

Economic Policy Challenges for South Asia

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The restoration of high growth should not be taken for granted.

— Dr. Manmohan Singh, Prime Minister of India, March 2010

South Asia has weathered the 2008–09 global financial crisis much better than expected. The slowdown in regional gross domestic product (GDP) growth of 3 percentage points—from the peak of 8.8 percent in 2007 to 6.2 percent in 2009—was the least pronounced among all developing regions, compared with the decline of 13 percentage points for emerging Europe, 8 percentage points for Latin America, and 5 percentage points for East Asia. South Asia is now rebounding and is expected to grow around 7 percent in 2010 and nearly 8 percent in 2011, close to precrisis levels—only slightly behind East Asia and better than its own historical average (6.5 percent annually between 2000 and 2007). However, as the prime minister of India cautioned in his comments on the problems facing the Eleventh Five-Year Plan, “the restoration of high growth should not be taken for granted” (*Business Standard* 2010).

Economic growth is not enough to make significant gains in poverty reduction. South Asia has the largest concentration of poor people—home to 1.5 billion people with over 1 billion living on less than US\$2 a

day. In the region, growth has not been fast enough and inclusive enough to reduce the total number of people living on less than US\$1.25 a day, which has increased and stands at around 600 million people. The challenge ahead for South Asia is to make the recovery stronger, inclusive, and sustainable. Policy makers need to start reshaping tomorrow today and position the region in what will be the “new normal.”

There is significant consensus that what will come after the global financial crisis will not look like the normal of recent years. To position the region in this “new normal,” policy makers need to draw lessons from the crisis and reassess the policy reforms that can best position South Asian countries to take advantage of the restructuring of the economic order. While ensuring that the exit from fiscal and monetary stimulus is gradual and in tune with the recovery of private demand, policy makers in the region will need to establish the basis for the future. They need to do the following:

- Create fiscal space to improve macroeconomic stability, avoid crowding out the private sector, and permit financing of infrastructure and social safety nets.
- Manage inflationary pressures, particularly food prices, with renewed attention to agricultural productivity growth.
- Revisit South Asia’s trade and investment integration strategy to take advantage of the global rebalancing underway, including supporting faster manufacturing growth.

The aim of these policies is to achieve faster, inclusive growth with more and better jobs. To succeed, policy makers in South Asia will need to focus their attention on four areas of transformational change in the region: governance, conflict, demographic transition, and urbanization and spatial transformation. The future of the region depends on the positive outcome of these changes.

Learning from the Global Crisis and Positioning the South Asia Region in the New Normal

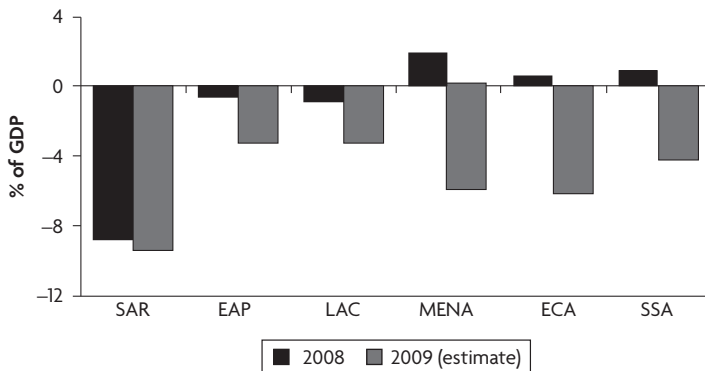
To ensure future growth and realize its potential, South Asia needs to address the following nine areas.

Creating Fiscal Space. One of the urgent tasks facing South Asia after the 2008–09 global crisis is to create fiscal space to provide governments room to address three objectives:

- Improving macroeconomic stability—including building more room to run countercyclical policies to deal with unexpected future shocks
- Not crowding out the private sector and growth as economies recover, by reducing their deficits and borrowing needs
- Permitting governments to increase the financing of crucial expenditures for public goods, especially infrastructure and social safety nets.

Entering the global financial crisis, South Asia’s economies were a large outlier in having inadequate fiscal space to accommodate countercyclical policies to support the fall in aggregate demand. In this crisis, South Asia showed the least ability to inject additional countercyclical demand to counteract the global shock (although some did, such as India and Bangladesh). Indeed, Pakistan, the Maldives, and Sri Lanka bound themselves to conservative fiscal stances to control expenditures. The reasons were structural: high initial fiscal deficits (figure 23.1) and high public debt (figure 23.2)—the highest in the developing world. How might South Asian countries create more fiscal

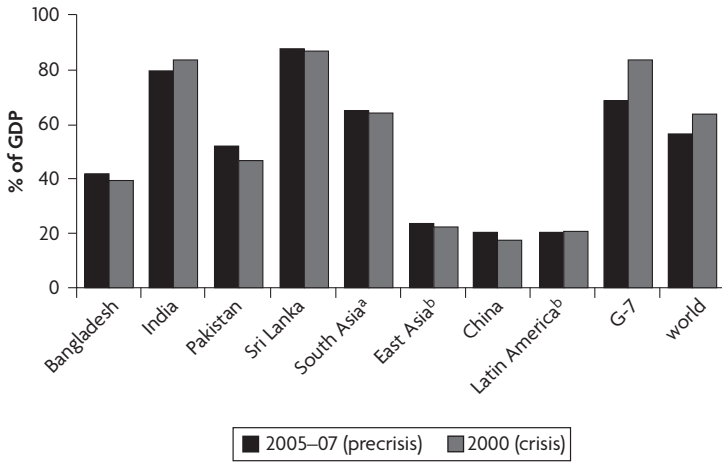
Figure 23.1 Government Fiscal Balance



Source: World Bank 2010a.

Note: EAP = East Asia and Pacific; ECA = Europe and Central Asia; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; SAR = South Asia; SSA = Sub-Saharan Africa.

Figure 23.2 Public Debt Dynamic



Source: Economic Intelligence Unit and the World Bank's Unified Survey.

a. South Asia is a simple weighted average of Bangladesh, India, Pakistan, and Sri Lanka.

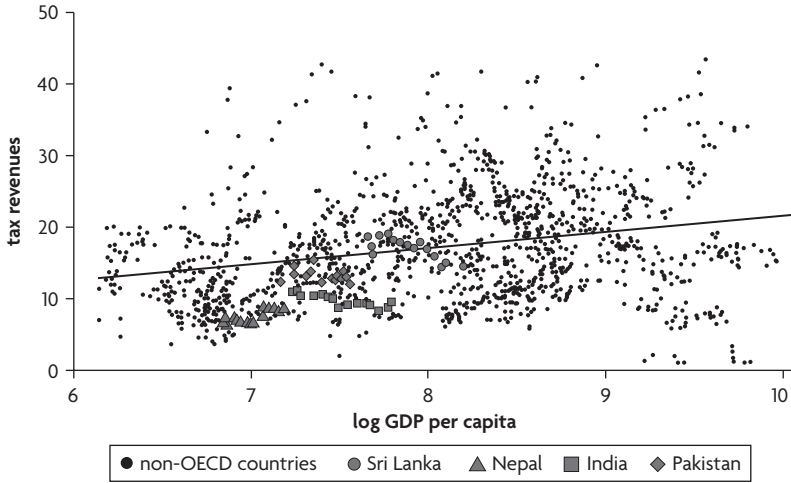
b. The data include only developing countries in the region.

space? Lessons from other countries suggest some options—including faster growth itself.

Raising Revenue. The tax-to-GDP ratios of South Asia's economies are low compared to many similarly placed developing and emerging market economies (figure 23.3) and relative to its development needs, and thus, a key focus of attention should be on efforts to increase domestic resource mobilization. The evidence seems to indicate that relative to income, tax efforts in South Asia are below expected levels—averaging around 8 to 14 percent of GDP in countries other than India and about 19 percent in India (figure 23.4). Structural constraints to raising revenues in South Asia are nevertheless significant—in particular, the high share of agriculture and the informal sector in the region.

Reprioritizing Expenditure. Focusing on more productive spending is also important. While considerable gains in prioritizing spending on primary health and education are being made, there still remains large and escalating budget and off-budget spending on petroleum, electricity, fertilizer, and food subsidies, which can drain as much as 4 to 6 percent of GDP by

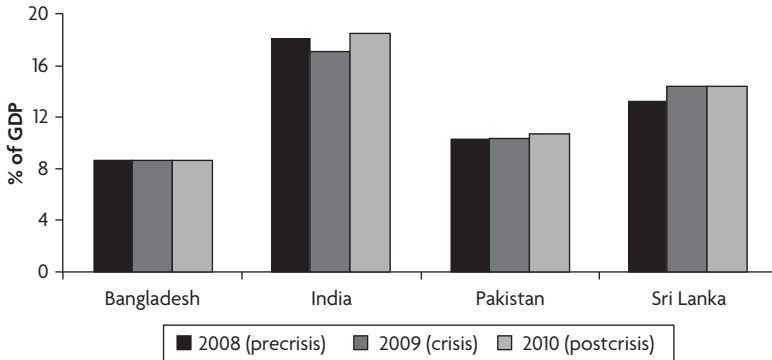
Figure 23.3 Ratio of Tax Revenues to GDP and GDP (PPP Per Capita) from 1975 to 2000



Source: Authors' calculations.

Note: OECD = Organisation for Economic Co-operation and Development.

Figure 23.4 Tax Revenue



Source: World Bank unified survey.

Note: India's revenues reflect the central government only.

some estimates—with large leakages to the better off. More carefully targeted and designed schemes would save resources, better protect the poor, and raise growth. Agricultural subsidies, for example, now exceed capital investment in agriculture in many South Asian countries. Rising civil

service salaries, which distort recruitment without gains in service delivery, are another issue, as are escalating military and security expenditures. These are political-economy-sensitive areas, especially for influential electorates used to a pattern of receiving public largess in lieu of more effective public services. The challenge will be to turn the logic around and convince citizens of the rationale and desirability of better services.

Infrastructure Financing. A key binding constraint to economic growth in South Asia is infrastructure. The biggest infrastructure gaps are in energy, transport, ports, airports, and urban development. Given large fiscal deficits, it is essential to crowd in private investment. South Asia is already well on its way (box 23.1) and will benefit from supporting such

Box 23.1 Private Participation in Infrastructure (PPI) Is Bouncing Back

South Asia accounted for around 40 percent of total developing country PPI investment commitments (hereafter investment) in the first three quarters of 2009, a record for the region. Investment in new PPI projects in the region has grown every year since 2005, reaching a record US\$26.2 billion in the first three quarters of 2009. South Asia has had the most resilient investment during the financial crisis. In the first three quarters of 2009, investment was 72 percent higher than in the same period in 2008, and there were 41 new projects, 28 percent more than in the same period in 2008.

The growing activity in private infrastructure, however, is not a regionwide trend—India accounted for almost all the PPI activity in the region in the first three quarters of 2009, registering US\$25 billion of investment and 33 new projects in this period. Larger projects have been implemented in India since 2006. The average size of new projects tripled from US\$211 million in 2006 to US\$638 million in 2009. The growth of private infrastructure activity was facilitated by national and state government policies to encourage private sector investment in infrastructure and by the depth and liquidity in India's local capital market. In 2009, the top four initial Mandated Lead Arrangers (MLAs) for project loans in the Asia-Pacific region were Indian banks.

Excluding India, investment in new PPI projects in the rest of South Asia amounted to US\$1.4 billion in 2008 and US\$1.1 billion in the first three quarters of 2009. The latter activity was confined to eight power plant projects in three countries—Pakistan (3 projects; US\$852 million), Bhutan (1 project; US\$205 million), and Bangladesh (4 projects; US\$52 million).

The energy sector has driven investment in PPI projects, growing from US\$1.3 billion in 2005 to US\$19.4 billion in the first three quarters of 2009. Investment in transport projects has remained in the range of US\$4.6 billion to US\$5.8 billion annually since 2007. Investment in telecommunications remained in the range of US\$12 billion to US\$14 billion between 2005 and 2008, while there has been minimal investment in new water projects in the region. There is also a large pipeline of new projects coming to the market. As of September 2009, 96 projects with associated investment totaling US\$48.5 billion were at one of the following stages: "awarded," "looking for financing," or "advanced stage of tender." Of those projects, India accounted for 55, with associated investment of US\$44.5 billion.

Source: Authors.

private provision of an even larger set of investments—with transparent and appropriately managed institutional frameworks as essential and including intraregional coordination and cross-border investments.

Social Safety Nets. The availability of effective safety nets to respond to shocks is critical to ensure an adequate toolkit for policy makers. Indeed, social safety nets should be established during good times. Designing effective social protection systems can be particularly important for the poor, women, and disadvantaged social groups, which are disproportionately represented among the unemployed and have riskier jobs and fewer tools to manage their risks. It is important to ensure that programs do not discourage the ability to move from place to place, which is central to facilitating labor market transitions.

Inflation and Food Prices. The upsurge in global commodity prices immediately before the global financial crisis posed a significant challenge to the region and clearly indicated one of its key vulnerabilities. While global commodity prices have since declined and the rest of the world is still facing very low rates of inflation, prices are rising much faster in South Asia. The price rises have been led by food items, raising additional concerns given large numbers of the population at or near caloric deficiency levels. Farmers are benefiting, but poor households, even in rural areas, are net buyers of food, and this puts a strong political economy premium on managing food price inflation in South Asia, unlike elsewhere (for example, where land is more abundant and surplus-producing farming households dominate in rural areas, as in Latin America).

Core inflation in South Asia is now converging to a distinctly higher level of 7 to 10 percent, surpassing the previous decade's precrisis average of 4 to 6 percent. India's increase is correlated not just with the food price shocks, but also with fuel prices. Pakistan's core inflation fell from high levels during a contractionary phase and is now rising, and in Bangladesh, it is rising steadily upward (independently of commodity price shocks). The issue that monetary authorities now face in South Asia as economies recover is whether more aggressive steps are needed to moderate demand-side pressures on core inflation. The Reserve Bank of India has already started tightening the capital account and raising policy rates and reserve

ratios from very low levels. Others face similar choices. In Nepal, liquidity management pressures were growing even earlier, and overheating land and real estate markets were notable, as a result of very large remittance inflows (and fixed exchange rates).

Revitalizing Agriculture. Food prices are expected to remain high, providing an opportunity to focus on policies in agriculture, with a second “green revolution” aimed to increase productivity in the sector. In particular, productivity-enhancing investments (improvements in input supply, extension services, irrigation, and so forth) can facilitate the supply response. Part of that will be a shift to the lagging states and regions of South Asia, where yield potentials remain large. Another part will benefit from the increasing adoption of better seeds and fertilizers. Although still controversial, the adoption of genetically modified seeds is rising rapidly in South Asia, with large gains (as in cotton production and exports). The private sector is also turning its focus to the possibilities for agricultural and rural areas.

Global Rebalancing. South Asia needs to shift its market integration strategy with the global rebalancing underway, as developed countries start to save more and spend less and grow more slowly in North America and Europe and as the East, especially Asia and emerging markets overall, looks to become a bigger driver of global growth. As can be seen in figure 23.5, bilateral trade between India and China has been on the rise since 2008 and has overtaken the bilateral trade between India and the United States. Furthermore, trade between India and China remained constant during the crisis, while trade between India and the United States declined. This provides initial evidence that South-South trade is becoming more important and has recovered much faster than South-North trade.

There is similar evidence from other South Asian countries. The share of exports from Pakistan to the United Arab Emirates and Afghanistan has surpassed the corresponding share from Pakistan to the United States. It is also worth noting that the top four importing countries from Pakistan are developing or Middle Eastern countries. Similarly for Bangladesh and Sri Lanka, China and India are the two most important trading partners, accounting for 30 percent of total imports for both countries.

Figure 23.5 Share of India's Bilateral Trade with China and the United States



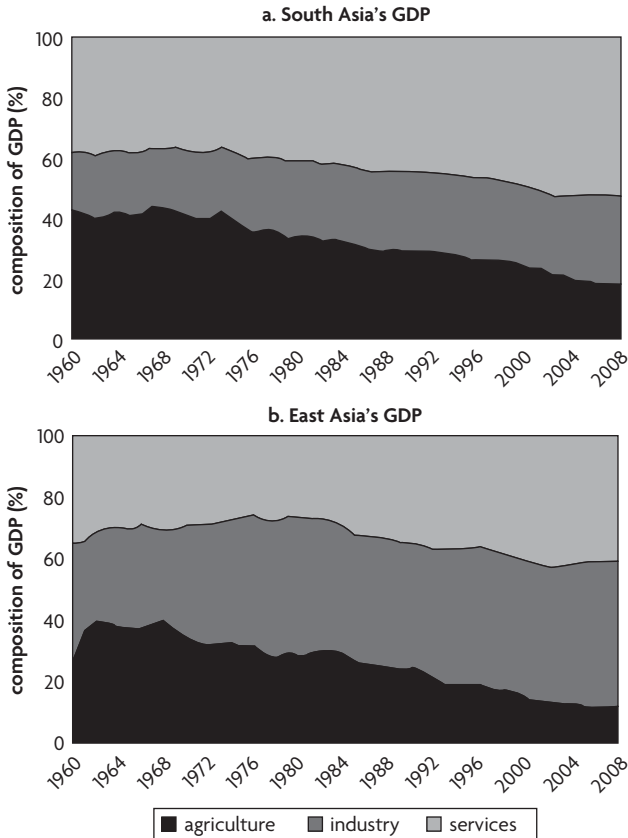
Source: CEIC Data Ltd. <http://www.ceicdata.com/>.

In revisiting its integration strategy, the South Asia region needs to enhance its Look East Strategy, looking to integrate more quickly with East Asia (the gains being potentially large—some US\$450 billion of increased trade), and find opportunities to integrate more closely with each other in the region (the gains are also potentially large—some US\$50 billion of additional trade).

Supporting Faster Manufacturing Growth. A critical area to reposition South Asia in the ongoing global rebalancing is the faster development of an outward-oriented manufacturing sector, especially the “missing middle” of medium-size firms. During the past decade, services growth has been the biggest driver of overall growth and employment in South Asia (figure 23.6, panel a), in contrast to East Asia, where manufacturing and industry have been the main drivers (figure 23.6, panel b).

The biggest reason for the rapid shift away from agriculture in both regions has been the highly constrained land-labor ratios in Asia, relative to elsewhere (see figure 23.7, which shows the relative endowments of education and land-labor ratios). But given much lower human capital endowments (as proxied by expected years of schooling), especially compared to East Asia, and the paucity of physical capital accumulation, South Asia was forced to shift to services at a much faster speed. Over

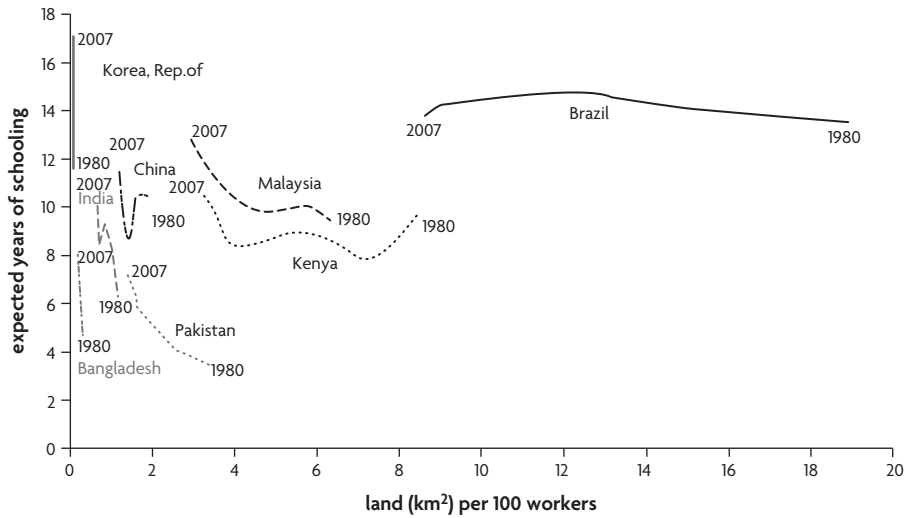
Figure 23.6 Structural Change of South Asia's GDP Compared to East Asia's GDP



Source: World Bank 2010c.

time, with increased openness in South Asia, its services are increasingly driven by modern services and exports, including information technology, business process services, trade, transport, tourism, and finance. The result has been faster productivity growth.

The opportunity now exists to transform the manufacturing sector in South Asia—with East Asia transitioning to more skill-intensive manufactures, rising wages there, and faster accumulation of human and physical capital in South Asia. South Asia's manufacturing will remain more labor intensive, with differences among countries depending on their endowments: Bangladesh is more labor intensive, Pakistan is more

Figure 23.7 Comparative Advantage Driven by Land and Human Capital Endowments

Source: World Bank 2010c.

Note: km² = square kilometer.

natural-resource oriented, and India is starting to move into higher skills and to be oriented to larger-scale domestic markets, while the smaller countries find more specialized niches. This process is beginning. In garments and textiles, Bangladesh is emerging as a competitive supply alternative to China in lower-cost segments, Sri Lanka is emerging in higher-end niches, and India is scaling up with larger factories. India is also emerging as a competitive producer of small cars (over 230,000 units exported in the first six months of 2009, overtaking China), with the relocation of scale production to Chennai from the Republic of Korea. Faster trade and investment integration is thus an important element to realize this potential.

Key Areas of Transformational Change

This section discusses the four key areas of transformational change.

Governance

For the first time since their independence, all countries in South Asia have democratically elected governments. However, governance remains

a key development challenge in the region. Political instability and corruption are cited most frequently in investment climate surveys as major or severe constraints to business. Weak property rights and corruption permeate the business environment in South Asia. Indeed, the region's growth has been affected by weak governance. The rule of law (especially property rights enforcement and law and order) and judicial systems are weak, and some parts of public administration appear to be worsening due to politicization, distorted incentives, and limited accountability. The costs of poor governance—whether unenforceable property rights and contracts, deteriorating law and order, or widespread teacher and doctor absenteeism—are largely borne by the poor.

Rising standards of living are increasing demands by citizens for better results from governments in areas such as service delivery, law and order, the courts, the right to information, budgeting and implementation of government programs, corruption, and the cost of doing business. New initiatives in South Asia, including India's Freedom of Information Act, Bhutan's Anti-Corruption Commission, and Bangladesh's strengthening of public expenditure programs, suggest that governments in the region are listening. Indeed, if policy makers in South Asia continue to respond to these growing citizen demands for greater accountability, building on successes and learning from failures, they will help accelerate and sustain the growth and inclusion that the region needs.

Conflict. South Asia has the world's largest conflict-affected population and has become the most violent region in the world, including war, insurgency, terrorism, and other forms of organized violence. Afghanistan is in the midst of conflict. Pakistan faces serious localized insurgency. Nepal and Sri Lanka are facing the challenges of reintegration in the aftermath of conflict and insurgency. India has been affected by serious terrorist attacks. Insurgencies are rooted in long-standing regional and cross-border tensions and rivalries, creating politicization of regional issues. The development paths of most of the countries in the region will be determined by their ability to transition out of conflict to peace and security.

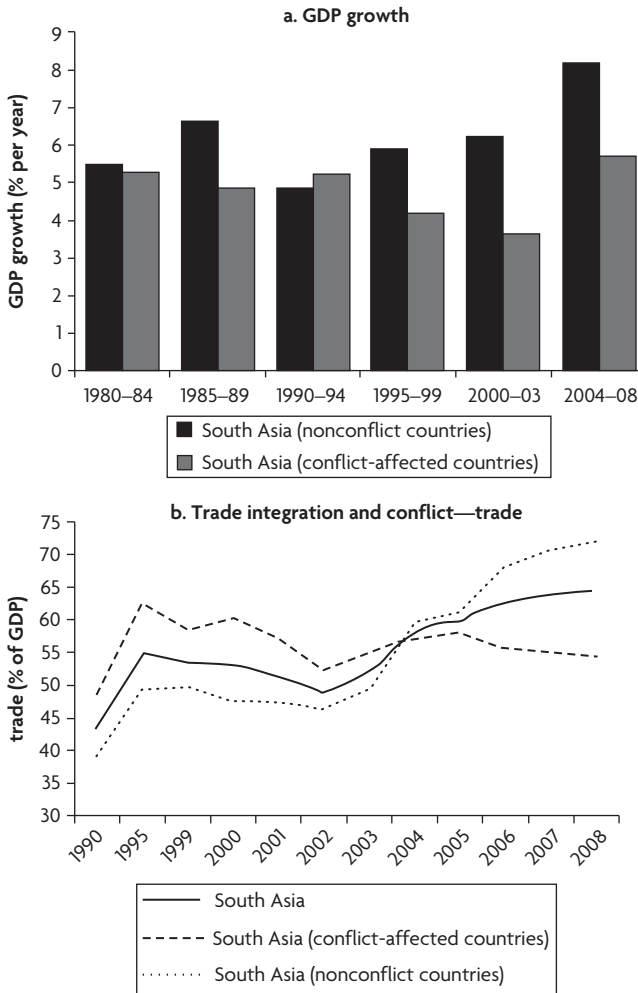
Figure 23.8 plots the trend in conflict rates and real per capita income for a large group of developing and developed countries. The vertical

axis reports the number of people killed in terrorist incidents (normalized by population) as a measure of conflict rate. The horizontal axis plots real GDP per capita. The downward sloping line suggests that countries that have lower per capita incomes also have higher conflict rates. Most South Asian countries (except for Bangladesh) are huge outliers on conflict, that is, they have much higher conflict rates given their income levels.

What are the costs of conflict for the region? Or in a positive sense, what might reduced insecurity and conflict deliver? First, the “peace dividend,” or bounce-back potential, is large, and recent faster regional growth could accelerate. For example, countries in past or current heightened conflict (Nepal, Pakistan, and Sri Lanka) have tended to show slower growth—with a differential of 2 to 3 percentage points of annual GDP growth.¹ Second, countries would integrate faster and trade more. When differentiated by two groups—conflict affected compared to others—the former showed sharply slowing trade-to-GDP ratios throughout the past decade, becoming markedly less open, while the opposite was the case for the others. The transition was especially marked after 2003, when the average trade-to-GDP ratio climbs to over 70 percent for the nonconflict countries (unweighted average), while the ratio for the conflict-affected group falls to about 50 percent by 2008—a 20 percentage point gap. The reasons that conflict reduced trade are rising risk-aversion of trade partners; higher transaction costs, such as higher insurance risk premiums on international shipping; and reduced trade financing.

This is consistent with broader findings in the literature that suggest that conflict has a powerful negative effect on trade (using a gravity model for a large set of countries for trade in 1999–2000 and an internationally comparable Heidelberg conflict-intensity index) (Pasteels, Fontagné, and Brauer 2003) (figure 23.9, panel a). The effect of conflict in that study was calculated as equivalent to a 33 percent tariff barrier and additive to other factors. There is also evidence of the opposite—that increased trade between partners reduces the probability of conflict (O’Neal and Russett 1999) (figure 23.9, panel b). But the worst is when partners do not trade. One study, for example, finds that contiguity enhances conflict when contiguous states conduct little trade (Chang, Polachek, and Robst 2004).

Figure 23.9 Conflict Reduces GDP Growth

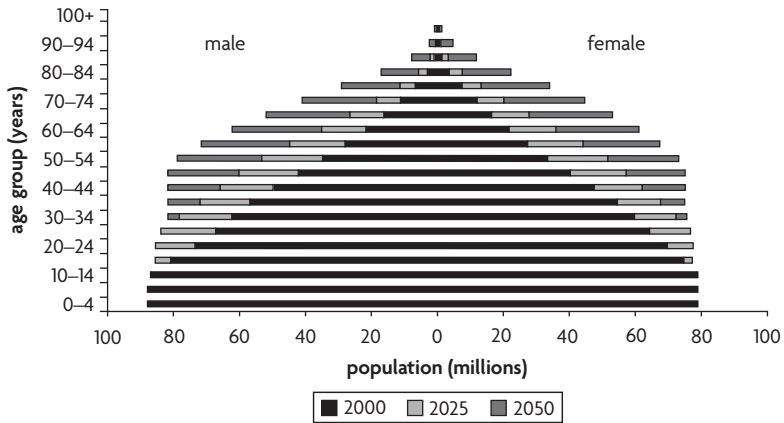


Source: World Bank 2010c.

Note: Conflict-affected countries include Nepal, Pakistan, and Sri Lanka but not Afghanistan. Maldives' weight is adjusted by a factor of 0.4. Simple unweighted averages are used.

Reaping the Demographic Dividend. As figure 23.10 shows, South Asia's changing population pyramid will bring about a growing young labor force, which for the region could turn out to be a blessing or a curse. Without urgent action, the potential demographic dividend from about 150 million entrants into the labor force over the next decade could

Figure 23.10 The Changing Population Pyramid in South Asia



Source: U.S. Census Bureau International Database, Population Projections. <http://www.census.gov/ipc/www/idb/informationGateway.php>.

become a liability. For assurance that South Asia reaps the demographic dividend, attention needs to be given to labor demand (creating more and better jobs), labor supply (improving the technical skills and education of the labor force), and labor market functioning (providing for efficient matching of labor supply and demand through regulations and mobility).

Despite high growth in South Asia, workers are often trapped in low-wage, low-productivity jobs. In the addressing of this issue, a key challenge will be to increase the productivity of the large number of workers in the agricultural sector and facilitate the transition of surplus labor from agriculture to more productive sectors. Policy makers will also have to address the economic factors that are keeping firms small and informal. In terms of labor supply, it is important to understand that half of the population in South Asia is illiterate. Except for the Maldives and Sri Lanka, less than 20 percent have reached twelfth grade, and the average schooling is only four to five years. Skills bottlenecks are emerging, as revealed by increasing returns to secondary and tertiary education relative to lower levels. Returns to education in South Asia are high, but there are low enrollment levels at the secondary and

tertiary levels and low levels of vocational training. South Asia therefore needs to improve the quality and accessibility of education and training systems so that new entrants are able to respond to the demand for higher skills.

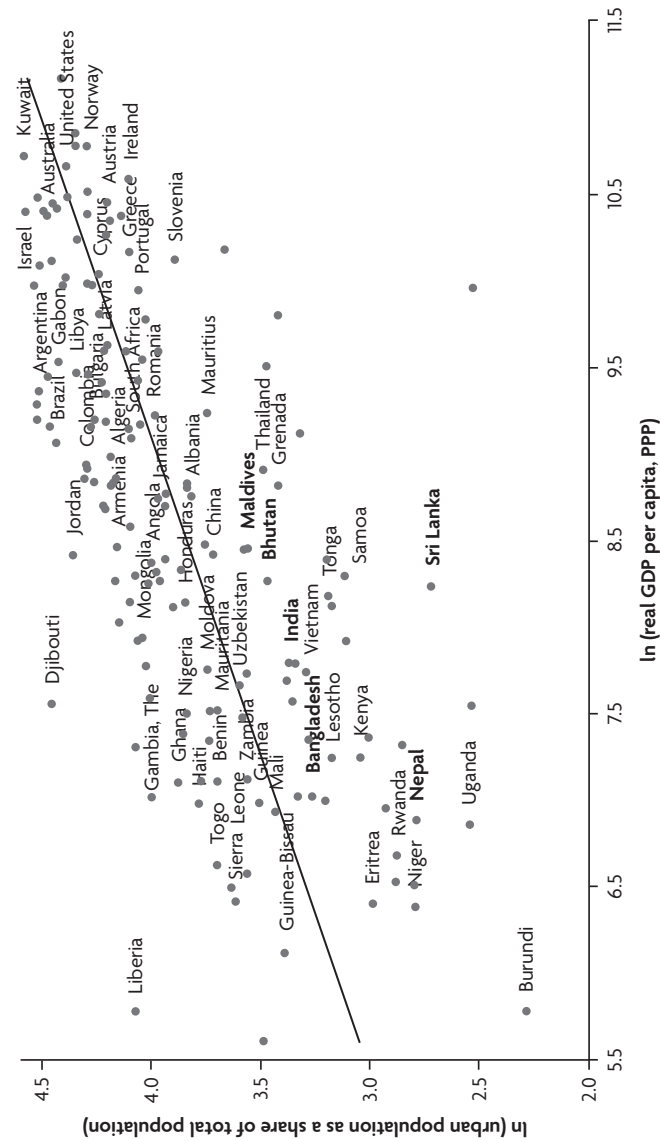
At the same time, informality is rampant (estimated at over 80 percent of employment in India), and the problems with formal-market regulations affect both the formal and the informal sectors. Within countries, the persistence of productivity differentials across sectors and locations (rural and urban) indicates significant constraints to both professional and geographic mobility. Policy makers therefore need to first identify the obstacles to mobility across jobs, sectors, and locations, and then take action to remove them.

Accelerating Spatial Transformation. It is a paradox that South Asia, which is among the most densely populated regions in the world, is also among the least urbanized. Figure 23.11 compares urbanization rates with income in more than 100 countries. It shows that urbanization rates (as measured by the share of the urban population in the total population) are positively associated with real per capita income. Spatial transformations that give rise to urbanization accelerate growth because households and firms benefit from economies of scale, mobility, and specialization. Increased urbanization contributes to productivity, which in turn is associated with higher growth and poverty reduction. This can indeed become a virtuous circle.

The paradox of India is that the urbanization rate is low—less than 30 percent of the total population lives in urban areas compared to 40 percent in China. In 2005, only 11 percent of the total Indian population lived in cities with a population of more than 1 million compared to nearly twice that percentage in China. China has many more cities than India, which is significantly underurbanized given its level of income. Nepal and Sri Lanka are among the least urbanized countries in the world; in fact, all South Asian countries are well below the urbanization line that is expected for each level of GDP per capita.

The urban population of South Asia will double over the next 20 years, so the region will need to devote more resources and leadership to develop the infrastructure necessary for urbanization. Jobs, education,

Figure 23.11 Much Lower Urbanization Rates in South Asia, 2005



health, and infrastructure are all strategic objectives closely intertwined with cities. If managed well, urbanization can be a key driver of long-term economic growth.

Note

1. Insecurity and conflict affect all countries in the region to varying degrees, and the exact classification is debatable; nevertheless, these growth differentials emerge within countries as well as in the lagging states in India.

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