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SOUTH ASIA'S OPPORTUNITIES
AND CHALLENGES

1

SUSTAINING RAPID GROWTH IN SOUTH ASIA

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INTRODUCTION

South Asia continues to grow rapidly and its largest economy, India, is close to becoming a ‘Tiger’.² This is a remarkable transformation of a region where countries have been infamously dubbed as a ‘basket case’. South Asia, which includes eight countries—Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka—was known for conflict, violence and widespread and extreme poverty. In the 1950s, when most South Asian countries gained their independence from the colonial masters, the political leadership in the region was motivated by the idealism of balanced growth, commanding heights of the public sector, labour intensive and low technology production, and self-sufficiency. South Asia adopted import substitution growth strategies with heavy trade protection, curbed the growth of private firms, and introduced restrictive labour laws to protect workers. After some 30 years, the outcome of these policies turned out to be very different from what the leadership had in mind. South Asia delivered sluggish growth, continued dependence on low-productivity agriculture, low levels of industrialization, weak export performance and inadequate creation of good jobs. Much of the labour force was engaged in low-income activities in agriculture and informal services and around 45 per cent

¹ We are grateful for comments to Homi Kharas, Pravin Krishna, Lakshmi Iyer, Carl Dahlman, Dipak Kumar Singh, Rabin Hattari, Nobuo Yoshida, Mark Roberts, Clive Harris, M. Dutz, Isabel Guerrero and Inder Sud. However, any errors are our responsibility.

² See *The Economist*, on ‘India Becoming a Tiger’, 8 March 2008.

of the population lived below the poverty line. It grew at a feeble growth rate of 3.7 per cent per annum—popularly known as the ‘Hindu’ rate of growth in India—between 1960 and 1980.

Destiny changed in the 1980s. South Asia adopted pro-growth policies. It opened up markets, replaced the public sector with the private sector as the engine of growth, increased competition, and improved economic management (Ahmed 2006). South Asia averaged an annual gross domestic product (GDP) growth rate of around 5.7 per cent during 1980–2000, which further accelerated to 6.5 per cent during 2000–7. It is now the second fastest growing region in the world, after East Asia. Growth rates in South Asia and East Asia appear to be converging (see Figure 1.1). In 2007, India experienced a GDP growth of 9 per cent, close to that of China. Other South Asian countries like Bangladesh, Pakistan, and Sri Lanka experienced a growth rate of 6.5 per cent. Private investment has boomed, supported by rising national saving rates in South Asia. It now attracts global attention because of rapid growth, global outsourcing, and skill-intensive service exports.

Having achieved high growth, the debate has now shifted to the question: Can South Asia sustain and increase the growth rate further? The experience of East Asia shows that growth that is supported by factor accumulation as well as productivity improvements can lead to higher growth.³ South Asia stands to benefit from growth hysteresis. Its two key assets, demography and geography, have not yet been fully utilized. It has a young labour force. More workers will join the labour force over the coming decades. Though the small size of the manufacturing sector has prevented the region from converting demographic dividend into a window of opportunity, the large and potentially competitive labour force could be the catalyst that could attract regional and global production centres to be located in South Asia, as firms move in response to wage differences, and globalization benefits low-income countries.⁴ South Asia’s geography also has the potential to accelerate growth. It has the highest population density in the world, and the second largest proportion of population living in the border areas after Europe. High population density and better access to markets can benefit growth by allowing South Asian firms to take

³ See Gill and H. Kharas (2007).

⁴ See Summers (2006).

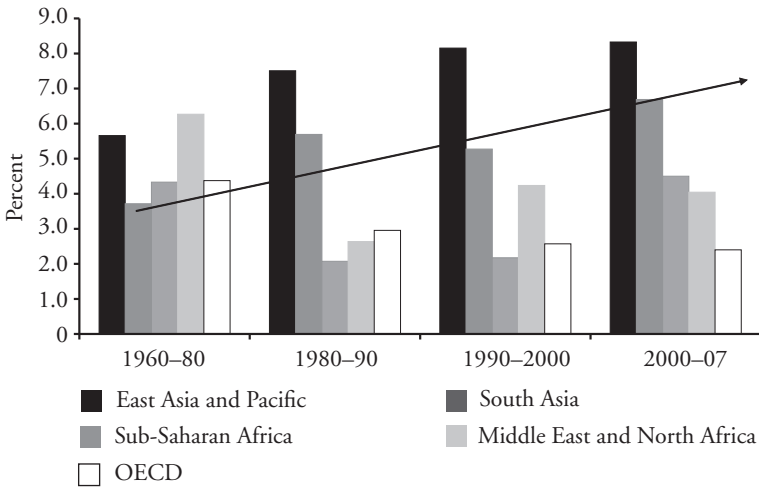


Figure 1.1: Real GDP Growth

Source: World Bank's World Development Indicators.

Notes: Data are averages.

South Asia's data include the 2007 growth rate, while the rest of the regions do not

advantage of agglomeration economies.⁵ However, poor connective infrastructure, low mobility, and conflict have prevented the region from taking advantage of its geography and spatial characteristics.

South Asia is also well below the international technology frontier (Dahlman 2007). The scope for productivity gains from improved education, knowledge, and technology is large for all South Asian countries. The continued opening up of the regions' economies to international trade, investment, and finance is an important indicator of improved prospects for acquisition of modern technology. This needs to be complemented with a more rapid pace of investment in education and skill development.

Growth is the best instrument to deal with the formidable challenges that South Asia will face in the years and decades ahead. Rapid growth has already pulled millions of South Asians out of poverty. The average poverty rate has now fallen to around 27 per cent, although there are large inter-country variations. Social indicators have improved. Maldives and Sri Lanka have achieved outstanding success in human development. Despite this progress,

⁵ See Ahmed and Ghani (2007: Chapter 1).

South Asia still has the largest concentration of poor people in the world. Nearly 400 million people live on less than one US dollar a day. South Asia has the potential to reduce poverty to single digit, if it can accelerate growth to double digit while also improving the inclusiveness of growth (World Bank 2006).

This chapter provides a broad review of the types of policies and institutions which could propel South Asia to higher growth. Growth in the region is at an early stage. There are substantial country variations in terms of size, resource endowment, and progress with policy reforms and institutions. Not surprisingly, the level of per capita income and the rate of growth vary substantially by countries. Yet, sustaining rapid growth remains a challenge for all South Asian countries. Notwithstanding past progress with reforms, all countries of the region still suffer from severe policy distortions. If the reform process can be accelerated, South Asia has the potential to achieve and sustain higher growth (Ahmed 2006; Ahmed and Ghani 2007).

Sustaining high growth rates is not easy. Growth is an outcome of complex interactions between policies, institutions, geography, and leadership. These interactions can be uncertain, and the jury is still out on whether initial spurts of growth acceleration, as experienced by South Asia, can be transformed into sustainable growth dynamics. However, growth has some common characteristics: rapid technological adaptation and learning, high rates of savings and human capital accumulation, high rates of public and private investment, rapid diversification, incremental productive employment, and resource mobility across sectors.⁶ The South Asian growth experience demonstrates most of these characteristics. For example, South Asia's average savings rate has expanded from around 16 per cent of GDP in the 1970s to 32 per cent in 2006. Investment rate has similarly expanded from the low 20 per cent range in the 1970s to 32 per cent in 2006. While these rates are still lower than in East Asia, the rapidly rising trend is very encouraging.⁷ The expansion of savings and investment rates have benefitted from sound macroeconomic management and other market-oriented reforms (Ahmed 2006). At the same time the recent adverse global developments relating to food and fuel show South Asia's vulnerability to external shocks and

⁶ See The Growth Commission Report, 2008.

⁷ See Ahmed and Ghani (2007, chapter 2 by S. Collins on growth accounting).

suggest that there is no room for complacency. Continued sound macroeconomic management remains essential.

There is no magic bullet for achieving high growth. The growth challenge will vary by country (and within countries by region). Policy and institutional reforms will need to reflect differences in initial economic and social conditions. Several regions in India and parts of Sri Lanka and Pakistan have already reached middle income status. The growth challenge they face will differ from that of Bangladesh, Nepal, Afghanistan, and lagging regions in India and Pakistan, which have per capita incomes of low-income countries. Country-specific strategies that address the main constraints to growth are most likely to be successful. A key challenge for the leadership is to develop a vision and a road map that will help the lagging regions in South Asia to accelerate growth and for the more developed regions to sustain high growth and achieve middle income status.

Leadership plays an important role in growth.⁸ Leadership, persistence, and determination matter. A government that acts in the interest of all its citizens rather than for itself or subgroups is important. A lesson emerging from East Asia is that good policies, when spearheaded by a leadership which is pro-growth and pro-private sector, can propel a country towards achieving double digit growth rates. Malaysia and South Korea are examples of countries that have achieved double digit growth. Their leadership, in coordination with the private sector, played a key role in spearheading pro-growth policies.⁹ These economies initially relied on a small, dedicated reform team that was connected to the top of the government and in charge of formulating and updating the reform strategy, building consensus, coordinating and mobilizing resources for implementing the strategy, and, crucially, nurturing the reformist political leadership over time.

The rest of the chapter discusses what South Asia can do to achieve and sustain higher growth and achieve middle income status. We believe that for the next stage of South Asia's development, there are at least five key drivers of growth. These are:

⁸ Criscuolo and Palmad (2008).

⁹ This does not imply that 'government can pick winners' or that this is an invitation to 'corruption and rent seeking'. These arguments are central not only to industrial policy but also to other policies such as education, health, social insurance, and economic stabilization.

- market integration,
- infrastructure,
- institutions,
- inclusive growth, and
- regional public goods.

MARKET INTEGRATION

Successful growth experiences are typically associated with greater integration in the world and regional economy—developing countries’ domestic markets are much too small to support rapid and sustained expansions of production. Market integration allows economic agents to interact across spatial scales: local, regional, and international. The benefit of this interaction is increased flow of labour, goods, capital, ideas, and technology. Firms benefit from Marshallian externalities (technological spillovers, labour market pooling, access to non-traded intermediate inputs) and non-pecuniary externalities (forward and backward linkages). The extent to which economic agents take advantage of market integration is impacted positively by density, but negatively by distance and division (Fujita, Krugman, and Venables 1999).¹⁰ Divisions, created by conflict, transport costs, and both formal and informal barriers to trade, separate economic agents in one country from the advantages of density in other countries.

The region has significantly more room to benefit from market integration globally, across countries within South Asia, and within country. Globally, South Asia’s rapid GDP growth benefited from rapid expansion in trade. It has experienced one of the fastest growth rates in trade (Figure 1.2) averaging 10.8 per cent in 2007, following growth of almost 12 per cent during 2005–6, which was the highest among all regions. Yet, the region has more room to benefit from trade. Despite recent reforms, South Asia continues to have the most restrictive tariff policies compared to other regions (figure 1.3). Among developing countries, South Asia has the most protective

¹⁰ Distance here is to be interpreted as an economic and social concept, rather than a purely physical concept. As such, a location that is physically close to a region of high density can, in principle, still be economically distant. This will be the case, for example, if the quality of spatially connective infrastructure linking the two areas is poor or there are economic, social, and institutional barriers to commuting and the free flow of labour between the areas.

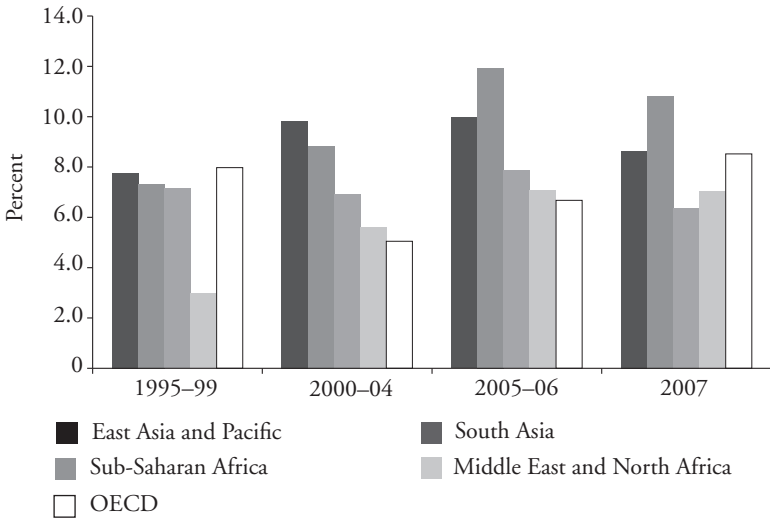


Figure 1.2: Real Growth in Trade of Goods and Services

Source: World Bank's World Trade Indicators 2008.

Note: Data for 1995-99, 2000-04, and 2005-06 are averages.

agricultural trade policies. Its global integration, measured by trade as a ratio of GDP, was 49 per cent in 2007, which although higher than its late 1990s ratio of 20 per cent, is the lowest among developing countries.¹¹

Within South Asia, individual countries cannot grow in isolation from each other, and regional cooperation is required. Market integration within South Asia is the lowest in the world as reflected by intra-regional trade between countries being less than 2 per cent of GDP for South Asia compared to 40 per cent for East Asia. Border barriers to trade and services have mostly disappeared in the rest of the world but not in South Asia. Divisions across countries in South Asia have increased dramatically over the last four decades.¹² In 1948, South Asia's share of intra-regional trade as a share of total trade was 18 per cent. In 2000-2007, it fell to 5 per cent of the total trade. Cost of trading across borders in South Asia is high. At the Petrapole-

¹¹ See World Bank (2008a).

¹² Borders and divisions are not the same thing. Borders define a nation state whereas divisions influence the flow of people, goods, services, capital, ideas, and technology across borders.

Benapole, one of the main borders between Bangladesh and India, trucks wait for more than 100 hours to cross the border. It takes 200 signatures in Nepal to trade goods with India, and some 140 signatures in India to trade goods with Nepal. It is estimated that trade between India and Pakistan, currently at US\$ 1 billion,¹³ could jump to US\$ 6 to 10 billion, if divisions were removed. Divisions in South Asia have been aggravated by conflict.

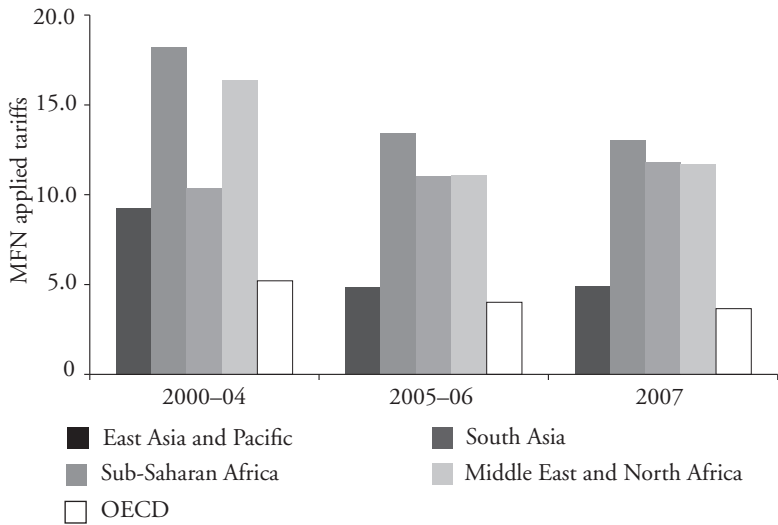


Figure 1.3: Trade Tariff Restrictiveness Index

Source: World Bank's World Trade Indicators 2008.

Note: Data for 2000-04, and 2005-06 are averages.

Within country, poor market integration is reflected in rising regional disparities. The increase of within country disparities is viewed by many as a potential threat to future growth as tensions between the poorer and richer states are likely to increase if current trends in regional inequality persist or increase in the future. Recent insights from the economic geography literature suggest that increases in regional disparities may be a natural feature of the growth process. However, the best approach to addressing regional disparities is to

¹³ Includes both formal and informal trade.

enhance market integration by reducing barriers to trade through improved policies and connectivity.

Growth benefits of market integration are likely to be large but unequal. India, a large country with a big home market, can get by with more restrictive borders, since the size of its economy and population provides the incentive to importers and exporters to overcome these barriers. It is the small, landlocked countries, like Afghanistan, Bhutan, and Nepal, which will benefit most from improved access to the markets of others. Small countries depend more on openness to overcome the disadvantage of size: small population, small markets, and inability to take advantage of agglomeration and scale economies. Even within India, the peculiar geography that isolates the seven north-eastern states (the so-called 7 sisters) from mainland India with the location of Bangladesh in-between suggests that market integration requires trade and transit arrangements with neighbours to benefit all regions that are lagging and isolated from the growth centres. Tradable economic activities are inherently scalable in the sense that small economies can expand output without running into diminishing returns (unlike domestic services). Rapid economic growth, associated with modern sector export growth, can be 'lumpy' (Venables 2006). Spatially, it can be uneven, with production being concentrated in some countries, regions or cities. In product space, specialization is likely to increase, with regions specializing in a few tasks rather than production of integrated products. Examples of specialization from South Asia include ICT service export from Bangalore in India; shirts, trousers and hats exported from Bangladesh; and exports of bed linen and soccer balls from Pakistan. Temporally, rapid growth will happen only once some threshold level of capabilities has been reached. Some countries may experience growth before others, resulting in sequential rather than parallel growth. The benefits of market integration, however, cannot be achieved without improving the infrastructure.

INFRASTRUCTURE

Infrastructure is like second-nature geography, which can reduce the time and monetary costs to reach markets and thus overcome the limitations of physical geography.¹⁴ Improved infrastructure

¹⁴ See Kanbur and Venables (2005a).

that enhances connectivity and contributes to market integration is the best solution to promoting growth as well as addressing rising inequality between regions. The Ganga Bridge in Bihar in India is a good example of second-nature geography. The bridge has reduced the time and monetary costs of farmers in the rural areas in north Bihar to reach markets in Patna, the largest city in Bihar. The Jamuna Bridge in Bangladesh is another good example of spatially connective infrastructure. The bridge has opened market access for producers in the lagging north-west areas around the Rajshahi division. Better market access has helped farmers diversify into high value crops and reduced input prices.

So far, South Asia has achieved impressive growth rates despite poor infrastructure. This may be difficult to sustain in the future. Poor infrastructure and restrictive labour laws (to be discussed later) are among the major factors that have restrained the growth of the manufacturing sector and prevented firms from growing.¹⁵ Table 1.1 shows that the manufacturing share of value added in India is smaller than that share in other large developing economies, though it is similar to that share in smaller countries with GDP per capita similar to that of India (such as Vietnam). However, as Table 1.2 shows, the growth of value added in manufacturing in India is noticeably lower than that in these smaller similar income countries. Indeed the sectoral growth comparisons in Table 1.2 are rather striking. The growth of value added in services in India is comparable to that in China, and about 10 percentage points higher than that in other countries. In rather stark contrast, the growth of value added in manufacturing in India is only about half of that in China and Vietnam.

The service sector in India has done well because it relies less on transportation and is less energy intensive than manufacturing. South Asia has the highest share of services in its exports at 31 per cent, which is higher than OECD (Organisation for Economic Co-operation and Development) high income countries. ICT exports and global outsourcing have benefited from the use of the internet which has reduced information transmission costs dramatically. While other countries can emulate India's successful efforts to boost services export, sustained high growth will require a substantial effort to raise manufacturing growth in all South Asian countries. In general,

¹⁵ See Chapter 6 by Fernandes and Pakes (this volume).

TABLE 1.1: Industry and Manufacturing Share of Employment and GDP Across Countries

	<i>Employment in industry as % total employment in 2000</i>	<i>Value added in industry as % of GDP in 2000</i>	<i>Value added in manufacturing as % of GDP in 2000</i>	<i>2002 GDP per capita (in 2000 US\$)</i>
India	18.2	26.3	15.6	480
Brazil	19.3	28	17.1	3473
China	23	45.9	34.7	1106
Indonesia	17.3	45.9	27.7	844
Pakistan	18	22.6	14.8	532
Vietnam	12.4	36.7	18.6	444
Low-income countries	12.3	26.6	14.1	
Lower-middle income countries	18.5	38.3	24.2	

Source: World Development Indicators 2005.

Notes: Industry includes manufacturing, and also mining and quarrying (including oil production), construction, and public utilities (electricity, gas, and water). Lower-income countries and lower-middle income countries are defined based on the World Bank classification.

TABLE 1.2: Growth in Sectoral Value-Added Across Countries

	<i>Growth in value added in manufacturing</i>		<i>Growth in value added in agriculture</i>		<i>Growth in value added in services</i>	
	<i>1995– 2000</i>	<i>2000–5</i>	<i>1995– 2000</i>	<i>2000–5</i>	<i>1995– 2000</i>	<i>2000–5</i>
India	28.1%	38.4%	13.7%	14.9%	48.4%	50.3%
Brazil	5.7%	5.6%	17.3%	23.7%	26.5%	31.8%
China	57.6%	67.4%	18.5%	21.2%	57.3%	61.2%
Indonesia	14.6%	27.5%	7.0%	17.3%	-2.4%	35.7%
Pakistan	17.1%	56.6%	26.5%	12.0%	20.9%	29.9%
Vietnam	70.3%	73.8%	24.2%	20.7%	31.9%	40.0%

Source: World Development Indicators 2005.

Note: The table shows grow rates for each sector in total value added (in constant local currency units) between year t and year t+5.

poor infrastructure has constrained the growth of labour-intensive manufacturing firms in South Asia and prevented the region from making use of its most important asset, its people.

South Asia suffers from three infrastructural deficits. First, there is a *service deficit*, as the region's infrastructure has not been able to keep pace with a growing economy and population. Power outages and water shortages are a regular occurrence in India and Bangladesh. Rural roads are impassable in lagging regions in India (e.g., Bihar, Uttar Pradesh) and Sri Lanka. India has 6000 km of four lane highways and China in the last 10 years has built 35,000 km of four to six lane highways. Every month, China adds power capacity equivalent to what exists in Bangladesh. Second, South Asia suffers from a *policy deficit*, given highly distorted pricing, poor sector governance and accountability, and weak cost recovery. It is estimated that eliminating the financial losses from the power and water sectors alone would provide a substantial chunk of the incremental funds for infrastructure investment that India needs. Third, South Asia suffers from a *cooperation deficit*. India, one of the energy thirsty nations, sits next to an immensely energy-rich neighbour, Nepal. Yet there is very little exploitation of Nepal's hydropower potential because of inadequate cooperation with India. Similarly, India, which has attracted global attention in ICT, contrasts with other South Asian countries that are lagging in ICT. In South Asia, only 7 per cent of the international calls are regional compared to 71 per cent in East Asia.

South Asia needs to overcome a huge gap in infrastructure. The region has invested only 3.5 to 4 per cent of GDP per year in infrastructure over the period 2000–5. This is lower than what the East Asian countries have invested: Vietnam and China had investment rates of around 8 per cent to 10 per cent of GDP. In 1980, India actually had higher infrastructure stocks—in power, roads, and telecommunications—but China invested massively in infrastructure, overtaking India by 1990 and the gap is currently ever widening. It is estimated that for the South Asian region to sustain a growth target of 8 per cent, it will require an investment in infrastructure amounting to 7.6 per cent of GDP (Harris 2008). Higher growth rate in the 10 per cent range will require an even more rapid pace of investment to modernize the infrastructure.

Much of the infrastructure investment gap has to be financed at the national level along with necessary improvements in sector

policies and institutions. Yet, regional cooperation can be of great help to meet a significant part of this need. The three priority areas for regional cooperation include telecom and internet, energy, and transport. A regional telecom network and a high-bandwidth, high-speed internet-based network could help improve education, innovation, and health. A regional network would facilitate better flow of ideas, technology, investments, goods, and services. It would facilitate greater interactions between knowledge workers in areas such as high-energy physics, nanotechnology, and medical research. There are untapped positive synergies at the regional level that would come from information sharing and competition in ideas among universities, non-university research and teaching entities, libraries, hospitals, and other knowledge institutions. It also could help in the building and sharing of regional databases, and in addressing regional problems, including multi-country initiatives such as flood control, disaster management, climate change, and infectious disease control. Importantly, such an effort could help spark higher and more sustainable regional growth.

Regional cooperation in the telecom sector and the internet could strengthen the competitiveness of South Asia in the services-export sector. India has established itself as a global player in ICT and outsourcing. Other countries in South Asia could potentially benefit from neighbourhood and spillover effects. The expansion of services exports would contribute to growth, create jobs, and other sectors would benefit from improved technology and management (Hamid 2007). The service-export sector, although less infrastructure intensive than manufacturing, needs different types of infrastructure than the traditional export sectors. For these exports, there would be a need to invest in fibre optic highways, broadband connectivity, and international gateways and uplink facilities. Investments in tertiary education, and in technical and English proficiency would need to be increased. South Asia would need to remove barriers to trade in ICT services, eliminate restrictions on the flow of intra-regional foreign direct investment (FDI), and remove visa restrictions on the flow of people.

The potential gains from regional trade in energy are substantial. After decades of insignificant cross-country electricity trade and the absence of any trade in natural gas through pipelines, regional political leaders and businessmen have recently evinced a great deal

of interest and enthusiasm in cross-border electricity and gas trade, not only within South Asia but also with its neighbours in the west (Central Asia and Iran) and in the east (Myanmar). There are two regional energy clusters in South Asia. The Eastern market includes India, Bangladesh, Bhutan, Nepal, and Sri Lanka, extending to Myanmar, and the Western market includes Pakistan, Afghanistan, and India, extending to Central Asia and Iran. India bridges the two clusters. While all countries would benefit from energy trade, in relative terms the gains would be especially large for Nepal, which could double its GDP if it could trade its hydro-power with India and Bangladesh.

What can governments do to promote energy trade? They need to continue reducing political and security tensions; consider energy trade as enhancement of energy security and political and economic cooperation; continue energy sector reforms; improve commercial performance of the utilities; improve the credibility, competence, and accountability of regulation; adopt sustainable (cost-reflective) tariffs and a social protection framework; promote commercial approach to energy trade; encourage private sector participation in the form of public–private partnership (PPP) structures in cross-border investments; help the transit countries—especially Afghanistan—integrate; engage in reaching water sharing agreements; seek accession to international agreements (such as Energy Charter Treaty); strengthen regional institutions at both political and technical levels; and identify priority trade-oriented investment projects and pursue their implementation. The success of India-Bhutan electricity trade should offer useful lessons to other countries.

Restrictions in transport border crossings are a major constraint to global and intra-regional trade in South Asia. Removing these restrictions would boost trade within the region as well as lower the cost for international trade in general as many land-locked countries and regions will benefit from access to the closest ports. Currently, the efforts at improving trade facilitation and transport networks are being done in a fragmented manner and with little cooperation even where cross-border issues are involved. Establishing corridor-based approaches for improving the trade–transport arrangement for intra-regional trade would be essential for improving the efficiency of regional transport and for reducing trade costs.

INSTITUTIONS

Many good policies can be implemented immediately while institutions are built over time. Economic governance¹⁶ in South Asia has improved over time with the implementation of the first-generation policy reforms. First, market-creating institutions have improved since the 1980s, as the policy makers replaced resource allocation based on centralized planning with market-based allocation. Global integration, by fostering competition and transferring knowledge, has further helped to strengthen market-creating institutions. Second, market-stabilizing institutions have strengthened as the policymakers have improved economic management.¹⁷ The good aspects of the market-stabilizing institutions have allowed South Asia to achieve one of the lowest inflation rates in the world during the last three decades. Output variability in South Asia over the period 1960–2000 has also been low compared to other regions. Third, some progress with institutions on conflict management has helped to avoid extreme outcomes in South Asia, such as famines, or the disintegration of states (such as seen in the Soviet Union, former Yugoslavia, and Sudan). Fourth, South Asia is credited with achieving large growth responses with small policy changes. It is the underlying institutions, which encourage consensus and policy stability, that have helped magnify the effect of policy changes on growth. Governance institutions have improved, although slowly, as a result of the increased role of the civil society, right to information, and education. Are these institutions strong enough to support and sustain high growth?

South Asia's institutions are particularly weak in three areas: business environment, labour laws, and conflict management.

¹⁶ Economic governance is defined as the legal and institutional framework to support economic activity and economic transactions by protecting property rights, enforcing contracts, and taking collective action to provide physical and social infrastructure. Security of property rights provides incentives to save, invest, achieve efficient allocation of assets, and enable productive use of labour. Enforcement of contracts removes the fear of counterparty cheating which constrains mutually gainful transactions.

¹⁷ See Rodrik (2002) for a detailed discussion of market-creating and market-stabilizing institutions.

Business Environment

South Asia has the second worst business environment in the world. Figure 1.4 shows a comparison of the business environment in South Asia with other regions. South Asia performs poorly on most indicators of business environment and also fares poorly in terms of corruption (Figure 1.5), although it is home to some of the most dynamic entrepreneurs in the world. These entrepreneurs have managed to overcome regulatory barriers, and grow like the banyan tree which spreads around concrete barriers. Restrictive regulatory policies and corruption are associated with the loss of productivity and investment. South Asia could check corruption by mainstreaming “one stop” licensing agencies (which combine central, state, and local authorities); introducing competing authorities (but one license) so that bribes can be competed down to zero; improving access to land titles; and making the right to information more effective. Law and order could be improved to strengthen the protection of property rights. Business institutions, chambers of commerce, and media can guard against government’s predation.

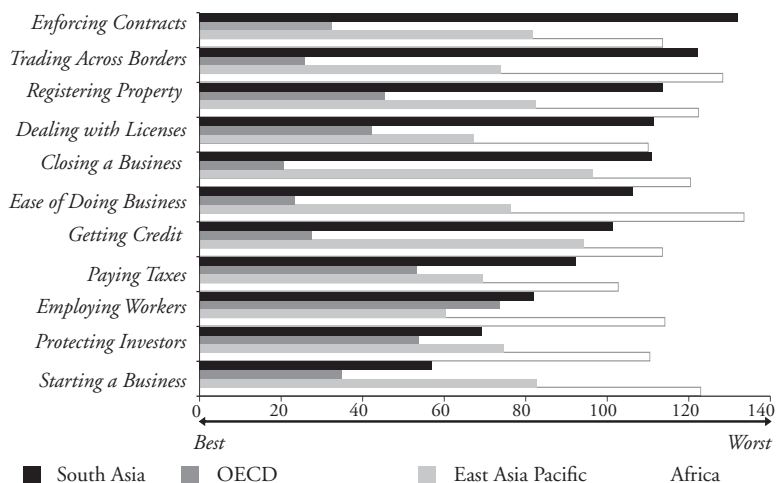


Figure 1.4: Ranks of Doing Business Indicators

Source: Doing Business Reports.

Note: Data are average of 2003 to 2007.

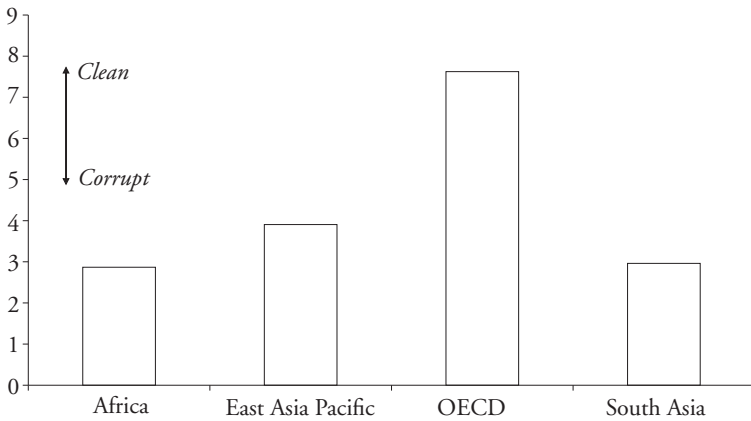


Figure 1.5: Corruption Perception Index in 2007

Source: Transparency International.

Notes: The CPI should be interpreted as a ranking of countries with scores ranging from 0 (highly corrupt) to 10 (highly clean).

Data are averages of sample countries in each region.

Labour Laws

A key regulatory weakness of South Asia is rigid labour laws that protect workers rather than jobs. South Asia has one of the most restrictive sets of labour regulations in the world. Figure 1.6 shows global perspectives on the restrictiveness of hiring and firing workers. India and Sri Lanka are rated very restrictive on hiring and firing. Average severance pay is 75 weeks in South Asia compared to 33 and 63 weeks in other parts of the world. However, not all South Asian countries suffer from rigid labour laws. Pakistan and Bangladesh have market-friendly labour laws. The World Bank has developed an index, ranging from 0 to 100, of how hard it is to let go workers, where 0 denotes the easiest and 100 the hardest. India scores 90 on this scale while Bangladesh and Pakistan score 20 and 30, respectively, and Bhutan scores 0.

The adverse implications of rigid labour laws for the manufacturing sector are illustrated by the experience of India. The Indian manufacturing sector includes a much larger share of relatively small firms than the manufacturing sectors in other economies. This is shown in Figure 1.7 which compares the size distribution of firms in India to that in China, Brazil, and Indonesia.

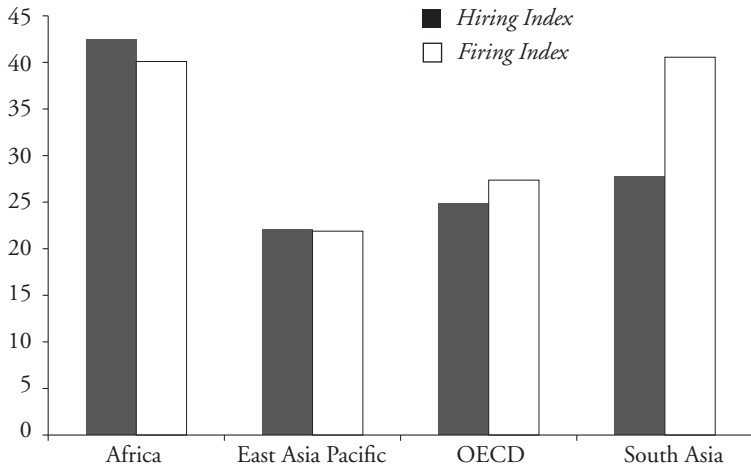


Figure 1.6: Hiring and Firing Indexes

Source: Doing Business Reports.

Note: Data are averages of 2003 to 2007.

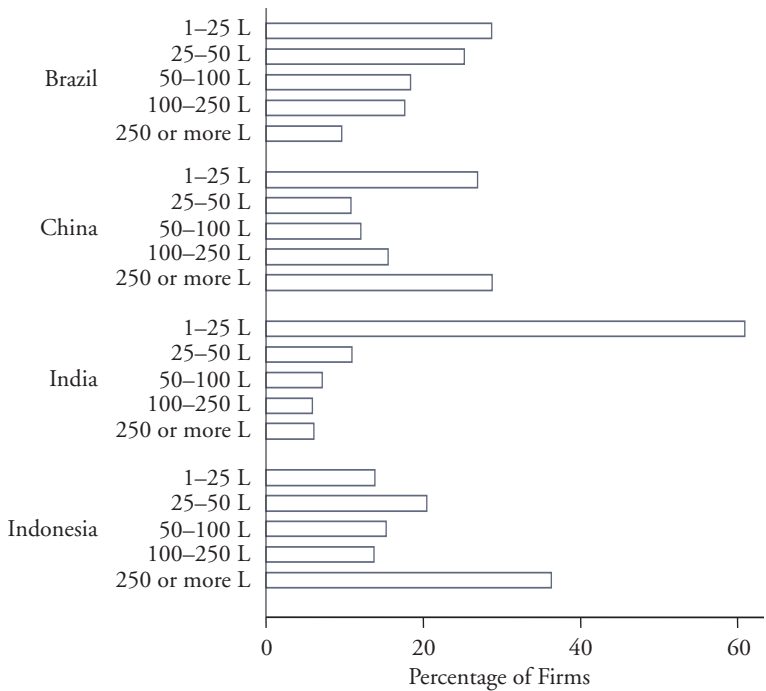


Figure 1.7: Percentage of Firms by Size Group across Countries

Source: Investment Climate Surveys for Brazil, China, India, and Indonesia.

In a recent study, Fernandes and Pakes (2008) examine the issue of factor utilization in the Indian manufacturing sector. They find that labour is underutilized in manufacturing firms in the formal sector in India. That is, given the amount of capital used by firms, their productivity, and the cost of labour, firms are employing less labour than they would employ if they faced no hiring and firing costs. In contrast, there is over-utilization of capital in Indian firms. One important implication of this finding is that the reduction of labour restrictions will create more employment in the manufacturing sector. More generally, several studies (Beesley and Burges 2004; Aghion and Burges 2003; Kochar et al 2006) have shown that labour restrictions tend to hurt investment and productivity in India's organized manufacturing sector.

Conflict Management

The South Asian region suffers from a high degree of conflict, both within and across countries. Nepal witnessed a long-running civil war from 1996 to 2006, in which more than 12,000 people were killed. Afghanistan and Sri Lanka have also been the scenes of long-running conflicts. The provinces of Balochistan and North West Frontier Province (NWFP) in Pakistan are widely regarded as conflict-ridden places. In India, 749 people were killed in incidents of Naxalite violence in 2006; such incidents have been reported from 13 different states, and 70 per cent of these deaths occurred in the lagging regions of Chhattisgarh, Jharkhand and Bihar.¹⁸ More than 70 million people have been displaced by conflict in South Asia and incidents of terrorism are also on the rise across these countries.

There are several potential causes for a higher degree of conflict in the lagging regions, many of which have been found to be significantly associated with the incidence of conflict in cross-country studies. These include geography, economic factors such as poverty and unemployment, social diversity, and institutional factors such as poor property rights, landlessness, inequality of access to public infrastructure, and weak state capacity in the delivery of services. Within South Asia, areas with historically poor property rights have been found to display higher levels of violent crime.¹⁹

¹⁸ Asian Center for Human Rights (2007).

¹⁹ Banerjee and Iyer (2005).

District-level research in Nepal finds that geography and poverty are very significantly associated with the intensity of conflict, while measures of social diversity based on caste or language play a much smaller role.²⁰

In addition to dealing with conflict within countries, the region also suffers from significant conflict across countries. Two well-known examples are the long-drawn conflict between Pakistan and India over Kashmir, and the Afghan-Pakistan conflict over the Taliban issue. Less open yet unfortunate is the low-level conflict between Bangladesh and India over the perceived rise of terrorism in the region. The development costs of these conflicts have been tremendous in terms of loss of life, restrictions on people to people contact across countries within the region, high financial cost of military and other security-related operations, and the loss of benefits from lack of economic, social, and political cooperation. Cross-country conflict is the most important reason why South Asia is the least integrated region of the world.

What can South Asia do to transform conflict into cooperation? South Asian countries have implemented different measures to control internal conflict. In most countries, the official government policy has been to combine implementation of development schemes with the deployment of additional security forces. By and large, efforts to curb ethnic conflict with force appear to have exacerbated the intensity of conflict. In Nepal, after several years of trying a military response, the government signed a peace deal with the Maoist rebels in 2006.

The challenge for South Asia is how conflict can be converted into cooperation and the resources channeled towards achieving growth and sharing the benefits of growth with minority and disadvantaged groups. Nepal's success in reaching a peace accord with the Maoists and bringing them into the democratic process sets a good example for other countries regarding how to address long-term conflict at its source. Ensuring good governance that allows participation and voice of all citizens in the development effort can play a key role in reducing in-country conflicts. Better economic cooperation and stronger trade relations can be helpful in reducing cross-country conflicts.

²⁰ Quy-Toan Do and Iyer (2007).

INCLUSIVE GROWTH

Can South Asia achieve both high and inclusive growth? Good examples of factors that can contribute to high and inclusive growth are labour mobility, better job creation, skills and education, and resolution of internal conflict. Inclusive growth is not about balanced growth but shared opportunities. Spatial disparities in growth are inevitable when growth accelerates and countries make the transition from being an agricultural to an industrialized economy. Regional policies to support balanced growth do not work, as shown by India's experience. In the 1960s, India promoted uniformity in economic production, which turned out to be

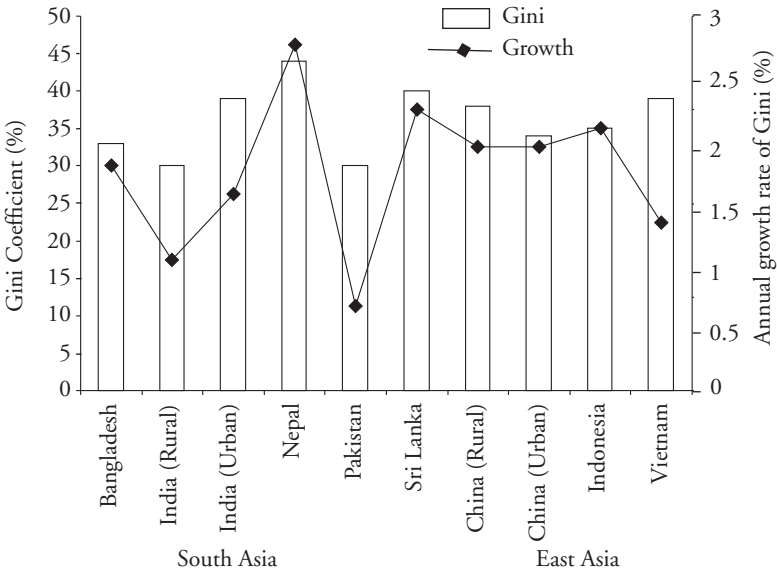


Figure 1.8: Gini Coefficient (the latest available) and the Annual Growth Rate of Gini (%)

Source: World Bank staff estimation using household income and expenditure surveys of each country.

Note: Source data for Bangladesh—HIES 1991–92 and 2005; Pakistan—PIHS 1998–99 and PSLM 2005–06; India—NSSO 50th and 55th rounds; Sri Lanka—HIES 1990–91 and 2002; Nepal—NLLS 1996–97 and 2003–04. Data for all East Asian countries are in the World Bank's data department; and survey years are 1993–2004 for China; 1999–2004 for Indonesia; 1992–2004 for Vietnam.

expensive.²¹ Since the liberalization of these policies in the 1980s, the dynamics of growth have changed from ‘race to the bottom’ to ‘race to the top’. Is South Asia’s growth inclusive? Is growth creating jobs? Do people have skills to support and sustain high growth?

Figure 1.8 shows economic inequality as measured by the Gini coefficient.²² Inequality in South Asia is rising but less than in East Asia.²³ This is apparent when comparing the growing inequality between the rich and the poor in India compared to China. Nepal and Sri Lanka have the highest levels of inequality in South Asia. They also have the highest growth in inequality. Pakistan and rural India have the lowest levels of inequality. Is inequality between regions, that is, spatial inequality, also rising?

For most countries, growth in inequality across leading and lagging regions is rising faster than growth in inequality across individuals. Figure 1.9 reports regional inequality at the sub-national level using the Theil inequality measure.²⁴ The figure shows that *regional* inequality is rising at a much faster pace than *pure between-individual* inequality in all countries except for Nepal and, to some extent, India. Regional inequality generally increases as an economy shifts from agriculture to manufacturing. There are some signs of regional convergence in Nepal and India, as the extremely poor areas in these countries have achieved faster growth rates in consumption. Poorer parts of Nepal and India have benefited from remittance flows as workers have moved to areas of higher economic density either at home or abroad.

²¹ Economic imperatives cause economic activity to concentrate in some regions and not in other regions. Government efforts, based on tax breaks and subsidies to capital and labour, to alter the location of economic activity are likely to be ineffective or very expensive. Instead, government policy should focus on addressing problems of distance and divisions, and allow the market to respond accordingly.

²² We are grateful to Nobuo for this work.

²³ Based on their survey of evidence of over 50 developing nations, Kanbur and Venables (2005a, 2005b) argue that the uneven spatial impact of trade and globalization played a major role in the increase in regional and urban spatial inequalities in developing countries in recent years. Moreover, they argue that, in addition to geographic remoteness, the backward regions and rural areas suffered from an inequitable distribution of infrastructure, public services, and policies that constrained the free migration of people from backward places.

²⁴ The Theil inequality measure has a convenient property: it can be decomposed into inequality across areas, or ‘*regional* inequality’, and inequality between individuals, after controlling for the former, or ‘*pure between-individual* inequality’.

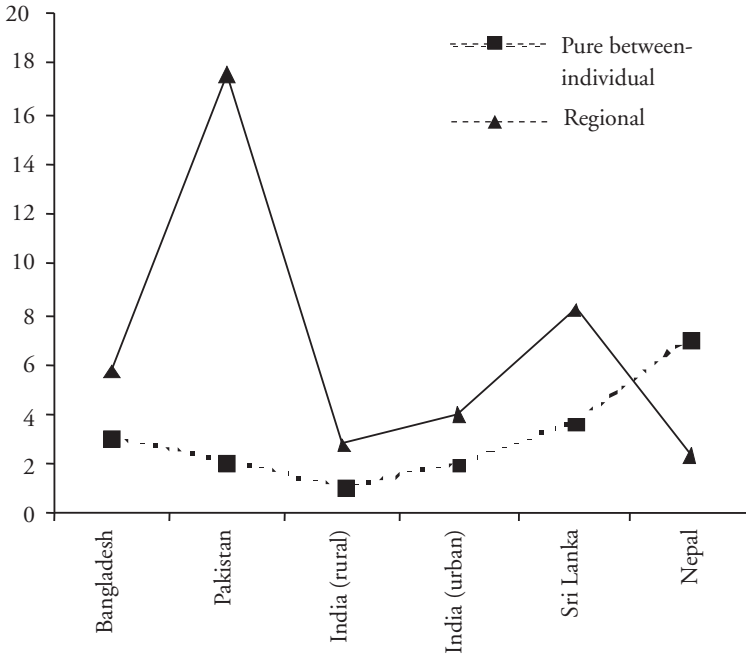


Figure 1.9: Annual Growth Rate of Regional Inequality and the Pure Individual Effect for Selected South Asian Countries

Source: World Bank staff estimation using household income and expenditure surveys of each country. Data sets are the same as figure 1.1.

Notes: The sub-national level indicates division for Bangladesh; province for Pakistan and Sri Lanka; state for India; and region for Nepal.

For all countries but Pakistan, per-capita household expenditures are used for computing Theil inequality measures. For Pakistan, household expenditure per adult equivalent is used

The strongest indicator of inclusive growth is poverty reduction. As mentioned earlier, all South Asian countries have reduced poverty. Going forward, however, poverty reduction is likely to be complicated by the fact that income is increasingly concentrated in the leading regions, while poverty is concentrated in the lagging regions. Most lagging regions in income terms are also lagging in terms of having higher than average incidence of poverty. Based on national sample surveys and national poverty lines, there are more than 330 million people in South Asia who are considered poor. An estimated 200 million poor people live in the lagging regions. The

evidence also suggests that lagging regions are growing slower than leading regions. What can South Asia do to achieve high growth and reduce poverty given this spatial asymmetry between income per capita and poverty incidence?

Migration

Labour mobility is the natural mechanism for promoting faster and inclusive growth regionally and globally. In the case of South Asia, remittances are almost twice as large as private debt and portfolio equity, three times as large as foreign direct investment, and seven times as large as official development assistance. It is estimated that over 22 million people, or 1.5 per cent of the South Asian population, live outside their country of birth. Intra-regional migration is the largest share of international migration movement in South Asia (mostly illegal), while high-income non-OECD and high-income OECD countries are the second and third largest destinations. In 2007, the top recipient countries of recorded remittances in South Asia were India (US\$27.0 billion), Bangladesh (US\$6.4 billion), and Pakistan (US\$6.1 billion), collectively making the South Asian region the third largest regional recipient of remittances. As a percentage of GDP, remittances are most important for Nepal and Bangladesh. Migration contributes to the movement of surplus labour from rural to urban areas, from lagging to leading sectors, and from lagging to leading regions. This promotes higher productivity, wages, and inclusive growth.

The flow of resources and products to areas where demand and prices are higher allows more efficient use and higher incomes. In India, inequality is emerging between the populous northern and interior states where there are few jobs, and the coastal states that are creating more jobs but face labour shortage, due to low labour mobility. Labour mobility in South Asia is low within countries. For example, over 96 per cent of the Indian population lives in the state in which they were born. The parallel number is dramatically lower for China, Turkey, Mexico, and other large developing countries. Among the factors that inhibit labour mobility are internal distances, poor infrastructure (such as roads), cultural factors (such as language), poor education, and *location*-specific safety net programmes such as rural employment guarantee schemes in India, which prevent migrant workers from using safety nets in states where they were not born.

Given the positive role of migration and remittances in reducing inequality and poverty, policy efforts should focus on removing restrictions on migration and to lower the cost of sending remittance by facilitating money transfer through official channels. South Asia can learn from the positive experience of countries such as Brazil in helping reduce the cost of sending remittances.

Job Creation

Job creation is good for both growth and equity. South Asia has a young population (Figure 1.10) and the lowest female participation rate in the labour force (Figure 1.11). The demographic dividend will result in more workers entering the labour force in the future. More than 150 million people will enter the prime working age population over the next decade. Labour supply growth is 2.3 per cent per annum in South Asia, above the global average of 1.8 per cent. The increased bulge within the labour force can contribute to additional growth; so will the increased female participation in the labour force. This will also contribute to equity as, in the absence of unemployment and pension benefits, employment of a family member is the biggest safety net for families in South Asia. Labour markets are the main channels through which economic growth is distributed across people. How has South Asia done in job creation?

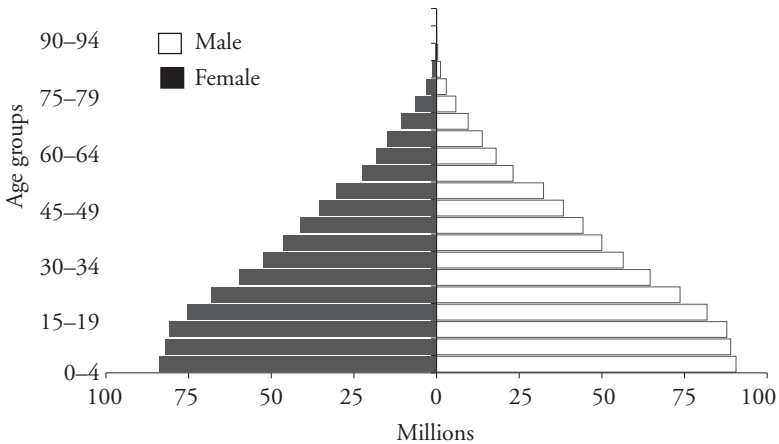


Figure 1.10: South Asian Population Structure in 2005

Source: UN Population Database.

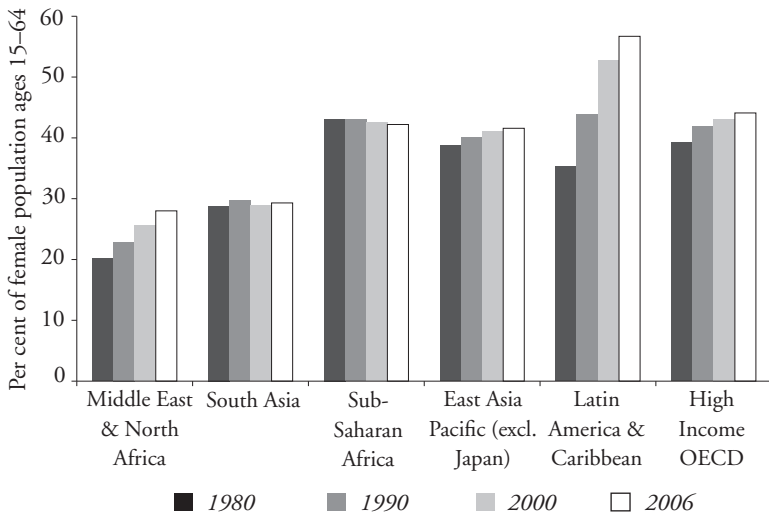


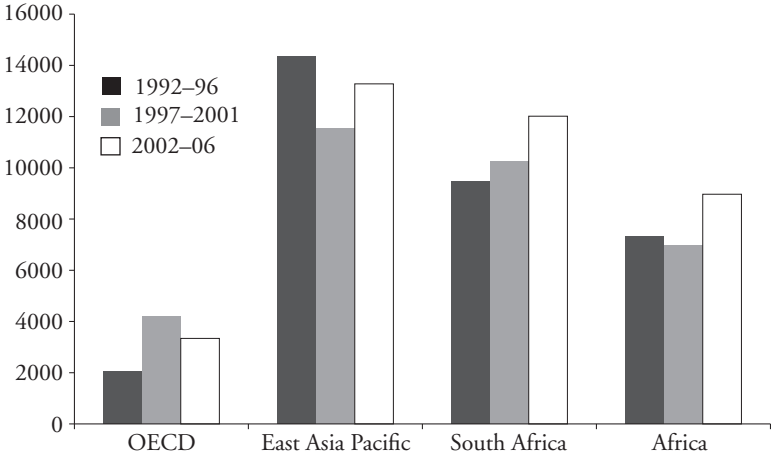
Figure 1.11: Labor Force Participation Rate, Female

Source: World Development Indicator.

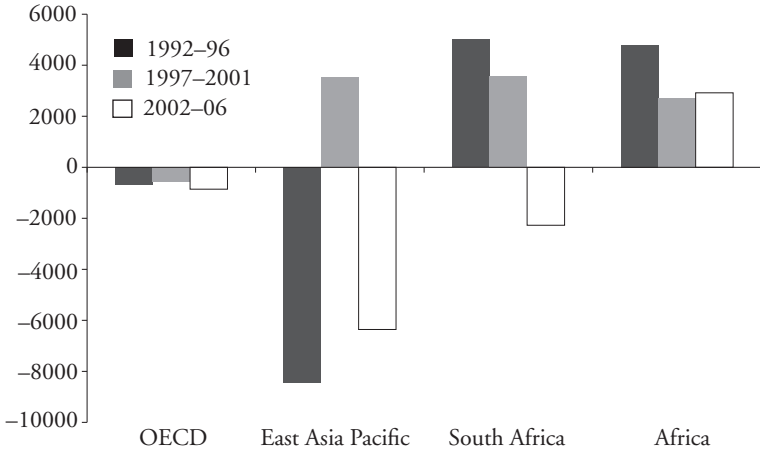
In terms of numbers, South Asia is one of the fastest job creators in the world. Figure 1.12 presents data on total job creation (formal and informal sectors). South Asia is the second fastest job creator in the world, after East Asia. Job creation has increased over time. Over the period 2000–5, India generated 11.3 million net new jobs per year, on average. The figure was 7 million in China. In India the employment growth in 2000–5 was 2.8 per cent while in China it was 1 per cent.²⁵ The largest job creation in South Asia is in the services sector, but the manufacturing sector is also showing progress. Jobs in the agriculture sector are shrinking in South Asia. As the agriculture sector modernizes, and farmers move up the value chain, and make better use of retail networks, storage facilities, refrigeration facilities, and transportation facilities from the fields to the markets, more jobs are likely to migrate from agriculture to other sectors.

²⁵ Nearly 90 per cent of job creation in India is in the informal sector compared to only 50 per cent in China. In addition, the growth in formal employment in urban China is much higher than the growth in formal employment in urban India (3.1 per cent versus 1.7 per cent in the last five years).

Job Creation in All Sectors
(in thousand of workers)



Job Creation in Agriculture
(in thousand of workers)



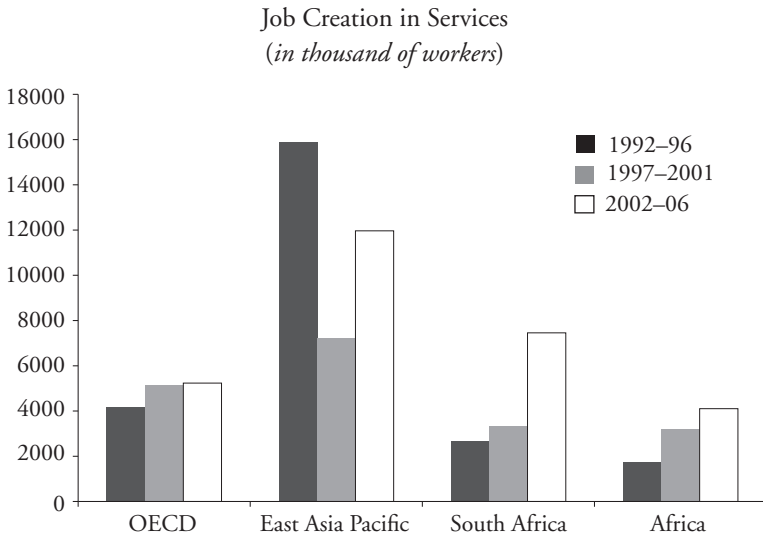


Figure 1.12: Job Creation

Source: International Labour Organization, 2008.

Notes: All data are averages of respective times.

Job creation is defined as difference of total employment in t and $t-1$.

Includes formal and informal sectors.

From the numbers it will appear that South Asian economies are modernizing and the transfer of labour from agriculture to services and manufacturing is a sign of this transformation. Yet this is misleading. In addition to country differences, even for the most dynamic economy, India, the employment story is not a happy story. Overall, the deceleration of real wage growth—and even decline of urban casual wage—in India suggests that it is the supply of workers and self-employment that is driving job growth. The employment challenge facing South Asia is how to create ‘good’ jobs in sufficient quantity so as to productively absorb the increasing number of people entering the labour market.²⁶ A large number of jobs being created in South Asia are ‘bad’ jobs. Nearly 90 per cent of jobs created are in the informal sector of the economy, with difficult working conditions and low wages. The absence of unemployment insurance and limited safety nets mean that open unemployment in South Asia is limited. Most people accept any job that allows them to survive. These people are employed but they have a ‘bad’ job.

What will create ‘good’ jobs? First, rapid growth is essential to create more and better jobs. Second, restrictive labour laws need to be reformed to remove barriers to creating jobs in the formal sector. Labour market reforms should be accompanied by improved social protection. Third, for South Asia to accelerate growth and create good jobs, it will require much better training and education to produce more skilled labour.

Technology, Education, and Skills

South Asia has a large technology gap. In developing countries, innovation should be interpreted as knowledge that is new to the country, although not necessarily new to the world. This means that an important element of innovation is not only the investments in domestic research and development (R&D) and its output such as technical and scientific papers and patents, but also the extent to which an economy taps into global knowledge through trade, direct foreign investment, technology transfer, foreign education and training, etc. South Asian economies have been weak in both the domestic innovation effort (except India) and in the extent to which they have tapped into global knowledge. Figure 1.13 shows how

²⁶ See Bourguignon (2005) for definition of good and bad jobs.

South Asia compares to the other five developing country regions (Africa, Europe and Central Asia, East Asia, Latin America, Middle East, and North Africa), and the developed country triad (Europe, Japan, and the United States) on an index of innovation that includes both components. Within South Asia, India does better than the other countries because it does have critical mass in R&D, although it is not very integrated into global markets.

On a broader measure of the knowledge economy²⁷ that includes not only innovation but also the basic economic and institutional regime, education and R&D, South Asia does not do any better. Figure 1.14 shows the results, where the bars indicate the relative score on each of the four components. In this broader measure, Sri Lanka is the South Asian country that has improved its performance compared to its position in 1995. It does better than India, particularly because of much higher scores on education, and on the basic economic and institutional regime. For South Asia as a whole, the knowledge gap is substantial.

There is a large policy agenda for addressing South Asia's technology gap. The main priorities include: tapping into global knowledge; creating new knowledge through investments in R&D; disseminating existing knowledge; and networking and collaboration among South Asian countries (Dahlman 2007).

Adoption of new technology suggests the need for continuous learning over the work-life. How educational and training systems respond to these challenges will have far reaching implications for economic growth and competitiveness of South Asian countries, and for income growth, employment, job creation, and poverty reduction.

The educational stock of the workforce in South Asia is still low compared to other parts of the world, in particular East Asia (see Figures 1.15 and 1.16 on secondary and tertiary education). There is both a 'quantity' and a 'quality' challenge at all levels of education. Progress on the educational front has been unequal over time across countries. The countries in the region are making efforts to upgrade the education levels of the population. Yet this progress is rather slow and the focus has been mostly on increasing access. The demand for quality education is growing. The returns to higher secondary and tertiary education have remained high and even increased relative to lower schooling levels, especially in business services as compared to

²⁷ See Dahlman (2007) for more details on this concept and its measurement.

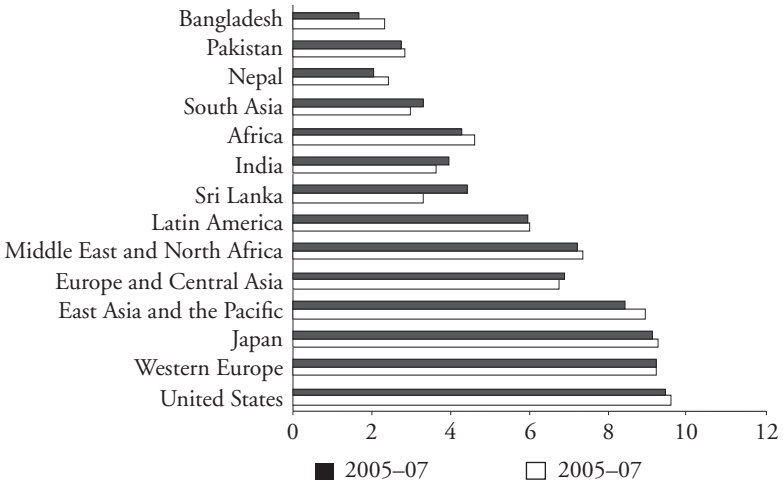


Figure 1.13: Innovation Index

Source: World Bank (2008a)

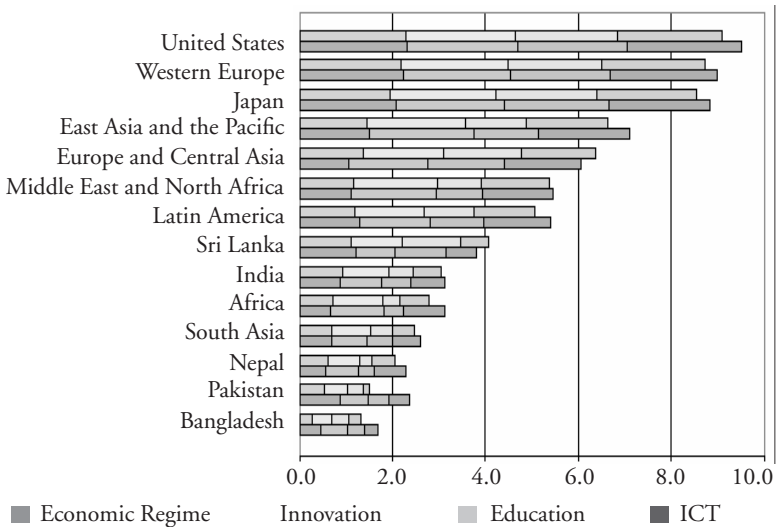


Figure 1.14: Knowledge Economy Index

Source: World Bank (2008a).

Note: For each country grouping, the first bar is the score for the most recent period (based on indicators for 2005-7), while the lower bar is the score for 1995.

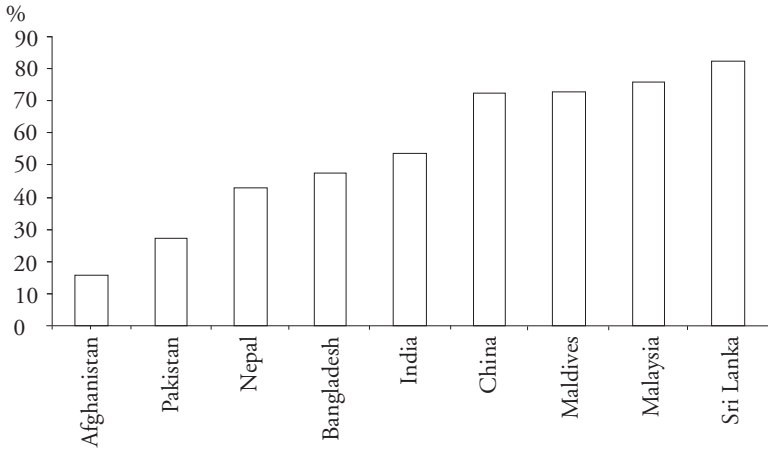


Figure 1.15: Gross Enrollment Rates of Secondary Education, 2004

Source: Riboud and Tan (2008).

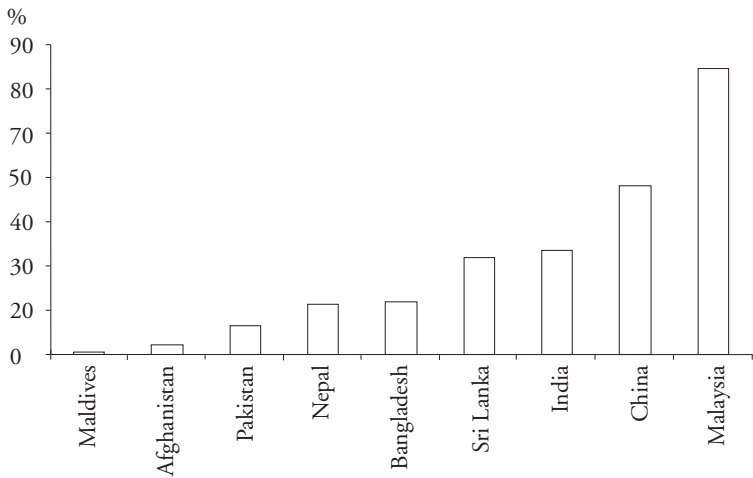


Figure 1.16: Gross Enrollment Rates Tertiary Education, 2004

Source: Riboud and Tan (2008).

industry. The inability to meet the fast growing demand for skills is an indication that education policies have not yet responded adequately.

Evidence also suggests that South Asia invests inadequately in skills development. The estimated returns to post-school training are high and comparable to returns to formal schooling. Despite high returns, the efforts to provide post-school training is low, being

lowest in Pakistan and highest in Sri Lanka, with other countries falling somewhere in between.

Regarding employer provision of in-service training, the story is similarly disturbing; South Asia lags behind other regions. Evidence suggests that in-service training in manufacturing firms in South Asia is among the lowest in the world, which is less than half of the average for Europe and Central Asia, East Asia, and Latin America and the Caribbean (Figure 1.17). The deficit is particularly large when South Asian countries are compared to their competitor countries in East Asia, such as Malaysia (where the incidence is twice as high) and China (where the incidence is three times higher). A low incidence of training has negative implications for the industrial competitiveness of countries in the region.

Policymakers are increasingly aware that an educated and trained workforce is critical for technological change and creating a knowledge economy. But countries are yet to put education and training at the top of their priorities. For most countries, education and training policies and programmes are still not responsive to the needs and signals from the labour market. In the low-income regions, the immediate challenge for South Asia is to promote basic education, which would enable its labour force to find employment outside of agriculture and

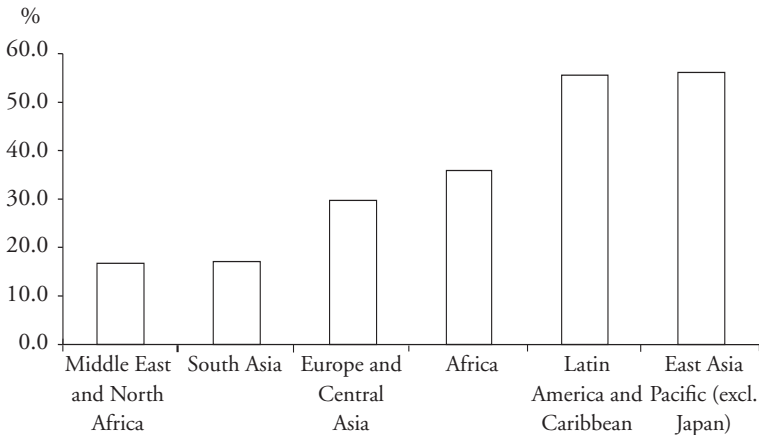


Figure 1.17: Regional Comparisons of In-Service Training in Manufacturing

Source: Riboud and Tan (2008).

especially in industry. In the high-income regions, the challenge is to shift emphasis to higher levels of education without neglecting the unfinished education agenda at the primary level. There is also considerable scope for improving the effectiveness of public vocational training institutions in the region, including greater partnership with the private sector to develop and deliver skills training demanded by employers and by the labour market. Promoting inclusive growth would call for increased emphasis to improve workers' skills, by taking steps to improve the training institutions and enhancing incentives for both firms and workers to invest in life-long learning. This needs to be complemented with well-targeted support to improve learning opportunities for the low-skilled workers, who have less access to on-the-job training than skilled workers.

REGIONAL PUBLIC GOODS

High growth in South Asia cannot be sustained without better management of natural disasters and regional public goods. Figure 1.18 shows the impact of natural disasters in terms of the share of

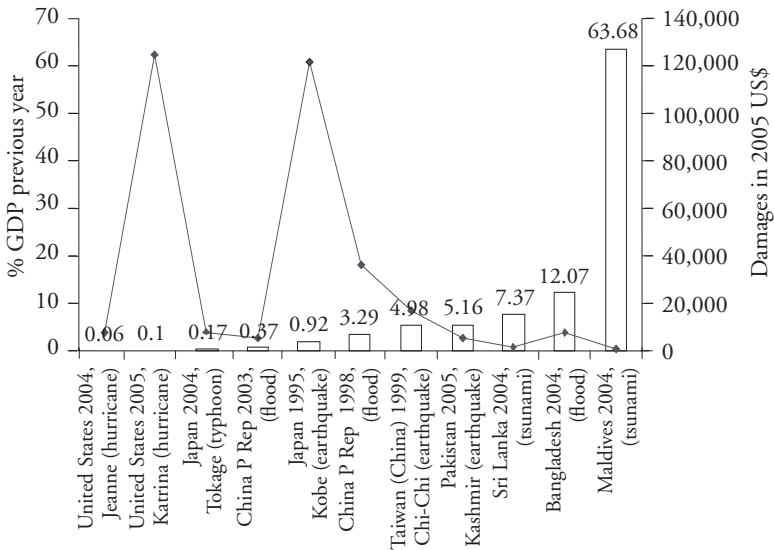


Figure 1.18: Percentage of National GDP Damaged by Select Natural Disasters

Source: <http://www.unisdr.org/disaster-statistics/top50.htm>

GDP lost. South Asia has lost a significant amount of its GDP because of natural disasters. This loss has been significant for Maldives, Bangladesh, Sri Lanka, and Pakistan. The impact of natural disaster is particularly strong in South Asia because of its high population density. The losses are typically not insured in the financial market. It is the poor who are adversely affected by disasters.

Benefits of regional cooperation in water and climate change would be immense in South Asia. From the Himalayas, where glacier melt is already changing water flows in ways that remain to be understood, to the coastal floodplains of Bangladesh and Pakistan, South Asian countries need to adapt to climate change. The melting of Himalayan glaciers leading to the disastrous prospect of reduced water availability in the South Asian rivers, the frequency of floods and cyclones, and the evidence of rising sea level have given South Asia a wake up call for collective action for managing climate change to reduce vulnerability and poverty over the longer term. This can provide the much-needed trigger for opening a dialogue on regional water cooperation. Cross-border cooperation on water between India, Bangladesh, and Nepal offers the only long-term solution to flood mitigation, and would benefit over 400 million people. The benefits of cooperation are clear. For example, watershed management and storage on Ganges' tributaries in Nepal could generate hydropower and irrigation benefits there and flood mitigation benefits in Nepal, India (Uttar Pradesh, Bihar), and Bangladesh; water storage in northeast India could provide hydropower and flood benefits in India and Bangladesh; and both would also provide increased and reliable dry season flows. There is an emerging and promising opportunity on the specific cooperation between India, Nepal, and Bangladesh on the Ganges.

More generally, regional cooperation can be instrumental in facilitating the design and implementation of effective country-level strategies for addressing a range of global public goods, improving water management, disaster management, climate and environmental management, combating HIV/AIDS, narcotics and drug trafficking, and security and arms trade. Geographic proximity and common borders mean there are areas where common action by neighbours will eliminate negative externalities, reduce transaction costs of monitoring and implementation, and allow learning from sharing of best practices. South Asia's track record on regional cooperation

is not without any success. The Indus Valley Water Treaty between India and Pakistan is an example of successful regional cooperation that helped to bring about the green revolution in agriculture in the two Punjabs. The challenge is to build on this success.

South Asia needs to strengthen regional governance institutions. This is vital for managing the provision of regional public goods and management of common pool resources. South Asia suffers from numerous prisoners' dilemmas such as free riding and overuse of resources, because of a lack of effective institutions. This problem can be overcome by engaging the government, the private sector, NGOs, and communities in formal and informal social institutions (networks, norms, and sanctions) based on collective action. Regional cooperation initiatives could unlock the growth benefit of South Asia's geography and people, consistent with improved management of regional public goods. Better regional cooperation can also contribute to reducing regional conflicts, which will remove an important long-term constraint to growth.

CONCLUSION

The challenge of South Asia to further accelerate growth and strive for middle income status is a 'stretch target' but not an impossible target to attain. South Asia's transition from low income to middle income status is not only an enormous economic challenge; it is also a major social and political challenge. There is no magic formula that will propel the region towards higher growth rates. This is not a reason to give up trying. As South Asia's experience since 1980 shows, reforms of policies and institutions can yield large supply responses. There is ample room to achieve and sustain higher growth rates if South Asia can take advantage of its geography and demography and accelerate the implementation of second generation reforms. These include market integration, both globally and regionally; inclusive growth that will convert the 'demographic dividend' in South Asia into a 'window of opportunity'; improved infrastructure that will behave like second nature geography and propel higher and inclusive growth through improved connectivity, allowing its benefits to be shared widely; strengthened institutions that will result in a stronger business environment and less conflict and corruption; and mainstreamed management of regional public goods into the national development agenda.

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SOUTH ASIA STORY OF DEVELOPMENT OPPORTUNITIES AND RISKS*

Jeffrey D. Sachs

The real challenge is to make our political processes work at something that even remotely resembles the efficacy of our technological know-how right now, in getting us connected from miles apart. Bringing together the business community of the South Asian region is one of the most promising ways forward. We have a remarkable mix of positive progress and trust, while at the same time, certain areas are experiencing stagnation. The region presents great opportunity, but also enormous risk. On the one side, we have fast economic growth, as is absolutely the case in India—one of the fastest-growing economies in the world, an economy that has now grabbed the attention and captured the imagination of the world in a way that China had before. At the same time, several other countries in the South Asian region are also experiencing brisk economic growth. Yet what we also still see is a considerable amount of turmoil, a failure to complete peace processes in several parts of the region, and a failure to achieve the cooperation in economic enterprise within the region, with skills being divided along ethnic, or sectarian, or political lines. I am a big believer in business communities everywhere being in the lead in solving such problems. I believe that this will be true for South Asia as well.

I spend most of my time on the Millennium Development Goals (MDGs) project in Africa, which has the highest poverty rates in the world, and where economic growth has not come in the way that

*This is an abridged version of the speech delivered by Professor Jeffrey D. Sachs, Director, the Earth Institute, Columbia, through video conferencing to Mumbai on 18 February 2007.

it has to South Asia. But it is no secret that South Asia remains the region with the largest absolute number of people living in extreme poverty. While the count is debated, it is still over 300 million people in South Asia, and there may be as many as 400 million people living in what we would call extreme poverty, meaning poverty that is so severe that life is a struggle for survival.

The good news, of course, is that South Asia has made a tremendous amount of progress over the last 25 years, unlike sub-Saharan Africa. In South Asia, the rate of extreme poverty has come down from around 50 per cent back in the 1970s, to perhaps 25 to 30 per cent today. But in a region of 1.5 billion people, it represents a considerable number of people who are in extreme poverty. While there has been marked improvement in the important indicators—life expectancy, child mortality rates, literacy rates, etc., it is also true that the levels of those critical indicators, which really signal the poverty of life, show that South Asia is still between where it once was and where it aspires to be. Life expectancy in South Asia remains between 60 and 65 years, while in high-income countries, life expectancy is pushing beyond 80 years. Under-5 mortality rates in the high-income countries are well under 10 for 1,000 live births, whereas in South Asia they remain at 80 to 100. Of course, these statistics are averaging over very diverse regions, as well as disparities across countries, to give an overall picture.

We see many of the social problems still continuing. So, from my point of view as one who focuses on meeting basic needs and achieving the MDGs, South Asia again presents a mixed picture: some significant progress, still vast numbers of extreme poor, and some really notable shortcomings. Very high undernutrition rates remain a problem throughout the region. Children who do not get proper nutrition during the infancy stage and early years of life, constitute about one-fourth of the children of the region. This is shocking because the more we learn, the more we know that early nutrition for children is critical for a healthy and safe life, for cardinal and physical development, and that undernutrition not only affects children's ability to learn and develop, but also increases the risk of diseases—cardiovascular disease, diabetes (which is now an epidemic in South Asia) and many other serious problems.

However, the region's potential for growth cannot be denied, given the level of progress made so far. I would like to discuss some

of the challenges, as well as their likely solutions, and what the role of the business community can be. The rate of poverty still signals intense pressures, particularly in the countryside. There is much urban poverty, too, but the concentration of poverty in South Asia remains in the countryside, partly because that is where most people live, and partly because the rates of poverty are higher in rural areas than in urban ones. The starting point in looking for the causes is the incredible population densities in South Asia. This has been true for two millennia now, but it has become much more extreme in the past 50 to 100 years. South Asia's land-to-person ratio is about the lowest in the world, and it continues to decline. So there is rapid population growth, particularly in rural areas, in the face of what are already extraordinary rural densities and extraordinarily small land sizes. Not surprisingly, the poverty head count is strongly correlated either with landlessness in rural areas or very small farm sizes—sometimes 0.1 hectares or 0.2 hectares.

We also find that the population growth continues to be high because the fertility rates of women remain very high. Even though there has been much demographic transition in several key indicators, the total fertility rates in rural South Asia remain, perhaps, four children per woman. It implies that each woman is raising, among surviving children, on an average, perhaps 1.5 daughters per mother, and that means continued rapid population growth. If today the population is 1.5 billion in South Asia, the United Nations' medium forecast projection for the region is about 2.5 billion people by mid-century, which will make it the most crowded place in the world, and where the farm sizes will decline.

A third aspect is the still low levels of social investment in critical areas, particularly education and health, to which I will come back in a few minutes. Though it is true that the overall literacy rates have gone up, the number of young girls who do not finish primary school, who do not become functionally literate, still remains very high, and that is part of the syndrome of their poverty, and is part of the syndrome of the high fertility rates that continue as well.

The fourth point that I would mention is especially relevant not only in the light of crowding, but also in the light of global changes. South Asia is extraordinarily vulnerable to environmental risk, and I would put water risk right at the top. In fact, the water challenge in South Asia is so significant that nobody can yet find an answer. It is

not only a grave problem, but also highly complex and multifaceted. Many parts of South Asia are inherently water-stressed regions. Many parts of South Asia depend on rain-fed agriculture, which is highly vulnerable, and life may become more vulnerable with global climate change. Also, hundreds of millions of people depend on groundwater. One of the great revolutions of the last 25 years is the pumping from bore holes in the Ganges Valley, the Brahmaputra, and the other great river systems in South Asia. However, it is now leading to a collapse of water tables. In Punjab and some other places, the water table is now down to 500 feet below the surface, and increasing numbers of dry bore holes are leading farmers to utter desperation. But let me add one more major consideration on the environmental side, and that is global climate change, which is so well appreciated now. It was the subject of the major UN study by the Inter-Governmental Panel on Climate Change (IPCC) led by Dr R.K. Pachauri of The Energy Research Institute (TERI) in New Delhi. The IPCC has confirmed that human-made climate change is accelerating, and it threatens the water situation throughout South Asia in a number of ways. But truly the one that is most important is deforestation, which would change the monsoon patterns in ways that are difficult to know with certainty, but probably would result in more intense monsoons over shorter periods of time, while dry areas will be getting still drier because of higher temperatures. Perhaps most predictably, climate change is having a serious impact by melting the glaciers of the Himalayas, and is also changing the pattern of snow melt in the Himalayas so that the water flow is becoming lower and lower every spring in the whole region of the Indus, Ganges, Jamuna, and Brahmaputra rivers. As a result the great river systems of South Asia are changing their water flows significantly, which threatens the viability of summertime buoyancies in much of the region.

Hence there are very serious environmental challenges, which would be tough enough even if the population was not expected to increase by another 50 per cent. But to load these environmental challenges together with another, maybe 1 billion people in South Asia, is really a quite extraordinary challenge to face over the next 45 or so years.

At the same time, I see South Asia as a region with tremendous dynamism, and a tremendous potential for breakthrough. I see India as perhaps the fastest-growing major economy in the world right now, certainly catching up with China's economic development. A

tremendous surge in the number of qualified graduates and engineers and scientists is thrilling. But at the same time, some very major risks exist—first, the continuing population pressure, undernourishment, water stress, high fertility rates, and lack of investment in social and human capital. Second, the conflict situations prevailing in the region—domestic strife in Sri Lanka and Nepal, and the ongoing conflicts between Pakistan and India—pose a major challenge. The risks are exacerbated due to the region being extraordinary in social, ethnic, linguistic, and religious divisions.

While outlining the risks and opportunities, I believe that there are practical solutions to all these problems. I believe that the South Asian Association for Regional Cooperation (SAARC) and the business community have to be in the lead. SAARC is critical because regional integration is going to be the only way to find solutions to these problems. Regional integration is the only solution for the conflicts, for the environmental challenges, and for economic development through increased trade, just as it was in Europe. At the same time, as the engines of growth, the business community needs to continuously be in the lead to tell politicians to get serious, make peace, build infrastructure, and invest in people, so that business can get on with providing practical solutions.

First, I would put great stress on real integrated development of rural areas. This is where hundreds of millions of extremely poor people live, and where their isolation and lack of services is profound. The evidence is overwhelming. If roads and power, schools, and clinics are available in rural areas, life can be transformed. Not only the agricultural productivity will rise sharply, but non-agricultural manufacturing and services can develop sharply in rural areas as well. One of the stunning facts of most of South Asia is the systemic underinvestment in rural areas for decades, and this has occurred in health care; to some extent in schooling, though that is improving; and in other basic services. The situation has improved gradually over the last decade. But when I look at the situation in rural India which I know best, the underinvestment, for example, in health care remains remarkable. India and the rest of South Asia still spend less than 2 per cent of GNP on public health. Sometimes it is just 1 per cent of GNP. This is a completely inadequate level, and it then contributes to continuing high undernourishment, high child mortality rates, and high fertility rates.

Hence, increasing investments in rural areas, ensuring connectivity of all rural villages with roads, power, telecommunications, and the Internet, ensuring a network of public health facilities, ensuring that children are in proper public schools and are completing not just primary education but secondary education, are other important things. The rural areas tend to get underserved. But voices are being raised, and it is vital that the politicians respond. We know businesses can make money in rural areas as well. But that depends on a basic structure of public investment to build out the infrastructure, roads, power, telecom, Internet, public health, and education. All of this is essential, and I think it is a great challenge ahead.

The second big challenge is regional integration in trade. SAARC has been around for many years now, but its ability to make change has always been impeded by the poverty of the region. Regional integration could be the most crucial engine of growth for a true boost in South Asia. The market is vast. The ability to integrate from a feasible point of view is very large. Yet the amount of actual infrastructure for transport, communications, and port services within the region still lack significantly, and the trade data shows that the GNP for most of the SAARC countries remains between 10 per cent and 15 per cent, whereas it should be, perhaps, 25 per cent. The amount of trade that India or Pakistan or Bangladesh engaged in within the SAARC region is a tiny share of their total trade.

The lessons of Western Europe are profoundly important. We are now in the fiftieth year of the European Community, now the European Union (EU). This is the 50th anniversary of the Treaty of Rome. The worst wars in human history took place in Europe, and just in the shadow of those wars came a durable peace and the deepest economic integration among countries of any part of the world. If Germany and France can make peace, Pakistan and India can make peace and can have the same kind of dramatic progress of economic development because these are countries in Europe that had exhausted each other in mass murder and in mass war, and then decided enough is enough. SAARC should be able to put forward a development agenda that is truly dynamic and truly brings countries together at this point in the twenty-first century. I believe that regional integration would lead to a dynamism of trade of huge proportions and the export-to-GNP ratios would double within the SAARC region if proper infrastructure, air travel, fibre optic connections,

regular overland—rail, road, and bus—services are integrated, and roads are expanded and built between the regions. I think it would have a phenomenal effect, and I think it would be of huge benefit for the well-being of the people.

The third area, already mentioned, is regional environmental management. It may be true that there is no region that has greater environmental stress than South Asia by virtue of the mass deforestation, which is a centuries-old story. There is also the extraordinary population growth. The whole region is the most highly densely populated part of the world. I think it needs major thinking about how to handle the existing water stress and the coming water crisis.

Since all water supplies of the region are from river systems that cut across national boundaries, all being part of the Himalayan river systems, there is no way to solve the water problems except through peaceful development and peaceful integration. Even the safety of the water that is being used right now is not adequate because of arsenic poisoning and fluoride poisoning in some places. Those people in Bangladesh and elsewhere who are drinking water that is contaminated with arsenic through natural processes, leading to arsenic houses and to serious long-term diseases, need to be assisted urgently. This is an urgent problem, which the whole world should be helping with, not just forcing Bangladesh to solve it on its own.

The fourth point is related to the business community. My experience in many parts of the world has told me that business leadership plays a crucial role in political development, democratization, and peace. Business people are practical and only want expanded markets for doing their businesses. They do not really care too much who their customers are. I think that this is the right way to solve problems, to get down to business, create employment, and improve the economic prospects of people. The business community is also, to an important extent, the eyes and ears of their countries vis-à-vis the world community. They are out in the international markets ahead of the general public. They have to emphasize that this is a competitive world, that SAARC does not have time to lose, that the jobs that do not come to South Asia, go to East Asia, or that the opportunities for getting ahead are not going to wait on South Asia.

Let me finally conclude by saying it is not only South Asia, it is all of Asia where, I think, the world looks right now. Asia will

be the centre of gravity of the world's economy in the twenty-first century. It is where most of the people are. I find it thrilling to watch the Indian Ocean trade come back to life as it was during the great history of centuries past. Now Africa, where I work a lot, and South Asia and East Asia are all becoming integrated in regional trade again. This is a marvellous thing for a very large part of the world. It is a success on which the whole world depends. The initiatives being taken by the business community today can play an important role in furthering the integration of the trade between Africa, South Asia, and East Asia.

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IMPROVING GOVERNANCE IN SUSTAINING EQUITABLE GROWTH

Paul A. Volcker

When I recently set foot in India after 30 years, I came face-to-face with two facets of development. In Bengaluru, I saw companies at the leading edge, exploiting sophisticated technology to serve the needs of the most demanding clients, not primarily in India, or even South Asia, but all around the world. Notably, that includes large firms in the financial markets of my hometown of New York. Indian companies are working 24 hours a day, seven days a week, for businesses that simply cannot tolerate errors or breakdowns in service. On the other hand, I could also see the gap between the high-tech wonders of Bengaluru and life in Indian villages. Those villages may have a computer or two, but they lack even basic sanitary facilities or a reliable supply of potable water. Of course, the same contrast exists even in Mumbai—luxury hotels alongside urban squalor.

Hence the challenge is obvious: how to build upon and extend the unprecedented economic progress in the region, and to bring more of the potential benefits to the hundreds of millions still trapped in poverty, without the resources and education required.

A big part of what is required is hard, slogging work on the ground, in villages one by one. That is the kind of thing I see in government projects (supported by the World Bank) that are beginning to have a real impact in Maharashtra. Step by step, organizing the men and women to plan and participate, a more reliable water supply, and basic sanitary facilities are being developed. I am well aware of the success elsewhere in this region in encouraging sources of local 'micro' finance, an approach that seems beyond the capacity of established financial institutions.

That work is local by its nature. The particulars may vary nation by nation, state by state, and city by city. But there is important common ground, and the impulse here in South Asia to learn from one another and to work together is natural. It parallels efforts in other parts of the world to work towards regional integration. There are potential political, as well as economic, benefits. However, I want to emphasize that we cannot lose sight of a larger reality.

The recent success of India and South Asia, of China and Asia generally, of Eastern Europe, and now hopefully beginning in Africa as well, is not so much a matter of unique national or regional accomplishment, but of effective response to the opportunities provided by the globalization of business and finance. The fact is that almost all countries are growing—by one tabulation, every country grew in 2006, something that had not been true for almost half a century.

In part, that common success has been inherent in today's technology—the speed and economy of communication and transport. But it is also a result of deliberate policy. Barriers to trade and investment have been reduced and even removed, and international trade and finance have provided enormous impetus to growth. Initially, the benefits were largely seen in the opportunities to expand exports and build manufacturing, offered to low-wage countries in Asia and elsewhere. Today the main thrust has been on services, partly mundane but increasingly high-tech. These services are built on technology that was literally unknown two or three decades back; today, these high-tech services are the quintessential characteristic of the global economy.

Another characteristic of that economy is the immense growth and complexity of international finance. India and other South Asian nations for a while chose to wall off the international money markets. Then, as those markets opened, it was only a decade ago that some Asian economies were thrown into turmoil by financial crisis. It was a dramatic demonstration of the potential volatility of capital flows and exchange rates. There were lessons to be learned.

South Asia escaped the full force of that crisis, in part because its economies and markets were then not so financially exposed. Closing markets is no longer a real option. But I also believe emerging economies now have generally learned how better to protect themselves against the potential risks and volatility. That is a matter of recognizing the importance of sound fiscal and monetary

policies, of maintaining a cushion of reserves, and, most importantly, of avoiding inflationary excesses.

All of that is now common ground in economic thinking and public policy around the world. And the result is that South Asia is much better positioned to benefit from the flows of international capital.

Surely, the needs are obvious. Basic infrastructure needs to be improved to support growth, more electricity is basic both to industry and living standards, and a growing manufacturing industry requires access to large amounts of capital. Internal savings cannot meet all those needs. Even more clearly, the investments by internal savings do not bring with them the technology transfer, managerial strengths, and long-time perspective that, at its best, are characteristics of direct foreign investments.

There is not any real doubt that India and South Asia are now seen as providing potentially profitable opportunities for international business and finance. Steps have been taken here in India and elsewhere to facilitate flows of capital, and loans and direct investment from abroad have increased significantly—although still far below their potential. And there have been dramatic illustrations of the willingness and ability of Indian businesses themselves to participate in the rationalization of manufacturing and services on an international scale.

What needs particular emphasis is another aspect of participation in global markets. It is of key importance precisely because it is necessary to unlock the full benefit that international flows of funds can provide in meeting the obvious needs for resources and technology.

Economists have struggled for decades to develop consistent approaches and policies towards enhancing economic development. Intellectual fashions change, but at this time there is indeed a broad consensus. Disciplined fiscal and monetary policies, the importance of price stability, the need for efficient domestic financial institutions, and the benefits of open markets are all recognized as fundamental. For South Asia, there is still a lot to be done in those areas.

But there is something further, something less tangible but in a real sense even more important if growth is to be encouraged and sustained. What I am referring to is something that can be broadly labelled as ‘good governance’. By good governance I am not thinking of specific public policies or practices, but the basic framework within which both governments and businesses work.

- Is there a strong sense of the ‘rule of law’—that is, are there defined rules that are fairly and consistently understood and applied?
- Is the system of justice independent, characterized by integrity, and are court decisions respected as reasonably speedy and fair?
- Are management processes in both government and businesses reasonably transparent and open to debate?
- Are contracts enforced, and the system of taxation bearable and equitable?
- Is there a willingness to accept and conform to international standards in accounting, auditing, financial regulation, and other areas essential to a well-functioning international system?
- Then, there is the truly important, sensitive, and difficult issue: is corruption—bribery, collusion, and cheating—tolerated?

An effective international system rests on a negative answer to the last question and on affirmative answers to the rest. I am also aware that perfection in these respects is beyond reach. Even the United States, having prided itself to the point of a certain arrogance about its own approaches, has had to face the embarrassment of a succession of accounting, auditing, and compensation scandals. The legislative and administrative procedures are also not free of corruption. However, in the United States, it can be claimed fairly that substantial reforms are in place. There are prominent men and women shamed and in jail. Ordinary citizens have made their views known in the recent electoral process.

In fact, while circumstances differ widely even within countries, my sense is that progress is being made in India and elsewhere in South Asia. There is greater recognition of the importance of the rule of law and means for enforcing it. There is pressure for greater transparency. Financial practices and accounting standards are slowly being brought into line with international standards. Particularly, there is a growing sensitivity to corruption. It has become a pressing political issue.

Nonetheless, the hard fact remains that South Asia ranks low on the international scale of governance, according to surveys of business attitudes as well as the judgement of independent agencies and non-governmental organizations (NGOs). Its relative position has not improved much, if at all, in recent years. It hurts in the competition

for capital, in the efficiency of industry, and in perceptions of fairness of who wins and who loses.

A lot is heard these days about the competition between the two population giants, China and India, for growth and for reducing poverty. But there are two areas in which India is plainly lagging, areas that are limiting its potential. I am referring to manufacturing and infrastructure. They are ‘big-ticket’ items. They take capital. They should attract employment at wages that may be low by international standards but are very attractive to those in poverty-stricken rural areas or the unemployed. Those sectors of the economy won’t prosper without substantial international participation, most particularly foreign capital and foreign markets. And those are precisely the areas where China—and before China, Taiwan, South Korea, and Hong Kong—are way ahead. Still others are catching up.

There is one aspect of governance with which I have had direct contact in recent years, and that is corruption—corruption not just in the United States, but also in the United Nations. Corruption in the Oil-for-Food Program has left deep wounds in the UN organization, impairing its effectiveness. The woes of the UN may not be at the top of the agenda. However, the problem strikes home when the work of development economists and surveys of business firms coincide in ranking corruption as a leading threat—perhaps the leading threat—to investment and development. It is often correctly cited as a tax on the poor.

Corruption is not only pervasive, it also takes many forms. In some societies it cannot be effectively controlled and eliminated without public understanding and a strong political commitment, without insistence on transparency in contracting, and without simplifications and effective administration of regulations. These cannot be achieved overnight, but cannot be avoided, either. That is why the approach of the World Bank, and of other international institutions, to focus more attention and effort in this area is to be welcomed. Both the OECD and the United Nations have adopted strong conventions about foreign corrupt practices. If and as those conventions are made effective through domestic legislation and determined law enforcement, corrupt practices could and will become even more self-defeating for countries needing investment.

It needs to be realized that this is a sensitive issue in this part of the world, and I have wondered a bit as to whether to brush over the

subject lightly. I have raised that question among businessmen and other friends here in India. They have been virtually unanimous in encouraging me to speak out here. More importantly than a speech here in Mumbai, they support the efforts of the World Bank and other providers of investment to strengthen their surveillance and to enforce strong standards. I believe that in another eight or ten years, South Asian economies could double in size. Hundreds of millions can be lifted out of poverty. Asia, with more than half the world's population, should become the driving force for the world economy. However, sustaining this growth would require open markets, strong competition and, not least, effective governance.

There is a lot upon which to build, more than I could have imagined 30 years ago. That is a great tribute to the businessmen in this room, and to your governments. I trust the sense of competitive vitality in this visit will be translated into good governance as well as good business.

