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Commentary

South Asian Surprises

Factors such as weak governance, civil conflict, fiscal deficits and a fixed exchange rate are deemed largely responsible for impeding growth in low income countries. One or more of these factors are present in each of the south Asian countries. Surprisingly, the economies in the region have been showing rapid growth. For each of these apparent surprises there is an explanation or interpretation, but one that goes beyond conventional macroeconomics.

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The macroeconomics of low income countries has been dominated by the efforts to understand Africa's 'growth tragedy'. Policy reforms are important for growth. But lack of policy reforms is insufficient to explain Africa's disappointing economic growth over the past two decades. Several authors have identified a variety of other factors that have retarded growth in the continent. Foremost among these is the role of weak governance, or less euphemistically, corruption, in countries such as Nigeria, where per capita income today is lower than it was before the oil boom [Kaufmann 2002]. A second factor is the corrosive role of civil conflict, which has been estimated to reduce GDP growth by 2-3 percentage points [Collier and Hoeffler 2003]. Finally, macroeconomic instability, as reflected in high fiscal deficits, has always been a constraint to economic growth in Africa [Fischer 1993; Ames et al 2000].

In addition to these basic factors which unambiguously hurt economic growth, there are two other features of the African landscape that could have helped but, in fact, turned out to retard growth: the reliance on an enclave natural resource – the famous 'natural resource curse' [Gelb 1988; Auty and Miksell 2000], and in the case of the countries in the CFA zone, a rigid and fixed exchange rate [Devarajan and de Melo 1991].

For each of these growth-retarding factors, south Asia – the only other low-income region in the world – appears to have a counterexample. Take corruption. According to Transparency International, the most corrupt country in the world is Bangladesh. Yet, this same country is growing at 5 per cent a year, with per capita GDP growing at over 3 per cent. Its GDP growth rate has been accelerating at 1 percentage point per decade over the last three decades. Moreover, this country has made remarkable progress in human development, even compared to its less corrupt neighbours. Bangladesh has almost achieved universal primary education; it already has an equal number of girls and boys in primary and secondary schools; and its infant mortality rate, which is lower than India's, is on track to reaching the Millennium Development Goal of a two-thirds reduction by 2015.

On conflict, Sri Lanka has had a civil war for the last 20 years during which its per capita GDP grew at over 3 per cent a year. In the 1990s, it grew at 3.9 per cent a year. Nepal has had a Maoist rebellion for some time, but between 1996 and 2004 per capita private consumption grew at over 4 per cent a year, or 40 per cent over the eight-year period.

On high fiscal deficits, India, although it is not macroeconomically unstable, has had a fiscal deficit of 10 per cent of GDP for the last 20 years, during which its GDP grew at 6 per cent. Last year, the GDP growth was 6.9 per cent; the year before, it was 8.5 per cent.

As for the natural resource curse, at least one south Asian country has successfully developed a type of natural resource, using enclave-style development: The Maldives' tourism industry leases out islands to tour operators. The industry employs foreign labour, and uses imported materials. The country has averaged 9 per cent GDP growth over the past two decades, with per capita GDP tripling to $ 2,300.

Finally, on fixed exchange rates, Bhutan, a tiny kingdom of about 6,00,000 people, has a fixed exchange rate with India, a country of over a billion people. Despite very different economic structures, Bhutan's economy has grown at 6.6 per cent, with per capita GDP growing at 4.4 per cent.

What Is Going On?

For each of these apparent surprises, there is an explanation or interpretation, but one that goes beyond conventional macroeconomics. In Bangladesh, basic services such as education and health have been delivered by the non-state sector – NGOs and the private sector. Over 93 per cent of secondary education (and 50 per cent of primary education) is provided by the private or non-profit sector. Many aspects of primary health care were delivered by NGOs. The providers have been financed by the government or donors, but they are not government officials. Essentially, there is a parallel economy for service delivery. The growth has been helped by the rapid expansion of garment exports, which in turn enjoyed access to duty-free imports of textiles (getting around the corrupt customs department), as well as – until 2005 – quota-rents in developed-country markets. And Bangladesh's world-famous microcredit industry, which now has 14 million borrowers, most of them women, has operated almost entirely outside the public sector.

In short, there was development despite the corruption because people found ways of going around the government. The other side of this is that the government made space for the NGOs and private sector to function.

In Sri Lanka, almost all of the growth during the conflict period occurred in one province – the western province, the region around Colombo. This province's share of GDP went from 40 to 50 per cent in the 1990s alone.[1] The reason is that this was the province that benefited from all the trade reforms Sri Lanka undertook. In addition, Sri Lanka's high literacy rate enabled it to enter niche garment markets with high export unit value. The rest of the country, which is mainly rural, stagnated

because there was much less reform in the agricultural sector. Sri Lanka is an example of how reforms do work – there is a supply response. And it shows how, when the conflict is localised, there can be growth in non-conflict areas.

Nepal's story is different. The dramatic reduction in poverty comes mainly from a sharp increase in remittances, which in turn is due to an increase in migration to India, and now increasingly to west Asia. The migration is partly due to greater opportunities elsewhere, such as rising agricultural wages in India, but also due to a 'push' factor from the Maoist rebellion. Families with young males sent their sons across the border to avoid them being recruited by the Maoists.

In India, not only are fiscal deficits 10 per cent of GDP, but the debt-to-GDP ratio is above 80 per cent. But inflation and interest rates are low, and growth was a healthy 6.9 per cent last year. How can this be? There are many interpretations, but I am particularly attracted to Brian Pinto's and Farah Zahir's story [Pinto and Zahir 2003]. They show that India is suffering from a 'hidden crisis'. By forcing the banking system to finance these high fiscal deficits, India is squeezing both public and private investment. While this may not show up in GDP growth today, it will mean that future growth will be constrained by a slow-growing capital stock.

For the last two puzzles, namely, why Maldives has not succumbed to the natural resource curse, and why Bhutan grows rapidly despite a fixed exchange rate, we can only speculate in the absence of any analysis. Unlike some of the African countries, Maldives has a homogeneous population, with a single ethnicity, language and religion. This could have helped create a sense that everyone shared in the tourism sector's prospects. Bhutan's largest trading partner and aid donor is India also, so the distorting effects of the fixed exchange rate may be minimised.

Possible Responses

How to respond to these puzzles also goes against conventional wisdom. This takes us into a discussion of the binding constraints to growth.

Bangladesh: Although NGOs have been the mainstay of service delivery, the solution now is not necessarily to push even more services through the non-state sector. Rather, it is to strengthen the public sector, so it can provide those services that it still needs to (but currently is not doing), such as standards and quality assurance for education. While corruption may not have been a binding constraint in the past, it may turn out to be one in the future.

Nepal: In addition to poverty reduction, there has been substantial progress in human development indicators. Both have to do with decisions being made at the local, community or household level. We need to strengthen, for instance, community-managed schools, as the government is preoccupied with internecine battles and stopping the Maoist rebellion.

Sri Lanka: The skewed distribution of income is a major source of concern, and possible instability. The key here is agricultural growth which will require liberalisation of agricultural and land markets. But there is a problem. Many people interpret the lack of growth in rural areas during the era of trade liberalisation as evidence that liberalisation does not help the poor. This is precisely the wrong conclusion. Where there were trade reforms, as in the south-west, it did help the poor (urban poverty fell by half in the 1990s). The reason for the rural sector has stagnated is because there have not been substantial reforms in this sector. How to change this mindset, and thereby give the government the political space to liberalise agriculture, is one of the biggest challenges facing Sri Lanka today.

India: Despite the unconventional circumstances, the policy prescriptions are quite conventional: fiscal adjustment is needed now, to allow greater room for public investment and other public expenditures, such as health and education, so growth will not be penalised in future. But the real problem in India is not asset creation, but asset management. Improving asset management can crowd-in private participation, lessening the need for public expenditures.

Clearly something is going on in south Asia. Roberto Zagha's 'Lessons of the 1990s' [World Bank 2005] lists as 'growth successes' those countries that had a faster per capita GDP growth rate than the US in the 1990s, and a 1980s growth rate of at least 1 per cent. The list contains only one Latin American country (Chile), a few tiny African countries (Botswana, Lesotho), no eastern European or central Asian country. Six of the eight countries in the south Asian region are on the list.

There has been substantial policy reform in south Asia. The pace of reforms has been slow but steady. As one observer puts it the south Asian policy-makers "only chewed what they can swallow". There have been very few policy reversals in south Asia (unlike Africa). And the sequencing of reforms has been reasonable – most probably by accident, not by design. One reason for this particular pattern is that India, Bangladesh and Sri Lanka are established democracies. Policies are formulated by consensus. The process is slow, but the outcomes are more durable.

The reforms are paying off better than expected in the sense that the underlying governance problems, conflicts and macroeconomic imbalances would normally be expected to retard growth, as they have in Africa. It appears as if the people of south Asia have found ways of getting around these problems, by seeking other ways of growing and reducing poverty, as with migration in Nepal, using NGOs in Bangladesh or concentrating on the industrial south-west in Sri Lanka.

This does not mean that the future is all rosy for south Asia. The governance and conflict problems have increased in Bangladesh and Nepal; Sri Lanka's conflict has not really subsided, even after the tsunami. And some people are quite worried about India's fiscal deficits.

What Are the Lessons?

These south Asian surprises, and their interpretation, lead to several lessons for different groups.

For Africa: Growth is possible, even with conflict, corruption and macroeconomic imbalances, but not without policy reforms. There may be room for more support to institutions that go around the government.

For South Asia: Stop seeking grand reforms that are too complex anyway (e g, civil-service reform in Bangladesh). Instead, look for the one or two salient reforms in your country that can strengthen what works in the country (e g, get the government to work more like NGOs in Bangladesh).

For donors: The binding constraints to growth vary across countries and over time. What you think is the binding constraint in a country may turn out not to be – so don't predicate support on relaxing that constraint. Be humble.

For researchers: We need to go beyond macroeconomic aggregates to understand better the functioning of labour markets, accountability of service providers, and political economy, to understand why a constraint that was binding in one context is not in another. And when we think we

have understood the problem, we need to think outside the box for solutions. EPW

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Note

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1 The regional concentration of growth has been observed in India, Pakistan and Bangladesh as well.

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