

## **Ishrat Husain: Economic development in South Asia and the impact of globalisation**

Keynote address by Dr Ishrat Husain, delivered on the occasion of the Middle East and South Asia Conference of KPMG, Bahrain, 11 July 2004.

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I would like to address three questions pertaining to the topic assigned to me this morning. The first question is: How have the South Asian economies fared in the last decade and what are their prospects for the future. The second question is: How well they have done compared to other competitor developing regions particularly East Asia? Finally, how have these countries positioned themselves to meet the challenges of globalization and what should they be doing to maximize the benefits of globalization?

### **Economic situation and prospects**

South Asia has grown at 5.6 percent in the decade of 1990s - faster than for low-income countries but slower than the East Asian countries. The wide ranging reforms that have been implemented in this region during the last ten years or so have brought about some fundamental changes in the economic landscape and removed some of the major constraints that were retarding the progress of this region. Let me recapitulate them briefly.

First, there is now a broad political consensus about the thrust and direction of economic policies in almost all the countries. The defeat of BJP Government in the recent Indian elections should not be construed as an indictment of reforms but a manifestation of the growing impatience of the electorate that these reforms have not been deep, pride and fast enough to touch the lives of the majority of the population. This political consensus has survived many changes of the governments in India since 1991 and the alternating shift of power in Pakistan, Bangladesh and Sri Lanka.

Second, reliance on private sector as the main investor, producer and distributor of goods and services has replaced the old notion of the commanding heights model of the economy in which State and State-owned enterprises were the main tools of industrial development. The demise of Licence Raj has given rise to a healthy competitive environment in which market mechanism is used for allocation of resources. This shift has improved the overall efficiency of resource allocation and utilization in South Asia.

Third, unilateral trade liberalization has been quite rapid in the 1990s in the whole region. Average tariff rates have declined from 90-100 percent in 1980s to 13-32 percent today. Sri Lanka leads the way followed by Pakistan. India and Bangladesh are considered laggards in trade liberalization according to a World Bank study, but are in much better shape than what they were in the 1970s and 1980s. Export promotion has finally been accepted as the new gospel in contrast to the past five decades of obsession with inward looking import substitution and protection of domestic industry.

Fourth, domestic financial and capital market reforms have made the financial sector sound and healthy. In Sri Lanka and Pakistan the strides made are quite advanced. India is slowly and gradually opening up to foreign competition and introducing new legislation to improve the performance of the banks and upgrade the quality of assets. Bangladesh has begun the process more recently but is committed to move forward in the same direction.

Fifth, macroeconomic stability i.e., low inflation, low domestic interest rates, and stable but realistic exchange rates, has become the hall-mark of these economies. Exchange rate regimes in all the countries have switched from fixed to managed float. Bi-directional movement i.e. both, depreciation or appreciation of domestic currency takes place according to market supply and demand conditions. There is no longer a hang up to defend a particular level of exchange rate and preserving competitiveness of exports and smoothing volatility are the main policy considerations. Large foreign exchange reserves are piling up in all the countries with India's coverage more than 15 months imports followed by Pakistan about 12 months and Bangladesh 4 months.

Sixth, fiscal consolidation and discipline are the furthest in Pakistan with fiscal deficit down to 4 percent of GDP compared to average 7 percent and domestic resource mobilization stepped up in the last five years by almost 70 percent. India's recent budget announced on Thursday aims at

4.4 percent of GDP for the Central Government but the consolidated deficit is still uncomfortably high. Tax-GDP ratios are low by comparison to other countries at the similar income levels. Therefore domestic savings and investment ratios have not matched those of China and other fast growing East Asian countries.

Seventh, India has clearly taken advantage of the low wage, English speaking, highly educated technical manpower to become a leader among the recipients of outsourcing of IT related services. The same trend is beginning to emerge in other services such as drug clinical trials, health Care, biotechnology, research and development. Although the immediate employment impact of the exports of these service is likely to be limited, in the medium and long term the expansion of burgeoning middle class and the demonstration effect on the younger generation to acquire higher scientific and technical education will help India in the transformation of its economy. Other countries in South Asia are latecomers to the scene and have a lot of catching up to do.

These improvements in macroeconomic fundamentals have led to up gradation of credit worthiness of India and more recently Pakistan. Both the countries have established access to international bond market at fine pricing.

Despite these positive achievements and strides made in these countries there are some very difficult challenges to surmount.

First, political and geopolitical risks in the region are still quite elevated. The long standing hostility between India and Pakistan, the acquisition of nuclear and missile capability by the two countries and the consequential sanctions imposed upon them, the active frontline status of Pakistan in the war against terrorism, the prolonged civil war between Tamil Tigers and the government in Sri Lanka, and the frequent strikes called by the opposition parties against the government in power in Bangladesh have added risks to doing business and locating investment in these countries.

Second, bureaucratic hassles, long drawn procedures, un-even application of rules and regulations, excessive discretionary powers in the hands of lower level bureaucracy, shortages of essential infrastructure facilities and low productivity of labor force have also made the region not such an attractive place for foreign investors.

Consequently, Foreign Direct Investment (FDI) has not yet made any significant impact on the economies of the region. FDI accounts for 0.5% of GDP with India receiving \$3-4 billion annually and Pakistan about \$1 billion. Portfolio investment to India had taken an upward trend but suffered a set back in the aftermath of the recent elections.

Third, there is a very little intra-regional trade taking place in South Asia. Intraregional trade has remained stagnant at less than 2% of the total trade in the last twenty five years. Regional trading arrangements have made a huge difference in North America, Europe and East Asia, but they have been unsuccessful in South Asia. The recent attempt to revitalize SAARC is in the right direction and will stimulate trade and growth but only to the extent that it unleashes competition that lowers domestic prices, enables achieving economies of scale and acquiring new technology.

A World Bank study has estimated that if normal relations had prevailed in 2001 and trade was at global averages, the Indo-Pak trade would have been \$1.85 billion rather than the actual trade of only \$254 million. Other estimates show that the volume of bilateral trade can surpass \$4 billion.

On the basis of the above developments, policy and structural changes that have taken place during the last ten years or more it would be safe to surmise that the probability of South Asia to attain average annual growth rate of 6 to 7 percent is within the realm of possibility. But as I point out in the later part of my remarks there are a number of additional measures that need to be taken as this growth rate can neither be automatically attained nor it can be taken for granted.

### ***South Asia - East Asia comparison***

It must be recognized at the outset that India accounts for 80 percent of the aggregate regional GDP of South Asia with only 7 countries while China's weight in East Asian GDP is only 60 percent among a group of 20 countries. Thus whatever happens to Indian economy has a much greater bearing on South Asia than is the case with China.

The above structural feature is amply reflected in highly differentiated trade expansion trends of the two regions. In 1978, the merchandize exports of both India and China were close or almost at identical level. But by 2004, China's exports have jumped to \$400 billion plus while India's exports had

reached \$60 billion. This trend is mirrored in the lackluster performance of South Asia's exports. During 1980-2002, South Asia's exports have barely grown from under \$50 billion to roughly \$100 billion. East Asia, a region of comparable size in population and GDP in 1981, has seen its exports grow from \$100 billion to nearly \$1 trillion in the same twenty-year period. In fact, all developing countries expanded their exports about three times from \$1.2 trillion to \$3.5 trillion and South Asia could not even attain the average growth rate of all developing countries.

As pointed out earlier, intra-regional trade as a share of total trade within South Asia was less than 2 percent and remained unchanged two decades later. But in 1981 East Asia saw its intra-regional trade grow from 10 percent to more than 18 percent between 1980 and 2002. This was all the more remarkable because trade was growing much faster as a share of GDP. In East Asia, trade grew at 2 to 3 times the pace of overall GDP growth. Today, South Asia is the least integrated of all six regions when measured as a share of GDP. While South Asia's share was 0.8 percent of GDP and East Asia's 26.5 percent, sub-Saharan African had intra-regional trade at 5 percent of regional GDP.

Why this dismal performance of South Asia when it is quite well established that openness leads to higher growth that, in turn, reduces poverty? As the region containing the highest number of the poor countries, South Asia has not been able to take full advantage of the opportunities offered by integration in the world markets through trade. It is only quite recently - the decade of 1990s to be more precise - that South Asian countries have resorted to liberalization but the pace needs to be accelerated to catch up with other regions.

South Asia today still has higher trade barriers than do other regions. India and Bangladesh have overall trade restrictiveness index of 36 percent and 24 percent respectively falling in the last decile of the most restricted trading regimes. This level of protection puts South Asian exporters at a disadvantage in third country markets. Not only the South Asia's predominant labor intensive exports face high tariff wall in the developed countries (Average tariff on Bangladesh's exports to the U.S. is 14.6 percent compared to 1.5 percent for the European Union exports) high import tariffs escalate domestic costs of imported inputs into export production putting them at a cost disadvantage compared to their competitors.

FDI flows into South Asian countries - other than for natural resource exploitation - have been mainly targeted at domestic markets. Unlike China where one half of all manufactured exports emanate from foreign owned ventures India offers its vast market of 1 billion population and 400 million consumers as a point of attraction for foreign firms engaged in non-IT related industries and services. Exports from foreign firms in South Asia are almost negligible as the high tariff protection to domestic industry makes the latter more profitable compared to manufacturing for exports. No wonder, FDI flows into East Asia have surpassed \$50 billion while South Asia has hardly reached one-tenth of that level. Proscriptions and restrictions on foreign investment in several sectors have also kept these inflows at a trickle. South Asia that accounts for 11 percent of GDP of developing countries receives only 3 percent of FDI flows.

### ***Meeting challenges of globalization***

Empirical evidence clearly indicates that globalization, technological progress and competition are the main drivers of growth and prosperity in the 21st century world. How well South Asian countries have positioned themselves in meeting this challenge is the question I wish to turn to now.

Economic fundamentals have improved to a very large extent in all the South Asian countries in the last decade or so. Broad political consensus on the content and direction of economic policies does provide some reassurance that the countries will be able to traverse this path with care and agility. I would therefore focus my attention on the things that need to be done to maximize the benefits from globalization.

First and foremost is investment in education and human development. The most recent census data for 2001 shows that India's literacy rate has gone up to 64 percent but it also demonstrates that at least one third of its population and labor force is not fully equipped to take up the ever changing and more complex tasks of the economy trying to outclass other competing countries. Pakistan and Bangladesh have almost half of their population illiterate and Sri Lanka is the only country in the region with almost one hundred percent literacy.

But his full literacy level raises another stark fact in our face i.e., the growing imbalance between the demand for skills imposed by market economic forces and the supply of skills produced by our educational institutions. There is a surfeit of highly educated graduates who are not employable and

there is a shortage of workers who can carry out routine technical jobs in production and service. India produces good quality Science and Engineering graduates every year who can cater to the high end of the job market but lack of attention to non-University technical education and its quality have created wide gaps at the middle end of the job market. This situation is much aggravated in Pakistan and Bangladesh where the issues of quality, relevance and numbers are all intertwined. Sri Lanka has no problem with the numbers but high level of unemployment among University graduates testifies to this mismatch in the skills. The widespread frustration among the parents and graduates on one hand and a high level of dissatisfaction among the employers in finding the right persons for the right jobs are further evidence of the imbalance in labor market.

This imbalance and lack of employability has serious repercussions for the composition and growth of the basket of goods that can be exported. The most dynamic and rapid growing sectors of exports in the world market today and in the medium term are those associated with high technology and to some extent medium technology. While India is making some headway in increasing its penetration of high technology exports the record of other countries in the region is not very promising. They are still stuck in the low technology exports particularly textiles and clothing which have a declining shares in the world trade. Thus the need to overcome the skill obsolescence and turn towards medium and high technology exports was never as apparent as it is today.

One particular means through which this change in the composition of exports can be accelerated is by removing the barriers and constraints in the way of foreign investors and Multinational Corporations (MNCs). FDI is an important force for integration for this as MNCs have set up supply chains and integrated production networks that tend to locate each stage of production in the country with the lowest cost. Affiliates of a MNC in one country often export to another for eventual sales in a third country market. These affiliates act as the on-the-job training grounds for the acquisition and dissemination of the skills needed for production and minimizing costs. These skills are then disseminated multiplied throughout other firms in the country.

South Asian countries have so far missed the boat by not becoming a part of global value chain and participating in international supplier chain arrangements. There is no single business model for participating in this chain and there can be many phases of transition and many modes of involvement. For example, joint ventures, franchising, purchasing by international firms, licensing, sub-contracting, fully owned firm, original equipment, manufacturing, original design and manufacturing, strategic partnerships for technology, overseas acquisition of equity are the diverse means whereby developing country enterprises can gain wide access to international markets at their own level of capability, climb the technology ladder and benefit from globalization. East Asia is a major participant in this global supply chain and produces parts and components for a variety of manufactures. It is time that South Asian countries do make an attempt to get engaged in this value chain.

SAFTA arrangements to be successful in the coming year require a number of important preparatory measures. These are described below:

- a) Trade facilitation through expeditious border crossings, quick custom clearance, efficient port facilities, improved transport links should precede or take and take place simultaneously with the expansion of volume of cross border trade.
- b) Domestic tax, tariff and subsidy policies that affect production and trade incentives should be harmonized to avoid recurrence of trade disputes and frequent use of anti dumping laws. As India provides a lot of subsidies to its producers in various forms and shapes the smaller countries are hesitant to allow MFN status to India. The recourse to a long negative list that restricts the volume of trade should be avoided at all costs.
- c) Macroeconomic policies such as fiscal and monetary policies should be harmonized to achieve a stable, non-discriminating macroeconomic environment for all the countries in the region.
- d) Supporting institutions to manage and facilitate integration, for example, setting standards, establishing regional development funds and for dispute resolution should be created.
- e) Communication and transport infrastructure between the bordering countries should be improved and upgraded to facilitate increased trade and factor mobility.

- f) Legal regulations for investor protection, intellectual property rights enforcement, anti-trust law, commercial law, labor relations, financial institutions should be harmonized.
- g) Financial markets should be widened and regulatory changes introduced to promote cross-border investment, listings, syndication, bond issues, etc.

Finally, I turn to the impact of WTO. I wish to clear the confusion that as if something drastic or unexpected or unknown is going to hit us in the near future due to WTO. All the countries in the region are already members of this organization since 1995 and have made binding commitments to maximum tariffs. In some cases the applied tariffs are lower than the bound tariffs. In actual practice, the South Asian countries have liberalized their imports and have been flooded with cheaper imports from China in the recent years. There could be no greater threat to the survival of domestic industry than competition from Chinese goods. Some industrial firms could not face the onslaught of this invasion and have died. Others have taken up by the challenge by cutting the fat, taking up the slack, becoming cost efficient, improving quality are competing with the new entrants. Thus the process of restructuring and transition is ongoing and should not pose any systematic threat to the industries of the region.

What we all seem to be focusing upon is the abolition of the textile quotas under the Multi-fibre agreement and the adoption of new agreement on Clothing and Textiles in January 2005. The impact of this new pattern of textile trade on the economies of South Asia region is highly varied and differentiated. Most simulation studies and modeling exercises carried by the World Bank, USITC and independent consulting firms give credence to the view that China followed by India and Pakistan will be the main beneficiaries of the abolition of quotas. These countries are all vertically integrated i.e., from producing cotton all the way to finishing, dyeing, stitching, etc. and enjoy low wage costs and low raw material costs. Pakistan, for example, has invested \$3 to 4 billion during the past five years to modernize and acquire state-of-the-art machinery that can produce quality goods according to the varying specifications and changing demand patterns of the buyers. On the other hand it is not obvious if all the ready made garment exporting firms in Bangladesh and Sri Lanka will be able to survive in the post 2005 markets. Both countries are seized of this problem and are taking measures to assist their firms and their workers.

Doha Development Round should be resumed as early as possible because whatever the benefits of regional trading blocks they are no substitute for participation in multilateral trade arrangements. These arrangements provide a much larger market to exploit which is several times the size of any regional block. Multilateral arrangements enlarge the market access substantially and permit wider competition, larger scale of operation and greater specialization all of which increase productivity and growth.

### **Conclusion**

South Asia has made substantial progress in the last decade to integrate in the World economy but given its slow start and initial handicaps there is a need for much rapid pace for liberalizing trade, attracting Foreign direct investment, assimilating new technology, upgrading human skills and actively participating in regional and multilateral arrangements.

Economic development and poverty reduction require ever expanding economic resources, which can only be generated through high economic growth. Openness is found to positively impact upon economic growth by making investment more productive and efficient and by nurturing incentives for new investment. South Asian countries faced with a high degree of poverty will benefit enormously from openness, integration in the World economy and maximizing benefits of globalization.