

## PREFACE

Even as late as the beginning of the 1980s, South Asia was known as a region suffering from conflict, widespread poverty, and autarkic and slow-growing economies. Some 28 years later, South Asia is drawing international attention for demonstrating rapid growth and substantial poverty reduction. Compared to 3.7 per cent growth per year during 1960–80, South Asia's gross domestic product (GDP) expanded by 5.7 per cent during 1980–2000; growth accelerated further to 6.5 per cent in 2000–7. Growth accounting estimates show that both factor accumulation and total factor productivity contributed to rapid growth. While the growth momentum is led by the largest country, India, other large countries like Bangladesh and Pakistan have also shown signs of growth dynamism. Poverty is declining, falling from around 45 per cent in the early 1980s to about 27 per cent at present. Although substantial inter-country differences remain, poverty has come down in all South Asian countries.

Notwithstanding this impressive progress, South Asia remains home to the world's largest number of poor. There are substantial differences between countries, particularly the differences between the low-income countries of Afghanistan and Nepal and the rest of the region, and the large disparities within countries. Overall, the concentration of poor in the lagging regions of South Asia is generating considerable social and political concern. There is a broad consensus that South Asia must continue to grow rapidly and possibly faster to attack poverty more comprehensively than in the past. There is also an emerging consensus that this growth must be more inclusive to address the dichotomy of the two faces of South Asia resulting from the growing gap between leading and lagging regions. The first face is dynamic, urban, globally integrated, and rapidly growing. These are the leading regions of South Asia. The second face is rural, afflicted with poverty and conflict, and not well integrated with the markets.

These are the lagging regions of South Asia. The concern with the growing gap between these two faces applies to both disparities within countries as well as between countries of the regions. Given long physically open borders, fast growing countries such as India cannot fully ignore the adverse effects of slow growing neighbours. Indeed, unofficial migration resulting from differential income opportunities is already emerging as a major social and political challenge for India and its neighbours. What can be done to sustain and increase growth in South Asia? How can growth become more inclusive? These are leading issues for South Asia's development moving forward.

To provide an input to this debate, the South Asia Region of the World Bank joined hands with the South Asian Association for Regional Cooperation (SAARC) to organize a regional conference, called the Second SAARC Business Conclave, that brought together a number of key players from the private sector, political leadership, policy makers, and academics whose ideas and thoughts could shed new light on the growth challenge. The conference recognized that growth in South Asia is at an early stage. Despite solid progress, the region still suffers from severe policy distortions. If the reform process can be accelerated, South Asia has the potential to achieve and sustain higher growth. The growth practitioners and policy makers identified five key drivers of growth. These are:

- expanding the industrial base,
- modernizing the service sector,
- strengthening skills,
- strengthening institutions , and
- regional cooperation for boosting trade and infrastructure investment.

The work and analysis of this book of collected essays are an outcome of high-level dialogue on growth between the private sector, political leadership, policy makers, and academics in South Asia. The growth drivers discussed in this volume are by no means an exhaustive list of growth concerns. Other issues relating to the financial sector, urbanization, agriculture, etc., might be important for growth as well. But these were not discussed at the conference. In each of the five areas identified by experts as growth drivers, the book looks at the types of policies and institutions that could propel South Asia to higher growth, while also promoting growth inclusiveness to

address the inequality concerns. The views expressed in the essays are those of the authors. The methodology and approach differ, and the conclusions of some of the works are open to debate. This diversity, however, is also a strength and some of the questions raised will likely spur new research.

Despite the diversity, each of the chapters intends to address issues affecting growth and employment. Based on the contents of the essays, the book is organized along three themes: an overview of South Asia's growth opportunities and challenges; sources of growth and policies; and the role of regional cooperation in promoting growth.

Part I on growth opportunities and challenges starts with a study by Sadiq Ahmed and Ejaz Ghani that identifies some of the key challenges facing South Asia which, if addressed, would accelerate growth further, especially in the smaller countries. These are in the nature of 'second generation reforms', building on the momentum of reforms in the first phase starting in 1980. These include market integration, both globally and regionally; inclusive growth that would convert the 'demographic dividend' in South Asia into a 'window of opportunity'; improved infrastructure that would behave like second nature geography and propel growth through improved connectivity, allowing its benefits to be shared widely; strengthened institutions that would result in a stronger business environment and less conflict and corruption; and the inclusion of regional public goods into the national development agenda. In the two subsequent brief commentaries, Jeffrey D. Sachs and Paul A. Volcker share their perspectives on South Asian growth opportunities and challenges. Professor Sachs notes the past progress in growth and development in South Asia and recognizes the large potential moving forward. He highlights four priority areas of focus for South Asia: investment in rural areas; regional trade and integration; paying attention to the natural environment, especially water; and the greater role of business leaders to influence political outcomes. Volcker appreciates the progress made by South Asia, in particular in becoming more open and competitive and benefiting from global integration. At the same time he notes the two faces of South Asia. In addition to consolidating the gains from good policies including prudent macroeconomic management and global integration, he emphasizes the critical role of good governance in promoting growth and inclusiveness. Some progress has been made by South Asia in improving governance but there is a long way to go.

Part II looks in-depth at sources of growth for the future and policies and institutions needed to accelerate growth, as well as make growth more inclusive. The key link between growth and inclusiveness is creation of good jobs. South Asia is already undergoing a major structural transformation based on rapid growth of services and manufacturing. The GDP share of agriculture is shrinking fast. This trend is likely to continue in the future, although the growth rates in both manufacturing and agriculture could be accelerated. The employment story is different from the experience of East Asia. South Asia has so far has seen a rapid increase in the contribution of the services sector in employment. However, there is a concern that job creation has been mostly in the informal sector characterized by low skills and low earnings. At the same time, the reduction in the GDP share of agriculture is not matched by a commensurate reduction in the employment share. The manufacturing sector has not shown the dynamism found in the East Asian Tigers. Many experts believe that the ability to convert the manufacturing sector into a dynamic sector with rapid growth in value added will be a key driver for overall economic growth as well as for adequate creation of high-income jobs (called good jobs). What path might the manufacturing sector take to achieve this dynamism? Should South Asia emulate the export-led large scale manufacturing path of the East Asian Tigers? The study by Howard Pack addresses the question of the path of industrialization for South Asia. Pack believes that the path followed by the East Asian Tigers is not a viable option for South Asia because of the difficulties of market penetration in this heavily contested world market. The alternative he suggests is that of a balanced effort at promoting agricultural and rural industry. The small and medium enterprise (SME) strategy, he observes, is not that of a collection of informal sector enterprises whose demonstrated economic benefits are open to question. The type of firms envisioned are factories with 10 to 300 employees, are labour-intensive in nature, and show good total factor productivity. In his view, the balanced path has the advantage of being likely to generate more jobs for the growing labour force, thus limiting the growth of income inequality. It is less exciting, he accepts, but is more politically sustainable. His essay makes an important contribution to the debate on South Asia's industrialization challenge. But this view is likely to be heavily contested.

Kaushik Basu and Annemie Maertens tackle the question of job creation directly in their essay. They observe that a key feature of South Asia is its large labour force and related to this is the expected demographic dividend emerging from a growing labour force. A key challenge facing the region is whether it can create enough good jobs to convert this large population into a productive asset. Drawing on the experience of growth in manufacturing and services sectors in South Asian countries, the study notes the disappointing outcome in terms of creation of good jobs which has limited the poverty reduction impact of rapid growth. Basu and Maertens argue that among the factors that have contributed to this disappointing outcome are restrictive labour laws in the largest country India. These laws have not only reduced employment prospects in organized manufacturing but also constrained its growth by adversely affecting investment and productivity. In all South Asian countries including India, weak infrastructure has also constrained the expansion of the manufacturing sector, thereby adversely affecting both growth and employment creation. The policy conclusions are obvious. South Asia must put much greater emphasis on infrastructure development and addressing the restrictive labour laws in countries where they are binding in order to boost investment and production in the organized manufacturing sector and create more jobs.

In their paper, Ana M. Fernandes and Ariel Pakes focus on the employment challenge facing India's organized manufacturing sector. Using the data from the World Bank's Investment Climate Surveys, the study analyses the labour and capital employment rates of Indian manufacturing firms and their relationships to productivity and various institutional constraints on manufacturing. The essay derives a number of important results from this empirical work that have implications for growth and employment creation in the Indian manufacturing sector. First, there is evidence that labour is underutilized by manufacturing firms in all states, where underutilization is defined as the ratio of optimal labour employment if there were no hiring or firing costs to actual employment. Second, the extent of underutilization of labour differs substantially by states; in particular, states with higher GDP per capita exhibit much less under-utilization of labour. Third, the extent of labour underutilization by firms is strongly and positively related with firm productivity. Fourth, the more productive firms tend to over-utilize

capital more than average, though not to the same extent as they under-utilize labour. These results suggest that if labour market restrictions in states with poorly functioning labour markets were liberalized to the level of restrictions in states with better functioning labour markets, labour demand and wages would possibly increase significantly in those states. Also, such liberalization may increase productivity without significant demand for capital.

The growth and employment dividends from the services sector have benefited most South Asian countries. Yet the dynamism experienced in India is yet to be found in other South Asian countries. The study by Aaditya Mattoo looks into the question of how the services sector might be further propelled to provide impetus to higher growth in South Asia. He argues that a number of domestic policy constraints weaken the potential contribution of the services sector as a source of growth. These include regulatory restraints on competition, lack of proper regulations to enforce service standards and quality, weak labour skills due to low investment in education and training, inefficiencies in the financial sector, and restraints on foreign direct investments. In all these areas, progress has been made in most countries with India moving faster than others. Yet a substantial unfinished agenda remains. South Asia can also benefit from stronger regional cooperation in this area to benefit from economies of scale and by reducing the huge transaction costs on trade in regional services.

Raising labour productivity is critical for both growth and job creation in South Asia. While removal of growth constraints, such as weak infrastructure and labour market restrictions, will help increase the demand for labour, this must be matched by a much stronger effort to improve labour skills to sustain more rapid growth and employment. The skills challenge becomes particularly demanding as South Asia opens up to global competition and technology. Michelle Riboud and Hong Tan look at this South Asian challenge and throw light on what needs to be done to gear up. The essay's findings suggest that the educational stock of South Asia is still low compared to other dynamic regions, especially East Asia. Progress on the educational front has been unequal over time across countries, but none of the countries currently upgrade the education of their populations at a speed that would allow them to catch up quickly with East Asia and the rest of the world. The available data also suggest that South Asia

invests inadequately in skills development after formal schooling. Similarly, South Asia lags behind other regions in employer provision of in-service training. Clearly, the skills challenge is enormous. A key policy imperative for South Asia moving forward is to put emphasis on higher levels of education without neglecting the unfinished agenda at the primary level. Enhancing the quality of education at all levels is a huge challenge for all South Asian countries. There is also considerable scope for improving the effectiveness of public training institutions in the region, including greater partnership with the private sector to develop and deliver skills training demanded by both employers and the labour market.

The importance of institutions and governance for economic growth and development is now well-established. Ahmed and Ghani and Paul Volcker note the importance of institutions and governance in their essays. There are different dimensions of this long-term challenge. In her contribution Ana M. Fernandes focuses on the differences in institutional quality between South Asia and East Asia. Using measurable proxies for institutional quality, her essay finds that institutions in South Asia on an average are weaker than the rest of the world and in particular in comparison to East Asia. Focusing attention on improving these institutions, especially those that concern improving the rule of law and reduce corruption, can boost the growth momentum in South Asia. Also, greater regional cooperation, as in East Asia, can help the sharing of knowledge and the emulation of good practices, consequently reducing the differences in institutional quality across countries. For all countries, better enforcement of existing laws and regulations can greatly help to strengthen outcomes.

Part III asks the important question of how more and better regional cooperation might help boost growth and equity in South Asia. The region is the least integrated of global regions and barriers to trade and investment among South Asian countries greatly exceed those with the rest of the world. The hostile political environment of the past has caused this, but the environment is changing with much stronger interest in cooperation. There are different dimensions of this cooperation. The initial focus has been on trade, but there is now growing interest in infrastructure and services. The need to broaden cooperation with other regions, especially East and Central Asia, is also recognized. L. Alan Winters in his essay looks into the

question of benefits from deepening regional trading arrangements in South Asia. The chapter concludes that the case for increasing integration among South Asian countries is very strong. There are almost certainly major efficiencies to be reaped via increasing trade and competition. The regional agenda clearly should include the removal of additional trade barriers to regional trade and restrictions on transport border crossings. However, the creation of a free trade union is not the best option. Removal of trade restrictions on a global basis to foster international competition for trade and investment is the way to go.

Along with the removal of all trade and non-trade barriers, greater efforts to strengthen regional cooperation on energy and services can provide a substantial boost to growth in South Asia. This is the focus of the next two chapters. Vladislav Vucetic and Venkataraman Krishnaswamy show in their essay the potential for energy trade in South Asia as a basis for removing the growing energy constraint to development in the region. Fast-growing India, and to a lesser extent Bangladesh and Pakistan, are energy-thirsty countries. Nepal, Bhutan and Afghanistan, all relatively poor countries, are endowed with huge water resources that might be fruitfully exploited for generating hydro-power for trading with the countries where power is lacking. The outcome is a win-win situation as the income from hydro-power can substantially boost GDP growth in these poorer countries. Bhutan to some extent has already demonstrated this through its power trading agreement with India. More generally, South Asia needs to do much more to remove the constraints to energy trade within the region and also from other neighbouring Central Asian, Middle Eastern, and East Asian countries. The essay looks at these constraints and identifies the policy actions needed to spur energy trade in South Asia. Given the long-term nature of these investments, early action is necessary to jump-start the process. In the last chapter of the book, Simon Thomas shows why better regional cooperation in transport is necessary to reduce cost and raise the competitiveness of South Asian production, a point also emphasized by L. Alan Winters. In South Asia, there is a large concentration of poor people along the border areas. Additionally, two of the poorest countries of the region, Afghanistan and Nepal, are landlocked. Enabling these poor people to access markets and benefit from growth centres is critical for poverty reduction. Currently, there are major restrictions on cross-

border mobility of goods, services, and people. Most of the transport networks linking the border areas are also in bad shape. Removing these restrictions and improving the transport network to link markets with production centres is essential to raise the income of the poor as well as boost exports. The efforts at improving trade facilitation and the 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 transit and transport arrangements for intra-regional trade is an essential step towards resolving the regional transport issues.

In conclusion, South Asia's progress with increasing the rate of factor accumulation and improving factor productivity can be given a further boost by addressing the second generation reforms. This will provide the basis for sustaining growth. The immediate priorities are: expanding the industrial base by removing the infrastructure and labour market constraints; modernizing the services sectors by removing all regulatory barriers; strengthening skills and institutions; and enabling regional cooperation for boosting trade and infrastructure investment. These are by no means a comprehensive set of growth drivers. Other issues such as financial sector reforms, the urbanization challenge, and agriculture sector reforms are also important growth concerns. Finally, South Asia, like other regions, faces substantial downside risks from adverse global developments relating to financial, food, and fuel crisis. Continued prudent macroeconomic management will be critical to keep South Asia on the high growth path.

Can South Asia sustain growth momentum? This has attracted more attention as the downside risks to the global and regional growth outlook have increased. Growth experience has shown that no country can sustain high growth without sound economic management. The global economic downturn makes it even more important that South Asia further strengthens economic management. South Asia also needs to take advantage of its two unique assets: its *people* and its *geography*. The region has a large labour force, which will explode in the future as the share of working age population increases, thanks to demographic dividend. More than 150 million people will enter the prime working age population over the next decade. Demographic dividend can be the future growth catalyst. South Asia's geography can be the second growth catalyst. South Asia is the most densely

populated region in the world, and it has the benefit of low distance across countries. Nearly all countries in the region share a common border with India, the largest and the fastest growing economy in South Asia. The potential growth benefits of density and distance have been neutralized by high division, low market integration, poor connectivity, and friction in the region. Increased global and regional market integration will enable South Asia's growth to benefit from proximity, scale, and agglomeration economies that are positively associated with density and distance. The people and geography of the region can help South Asia to transform high growth into inclusive and sustainable growth. Inclusive growth will be the key to poverty reduction in South Asia.

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