30 per cent in 1995–96, only to rise to around 32 per cent in 1999–2000. Clearly, the steep decline in GDP growth in the late 1990s contributed to the reversal of the earlier favourable poverty trends.

In Bangladesh, the poverty ratio declined by about one percentage point a year during the 1990s – a period when GDP growth accelerated with increasing inequality – but more recent data suggest that there has been no further deterioration of income distribution and that the poverty proportion has declined by two percentage points annually between 2000 and 2005.[20] Nepal has also experienced a rapid fall in poverty during 1995–96 and 2003–04 (the period for which reliable poverty data are available), especially in the urban areas.[21] Moreover, Nepal's experience provides an exception to the unequalizing pattern of poverty reduction: the fastest reduction in poverty was observed in the region with the highest incidence of poverty to start with (the Far Western Region), and the slowest reduction was observed in the region with least poverty in 1995–96 (the Central Region).[22]

Sri Lanka provides an example of the growth–poverty link being seriously affected by increasing inequality. The country not only has the most unequal income distribution in South Asia as measured by the Gini coefficient, but also has experienced the sharpest rise in inequality in the 1990s. This explains why the country has seen such anaemic and uneven poverty reduction despite a relatively high growth in per capita income. While urban poverty fell by half in the 1990s, rural poverty fell by only five percentage points, and poverty in the estates rose by 50 per cent.[23]

To understand the dynamics of poverty and inequality, one needs to look at the quality and pattern of economic growth. South Asia is renowned for its Green Revolution of the 1970s and 1980s that led to improved food security and a decline in rural poverty. Famines in South Asia are a phenomenon of the past. India has achieved not only self-sufficiency in food grains, but has also become a grain-exporting nation. Despite these achievements, poverty in South Asia is still largely a rural phenomenon with about 70 per cent of the population and 75 per cent of the poor living in rural areas. While there is untapped potential for strengthening and diversifying the agricultural and rural economy, agricultural growth has slowed in recent years.[24] The multitude of small farmers remain specially disadvantaged, particularly in terms of access to credit needed to pay for more expensive hybrid and genetically modified seeds and to meet the costs of producing high-value crops. Extreme inequality in land distribution, such as in Pakistan and Nepal, also aggravates rural poverty. Attempts at land reforms in terms of land ceilings and redistribution have been largely ineffective. Moreover, the poverty situation is accentuated by the social systems of castes and ethnicity that affect household economic opportunities in many parts of the subcontinent.

The vast informal and rural non-farm sectors, where the poor predominate, have also not had much attention in the policy reforms. Studies have shown that the development of small-scale enterprises provides potential paths out of poverty through the creation of productive employment opportunities.[25] For example, while Indian large-scale manufacturing seems to be booming at the moment, it alone is unlikely to create enough jobs to lift India out of poverty. Moreover, even within the organized manufacturing sector in India, the pattern of growth in the post-liberalization period seems to have contributed to increased inequality. Studies based on enterprise-level data suggest that liberalization has benefited those parts of the manufacturing sector that were already more technologically advanced and were located in the states with more business-friendly environments (Aghion et al., 2004).

The growth–inequality link in South Asia raises the spectre of the Kuznets hypothesis, according to which inequality increases to a point at the initial stage of economic development before it starts to improve. The logic of the hypothesis is simple: because of urban–rural disparity, urbanization initially leads to higher income inequality, which is eventually gradually lowered as the size of the urban population becomes predominant. Although the general validity of the Kuznets process has not been borne out by cross-country experience (Anand and Kanbur, 1993; Ravallion and Chen, 1997), this does not negate its relevance in particular country situations. For example, the increase in inequality in Nepal during 1995–96 to 2003–04 can be explained almost entirely by the growth of urbanization, with no deterioration of inequality within rural and urban areas.[26] Bangladesh's recent levelling off of the inequality trends may also seem like a Kuznetzian 'turning point', although the underlying factors are perhaps of a different kind.

The pattern of growth in Bangladesh would appear to have been fairly pro-poor – with the main stimulus to economic growth coming from labour-intensive garment exports, micro- and small-scale enterprises in manufacturing and services, and remittances from migrant workers. All these sectors typically provide scope for upward economic mobility for the poor. Even then, inequality tended to increase because the parts of the economy experiencing higher growth happened to be the ones with relatively unequal income – such as the dynamic part of the rural non-farm sector vis-à-vis agriculture – and also because growth, though employment-intensive, was not strong enough to pull wages in the vast agricultural and informal labour markets. These wages have shown strong upward trends only since the end of the 1990s, thus heralding a turning point in the income–inequality link.[27]

Social development: varying outcomes and alternative pathways

South Asia has made considerable progress in key areas of human development. However, as in the case of economic growth and poverty reduction, the overall improvement in human development indicators hides large differences among countries and among regions within countries. While these indicators are expected to improve with growth in income levels, more remarkable are the observed deviations between performance in economic growth and human development, the examples of which are in plenty in South Asia. These deviations can be found both by comparing levels of incomes and other measures of social well-being at a given time and by comparing the extent of improvements over time.

Sri Lanka is the well-known example of excelling in human development. For example, its success in reducing maternal mortality from 486 to 24 deaths per 100 000 births over the last four decades (from the mid-60s) is one of the globally recognized health triumphs. Its other health and social indicators including literacy and longevity are equally remarkable for a country with its level of per capita income. The government has always actively promoted social development, which is reflected in the country's historically high levels of public social spending. Sri Lanka currently spends about 5 per cent of its GDP on health and education (and used to spend even more in the 1960s and 1970s), which is comparable to that in East Asian countries and is higher than in other South Asian countries. Pakistan, which is clearly a laggard in key human development indicators, provides the opposite example of spending less than 3 per cent of GDP on social sectors, with other South Asian countries falling in between. Given Sri Lanka's relatively high per capita income among the countries of the region, the disparity in absolute amount of per capita social spending is even much higher.[28]

In India, achievements in human development are impressive only in a few southern states, particularly Kerala, that are neighbours of Sri Lanka. For the country as a whole, progress in human development indicators seems to have slowed in the 1990s. Moreover, the progress has been highly uneven among the states, largely depending on the extent of political commitment of the state governments. In states like Kerala, Tamil Nadu, Maharashtra, Haryana and Himachal Pradesh, a combination of state support and community awareness has resulted in improved human development outcomes, especially in primary education including gender parity. In contrast, in the laggard states like Bihar, Orissa and Uttar Pradesh, not only government commitment was lacking, but also weak social cohesion and low community involvement have persisted in reducing the effectiveness of public social spending.

In both Bangladesh and Nepal, the progress in basic human development indicators in the 1990s has clearly outpaced the progress made by the bigger and richer countries of the region, Pakistan and India. Nepal's achievements are remarkable, given its low economic growth and its geography that makes delivery of basic services in remote areas a major challenge. But unlike Bangladesh, Nepal's human development indicators reflect an acute form of gender discrimination and severe ethnic and regional disparities.

Bangladesh's progress in human development has been so remarkable that it has been termed as one of South Asia's 'development surprises'.[29] From being a laggard until the 1990s, Bangladesh now outperforms most Indian states and South Asia as a whole in indicators such as female school enrolment, child mortality and contraceptive adoption rates.

Much of these achievements have been made possible by the adoption of low-cost solutions (such as oral dehydration technology for diarrhoea treatment leading to decrease in child mortality) and by creating more awareness about, for example, immunization or contraceptives or female child enrolment. The scaling up of programmes has been relatively easy in Bangladesh, helped by the density of settlements (and their lack of 'remoteness') and effective social mobilization campaigns. Strong presence of non-government organizations (NGOs) and favourable budgetary allocations towards public social spending have also helped.

The variety of experiences in South Asian countries points to the possibilities and limitations of various pathways to human development. Amartya Sen, for example, distinguishes between 'income-mediated' and 'support-led' human development.[30] The former works through rapid and broad-based economic growth, which facilitates better standards of living and better provision of social services. The latter works primarily through effective welfare programmes that support health, education and social security. Sri Lanka and the Indian state of Kerala are cited as the examples of achieving support-led human development. The achievements in the other progressive Indian states, as mentioned above, possibly represent a combination of both income-mediated and support-led human development, since most of these states have benefited not only from the effort and commitment of their political leadership but also from relatively high income growth compared with the lagging states.

South Asian experience also shows that the success in support-led human development depends not only on the level of public social spending (representing the supply-side of public services), but also on the degree of public awareness (leading to demand for services). The regions that have performed well in human development have all benefited from favourable social attitudes and cultural factors that reinforce the impact of the government's effort in terms of public social spending and welfare programmes. Bangladesh's experience shows that social attitudes can be changed in a relatively short time and that much progress in human development can be made, at least at an initial stage, by creating more public awareness. Bangladesh does not in fact seem to have followed either of the typical pathways to human development discussed above. Its human development indicators compare favourably with the progressive states of India, although it lags far behind those states both in per capita income levels and per capita public social spending in absolute terms. However, as the gains from low-cost easy solutions are reaped, further progress will increasingly depend on the amount of public social spending, quality of service delivery and synergies with poverty reduction.[31] Like most parts of South Asia, Bangladesh suffers from poor quality of public health care, primary education and other public services.

Sri Lanka's exemplary achievements in support-led human development are also not without some limitations. The country is currently maintaining its stance as a welfare state only at the cost of large fiscal deficits that have increasingly become unsustainable. It even experienced a balance of payments crisis in 2001–02, which is attributed in part to the fact that the government had resorted to external borrowings on commercial terms to maintain and fund its public welfare system.[32] The challenge for Sri Lanka is to make its social welfare programmes more cost-effective and better targeted, so that the costs to the public exchequer can be reduced while maintaining its high human development standards.

Macroeconomic trends: basis for sustained growth?

The countries of the region have been generally successful in achieving economic stabilization, particularly in keeping inflation low and reducing the external current account deficits to sustainable levels. India has generally maintained low current account deficits, reflecting its cautious approach to external borrowings and a somewhat conservative stance towards foreign private capital inflows. Since the external payment crisis of 1991, India's balance of payments situation has remarkably improved, and in recent years, the country has run current account surpluses along with a rapid accumulation of foreign exchange reserves (Acharya, 2002).

Sri Lanka has had relatively large external deficits, reflecting in part the inflow of foreign aid on concessional terms and in part the country's more liberal policies (compared with India) towards private foreign investment. Bangladesh's previously large current account deficits have declined rapidly over the last two decades, reflecting an equally rapid decline in net foreign aid inflows as a proportion of GDP. Interestingly, unlike in India and Pakistan, trade liberalization along with reduction in external deficits in Bangladesh did not result in any large real devaluation of the domestic currency, which is largely explained by strong export growth and rapidly growing workers' remittances.[33] Nepal has maintained relatively large current account deficits by heavily depending on foreign aid inflows, but it has been able to reduce its deficits sharply in recent years by benefiting from rapidly increasing inflows of remittances. Each of these countries has managed their external debt in a way so that their debt servicing capacity (measured by annual debt repayment as a proportion of earnings from exports of goods and services) has substantially increased since the early 1990s. In each case, this was a reversal of the experience of the 1980s.[34]

Only Pakistan's experience of managing the balance of payments in the post-reform period of the 1990s is different and telling. A combination of non-concessional foreign aid and a liberal attitude toward foreign capital inflow resulted in a large debt overhang that was out of proportion to the increase in the country's debt servicing capacity. The result was an external payments crisis and disruption in economic growth during 1998–2000. The lessons of this crisis seem to have been learnt as reform efforts subsequently succeeded in reversing the crisis and restoring the growth momentum. This reversal was, however, largely also due to the US backing of the Pakistani government in the so-called war on global terrorism, resulting in large inflows of concessional foreign assistance.[35]

In regard to the reform agenda for fiscal consolidation, the results are less encouraging. In India, in the first five years of reforms, there was indeed a significant improvement in the fiscal situation with the combined deficits of central and state governments falling from above 9.4 per cent in the crisis year of 1990–91 to 6.4 per cent of GDP in 1996–97. Since then, however, the deficits have climbed back to the previous high levels, making India one of the world's few countries with the highest fiscal deficits (as a proportion of GDP).[36] Sri Lanka is also in similar straits, and its fiscal problem is explained largely by the costs of ongoing armed conflict with the Tamil insurgents over and above the costs of maintaining its extensive social welfare system. The budget deficits of the other countries are lower and at a more sustainable level.

One common feature of fiscal adjustment in most South Asian countries is that the fiscal deficits were reduced by curtailing capital expenditure and development spending and not by reducing current expenditure or by mobilizing more revenue (the only notable exception was a once-and-for-all increase in the tax–GDP ratio in Bangladesh following the introduction of value-added tax in the early 1990s). As a consequence, public saving as a proportion of GDP has increased very little, or has in fact declined, and remains much too low by East Asian standards.[37] Another consequence is that the efforts at fiscal stabilization have come mostly at the expense of resources devoted to such key areas as human capital accumulation and infrastructure development.

In India, not only was there a deterioration in fiscal deficits after 1996–97, public investment as a percentage of GDP declined significantly throughout the 1990s: from 9.3 per cent in 1990–91 to 7 per cent in 1996–97, and further to 5.8 per cent by 2001–02. This sharp fall in public investment has taken its toll on infrastructure development. The resulting fiscal situation had the worst of both worlds: the potential effect of high deficits in crowding out private investment from the credit market, and lack of public investments in infrastructure that were needed to 'crowd in' private investment. Expenditures on social sectors and rural development also suffered from inadequate allocations of resources from the centre and the states, while, as noted earlier, the differences in efficiencies and spending priorities among states made the regional disparities in poverty reduction and human development outcomes even worse (Ahluwalia, 2001).

India's experience in being able to sustain economic growth and macroeconomic stability with such high fiscal deficits remains somewhat of a puzzle. It defies one of the fundamental tenets of the 'Washington Consensus' regarding the need for maintaining low fiscal deficits. Although India faced a surge in inflationary pressure in the early 1990s, it was soon brought under control. Moreover, the large fiscal deficits financed by the domestic banking system did not apparently spill over as external current account deficits or put pressure on interest rates, which actually fell. This is all the more striking since there has been a build up of foreign reserves. Thus, it seems the Reserve Bank of India (RBI) was following a too cautious monetary policy in light of the balance of payments crisis and acceleration of inflation in the early 1990s. The build up of assets in its balance sheet due to increased foreign reserves and credit to the government was at least partially offset by reduced credit to the private sector. While the cautious monetary policy enabled the government to finance its fiscal deficits without overheating the economy, it squeezed the room for expansion of credit to the private sector.[38] That is, the macroeconomic policy mix of the time had some opportunity cost in terms of not enough credit available for the private sector, particularly those activities that have limited access to credit – small-scale enterprises and agriculture. However, the fact that the interest rate fell indicates that there was an overall decline in demand for credit. The stymied credit demand in the private sector is likely to have arisen from adverse 'desire-to-invest' variables due to an unfavourable investment environment. Some evidence does suggest that private corporate investment as a proportion of GDP declined after 1996–97.

The saving and investment rates generally exhibited a rising trend in South Asia and had exceeded 20 per cent of the region's GDP by the end of the 1990s, with further growth in the more recent years. Periods of growth acceleration were generally associated with higher investment rates. For example, an increase in investment rate in Pakistan in the 1980s led to higher GDP growth, while the decline in the growth rates in the 1990s was associated with lower investment rates.[39] Moreover, Pakistan's saving and investment rates have been the lowest in South Asia in recent times.

In all the countries, the increase in the investment rate was largely driven by the private sector, while the scope of public investment was redefined and curtailed as part of reforms under structural adjustment. As mentioned earlier, the 'desire-to-invest' factors as affected by the overall investment environment have thus assumed much greater importance in the post-reform era. For example, had there been a stronger response to reforms from private entrepreneurs, India arguably could have had more investment in recent years instead of building up foreign reserves and running external current account surpluses. To a smaller extent, this applies to the recent developments in Pakistan as well. Further, there may be a positive relationship between public and private investment. Hence, there is a doubt whether if and when fiscal deficits are reduced in India, the private sector will be able to fill in the gap in aggregate demand through higher investment. In Bangladesh in the early 1990s, the significant increase in domestic savings (resulting largely from higher public saving) was not matched by a similar increase in investment demand, thus resulting in recessionary symptoms (Mahmud, 2004). It may be tempting to even suggest, on the basis of the South Asian experience so far, that if investment demand were to rise, matching savings would be forthcoming.[40] Improving the institutional, infrastructural and policy environment for private investment thus appears to be the common challenge facing the South Asian economies.

This said, the importance of mobilizing more domestic savings cannot be ignored either. The region has not yet been very successful in attracting foreign private capital and has to depend therefore on domestic resources for increasing investment. The decline in foreign aid in Bangladesh and Nepal has resulted in increasing reliance on domestic savings for financing investment. Sri Lanka's relatively high inflation, along with persistently high fiscal deficits, points to the need for mobilizing more domestic savings, particularly public savings, to maintain the economy's aggregate supply–demand balance.[41] The importance of a domestic resource constraint is also amply demonstrated by Pakistan's recent turnaround in growth performance; increased foreign assistance along with fiscal consolidation has made it possible to expand credit flows and investment in the private sector leading to a recovery in GDP growth.

External liberalization: integrating with global markets

On the external front, all the countries have moved towards integration with the global economy through a process of lowering tariff and non-tariff barriers to imports and easing the restrictions on the inflow of foreign capital. They have also chosen to adopt a managed float arrangement (except Nepal pegging its currency with that of India), while trying to avoid excessive volatility in their exchange rates. The pace and extent of import liberalization have varied among the countries. Sri Lanka and Nepal moved the fastest, followed by Pakistan in the 1990s. Bangladesh and India have adopted a relatively staggered approach in dismantling their trade barriers and are still more heavily protected than most other developing countries. Even after the most recent reductions in tariffs in India, its tariffs are likely to remain significantly higher than China's. But, surprisingly, compared with other regions, the extent of reduction in import tariffs since the 1980s has been highest in South Asia, largely because of the initial high tariffs (World Bank, 2004).

In terms of integrating with the world markets, there is yet some way to go. South Asia's share in global trade continues to be low. By 2003, this share had risen to only 2.4 per cent after remaining nearly stagnant at about 2 per cent during the three decades from the

1960s to the 1980s. The contrast between India and China is particularly striking. Even after a decade of opening up, India's share in world exports rose only to 0.8 per cent in 2002 compared with 0.5 per cent in 1990; China's share, in contrast, was 5.2 per cent in 2002 as compared with 1.3 per cent when it opened up in 1978. At the other end is the relative poor performance of Sub-Saharan Africa, whose share in global trade in 2003 was almost the same as that of South Asia, but was only one-third of what it was in the 1980s.

Did liberalization help export growth? Import liberalization with exchange rate flexibility is expected to boost exports by removing the existing anti-export biases – through reduced protection provided to domestic import substituting industries, greater access to imported inputs and increased prices of exportables vis-à-vis non-tradables resulting from the devaluation of the domestic currency accompanying import liberalization. Exports expanded in Bangladesh and India with their opening up in the 1990s. India's export growth in the 1980s picked up to an average annual rate of 6.5 per cent (slightly ahead of GDP growth), up from a meagre 3 per cent over 1965–80; since the early 1990s, merchandise exports alone have grown at more than 15 per cent per annum, leaving aside the boom in IT-related export of services.

Sri Lanka has the lowest trade barriers with the highest trade–GDP proportion, followed by Nepal and Pakistan. However, trade liberalization is only one of many factors behind export growth. Pakistan's export volume either stagnated or declined slightly after 1993, after having grown at nearly 8 per cent per annum during 1960–93. It is argued that the country could not fully benefit from its trade liberalization until 2000 because of the offsetting effect of adverse macroeconomic developments (Hasan, 1998). While Bangladesh's export–GDP ratio has nearly doubled since the early 1990s, the improved export performance is entirely due to the rapid growth of ready-made garment export. The garment industry has flourished in Bangladesh because of the confluence of a number of favourable factors, especially the preferential access provided to Bangladesh's garment export in the major markets of the West and the creation of a set of enclave-type arrangements (e.g., bonded warehouses and back-to-back Letters of Credits (L/Cs) to facilitate duty-free import of fabrics).[42] However, the country's export base remains narrow as the impressive success in garment export has yet to be replicated in other industries. Indeed, Bangladesh's experience with the garment industry demonstrates the limitation of relying on enclave-type arrangements to facilitate export growth in a specific activity, while postponing institutional reforms for improving the investment climate generally.

Institutional bottlenecks are not, however, unique to Bangladesh. Throughout most of South Asia, export expansion has suffered from such factors as bureaucratic hurdles, inefficient customs administration, rigid labour laws and inadequate export infrastructure. For example, with the exception of Colombo, the seaports in South Asia are far too inefficient by international standards.[43] To offset these disadvantages (as well as the anti-export bias arising from the tariff structure), various measures of implicit and explicit subsidization of exports were put in place. But access to some of them, such as duty drawbacks on imported inputs, has proved cumbersome, time-consuming and corruption-prone.[44] Clearly, many complementary factors other than import liberalization are needed for success in achieving export growth, and the absence of these factors may explain why South Asia could not fully take advantage of the opportunities offered by the explosive growth in world trade in manufactured exports.

The phenomenal success of India's IT industry, which grew in a decade's time from nothing to US$15 billion worth of export, is explained largely by factors other than trade reforms: the new Internet-based technological possibilities and the availability of trained personnel. The IT industry has thrived also in part because it has escaped the red tape that continues to make life difficult for Indian businesses.

Across South Asia, tariff escalation has been used as a means of protecting domestic import-substituting industries while pursuing import liberalization. India's early import liberalization, for example, was mainly confined to industrial inputs, which helped to retain relatively high rates of effective protection on finished products. Thus, Indian industries were not exposed to foreign competition (Joshi and Little, 1996). In Bangladesh, capital goods and primary commodities are subject to much lower rates of tariffs compared with intermediate goods, while the highest rates apply to finished consumer goods. This has helped to retain relatively high rates of protection for the later goods even within the much lower average import tariffs; at the same time, the anti-export bias of the tax system has been reduced to some extent because of lower taxes on imported inputs. Such a system of tariff escalation has suited the interest of the protectionist lobbies, since the domestic import-substituting industries mainly produce finished consumer goods. In Sri Lanka, where tariffs have always been lower than in the larger South Asian countries, the difference in mean tariff between primary and manufactured product groups has also been small; even then the structure of tariffs and the cascading effects of turnover taxes and mark-ups are such that the effective protection rates on several products continue to be high.

The structure of industrial incentives created by import tariffs and the various export incentives raises an important policy dilemma. The effect of these tariffs and incentives are bound to vary across industries, even if for no other reason than for the limitations of administrative feasibility in applying these various incentive mechanisms. In other words, if there is no industrial policy by design, there will be one by default, at least as long as the import liberalization process remains incomplete. At the same time, it is argued that the governance environment in South Asia is not suitable for a 'picking the winners' policy to produce good results, as it has done in East Asia.[45] In this respect, South Asia's approach may be closer to that of post-reform China, namely, improvization through learning-by-doing.

In India, well-intentioned policies to promote small-scale enterprises may have hurt the country's opportunity to penetrate the global markets. A large number of sectors have been reserved for small-scale units defined in terms of certain prescribed upper limits for the value of plant and equipment.[46] The reservation of low-tech items with large export potential such as garments, toys and shoes is believed to have cost India dearly in terms of lost exports. India and China exported comparable amounts of toys, shoes, garments and some similar items in 1975. If India had shared the global market with China, India should have been exporting today US$55 billion worth of these items instead of US$15 billion.

In spite of acceleration in export growth, South Asia's exports remain undiversified and of low technology content. Exports are either resource-based or consist of simple manufactured products. Ready-made garments alone account for nearly 80 per cent of Bangladesh's and half of Sri Lanka's exports, while the cotton value-addition chain (raw cotton, yarn and textiles) accounts for about two-thirds of Pakistan's exports. Only India is now venturing into some high-tech exports, besides its software exports.

Besides trade openness, the extent of foreign private capital flows is another measure of integration with the global economy. South Asia is not a preferred destination for external investors for several reasons. One reason is the still continuing bureaucratic hurdles. But a major reason is the inadequate physical and social (that is, human capital) infrastructure in comparison to China and other East Asian countries. In China, foreign direct investment (FDI) has been attracted to infrastructural sectors and also to export activities. India's initial attempt to have foreign investors in power generation failed due to the fiasco surrounding the currently idle large power plant that Enron built in Dabhol in the state of Maharashtra. All others who had proposed investments subsequently withdrew. This reflects not only the complex governance problems surrounding such investments but also the near bankruptcy of state-owned electricity boards to which the independent power producers had to sell their output. The near bankruptcy is itself due to subsidization of agricultural users as well as large losses from electricity theft. Recent reforms are aimed at opening up power generation, transmission and distribution to greater competition. In both Pakistan and Bangladesh, the entry of private independent power producers in a largely state-owned electricity sector has created problems for the same reasons. Of all the South Asian countries, Sri Lanka has been most successful in attracting private foreign investors in the energy and telecommunications sector and in the expansion of ports.

It needs to be recognized that, in the infrastructural sectors, privatization (involving both foreign and domestic investors) is a complex process, which is often ignored in making simplistic prescriptions. It is true that public ownership in these sectors has led to gross inefficiencies. At the same time, privatization and market competition may not always be the answer because of several reasons: many of the infrastructural services are natural monopolies and they are often of the nature of 'public goods' with several kinds of externalities.[47] There is thus a need for effective regulatory agencies for privatization to be beneficial; but such agencies are only in their infancy in South Asia. There is also scope for institutional innovations in these sectors involving varying degrees of state–market mix. The problem of involving foreign private investors is compounded when such investors take into account their perception of 'country risk' in negotiating the terms of investments, such as regarding the 'administered' prices at which the government will buy electricity from independent power producers. This puts countries like Bangladesh at a disadvantage.[48]

One reason why India has been slow to open its economy to FDI is the high degree of protection still afforded to the industries serving the domestic market. As was argued long ago by Brecher and Alejandro (1977), in a situation of continuing protection of import-competing sectors, investment of foreign capital in these sectors may not be beneficial, particularly if the investments are of a capital-intensive type. India's domestic market can be attractive to FDI because of its large size. In the smaller countries of the region, however, whatever FDI has come in sectors other than infrastructure or mining, it has come mostly in export industries, such as the export-oriented garment industry in Bangladesh.

Governance and institutions

Weak governance is a key constraint for South Asia to realize its economic promise and potential. Governance problems can be interpreted to cover a broad spectrum of issues, ranging from political and economic corruption to capability of the state machinery for economic management and to the functioning of the political systems. The governance environment in South Asia, which cuts across all these issues, is alleged to be characterized by regional tensions, internal conflict, corruption and patronage politics, weak law and order, inadequate regulatory systems and public sector with a poor record of managing public enterprises and delivering services. The scale and nature of the governance problems, however, can be seen to differ widely across the region, depending on which aspects of governance one has in mind.

On conflict, Sri Lanka has had a civil war for the last 20 years and Nepal has had a Maoist insurgency since the mid-1990s. These internal conflicts must have adversely affected the economies of both the countries, but in neither case has the impact been nearly as severe as in the case of many conflict-ridden countries in Sub-Saharan Africa. Sri Lanka's experience shows that if conflict is localized in an economy having otherwise favourable conditions (e.g., high literacy, good policies), there can be economic growth in non-conflict areas. Nepal's impressive performance in reducing poverty over the last decade or so is owed to a great extent to a sharp increase in remittances from migrant workers.[49] A lesson from Nepal's experience is the danger of political instability arising from regional economic disparities. The Mid-western Development Region and the Far Western Development Region are the most economically backward parts of the country. These regions inherited the worst legacy of the caste system and suffered from prolonged neglect from successive governments of all political hues. The resulting widespread poverty in these regions provided the fertile grounds for breeding and sustaining the insurgency. Fortunately for the country, recent political developments with the inclusion of the Maoists in the central government have opened up possibilities for the resolution of the conflict.

As regards political systems, India and Sri Lanka are the most mature democracies in the region, but their governments are often characterized by weak coalitions. Bangladesh's parliamentary democracy remains fragile, in spite of three credible national elections held since 1991. Pakistan has been mostly under some form of military rule; during 1988 to 1999, it had an interlude of democratic politics, which failed to provide a stable political framework. In Nepal, which has hereditary monarchy, democratic politics introduced in 1991 turned out to be extremely factionalized with frequent changes of government.

Irrespective of the nature of the political regime, the countries of the region share many common governance problems. All the countries, for example, have serious corruption problems; only the nature and scale vary. Again, strong public awareness about governance problems and corruption in particular, which has found expression through civic actions and a lively media, has been a mitigating factor throughout South Asia. Democratic politics in India and elsewhere in the region will ensure that these issues have remained in the forefront of public consciousness and therefore on the political agenda, and there will be continuous pressure for improvement.[50] Both in Pakistan and Bangladesh, regimes fell because of the public's perception of deterioration in the quality of governance and increase in the incidence of corruption. In Bangladesh since 1991, popular discontent with corruption was expressed through credibly held elections since 199l, leading to the fall of the successive governments led by Begum Khaleda Zia and Sheikh Hasina respectively. Even when elected regimes, such as those led by Nawaz Sahrif and Benazir Bhutto in Pakistan, were removed through authoritarian interventions, the legitimacy of those actions derived from the popular discontent about corruption committed by those governments. People seemed to have demonstrated a willingness to move against regimes once they crossed some vaguely defined threshold with respect to poor governance and corruption.

The problem is that, without reasonably strong democratic institutions, the lessons learned by the leaders about the terrible consequences of bad governance are not translated into durable mitigating measures. In this respect, India and Sri Lanka have an advantage over Pakistan and Bangladesh – the two countries that rank near the top in the 'corruption index' prepared by Transparency International. One redeeming feature of the South Asian experience is that, even in the absence of strong institutions, public awareness and civic actions can sometime lead to impressive development outcomes by providing some informal mechanisms of accountability of the government. Even corrupt leaders have had to seek a compromise between private gains and public good (Mahmud, 2002).

How have the varying political settings across South Asia affected economic performance and the quality of economic management? On the whole, democracy seems to have served South Asia well, although it is not easy to make generalizations or establish causal connections. India and Sri Lanka, the only two established democracies in the region, have had the highest long-term growth among the major regional economies. Their institutions of political and economic governance are superior to those of the other countries – Pakistan and Bangladesh in particular – where economic reforms have generally lagged behind institutional reforms (Mahmud, 2001). In Bangladesh, acceleration in both economic growth and social development took place following a transition to democracy in 1991. In Nepal, a shift towards a liberal economic regime in 1991 coincided with the restoration of multi-party democracy under a constitutional monarchy. Earlier, the initiation of outward-oriented policies and dismantling of the public sector enterprises had taken place in the 1980s when a liberal Panchayat system (a form of local governance) replaced a more autocratic system with absolute monarchy.

The political economy of reforms under democracy is, however, liable to be affected by the electoral cycle and the resulting emphasis on short-run political cost–benefit calculations. The reforms that are seen to have immediate adverse affect on large sections of the population – like the withdrawal of food and agricultural subsidies – are vote-losing and likely to be politically blocked, as has happened in India. Similarly, in Sri Lanka, efforts to make the welfare system better targeted and cost-effective have met with political resistance. There are the other kinds of reforms that affect small but powerful interest groups, such as labour unions resisting reforms of state-owned enterprises or protectionist lobbies resisting import liberalization. With respect to such reforms, Sri Lanka is far ahead of the other countries, but Pakistan is also considerably ahead of India – which only shows that the relationship between the nature of the political regime and its ability to further economic reform is a complex one. To take another example, Bangladesh's success in withdrawing excessive agricultural and food subsidies in the 1980s had perhaps little to do with the fact that there was an authoritarian regime in place; the deciding factors were skilful timing, public awareness about the exclusion of the poor from the beneficiaries and donor conditionality that looked sensible (Mahmud, Ahmed and Mahajan, 2007).

In spite of ideological differences among political parties, there have not been major policy reversals in South Asia since the introduction of reforms towards economic liberalization. Sri Lanka's two major political parties with ideological differences have not hindered reforms over the long term, although the pace of reforms and the emphasis on spending on social sectors and welfare programmes have differed. This is also true of the two dominant political parties in Bangladesh – one left of centre and the other right of centre – which have been alternatively elected to power since 1991. In India, the first set of reforms in the early 1990s (after the elections in 1991) was in fact initiated by a weak minority coalition government faced with a balance of payments crisis. The governments formed by Congress-led coalitions may have in fact helped to make reforms possible by bringing in non-economic considerations; in trying to keep the Hindutva-based Bharatiya Janata Party (BJP) out of power, the secular parties compromised on their respective economic agenda, both in 1991 and in the current government (Varshney, 1999). On the other hand, it is also argued that governments formed by unstable coalitions are likely to have at best weak commitment to economic reforms.[51]

In fact, each coalition government in India since 1991 (and there have been five governments at the union level, some quite fragile) has endorsed and furthered the reform process.[52] The reforms have been slow but durable. There have, however, been some changes of direction in the policy agenda, depending on the mood of the electorate. For example, in the elections of mid-2004, the BJP-led government was voted out because of their alleged neglect of agricultural development and rural poverty. The current Congress-led government has acknowledged that the country cannot achieve prosperity without widespread improvement for the agricultural sector. In a recent budget speech, Mr Chidambaram, the Indian Minister for Finance, quoted Nehru: 'Everything else can wait, but not agriculture'. There are, however, opposing views regarding such a change of course in response to popular verdict. One view is that the expression of popular will in democracy may lead to corrective actions towards making growth more inclusive and pro-poor.[53] The other view is that increasing economic inequality could elicit a backlash against market-oriented pro-growth policies, sometimes leading to populist policies that slow growth.[54]

Pakistan's experience seems to provide a counter-example of the relative economic performance under democratic versus authoritarian rule (Easterly, 2003). Economic growth declined sharply in the 1990s following the introduction of democratic politics, after having peaked during the previous decade under the military rule of General Zia-ul-Haq. Again, a steady turnaround in the economy has taken place since the military takeover by General Pervez Musharraf. One is tempted to conclude that the greater stability under military dictatorships and the accompanying strong technical management have led to periods of higher growth. On the other hand, the elected governments under the premiership of Benazir Bhutto and Nawab Sharif were extremely weak and failed to provide even a minimum governance framework. It is noteworthy that the balance of payments crises in both 1993 and 1996 coincided with episodes of major political instability arising from conflict between the President and the Prime Minister. There were, of course, other external factors affecting the variations in economic performance, such as the economic sanctions imposed on Pakistan following its nuclear tests in the late 1990s and the reversal of the situation since Pakistan has become an ally of the West in the so-called fight against global terrorism. Another noteworthy aspect of Pakistan's experience is that high economic growth under autocratic regimes (in the 1960s under General Ayub Khan and in the 1980s under General Zia-ul-Haq) did not lead to a transition to a viable democratic order without disrupting growth, as happened in, for example, South Korea and Taiwan.

Regarding the quality of economic administration, South Asian countries suffer from many common problems. In fact, many of the development challenges faced by these countries – be they relating to inadequate infrastructure, inefficient financial markets, adverse investment climate, lack of foreign direct investment, poor delivery of public services – are related directly or indirectly to governance problems and their foundation in political economy. The effectiveness of public development spending is often compromised by large-scale leakages of funds. The allegedly high absenteeism of teachers in schools and doctors in health care facilities is one aspect of the poor governance of public service delivery. The financial viability of commercial ventures in the power sector is jeopardized by widespread electricity theft. The inefficiency of seaports arises in part from the stranglehold on them by politicized labour unions. The state-owned banks, which dominate the banking sector, are saddled with non-performing assets arising from their politically influenced loan operations. The list goes on.

South Asia's good development outcomes have occurred despite weak institutions of governance, which may appear as a puzzle (Devarajan, 2005). Bangladesh and Pakistan, in particular, suffer from serious shortcomings in most aspects of governance and appear to be outliers in cross-country comparisons relating governance to economic growth (ignoring Pakistan's low growth in the 1990s).[55] This calls for a better understanding of the relationship between governance and economic growth – a topic that has attracted considerable attention in recent years (Acemoglu, Johnson and Robinson, 2005; Rodrik, Subramanian and Trebbi, 2004). One view is that the effects of a large number of good policies have prevailed despite overall weak institutions.[56] Another view is that, despite the overall negative perception, the quality of governance in many crucial aspects is not as bad as to have proved binding constraints thus far. Overall, the governance environment across South Asia may have been barely adequate for the economies to break out of stagnation and extreme poverty, but it may increasingly prove a barrier to putting these economies firmly on a path of modernization, global integration and poverty reduction.

Concluding remarks

The recent improvements in growth outcomes in South Asia are encouraging and constitute a platform for further consolidation of economic performance in the coming years. These achievements have taken place despite numerous obstacles, such as conflict in Sri Lanka and Nepal, high fiscal deficits in India and Sri Lanka, and widespread corruption in most parts of South Asia – particularly in Bangladesh and Pakistan. This calls for a better understanding of the factors contributing to the resilience of the growth process. While these constraints may not have been binding in the past, they may become so in the future, as South Asia attempts to accelerate growth to eliminate poverty.

The moot question is whether South Asia has the ingredients of rapid growth that East Asia had. There are still numerous gaps between the two Asias in respect of these growth ingredients – such as in savings and investment rates, export orientation, technology intensity of manufacturing and the quality of labour. This does not mean that South Asia can or should entirely follow the East Asian growth model. The democratic institutions as prevalent in most parts of South Asia and its governance environment dictate that it has to find solutions to its specific problems, while still learning from the success stories of East Asia. As noted among others by Rodrik and Mukand (2005), sound economic principles – such as incentives, competition, fiscal prudence, sound money and property rights – do not translate into unique institutional and governance solutions, but need to be adapted to particular economic and social contexts.[57]

Many of the policy challenges facing South Asian countries are specific to the individual country's circumstances. Nevertheless, just as South Asian countries are jointly experiencing economic growth, they share some common themes for accelerating and sustaining this growth. They need to upgrade their infrastructure, attract more foreign investment, diversify their industrial and export base, and deepen their human capital through improved training and education. The income inequalities and regional economic disparities accompanying accelerated growth have created a sense that 'growth is not enough'. The recent experience of growth acceleration in Bangladesh shows that deterioration in income inequality is not inevitable, provided efforts are made towards a more inclusive growth strategy. The diversity of South Asian experience also shows the various possible pathways to human and social development – through increasing incomes, greater government support and creation of public awareness through effective social campaigns.

In spite of shared growth among the countries of the region, South Asia remains the least economically integrated region in the world. This is shown by the very low share of cross-border trade within South Asia – about 6 per cent – out of the region's worldwide trade.[58] This means that cross-border economic synergies due to proximity are not being exploited. In part, this is the result of conflicts between India and Pakistan, but also reflects poor intra-regional trade logistics. Both India and Pakistan incur large military expenditures at the expense of much-needed social development. It is essential to manage conflicts in a way that social investments are protected and intra-regional trade, investment and people's mobility are restored to levels enjoyed by other regional groupings.

The governance reform agenda in South Asia is large and cuts across a wide range of institutions and threatens powerful vested interests. Developing a strategic, sequenced approach that relies on success in a few key areas to generate momentum and demand for reform in other areas will be crucial. Compared with the first-generation reforms, there is a need for deeper and more complex policy innovations to deal with the emerging challenges. Will the governance environment improve through strengthened democratic institutions, increased civic activism and a lower tolerance shown by the public for weak governance? Or will there be a 'path-dependent' institutional deterioration as postulated, among others, by Douglass North?[59] Much will depend on which of these opposing forces will prevail on the other.

Notes

1. Latest poverty estimates according to the World Bank's *World Development Indicators* show that the proportion of population below US$1 (PPP) a day was 36 per cent in Bangladesh in 2000, 35 per cent in India in 1999–2000, 39 per cent in Nepal in 1995–96, 17 per cent in Pakistan in 2000 and 6 per cent in Sri Lanka in 2002; see World Bank (2006).
2. World Bank (2003: Table 4.1).
3. See, for example, Ahmed (2006) and Devarajan and Nabi (2006).
4. For some of the early doubts about the effects of economic reforms in India, see Nayyar (2001).
5. In retrospect, the Washington Consensus was not created exclusively by institutions based in Washington, DC, and did not really represent a consensus; see Stern, Dethier and Rogers (2005: 156–63).

6. These growth estimates are based on the World Bank's database; see Ahmed (2006: Table 2.2).
7. During the period from 1960 to 2003, average annual growth in per capita GDP ranged from 2.8 in Sri Lanka to 2.5 per cent in both India and Pakistan and to 1.3 per cent in Nepal (while the growth rate in Bangladesh was 2 per cent during 1973 to 2003).
8. For example, among all the seven countries of the region including Maldives and Bhutan, average GDP growth in the five-year period up to 2006 was below 5 per cent only in Nepal.
9. However, even a gradualist approach to reform should be able to achieve significant policy changes over a 10–15-year period; on this, see Ahluwalia (2002).
10. The reforms in India were triggered by a severe balance of payments crisis that hit the country in 1990–91 after the Gulf War broke out and the domestic political uncertainty induced non-resident Indians to withdraw their deposits in India; see Srinivasan (2000).
11. The growth of manufacturing is estimated to be 7.1 per cent during 1980–81 to 1989–90 and 5.8 per cent during 1993–94 to 2002–03. The estimates are derived from the national income statistics by using semi-log functions; see the chapter on India in this volume.
12. Pakistan's GDP growth rate peaked at 6.7 per cent during 1960–70, with even much higher growth rate during the first half of the decade; the other growth peak was attained in the 1980s with annual GDP growth at 6.4 per cent.
13. India's IT industries, consisting mainly of software programming, offshore back-office services and long-distance data transcription, grew from a negligible base in the early 1990s to US$17 billion in gross revenue terms in 2000–01. However, it still contributed less than 3 per cent of GDP.
14. Srinivasan (2000: 141) argues that one of the shortcomings of Indian reforms is that two important sectors, agriculture and social sectors, have largely been kept out of the reform process. For similar argument on Sri Lanka, see Devarajan (2005: 4014).
15. In Nepal, for example, although small agricultural schemes managed by farmers have done well, more government involvement in irrigation may be needed to revive agricultural growth; see the chapter on Nepal in this volume.
16. According to the World Bank's estimates, the percentage of people living on less than a dollar a day (in purchasing power parity) fell from 58 per cent to 15 per cent in East Asia over 1981–2001, from 52 per cent to 31 per cent in South Asia and increased from 42 per cent to 47 per cent in Sub-Saharan Africa; see Chen and Ravallion (2000).
17. See Ahmed (2006: Table 6.1).
18. The states include Bihar, Orissa, Madhya Pradesh and Assam. Punjab is an exception among high-income states to have experienced a fall in the growth rate.
19. In Bangladesh, for example, two poverty lines are used, an upper and a lower one.
20. Even then, poverty incidence remained as high as nearly 40 per cent in 2005. Of the two poverty lines used, this estimate is according to the higher one.
21. During this period, the poverty rate declined from 22 per cent to 10 per cent in urban areas and from 43 per cent to 35 per cent in rural areas.
22. See the chapter on Nepal in this volume.
23. The estimate of poverty incidence in 2002 is 25 per cent for rural areas, 8 per cent for urban areas and 23 per cent at the national level; see Ahmed (2006: Table 2.3).
24. In 2006, for the first time since the Green Revolution, India had to import wheat, and it had to do so in 2007 as well.
25. See, for example, Stern et al. (2005: 233–9).
26. See the chapter on Nepal in this volume.
27. See the chapter on Bangladesh in this volume.
28. According to the World Bank's *World Development Indicators*, the level of per capita public social spending in 2000 was equivalent of US$35 in Sri Lanka, US$19 in India, and US$12 both in Pakistan and Bangladesh; World Bank (2003).
29. See Ahluwalia and Mahmud (2004); Devarajan (2005) and Sachs (2005: 10–14).
30. Sen (1999: Chapter 2).
31. In spite of favourable budgetary allocations to the social sectors, Bangladesh's public social spending (say, in dollar terms) remains much lower than that of India as a whole, let alone the progressive high-income states; see the chapter on Bangladesh in this volume.
32. See the chapter on Sri Lanka in this volume.
33. See Mahmud (2004).
34. Ahmed (2006: Table 3.3).
35. Pakistan was the world's largest recipient of foreign aid in 2002, some US$2.1 billion, mostly concessional loans from the World Bank and the IMF and US foreign assistance.
36. See Srinivasan (2002). The fiscal deficits will be even higher if the contingent liability of the government arising from the losses of state-owned enterprises is taken into account.

37. In India, for example, the deterioration of the fiscal situation after mid-1990s was reflected in a major decline in public saving, from 1.7 per cent of GDP in 1996–97 to −2.7 per cent in 2001–02.
38. The lending practices of publicly owned banks may also have been responsible for keeping potential investors from accessing bank credit. These banks have shown a reluctance to lend to anyone other than long-established large farms and have invested much more in government securities than they are obliged to do under various reserve requirements.
39. An exception is the growth acceleration in Sri Lanka in the 1990s with a lower average investment rate compared with the 1980s.
40. A plausible explanation for this is that with more investment opportunities, potential savings are likely to be diverted away from unproductive uses.
41. In 2007, Sri Lanka's inflation rate peaked at 20 per cent, which is much higher than the one-digit rates of inflation experienced by other South Asian countries since the 1990s.
42. The other favourable factors were the early relocation of garment producers and marketing intermediaries from East Asian countries (especially South Korea) to Bangladesh to evade import quotas in the US and European markets, easy transfer and spread of garment-industry-specific managerial and production skills and the abundance of low-cost female labour; see, for example, Easterly (2003: Chapter 8).
43. Most cargo traffic to and out of India takes place through transshipment at more efficient ports like Colombo and Singapore, thus adding to the trading costs.
44. There has been a recent move in India to do away with these schemes.
45. See, for example, Stern et al. (2005: 162).
46. The policy of reservation was left untouched in the early reforms; only in the late 1990s farm equipment was excluded and the limit of investment was raised to allow bigger plants.
47. Public goods are characterized by their being non-excludable in their use. The externalities may be of different kinds, such as network externalities in telecommunications and transport systems, environmental and health externalities in the case of investment in water supply systems, sewage and waste disposal.
48. In India, only the period since 2001–02 saw some major policy initiatives in infrastructure development involving private sector participation. Reforms in telecommunications, which have moved faster than in the power sector, have led to better service at lower prices for significantly larger number of consumers.
49. The increased migration is partly due to the fact that families with young males sent their sons across the border to avoid them being recruited by the Maoists; see Devarajan (2005).
50. On this, see Ahluwalia (1997).
51. Srinivasan (2000), p. 151; see also Kohli (1991).
52. See Ahluwalia (2001).
53. See, for example, Sachs (2005: 183).
54. Devarajan and Nabi (2006: 3575–6).
55. According to the governance data set for 2005 prepared by the World Bank Institute, Bangladesh and Pakistan lag far behind India in most governance aspects – such as rule of law, government effectiveness and control of corruption. Only in respect of voice and accountability, Bangladesh does relatively well, although still behind India.
56. See Devarajan (2005) and Ahmed (2006: 8).
57. Some of the favourable policy ingredients behind East Asia's success are now well-recognized: openness to competition, the use of international markets, a high level of literacy and school education, successful land reform and public provision of incentives for investment, export and industrialization.
58. The corresponding figures for other regional blocks are 23 per cent in ASEAN, 56 per cent in NAFTA and 61 per cent in EU and 12 per cent in MERCOSUR.
59. See, for example, North (1997).

References

Acemoglu, D., S. Johnson and J.A. Robinson (2005), 'Institutions as the fundamental cause of long-run growth', in P. Aghion and S. Durlauf, *Handbook of Economic Growth*, New York: Elsevier.

Acharya, Sankar (2002), 'Managing India's external economic challenges in the 1990s', in M.S. Ahluwalia, Y.V. Reddy and S.S. Tarapore (eds), *Macroeconomics and Monetary Policy: Issues for a Reforming Economy*, New Delhi: Oxford Economic Press.

Aghion, P., R. Burgess, S. Redding and F. Zilibotti (2004), 'The unequalizing effect of liberalization: theory and evidence from India', mimeo, Harvard University and University College, London.

Ahluwalia, M.S. (1997), 'Governance Issues in India's Economic Reforms', Paper presented at the Workshop on Governance Issues in South Asia, Yale University, 19 November.

Ahluwalia, M.S. (2001), 'State-level Performance and Economic Reforms in India', Working Paper No. 96, Center for Research on Economic Development and Policy Reform, Stanford University, March 2001.

Ahluwalia, Montek S. (2002), 'Economic reforms in India since 1991: has gradualism worked?', *Journal of Economic Perspectives*, **16** (3), Summer, 67–88.

Ahluwalia, I.J. and W. Mahmud (2004), 'Economic transformation and social development in Bangladesh', *Economic and Political Weekly*, **39** (36), 4009–11.

Ahmed, Sadiq (2006), *Explaining South Asia's Development Success: the Role of Good Policies*, Washington, DC: The World Bank.

Anand, S. and R. Kanbur (1993), 'The Kuznets process and the inequality–development relationship', *Journal of Development Economics*, **40** (1993), 25–52.

Brecher, R. and C. Alejandro (1977), 'Tariffs, foreign capital and immiserising growth', *Journal of International Economics*, **7** (1977), 317–22.

Chen, Shaohua and M. Ravallion (2000), 'How Did the World's Poorest Fare in the 1990s?', Policy Research Working Paper 2409, Washington, DC: The World Bank.

Deaton, A. and Jean Dreze (2002), 'Poverty and inequality in India: a re-examination', *Economic and Political Weekly*, **37** (36).

Devarajan, S. (2005), 'South Asian surprises', *Economic and Political Weekly*, **40** (37), 4013–15.

Devarajan, S. and Ijaz Nabi (2006), 'Economic growth in South Asia: promising, unequalising, sustainable?', *Economic and Political Weekly*, **41** (33), 3573–80.

Easterly, W. (2003), 'The political economy of growth without development; the case study of Pakistan', in D. Rodrik (ed.), *In Search of Prosperity: Analytical Narratives on Economic Growth*, New Jersey: Princeton University Press.

Hasan, Parvez (1998), *Pakistan Economy at the Crossroads*, Karachi: Oxford University Press.

Jalal, Ayesha (1995), *Democracy and Authoritarianism in South Asia: A Comparative and Historical Perspective*, Cambridge, UK: Cambridge University Press.

Joshi, Vijay and I.M.D. Little (1996), *India's Economic Reforms*, Oxford, UK: Oxford University Press.

Kohli, Atul (1991), *Democracy and Discontent: India's Growing Crisis of Governability*, Cambridge, UK: Cambridge University Press.

Mahmud, W. (2001), 'Introduction', in W. Mahmud (ed.), *Adjustment and Beyond: the Reform Experience in South Asia*, Basingstoke, UK: Palgrave-Macmillan in association with International Economic Association.

Mahmud, W. (2002), 'National Budgets, Social Spending and Public Choice: the Case of Bangladesh', IDS Working Paper 162, Brighton, UK: Institute of Development Studies, University of Sussex.

Mahmud, W. (2004), 'Macroeconomic management: from stabilization to growth?', *Economic and Political Weekly*, **39** (36), 4023–32.

Mahmud, W., Sadiq Ahmed and Sandeep Mahajan (2007), 'Policy Reforms, Growth and Governance: the Political Economy of Bangladesh's Development Surprise', Paper prepared for the Growth Commission, Washington, DC: World Bank (South Asia Region), mimeo.

Nayyar, Deepak (2001), 'Macroeconomic reforms in India: short-term effects and long-run implications, in W. Mahmud (ed.), *Adjustment and Beyond: the Reform Experience in South Asia*, Basingstoke, UK: Palgrave-Macmillan in association with International Economic Association.

North, Douglass (1997), 'The Contribution of the New Institutional Economics to an Understanding of the Transitional Problem', Annual Lecture 1, Helsinki: United Nations World Institute of Development Economics Research (UN-WIDER).

Radelet, S. and J. Sachs (1997), 'Asia's Re-emergence', *Foreign Affairs*, **76** (6).

Ravallion, M. and Shaohua Chen (1997), 'What can new survey data tell us about recent changes in distribution and poverty?', *World Bank Economic Review*, **11** (2), 357–82.

Rodrik, D. and S. Mukand (2005), 'In search of the Holy Grail: policy convergence, experimentation, and economic perfromance', *American Economic Review*, **95** (1), 374–83.

Rodrik, D., A. Subramanian and F. Trebbi ((2004), 'Institutions rule: the primacy of institutions over geography and integration in economic development', *Journal of Economic Growth*, **9** (2), January.

Sachs, J.D. (2005), *The End of Poverty: Economic Possibilities of Our Time*, New York: Penguin Books.

Sen, A.K. (1999), *Development as Freedom*, Oxford: Oxford University Press.

Sen, Abhijit and Himanshu (2004), 'Poverty and inequality in India – I and II', *Economic and Political Weekly*, **39** (38), 4247–63.

Srinivasan, T.N. (2000), 'Economic reforms in South Asia', in Anne O. Krueger (ed.), *Economic Policy Reforms; The Second Stage*, Chicago: The Chicago University Press, pp. 99–154.

Srinivasan, T.N. (2002), 'India's fiscal situation: is a crisis ahead?', in Anne O. Krueger (ed.), *Economic Policy Reforms and the Indian Economy*, New Delhi: Oxford University Press.

Stern, J., J.-J. Dethier and F.H. Rogers (2005), *Growth and Empowerment: Making Development Happen*, Cambridge, MA: The MIT Press.

Stiglitz, Joseph E. (2004), 'The Post-Washington Consensus Consensus', Initiative for Policy Dialogue, Working Paper No. 7, Columbia University.

Varshney, Ashutosh (1999), 'Mass politics or elite politics? India's economic reforms in comparative perspective', in J.D. Sachs, A. Varshney and N. Bajpai (eds), *India in the Era of Economic Reforms*, New Delhi: Oxford University Press.

World Bank (2003), *World Development Indicators*, Washington, DC: The World Bank.

World Bank (2004), *Trade Policies in South Asia: An Overview*, Report 29949, Washington, DC: The World Bank.

World Bank (2006), *World Development Report 2006: Equity and Development*, Washington, DC: The World Bank.