

Economic Growth in South Asia: Promising, Un-equalizing,...Sustainable?

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Abstract

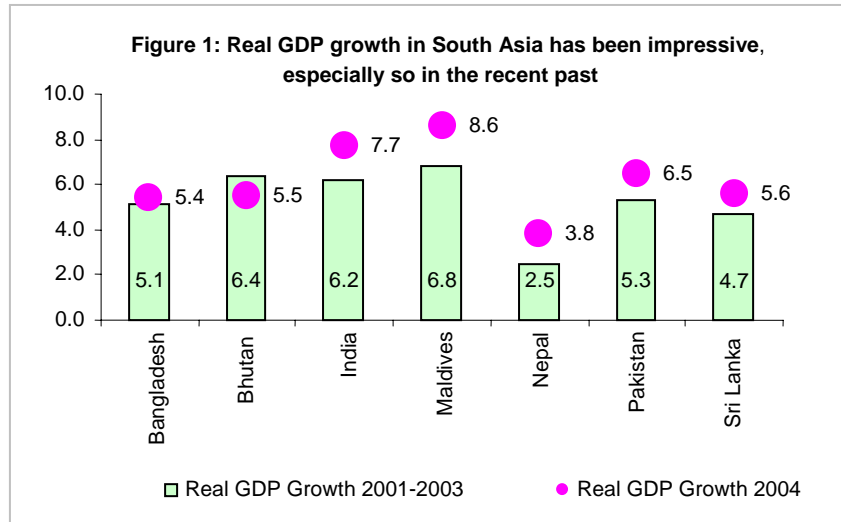
Despite obstacles such as conflict, corruption and high fiscal deficits in some countries, South Asia has achieved impressive economic growth and poverty reduction in the past decade, thanks mainly to economic reforms in the 1990s. If this growth accelerates to 10 percent a year, the region could see single-digit poverty rates by 2015. A closer look at the evidence suggests that much remains to be done to achieve these accelerated growth rates. First, economic growth in the past decade has resulted in growing income inequality which may act as a constraint to higher growth. Second, while conflict, corruption and high fiscal deficits may not have constrained growth in the past, their persistence may become binding in the future. Third, a comparison with East Asia--a region that has sustained 7-10 percent growth rates--shows that South Asia's export-orientation, inflows of foreign direct investment, workers' skill levels, infrastructure and ease of doing business are also substantially less advanced than East Asia's. South Asia's savings, investment and productivity are also lower. These challenges suggest a set of policy choices for South Asian countries aimed at increasing investment and productivity, and the quality of labor, while addressing the problem of lagging regions and poor service delivery. Finally, the least integrated region in the world, South Asia can benefit from regional cooperation in trade, water and energy, among other things. While the policy agenda appears daunting, the dynamism and openness that characterizes South Asia today makes us optimistic that some, if not all, of these challenges can be met and the region will be substantially free of poverty in a few decades.

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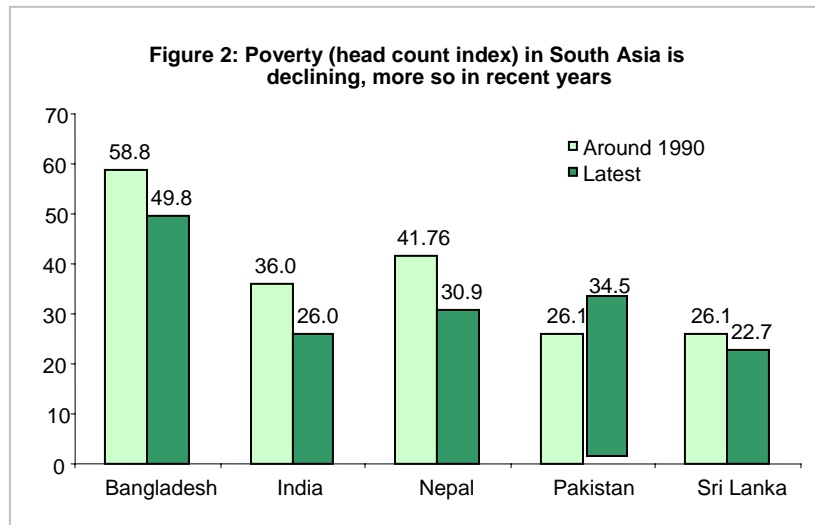
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I. South Asia's Promising Growth

South Asia's economic growth in the last five years has been impressive. Bangladesh, Bhutan, India, Maldives and Pakistan have all grown at over 5 percent per year on average, Sri Lanka at 4.7 percent and Nepal at 2.5 percent. In 2003-4, shortly before the Tsunami hit the region, all countries other than Nepal averaged above 5 percent GDP growth. India, Maldives and Pakistan performed especially well, averaging GDP growth of nearly 7 percent.



The economic growth of the last decade has contributed to an impressive reduction in poverty. In Bangladesh, India and Nepal, poverty fell by 9, 10 and 11 percentage points respectively, in Sri Lanka it fell by 6 percentage points. Only in Pakistan did poverty increase by 8 percentage points, but that was because Pakistan experienced economic stagnation throughout the 1990s. In the robust growth of the 1980s, poverty in Pakistan fell by 12 percentage points. Preliminary estimates based on PSLM 2004-5 survey show a substantial reduction in poverty associated with the recent rapid growth.



Source: (Data) Bangladesh: HES 1991-92, 95-96 and HIES 2000; India: NSS 50th and 55th rounds; Nepal: NLSS 1995-96 and 2003-04; Pakistan: PIHS 1990-91, 2001-02; Sri Lanka: HIES 1991, 2002.

Policies, Institutions or Luck?

South Asia's growth is all the more impressive because the subcontinent suffers from many growth-retarding factors--such as corruption, conflict, high fiscal deficits and dependence on an enclave natural resource--that have afflicted African countries, which have grown much more slowly.¹ Bangladesh is considered by Transparency International to be the most corrupt country in the world, and yet its GDP continues to grow at 5 percent a year, with per-capita income rising at 3 percent a year. Sri Lanka and Nepal have suffered severe civil conflict, but registered per-capita consumption growth rates of 3 and 4 percent a year, respectively. Sri Lanka and India have run fiscal deficits of over 9 percent of GDP for decades. And Maldives has successfully developed an enclave-type tourism industry (leasing out islands to tour operators, who employ foreign labor and use imported materials), with GDP growth averaging 9 percent a year over the last two decades, and per-capita GDP tripling to \$2,300.

Of course, much of South Asia's recent growth is due to the significant and sustained policy reforms that governments undertook in the last two decades². Sri Lanka began liberalizing its trade and industrial policies in the 1980s, India and Bangladesh in the early 1990s, and Nepal and Pakistan in the late 1990s. In the financial sector, India and Sri Lanka started deregulating interest rates and allowing private banking in the 1990s, followed by Pakistan and more recently by Bangladesh. Throughout, with some exceptions, South Asian countries maintained prudent fiscal and monetary policies. For much of the time, inflation in every South Asian country was below the world or developing-country average.

But it is also clear that institutions in South Asia have helped make the payoffs to policy reforms higher than expected, given the presence of seemingly binding constraints, such as corruption and conflict. For instance, the (mostly) democratic institutions and relatively free press in South Asia has meant that the process of policy reform, while painfully slow, results in reforms that represent a domestic consensus, and are therefore sustained.

In addition, external financing has played a complementary role to policy reforms in South Asia. Pakistan's recent economic turnaround illustrates how loosening the credit constraint in a reforming economy unleashes rapid growth. Macro-economic difficulties associated with the need to service a large and growing national debt, and steady decline in remittances and concessionary capital flows, halved the growth rate in the 1990s (it was 6 percent in the 1980s). All this changed after September 11, 2001. Pakistan's debt burden was reduced sharply, concessionary capital resumed, and remittances surged. This, combined with far-reaching reform of the banking and energy sectors, privatization of state-owned enterprises and improved public finances, has put Pakistan back on its trend growth path, even surpassing it in recent years.

¹ Devarajan, Shantayanan. "South Asian Surprises", *Economic and Political Weekly*, Vol XL No. 37, September 2005

² Ahmed, Sadiq. "Explaining South Asia's Development Performance: A Puzzle or Good Policies?" unpublished.

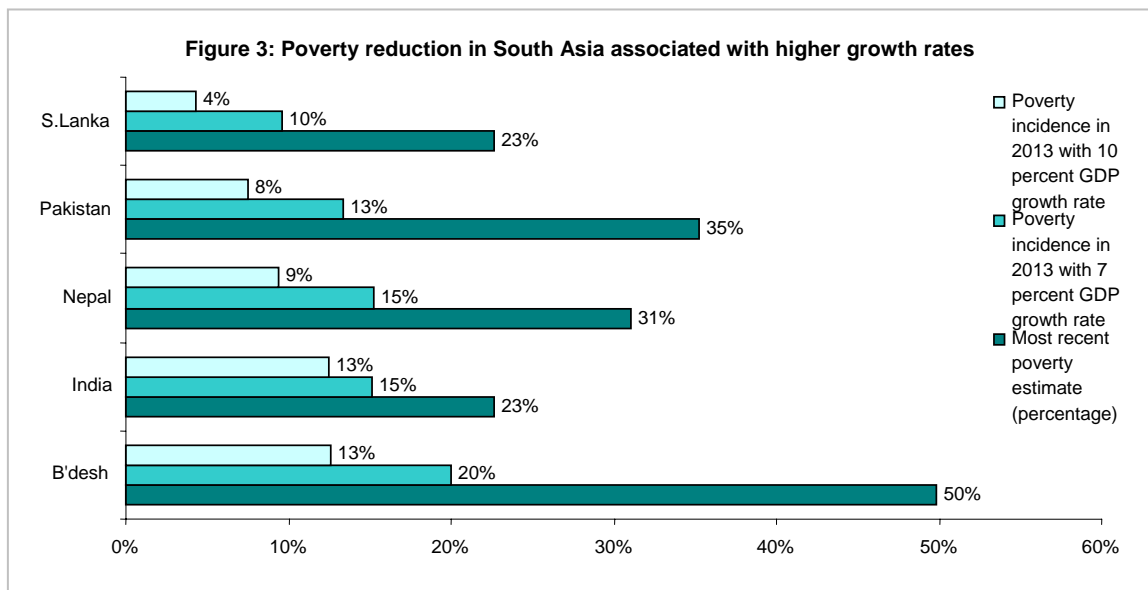
Another source of external finance is the substantial and rising inflow of capital by non-resident nationals in the form of remittances (repatriation of savings) that increases the pool of capital and stimulates demand to spur economic growth. Remittances by South Asian nationals working abroad totaled \$22 billion in 2004-5, and account for the region's stability in balance of payments. By comparison, remittance earnings in sub-Saharan Africa totaled \$6 billion. Remittances are a far more important source of external financing in South Asia than in East Asia, where external financing is primarily in the form of foreign direct investment.

Finally, relatively favorable external conditions contributed to South Asia's strong economic performance. In the past few years, good weather conditions have contributed to high agricultural output, still an important component of GDP in most countries. Low world interest rates have also helped some countries borrow in international markets. At the same time, South Asia suffered several adverse shocks, including three natural disasters in the last two years (floods in Bangladesh, tsunami in India, Maldives and Sri Lanka, earthquake in Pakistan), as well as sharp increases in world oil prices. That the region turned in an impressive growth record in 2005 in the wake of these negative shocks speaks to the strength of its policies, the robustness of some of the institutions, and the resilience of its people.

Accelerating economic growth

The impressive economic performance of the last decade, but especially the last three years, has encouraged South Asian policy makers and analysts to aspire to the East Asian growth rates of 7 to 10 percent, and sustain these over the coming decade. As we shall see later in the paper, a lot remains to be done to strengthen policies and institutions to sustain such high growth rates. But if the required changes are made and the higher growth rates are sustained for a decade, South Asia will see a substantial reduction in poverty³ (Figure 3), from the current range of 23 percent (India, Sri Lanka) to 50 percent (Bangladesh) to a much lower range of 4 to 13 percent. Poverty in Pakistan is likely to fall dramatically from the current 35.2 percent to 12.4 percent because of its high elasticity of poverty reduction with respect to income.

³ The poverty reduction estimates are based on several assumptions about the relationship between income and consumption growth and the poverty reduction responsiveness (elasticity) of the economy to income growth. The estimates are thus indicative.



Note: Most recent poverty estimates are those estimated by the World Bank and in some cases may be different from those reported in Figure 2. The method used for computing growth elasticity varies among countries. Bangladesh: Wodon (2001); India: Deaton and Dreze (2002); Nepal: Datt and Ravallion (1992); Pakistan: Bourguignon (2003); Sri Lanka: Bourguignon (2003).

II. Challenges to Sustaining and Accelerating Growth

Rising regional inequality

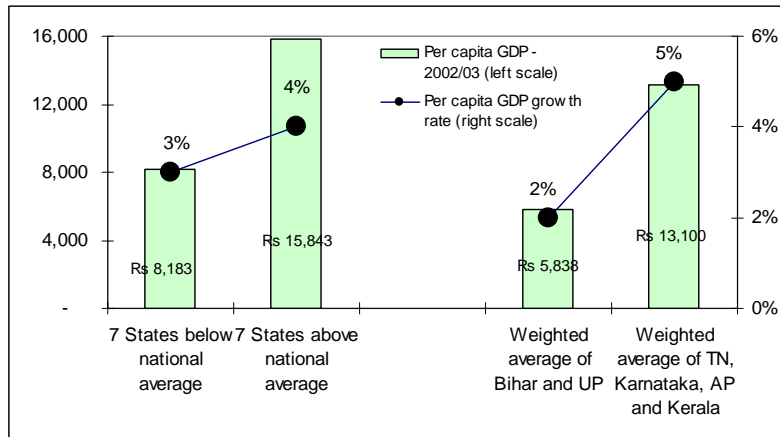
Despite recent growth and poverty reduction, South Asia still has nearly 400 million poor people (out of a population of 1.37 billion). Poverty is not just endemic, but increasingly concentrated in particular, lagging regions. Not only are these regions poorer, but their growth rates are substantially slower than the better-off regions.

The phrase “two Indias” exemplifies this difference in regional development outcomes (Figure 4). In 2002-2003, all-India per capita GDP was \$480; the poorest seven states (accounting for 55 percent of the population) had a per-capita GDP that was two thirds the national average, while in the richest seven states (33 percent of the population) per-capita GDP was nearly double that of the poorest seven states. In the two largest and poorest northern states (Bihar and Uttar Pradesh, 25 percent of total population) per-capita GDP was less than half the national average and only a third of the richest 7 states. The four southern states, Andhra Pradesh, Karnataka, Kerala and Tamil Nadu (21 percent of the total population), at an average, enjoyed more than twice the GDP per capita of the quarter of the population concentrated in the two poorest northern states.

Furthermore, with average GDP growth rates of 5 percent, the southern states are galloping ahead of the poorest but populous northern states with growth rates of only 2 percent. This threatens to further increase the poverty gap in the two regions; currently,

head count poverty in the poorest northern states and the better off southern states is 35 percent and 18 percent respectively.

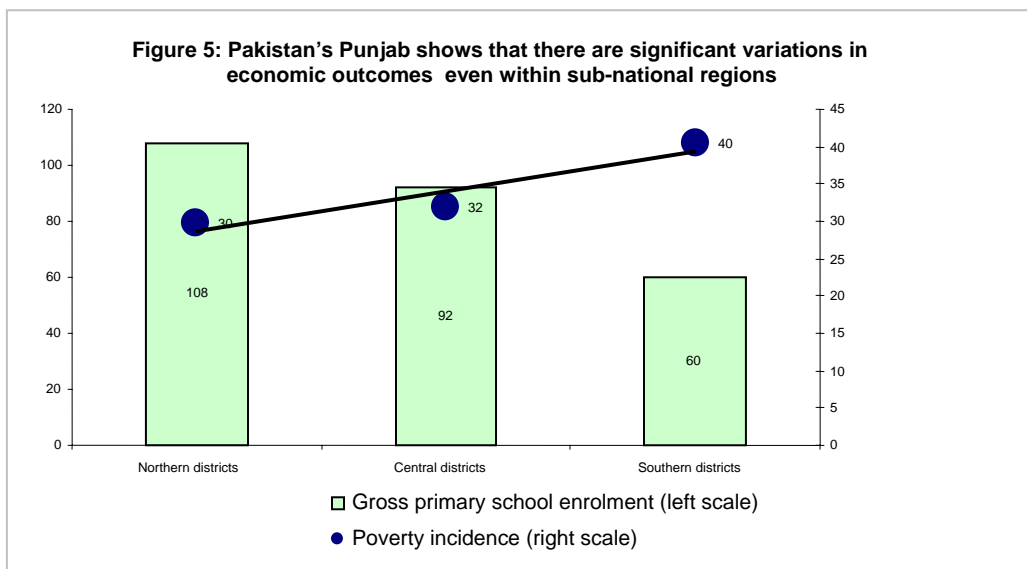
Figure 4: The two Indias



Regional variations in income and poverty outcomes are not peculiar to a large country like India. Sri Lanka, a much smaller economy, shows a disturbing regional disparity in income and poverty. The Western Province, led by Colombo, has 30 percent of the country's population but accounts for 47 percent of national GDP, and poverty in the Western province, at 11 percent, is less than half the national poverty rate of 23 percent. Furthermore, most of Sri Lanka's growth in the past decade was concentrated in this one province: the Western Province's share of GDP rose from 40 to 47 percent in 10 years.

Even within sub-regions, there is significant inequality. In Pakistan's Punjab province, Central and Northern districts are much better off than the Southern districts (Figure 5). With higher education standards and better infrastructure, the better off districts attract more investment and therefore grow more rapidly than the southern districts.

Figure 5: Pakistan's Punjab shows that there are significant variations in economic outcomes even within sub-national regions



South Asia's high and growing inequality may itself act as a brake on future growth and poverty reduction. First, the higher the inequality in a country, the harder it is for growth to reduce poverty. This is why Sri Lanka, which has the highest Gini coefficient in South Asia (World Bank 2005), had such anemic poverty reduction despite nearly 5 percent average annual growth. Second, inequality could reflect distortions in the economy as well as unequal power relations, both of which dampen growth. Highly unequal levels of education in Pakistan, for instance, means that some talented children--many of whom are likely to be girls--are denied the opportunity to develop their human capital, which is the main determinant of long-run growth. Inequality is often the reflection of capture of the political system by certain ethnic groups or castes, who then perpetuate the system by providing private benefits to their own group, rather than public goods which generate economic growth. Many of India's lagging states, such as Bihar, fit this description. Third, rising inequality in the wake of market-oriented pro-growth policies could elicit a backlash against these policies, sometimes leading to distortionary policies that slow growth. Recent electoral outcomes in India and Sri Lanka exemplify this. Finally, if inequality between regions rises above a certain threshold, it can trigger a violent conflict which, in turn, can lead to decades of reduced growth.

Overcoming "binding constraints"

As stated earlier, South Asia achieved relatively high growth in the past decade despite numerous obstacles, such as conflict in Sri Lanka and Nepal, corruption in Bangladesh and many Indian states, and high fiscal deficits in India and Sri Lanka. While these constraints may not have been binding in the past, they may become so in the future, as South Asia attempts to accelerate its growth rate to eliminate poverty in the coming decades. For instance, the conflict in Sri Lanka has been estimated as reducing the country's growth rate by 2-3 percentage points--just the gap needed to get to East-Asian growth rates (Kalegama et al. []). Although Nepal has reduced poverty by 11 percentage points in eight years, its growth has slowed considerably in the last few years, as the Maoist rebellion and other governance problems intensified.

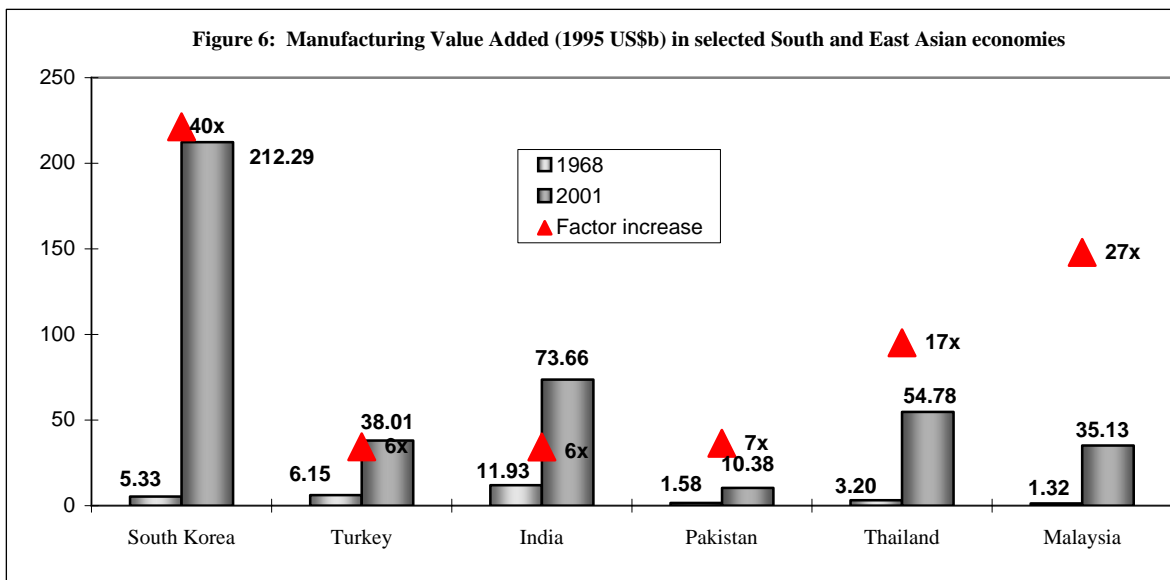
Similarly, Bangladesh may have been able to grow at 6 percent a year and achieve universal primary and (nearly) secondary enrolment with widespread perceptions of corruption, but it faces major hurdles, such as infrastructure bottlenecks and the need to diversify its exports, as it seeks to become a middle-income country. Modern infrastructure cannot be built without foreign direct investment, yet Bangladesh's ratio of gross FDI to GDP is 137th out of 141 countries. According to the World Economic Forum's *Global Competitiveness Index*, Bangladesh ranks 98th out of 102 countries in growth competitiveness and 91st out of 101 countries in business competitiveness.

Finally, India introduced an ambitious program to reduce its fiscal deficit--and then missed the plan targets in the first two years. While the deficit has been reduced in the past year thanks to higher revenues, there are limits to how much more deficit-reduction can be squeezed out of this instrument. Expenditure reduction remains politically very difficult in India. South Asia's other high-deficit country, Sri Lanka, is facing a fiscal deficit of 9 percent of GDP this year which, in the absence of concessional lending, will have to be financed by expensive commercial borrowing, increasing the country's debt burden further.

Achieving East Asian growth rates

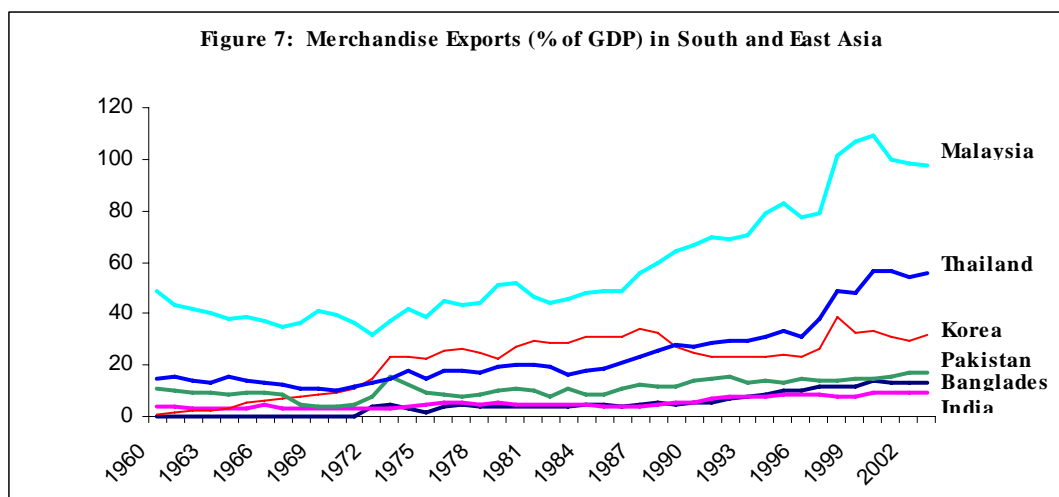
As we said earlier, if South Asia can achieve and sustain East-Asian growth rates of 7-10 percent a year, the subcontinent will see a substantial reduction, and perhaps elimination, of poverty. Does South Asia have the ingredients for rapid growth that East Asia had? We find numerous gaps between the two Asias.

Manufacturing. Expansion of manufacturing is critical because of its beneficial impact on employment; both in terms of generating more jobs but also higher wages for workers due to rapid productivity increases. Although manufacturing value added in South Asia has registered healthy growth in recent years, it needs to grow much faster to catch up with East Asia (Figure 6). Between 1968 and 2001, manufacturing value added increased by a factor of 40, 27 and 17 in South Korea, Malaysia and Thailand compared to a factor of 6 and 7 in India and Pakistan respectively. Consequently, the share of manufacturing value added in GDP increased 400 percent in Malaysia, 300 percent in Thailand and over 200 percent in Korea compared to an increase of only 20 and 30 percent in India and Pakistan.



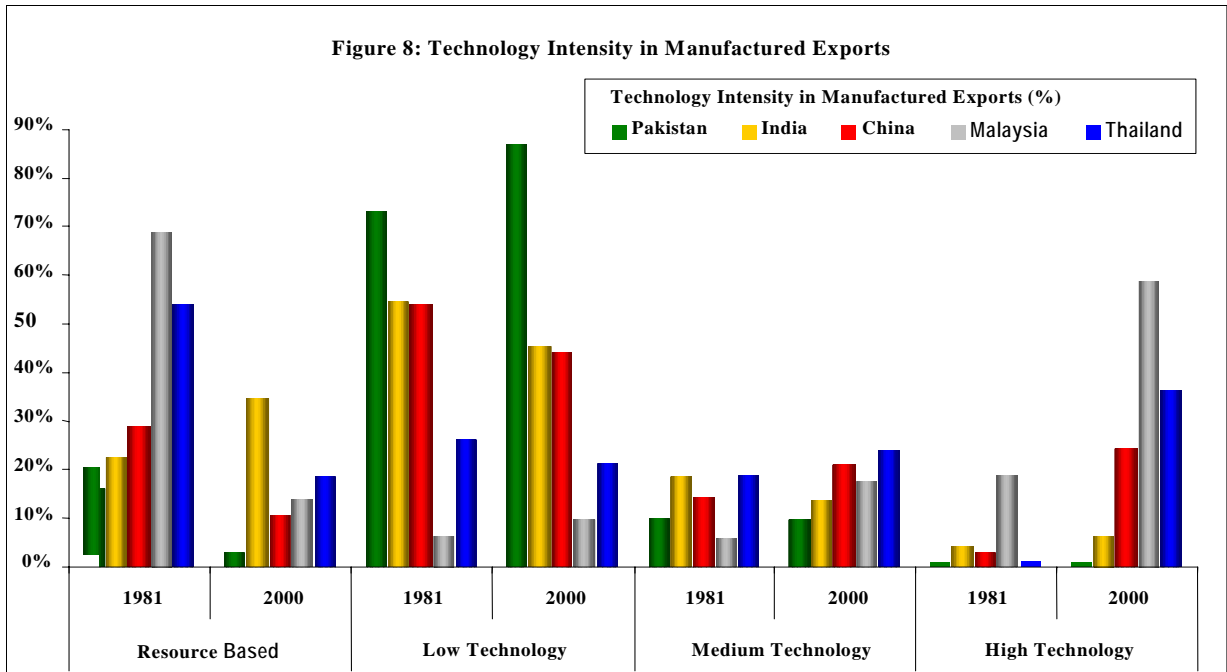
Source: World Development Indicators, various years

Export orientation. Export-led growth fosters sustained GDP and total factor productivity growth over long periods of time because it promotes competitiveness and efficient use of resources. South Asia's export performance, although improving, is still far below the successful East Asian economies. The ratio of exports to GDP in Malaysia, Thailand and Korea is considerably higher than in Pakistan, Bangladesh and India (Figure 7).



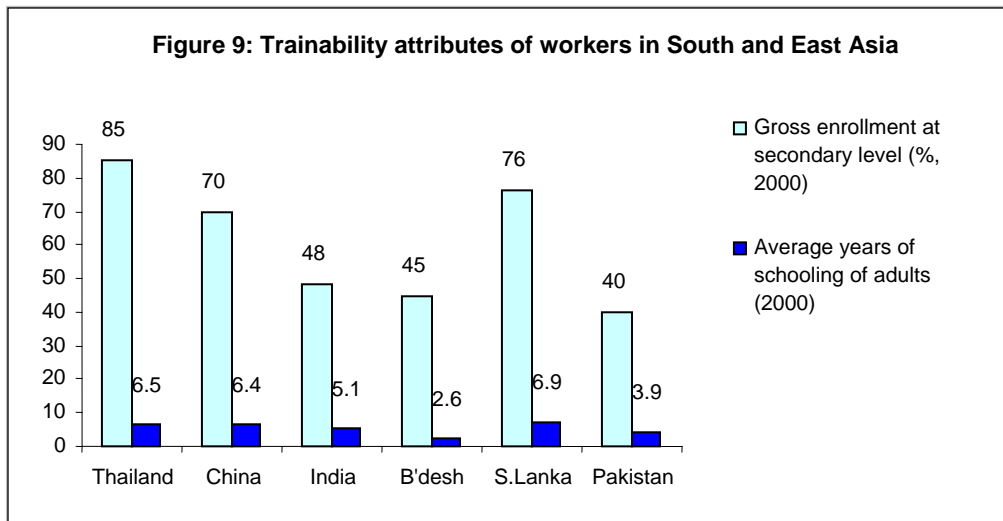
Source: World Development Indicators, Various years

Technology intensity. Export performance is related to the technology intensity of manufacturing (Figure 8). A significant feature of the leading East Asian economies such as China, Malaysia and Thailand is the speed with which they have moved up the technological frontier. Increasingly, their exports consist of products embodying high technology. In India and Pakistan, on the other hand, high technology intensity products are a small share of total exports.

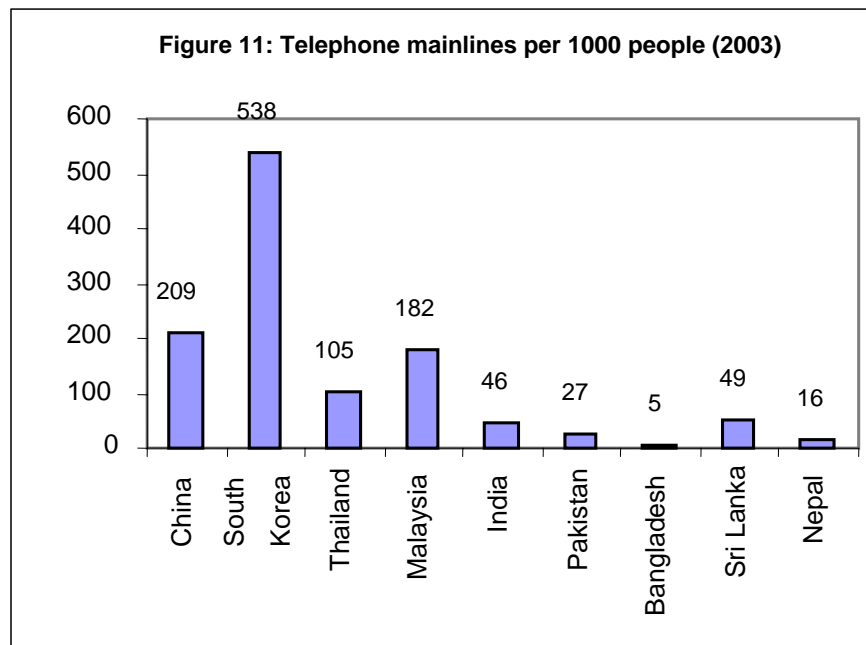
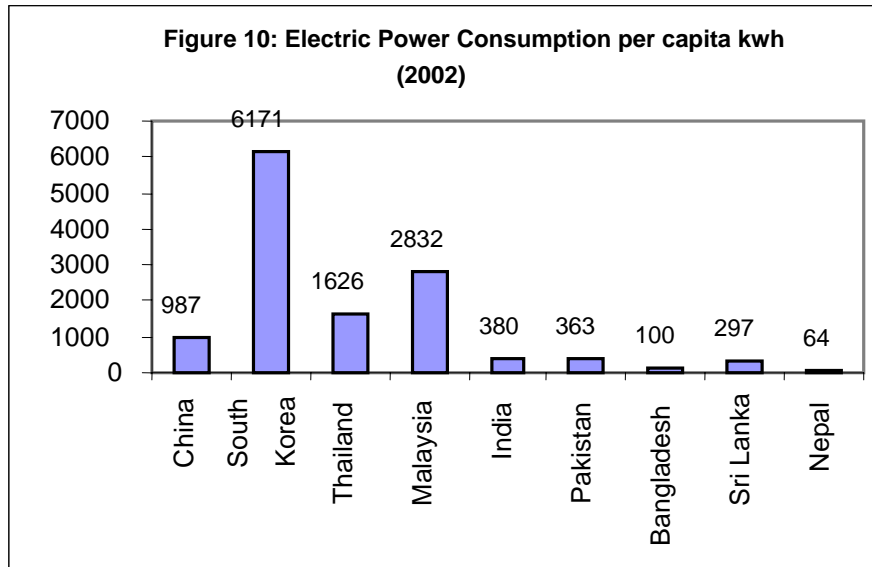


Source: Sanjaya Lall

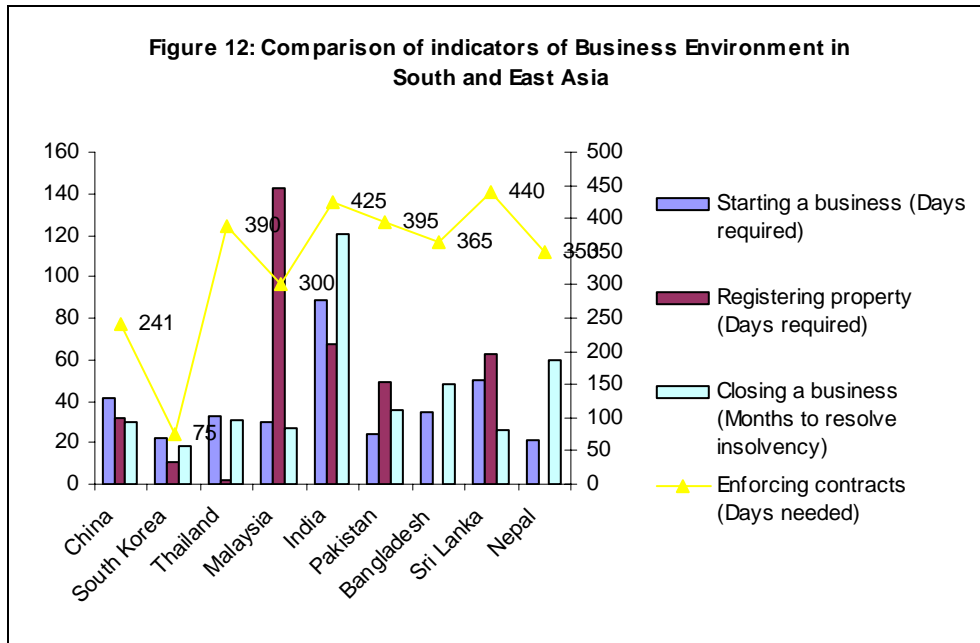
Skilled workers. South Asia also falls short of East Asian standards in the supply of skilled workers. Two proxies to capture workers' skills are gross enrollment at the secondary level and average years of schooling of workers. Both of these education attributes give information about the trainability of workers. Acquiring industry specific skills to attract FDI is facilitated by a trainable work force. On these measures, East Asian economies fair far better than the economies in South Asia (Figure 9).



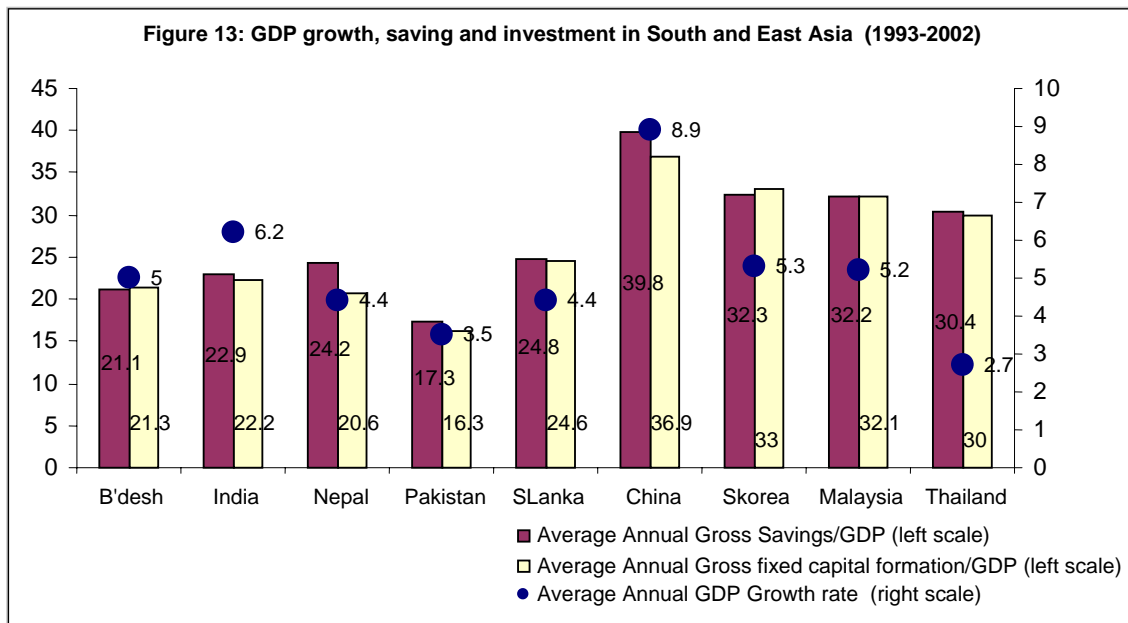
Infrastructure. The quality of infrastructure is a key determinant of investment, especially FDI. Figures 11 and 12 show that on two important types of infrastructure, consumption of electric power, and telephone mainlines, East Asian economies are significantly ahead of South Asian economies.



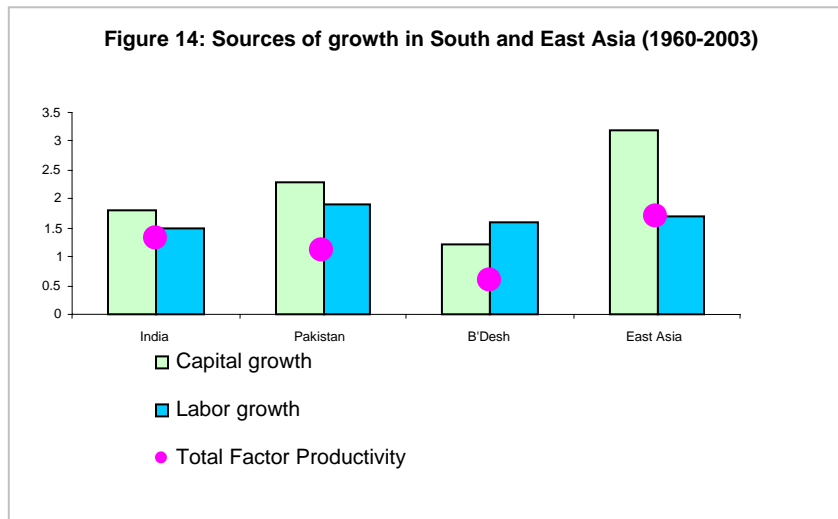
Costs of doing business. The business community faces several transactions costs, not directly related to the production cycle, but are, nonetheless, significant. These include costs associated with doing business such as the time it takes to start a business, register property, wind up the business file for insolvency and enforce contracts. Figure 12 shows that these costs are substantially higher in South Asia compared to East Asia.



Savings and investment rates. Finally, India, Pakistan and Bangladesh had much lower investment-to-GDP ratios compared to East Asia. In 1993-2002, China grew at 8.9 percent per annum with an associated average savings and investment rates of 39.8 percent and 42.3 percent respectively. In the same period, Korea's income per capita increased 55 percent with savings and investment rates of 32.3 and 34.4 percent respectively. These were substantially higher savings and investment rates than those of South Asian economies in the same period (Figure 13).



It could be argued that East Asia’s high investment rates, with only moderately higher growth rates than South Asia’s, means that East Asia is investing inefficiently. Indeed, the East Asian financial crisis in the late 1990s uncovered a large number of investment projects that were riddled with inefficiencies and waste. Is there a lesson for South Asia in this experience? Has South Asia been investing more efficiently than East Asia? Alas, the evidence does not support this. Figure 14 shows that compared to East Asia, both total factor productivity as well as capital accumulation has been lower in South Asia.



III. Policy Choices

In light of these challenges, the policy agenda facing South Asian countries, as they aspire to attaining 10 percent annual growth, seems enormous. Most of these policies are specific to the individual country’s circumstances. Nevertheless, just as South Asian countries are jointly experiencing rapid growth, they share some common themes for accelerating and sustaining this growth. In this section, we highlight the high-priority policy choices facing two or more South Asian countries⁴. These choices are organized around those aimed at increasing productivity and attracting investment; improving the quality of labor; reducing inequality; and exploiting cross-border synergies.

Increasing productivity and attracting investment

Resolving civil conflict. Civil conflict, especially in Nepal and Sri Lanka, closes off large areas to gainful economic activity. The long, drawn-out conflicts are a drain on the already thin administrative capacity and they erode governments’ ability to build a constituency for reform. Furthermore, conflict diverts valuable financial resources from public investments that attract private investment and promote growth to military expenditures. Resolution of civil conflicts therefore will have substantial pay-off in terms of unlocking development potential.

⁴ For country specific challenges, see annex “Growth Vignettes” on page 20.

Ensuring and sustaining macroeconomic stability. Macroeconomic uncertainty clouds the investment horizon and lack of fiscal space lowers public expenditures that attract private investment (infrastructure) and upgrade the quality of workers. Sri Lanka and India both have large national debts (105 and 85 percent of GDP respectively) driven by unsustainable fiscal deficits (8 and 9.5 percent respectively). In Sri Lanka, resolution of the civil conflict will help lower the deficit but the more chronic problems are the entitlements associated with the popular perception that Sri Lanka is a “welfare state” that must provide both jobs as well as economic and social services. In India, debt servicing increasingly shrinks the fiscal space for critical expenditures and it is only a matter of time before interest rates begin to rise steeply. Pakistan has pursued fiscal restraint after a decade of profligacy, but the rapid expansion of credit has led to an inflationary impetus which needs to be checked.

Upgrading infrastructure. The quality of infrastructure is critical for competitiveness and productivity growth. Bangladesh’s main port, Chittagong, is among the most inefficient and costly in the region. The generation capacity in the power sector (not increased for many years) has to be increased by addressing governance-related problems (corruption in tendering etc). Nepal must improve trade logistics with India to take advantage of the growth impetus of a large neighbor. In India, poor quality infrastructure did not impede export of internet-enabled services, but the competitiveness of trade in goods is affected by inefficiencies and bottlenecks in the road/railways network and ports. Equally important are city services that affect livability and thus influence location decisions. In Pakistan, the North-South corridor will be central to increasing up-country competitiveness. Sri Lanka’s road and rail network is in urgent need of modernization.

Diversification. India’s economy and its exports are beginning to diversify and create new growth vents. The other two large regional economies, Bangladesh, Pakistan also need to look beyond the cotton value chain. In Bangladesh, the considerable export potential in frozen food, pharmaceutical and ceramics needs to be exploited. Construction activity and new crop varieties (now that high-yielding rice varieties have run their course) will provide the next phase of productivity growth. Substantial growth impetus will also come from developing new urban clusters for economic activity to overcome the growth retarding congestion of Dhaka. In Pakistan, the canal colonies at the turn of the last century, import-substituting industrialization in the 1960’s, green revolution farm technology in the 1960s and the 1970s have run their course. Potential new growth vents are the Makran coast between Karachi and Gawadar, the opening up of the Eastern border for trade with India and product diversification, and the goods and energy trade with Central Asia.

Improving the quality of labor

Deepening human capital. Low productivity growth in South Asia (compared to East Asia) can be attributed, among other factors, to the region’s poor showing on worker trainability attributes (literacy, years of education) that discourage investment-led growth. The ongoing program of increasing gender-neutral enrolment in and completion of primary schooling is a welcome development. This needs to be complemented with a doubling of the transition to secondary education and tailoring East Asia’s public-private partnerships in firm-specific training programs to local conditions.

Nurturing remittances. South Asia with its young population is reaping rewards of increasingly integrated global labor market in the form of large remittances. Non-resident nationals have helped build up international reserves and give fillip to aggregate demand. In Nepal and Sri Lanka, they have helped bridge the regional income divide. South Asian workers overseas will remain an important source of income and economic growth for their respective parent countries. The human development programs must be mindful of this and must seek to strengthen the employability of South Asian workers in better paying jobs abroad.

Reducing inequality

Lagging regions. In India and elsewhere, growing income inequality will strengthen populist politicians and risk diverting the focus from pro-growth policies. The political leadership in lagging states will have to be engaged to address investors' reluctance to locate in those states. In Pakistan, agricultural productivity in lagging regions within provinces has to be increased and NWFP and Baluchistan governments' focus shifted to the growth agenda. In Sri Lanka, the growth potential of regions outside of Colombo and the Western Province has to be realized. Connectivity of Nepal's Western region and in parts of the Eastern region to domestic and international markets has to be improved via reliable and cheap road, telephone and electric power nodes.

Service delivery. Improved delivery of public services (health, education, water, sanitation) will help moderate the impact of personal and regional inequality on growth and will contribute to the sustainability of economic growth. Budget reform to give priority to cost effective public service delivery is ongoing throughout the region and needs to be completed. In Nepal, the legacy of social stratification by gender, caste and ethnicity in the allocation of public resources has to be redressed by making local institutions and the civil service more accountable for delivering socially inclusive outcomes. In Pakistan the gender gap in literacy has to be bridged and also the rural-urban divide. In India, state and central government sponsored services have to expand coverage, improve quality and be made more cost effective.

Achieving cross border synergies

Finally, South Asia remains the least integrated region in the world. Starting from such a low base, greater integration can generate enormous benefits along several dimensions.

Reducing cross-border conflict. Cross border conflicts, since independence, have eroded the old trade and investment patterns and mobility of people across borders. Both India and Pakistan incur large military expenditures at the expense of much needed social development. It is essential to manage conflicts in a way that social investments are protected and intra-regional trade, investment and people's mobility is restored to levels enjoyed by other regional groupings.

Regional trade. Intra-SAARC trade (at 6 percent of the area's worldwide exports) is woefully low compared to trade in other regional blocks (23 percent in ASEAN, 56 percent NAFTA, 61 percent EU, 12 percent MERCOSUR). This means that the cost efficiencies due to proximity are not being exploited. In part, this is the result of cross-

border conflicts (India-Pakistan), but also reflects poor intra-regional trade logistics. There are several fresh initiatives now towards “free trading agreements” between several South Asian countries. These are welcome as long as they restore the advantage of geography and facilitate global trade liberalization. The tendency to move to administered “free” trade agreements and the excessive focus on bilateral trade deficits need to be watched for their adverse impact on trade and competitiveness of the member countries.

Connectivity. Connectivity in general in the region is poor. Bangkok and Dubai, the two international airline hubs on either side of the region are better connected to capitals within the region than is any regional capital. This adds several hours of additional flying time and substantial cost to mobility within the region. Intra-regional telephone connections are also of poorer quality compared to each country’s global telecom access. Road/rail connections are sub-standard. Combined with visa restrictions and inadequate intra-regional banking services, we have a discouraging climate for intra-regional business activity.

Water. Nothing underscores more the need to promote pan-regional thinking than water. India and Pakistan on the West and India and Bangladesh on the East share common river systems. Agriculture in all three countries depends crucially on irrigation systems commanded by common rivers. Satisfactory water-sharing arrangements thus are critical in ensuring economic growth both via rising farm productivity and also by reducing the threat of conflict.

Energy. South Asia is characterized by one of the energy-thirstiest nations (India) sitting next to three energy surplus nations (Nepal, Bangladesh, Bhutan). Yet with the exception of Bhutan, energy trade between India and its neighbors is extremely small. Bridging the gap between energy supply and demand through regional cooperation could be one of the biggest wins in South Asia’s quest for growth.

To conclude, the recent improvement in growth outcomes in South Asia are encouraging and constitute a solid platform to build a program of sustained economic growth and poverty reduction in the coming decade. It is critical, however, that adequate investments are available and growth is broad-based and inclusive. This will require addressing a number of strategic and policy challenges specific to South Asian economies as well as cross border hurdles in the region. While the challenges are enormous, the dynamism and openness that characterize South Asia today make us optimistic that they will be met, and the region will be substantially free of poverty in a decade.

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Text Tables

Table 1: Pakistan: Sub-regional variations in economic outcomes: the case of Punjab Province

	Northern districts	Central districts	Southern districts
Poverty incidence	29.8	31.8	40.4
Gross primary school enrolment	108	92	60

Table 2: Growth Accounting in South and East Asia

	GDP growth	Capital growth	Labor growth	TFP
India	4.6	1.8	1.5	1.3
Pakistan	5.3	2.3	1.9	1.1
Bangladesh	3.4	1.2	1.6	0.6
East Asia and Pacific	6.5	3.2	1.7	1.7

Source: World Development Indicators and Regional data.

Table 3: Sources of External Funds \$ million in East and South Asia

	Net private capital flows	Foreign Direct Investment	Portfolio investment flows (Equity)	Remittances
China	59,455	53,505	7,729	4,625
South Korea	NA	3,222	NA	824
Thailand	1155	1949	1194	1,601
Malaysia	2207	2473	1340	987
India	10,651	4269	8237	17,406
Pakistan	132	534	-26	3,964
Bangladesh	86	102	0	3,191
Sri Lanka	236	229	-14	785
Nepal	14	15	0	1438

Source: World Development Indicators, 2005

Table 4: Income outcomes in 1993-2003 and targets for the next decade

	GDP Per capita 1993 (Constant, US\$)	GDP Per capita 2003 (Constant, US\$)	Percentage Change 1993-2003	Average GDP growth rate 1993-2003	GDP Percapita in 2013 @ 7% GDP growth per annum (Constant, US\$)	Percentage increase in GDP per capita (7% GDP growth) 2004-2013	GDP Percapita in 2013 @ 10% GDP growth per annum (Constant, US\$)	Percentage increase in GDP per capita (10% GDP growth) 2004-2013
Bangladesh	289	395	37%	5.0	665	68%	877	122%
India	332	511	54%	6.2	886	73%	1168	129%
Nepal	199	241	21%	4.4	388	61%	510	112%
Pakistan	493	546	11%	3.5	883	58%	1165	113%
Sri Lanka	681	921	35%	4.4	1641	78%	2164	135%
China	496	1067	115%	8.9				
Indonesia	665	781	18%	3.0				
Korea, Rep.	7916	12232	55%	5.3				
Malaysia	3039	4011	32%	5.2				
Philippines	877	1047	19%	4.1				
Thailand	1744	2276	31%	2.7				

Table 5: Poverty reduction associated with economic growth in the coming decade

	Annual average GDP growth rate of the last two years	Annual Population growth rate	Latest available poverty estimate	Poverty incidence in 2013	
				Base case: (GDP growth of 7% per annum)	High case: (GDP growth of 10% per annum)
Bangladesh	5.4% ¹	1.7%	49.8% (2000)	20%	12.6%
India	7.7%	1.5%	22.7% (1999-2000)	15.1%	12.5%
Nepal	3.4%	2.3%	31% (2003-04)	15.2%	9.4%
Pakistan	7.4%	2.4%	35.2% (2201-02)	13.4%	7.5%
Sri Lanka	5.7%	1.2%	22.7% (2002)	9.6%	4.3%

The following factors are critical in determining the growth impacts on poverty reduction:

1. **The relationship between household consumption and GDP:** It is not always that GDP growth rate is identical to the growth rate of household consumption. In fact, the latter tends to be lower than the former in the South Asia region. This distinction is important since the growth elasticity is computed with household consumption, not with GDP. For the above simulations, we estimate the relationship between the growth rates of household consumption and GDP from available data.
2. **Impact of inequality.** In Sri Lanka, the growth has not benefited the poor much during the last decade. Widening inequality tends to lower the growth elasticity of poverty reduction. The first table assumes there is no change in inequality, but Table 2 assumes inequality changes at the rate that is estimated from household surveys.
3. **Methodology used for estimating growth elasticity:** For Sri Lanka and Pakistan, the same method (Bourguignon (2003)) is used, while a different method was used for India and Bangladesh.

Table 6: Savings and Investment South and East Asia

	Average annual Gross capital Formation 1993-2003 Percentage	Average Annual Gross Savings/GDP 1993-2003 Percentage	Average Annual Gross fixed capital formation/GDP 1993-2003 Percentage	Incremental Capital Output ratio 1993-2003
Bangladesh	15.5	21.1	21.3	4.1
India	21.9	22.9	22.2	3.8
Nepal	13.7	24.2	20.6	..
Pakistan	14.9	17.3	16.3	7.4
Sri Lanka	16.5	24.8	24.6	2.8
China	42.3	39.8	36.9	4.2
Indonesia	27.0	22.6	22.2	5.3
Korea, Rep.	34.4	32.3	33.0	4.7
Malaysia	43.2	32.2	32.1	10.7
Philippines	16.9	21.6	21.0	1.0
Thailand	33.8	30.4	30.0	1.1

Source: World Development Indicators, 2005

Annex

Growth Vignettes

Sri Lanka

Social sector achievements, response to economic liberalization of the 1980's and recent out-migration in search of better employment opportunities are all indications of a country and work force whose growth potential should be similar to the East Asian economies' and the best performing regions of India. To realize that potential and to move towards doubling per capita GDP, the following aspects of the political economy need to be addressed:

Resolution of the civil conflict: The civil conflict has diverted valuable financial resources from public investments that attract private investment and promote growth, to defense and security related expenditures. This contributes to the low investment to GDP ratio. Furthermore, the long drawn conflict takes up a large share of the administrative capacity of the government. It also erodes government's ability to build a constituency for reform to generate political support to help meet the short term adjustment costs associated with reform. Progress in the resolution of the conflict is thus critical to realize the full growth potential of Sri Lanka.

Deepening economic liberalization: The impressive economic performance of the last two decades, especially in the western provinces (including Colombo) shows growth enhancing benefits of economic reform (in particular trade liberalization of the 1980's, and reforms in the 1990's spanning successful privatization of the 1990's in sectors such as telecommunications, airlines, ports and plantations; and strengthening of regulations and greater private participation in the banking sector). These reforms need to be deepened. For shared growth, it is important to extend economic liberalization to the rural economy, and especially, regions beyond the Western province. Some specific measures to increase rural incomes are better irrigation and farm technology and full and transferable ownership rights to land transferred to small holders. Economic stagnation in the estates sector needs to be reversed.

The economic program must be protected from the political uncertainties of delicate coalitions.

Public finances and public service delivery. The current structure of public finances that has resulted in a debt to GDP ratio of 105 and a fiscal deficit of 8 percent is unsustainable and inconsistent with the growth and poverty reduction targets for the next decade. Resolution of the civil conflict will help lower the deficit but the more endemic problem is the attitude of entitlements associated with the popular perceptions that Sri Lanka is a "welfare state" that must provide both jobs as well as economic and social services. The real challenge is to address this expectation and restructure public finances to give greater priority to market led growth and job creation while continuing to provide cost-effective social services to the deserving.

Nepal

The underlying resilience of Nepal and its growth potential can be gauged from the fact that despite the political uncertainties (associated both with the wrenching massacre of the entire Royal household a few years ago and the widespread Maoist insurgency), the country has registered respectable growth and has seen a sharp reduction in poverty. The private sector is understandably shy but the resourceful Nepali workers have found sources of employment outside the country and have sent a huge volume of remittances to fuel the economy. This gives

us confidence that, under the right policy mix, Nepal has the potential to meet the ambitious targets set for the next decade.

Civil conflict: The insurgency in Nepal is ongoing, widespread and less predictable than in Sri Lanka. Its impact on the economy therefore is all the more debilitating. Resolution of the conflict will thus have a large pay off in terms of meeting the growth and poverty reduction targets in the coming decade.

Connectivity: Large pockets of poverty in the Western region and in parts of the Eastern region, are due to poor resource endowment but also because the regions are poorly connected to the domestic and international markets. Reliable and cheap modes of connectivity (roads, telephone, electricity) will facilitate access to inputs and product markets and thus are a pre-requisite to releasing the growth potential of many poor regions.

Social inclusion and governance: The legacy of social stratification by gender caste and ethnicity in allocation of public resources has to be changed by strengthening local institutions and making them and the civil service more accountable for delivering socially inclusive outcomes.

Trade with India and the rest of the world: Although Nepal has benefited from the special trade and employment agreements with its large neighbor to the South, India, this geographical proximity can be exploited further especially given India's rapid growth and increasing openness to global trade. Improvements in trade logistics, customs and tax procedures, removal of the anti-export bias and measures that increase competitiveness of Nepali products and make Nepal an attractive investment destination, need to be implemented to increase productivity and derive the maximum benefit from trading with India and the rest of the world.

Nurturing remittances: Given resource poor areas, remittances by the Nepalese workforce employed overseas will remain an important source of income and economic growth. Nepal's human development program must be mindful of this and must seek to strengthen the employability of Nepali workers in better paying jobs outside the country.

Bangladesh

Optimism regarding Bangladesh rests on many achievements that include economic growth while maintaining macroeconomic stability, vibrant garments exports, the lowest fertility rate (and therefore population growth) in South Asia, outstanding human development especially removal of gender bias in education, reduction in income-poverty, overcoming famines and achieving food (rice) self-sufficiency, attaining disaster management capacity, promoting NGO's as an alternative service delivery mechanism, and nurturing a pluralist democratic civil society and a vibrant and free press. In order for Bangladesh to raise GDP growth by an additional four percentage points and sustain it through the next decade will require addressing the following:

New vents for growth: While there additional growth can be squeezed out of export of ready-made garments, the export potential of frozen food, pharmaceutical and ceramics is considerable, as is that of general manufacturing (currently growing at 7 percent) for the local market. Construction activity that received a large fillip due to remittances will also be a continued source of additional growth. In agriculture, new crop varieties and new technology (now that high yielding rice varieties have run their course) will provide the next phase of productivity growth. Substantial growth impetus will also come from developing new urban clusters for economic

activity to overcome the growth retarding congestion of Dhaka which will worsen as Dhaka's population increases to 23 million by 2015, making it the 2nd largest metropolis (the UN).

Competitiveness: To realize its growth potential Bangladesh will have to increase competitiveness of the economy. This will require upgrading trade and transport logistics, power and financial services. Bangladesh's main port, Chittagong port, is among the most inefficient and cost ineffective in the region and this has to be turned around. The generation capacity in the power sector (not increased for many years) has to be increased by addressing governance related problems (corruption in tendering etc). To support a higher growth trajectory, financial services need to be deepened and broadened and the capital market strengthened.

Competitiveness will also be strengthened by further deregulating the economy and especially, liberalizing trade (Bangladesh now is the most protected economy in South Asia).

Governance: Despite Bangladesh achievements, there is widespread view it suffers from mis-governance. Transparency International has ranked Bangladesh as the most corrupt country in its cross-country corruption ratings. Regardless of the methodological problems surrounding the measurement of corruption, there is plenty of anecdotal evidence to support the perception that corruption is endemic. Bangladesh will have to address this perception problem in order to attract the investment it needs to support the higher growth trajectory proposed for the next decade. A lowering of the *political temperature* will reduce allegations of corruption and will also be conducive to developing a consensus for taking tough actions to reduce incidents of mis-governance.

India

India's early (1950-1980) modest economic growth was the result of a broadly "socialist" policy framework that culminated in the balance of payments crisis of the late 1970's. Partly in response to that crisis, policy makers began a program of liberalizing the economy spanning policy and institutional reform in telecom, banking and capital market, tax reform, external trade and the exchange rate and foreign direct investment regimes (see Virmani, 1994, for an astute assessment of these reforms). Economic reform, in turn, attracted large inflow of savings (remittances) from non-resident Indians. In the 1990's, a confluence of factors (human capital, management expertise, enlightened political leadership in several southern states and advancement in telecommunications) contributed to India's emergence as a world player in IT services. While all of these features played a role in taking India to a higher growth trajectory, rigorous analysis (Virmani, 2005) shows that rainfall and its impact on agriculture remains critical in India's overall GDP growth. Thus, in order to sustain the recent high growth, even exceed it, dependency on the monsoon has to be reduced and the reform program has to be broadened and deepened to energize the non-agricultural sectors.

Address the debt overhang: The accumulating debt overhang fueled by high and unsustainable fiscal deficits must be addressed. Debt servicing increasingly shrinks the fiscal space for critical expenditures (social services, infrastructure) and it is a matter of time before interest rates begin to rise steeply. This is bound to dampen growth. Both public expenditure and tax revenues need a thorough review to bring the deficit under control.

Productivity growth: Sustained high GDPP growth has to be underpinned by productivity growth. The first phase of economic liberalization (1980's) bumped up GDP growth to a higher trajectory by unleashing productivity growth that has now tapered off as the pace of economic reform has slackened. Second generation economic reform, thus, needs to be hastened to regain productivity

growth. In agriculture, this means adjusting incentives to encourage farmers to shift to higher productivity crops; in manufacturing, it means upgrading products to compete in the international market on both quality as well as prices. Product diversification and standards, and quality control have to drive the production structures in both manufacturing and agriculture. National and state policy makers have to be conscious of this objective while intervening in input and output prices.

Upgrade infrastructure: While poor quality infrastructure did not impede export of internet-enabled services, the competitiveness of trade in goods will be affected by inefficiencies and bottlenecks in the road/railways network and ports. Equally important are city services that affect livability and thus influence location decisions. These elements of infrastructure, along with the power sector, need to be upgraded urgently.

Labor market reform: The regulatory framework governing factor markets, especially the labor market, needs to be reviewed to lower transactions costs. At xxx million or xxx of the labor force, India's large scale manufacturing generates surprisingly few jobs. This could reflect both high capital intensity of large units as well as a decision to contract work to smaller units to avoid costly regulation even though such business structures may be sub-optimal. Also, there are unintended, perverse consequences for the labor market. Informal labor contracts resorted to by the large firms result in far more insecure employment conditions than those sought by the regulation.

Regional equity: Indian democracy cannot sustain inequalities in living standards across regions. The growing income gap between the successful southern states and the lagging northern states thus has to be bridged. This will require upgrading health and education services and facilitating labor mobility to increase employability of lagging states' workers. State and Union government sponsored services thus have to expand coverage and made more cost effective. Furthermore, the political leadership of the lagging states will have to be engaged to address investors' reluctance to locate in those states.

Pakistan

Pakistan enjoyed impressive GDP growth of 6 percent per annum for nearly three decades till the end of the 1980's. Macro-economic difficulties associated with the need to service a large and growing national debt and steady decline in remittances (through the banking system) and concessionary capital, halved the growth rate in the 1990's. This changed soon after September 11, 2001 and its geo-political consequences. Pakistan's debt burden was reduced sharply, concessionary capital resumed and remittances surged. This, combined with far reaching reform of the banking and energy sectors, privatization of state owned enterprises and improved public finances has put Pakistan back on its trend growth path, even surpass it, in recent years. To sustain growth at this level, several aspects of the economic structure will need to be strengthened.

Macro-economic vigilance: Tight fiscal and monetary policies characterized the decade (1990's) of Pakistan's macro-economic difficulties and slow economic growth. Following improvement in external financing and revival of the banking sector under private control and with healthy balance sheets, it made sense to resort to credit expansion to jump start private sector-led growth. However, the recent pick up in inflation underscores the need to address the monetary overhang to avoid increasing the inflationary impetus. Furthermore, prudential regulations for the banking sector need to be enforced firmly to ensure that bank balance sheets remain healthy in this period of consumption-led boom.

Product diversification: Like India, Pakistan's overall growth performance is greatly influenced by the impact the vagaries weather have on agriculture. Unlike India, however, Pakistan's exports, heavily dependent on the cotton value chain, are also weather dependent. Crop diversification and more efficient use of water will help, but the need is to increase investment opportunities in manufacturing, especially beyond the cotton value chain.

Transitioning to investment-led growth: Low domestic savings and anemic foreign direct investment are indications that much need to be done to convince domestic and foreign private investors of the high return (net of risk) investment opportunities in the country. The efforts to reduce the political and economic risk of investing in Pakistan therefore have to be redoubled. In this context, government's commitment to deal firmly with militancy is reassuring as is its emphasis on second generation economic reform to further liberalize the economy and move to a pricing and investment regime (in energy, transport, exchange rates etc) that strengthens the incentives to invest in manufacturing.

Creating new vents for growth: Sustained long term growth comes from opening new growth vents i.e. frontiers that facilitate long term increases in productivity growth associated due to technical change. The opening up of canal colonies at the turn of the last century, import-substituting industrialization in the 1960's, green revolution farm technology in the 1960's and the 1970's were such growth vents. But they have now run their course. Potential new growth vents are the Makran coast between Karachi and Gawadar and the opening up of the Eastern border for trade with India and product diversification mentioned earlier.

Deepening human capital: Low productivity growth can be attributed to the country's poor showing on worker trainability attributes (literacy, years of education) and both discourage investment led growth. The ongoing program of increasing gender neutral enrolment in and completion of primary schooling is a welcome development. This needs to be complemented with a doubling of the transition to secondary education and tailoring East Asia's success in public-private partnership in firm specific training programs to local conditions.

Regional equity: Pakistan's cultural diversity and geography require paying special attention to the two western provinces, Baluchistan and the NWFP to ensure that growth is inclusive and citizens of those provinces consider their social welfare bound up with the country east of the river Indus. Education and connectivity in those provinces are of particular importance to enhance well-paying employment opportunities. In the Punjab and Sindh, the rural-urban divide requires urgent attention. Both provincial as well as the recently strengthened district governments will have to play a stronger role in initiatives that redress intra-provincial inequity.

Implementation capacity: Pakistan's record of reform as seen in new policy announcements is strikingly good. Results on the ground, however, could be strengthened further by enhancing institutional capacity to implement policy.

Annex Tables

Table A.1: South Asia: Recent Growth Performance (Average annual percentage change, 2001-2005)

	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
Real GDP growth	5.1 (5.4)	6.4 (5.5)	6.2 (7.7)	6.8 (8.6)	2.5 (3.8)	5.3 (6.5)	4.7 (5.6)
Growth in agriculture	2.2	3.0	3.1	6.6	3.0	3.3	0.7
Growth in manufacturing	6.3	5.3	6.4	6.2	-0.9	9.0	2.1
Growth in services	5.5	6.9	7.9	6.6	2.8	5.3	5.2
Recent reduction in poverty (last 10 years or so)	9% (1991/92)		10% (93/94)		11% (95/96)	-3% (90/91, but 12 points reduction in the 1980's)	6.1 (94-95)
Population							
GDP at market prices (latest, \$)	62 billion	725 million	672 billion	753 billion	5.5 billion	104.9 billion	20.7 billion

Table A.2: South Asia: Drivers of Growth (Average annual percentage change, 2001-2005)

	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
Export growth (last two years)	8.9 (15.0)	10.6 (20.3)	13.8 (22.7)	15 (14.3)	-0.5 (10.4)	11.5 (13.7)	1.5 (12.2)
Growth in remittances (latest in \$)	18.54 (\$2,932.53)*	No data	No data		10.8 (687.2 mil)	33.7 (\$4150)	7.9 (\$1,355)
Private investment growth (% of GDP)	2.13 (2.36)	23.5	14.8		8.2 (11.3)	9.3 (12.8) 13.2	-0.8 (17.9)
Public investment growth (% of GDP)	0.28 (0.44)	23.5	11		4.6 (2.4)	16.1 (2.7) (25.8)	-7.9 (-4.3)
Private consumption growth (% of GDP)	6.09 (6.41)	8.3	1.8		7.4 (7.5)	12.9 (75.6) (29.2)	1.3 (-0.3)

Notes: Bangladesh Remittances* US\$2,932 is the average period amount from FY01-05. Remittance in FY05 is US\$3,848

Pakistan: Remittances average period amount is \$2,970, the third entry for Pakistan is growth in the last two years.

Table A.3: South Asia: Macroeconomic balances (Average annual percentage change, 2001-2005)

	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
CPI inflation	5.1	2.9	4.4	1.3	4.0	4.8 (9)	9.4 (6.9)
Money supply change	14.2	12.3	15.3	18.9	10.3	17.8	15.5
Current account balance (% of GDP)	-0.3	-14.3	0.9	-7.9	0.03	0.9	-1.7
Fiscal deficit as % of GDP)	3.9	8.0	9.7	5.8	4.7	3.7	9.1
Debt as percent of GDP (share of foreign debt)	50.1 (31.9)	70.1 (66.2)	81 (7.8)	45.8 (27.9)	64.7 (48.2)	71.6 (34)	105.2 (47.6)

Table A.4: Poverty reduction in South Asia

	Previous			Latest		
	National	Rural	Urban	National	Rural	Urban
India 1	36 (1993-94)	37.1	32.9	26 (199-2000)	26.8	24.1
Pakistan 2	34 (1990-91)	36.9	28	37.3 (2001-02)	41.6	26.4
Pakistan 3	26.1 (1990-91)	25.2	26.6	32.1		
Bangladesh	58.8 (1991-92)	61.2	44.9			
Sri Lanka	26.1 (1990-91)	29.4	16.3	22.7 (2002)	24.7	7.9
Nepal	41.76 (1995-96)	43.27	21.55	30.85	34.62	9.55

Notes:

1. Planning Commission headcount estimates,
2. Pakistan: World Bank estimate, Basic needs Poverty Line
3. Pakistan: Official FEI poverty line

Table A.5. India: Regional variation in growth and poverty outcomes

	Population weight	Per capita GSDP (Constant prices, Rs) 2002-03	Per capita GSDP growth rate	Poverty head count (official), 199-2000	Poverty headcount (corrected), 1999-2000
All India	100	12,496	4.1%	26.1	28.6
Weighted average of 7 states below the national average	54.5%	8,183	3%	30	33
Weighted average of 7 states above the national average	32.9%	15,843	4%	18	21
Weighted average of Bihar and UP	24.3%	5,838	2%	35	38
Weighted average of Tamil Nadu, Karnataka, Andhra Pradesh and Kerala)	21.5%	13,110	5%	18	21

Table A.6. Trainability attributes of workers in East and South Asia

	Gross enrollment at secondary level (% , 2000)	Average years of schooling of adults (2000)
South Korea	>90	
Thailand	85	6.5
China	70	6.4
Philippines	78	8.2
East Asia		7.0
India	48	5.1
Bangladesh	45	2.6
Sri Lanka	76	6.9
Pakistan	40	3.9
South Asia		4.9

Source: World Development Indicators, 2004

Table A.7: Infrastructure Differences in East and South Asia

	Electric Power Consumption per capita kwh 2002	Percentage paved roads, 1997-2000)	Telephone mainlines per 1000 people, 2003	Container traffic TEU thousands 2003
China	987	NA	209	61,621
South Korea	6171	76.7	538	12,993
Thailand	1626	98.5	105	4,410
Malaysia	2832	77.9	182	10,072
India	380	57.3	46	3916
Pakistan	363	59	27	879
Bangladesh	100	9.5	5	625
Sri Lanka	297	81	49	1959
Nepal	64	30.8	16	NA

Source: World Development Indicators, 2005

Table A.8: Indicators of Investment Climate in East and South Asia

	Policy uncertainty	Corruption	Courts (lack of confidence courts uphold property rights)	Labor regulation
China	32.9	27.3	17.5	20.7
Malaysia	22.4	14.5	19.1	14.5
India	20.9	37.4	29.4	16.7
Pakistan	40.1	40.4	62.6	15
Bangladesh	45.4	57.9	83	10.8

World Development Indicators, 2005

Table A.9: Indicators of Business Environment in East And South Asia.

	Starting a business Days required	Registering property Days required	Enforcing contracts Days needed	Closing a business Years to resolve insolvency
China	41	32	241	2.4
South Korea	22	11	75	1.5
Thailand	33	2	390	2.6
Malaysia	30	143	300	2.3
India	89	67	425	10
Pakistan	24	49	395	2.8
Bangladesh	35		365	4
Sri Lanka	50	63	440	2.2
Nepal	21	NA	350	5

Source: World Development Indicators, 2005

