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South Asia's Diminishing Prospects

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Abstract

According to the latest assessments by two international development banks – the Asian Development Bank and the World Bank – and by the central banks of the three major countries of the South Asian mainland – Bangladesh, India and Pakistan – the region has lost some of the economic momentum built up over the last few years. This is largely the result of political uncertainty in the three countries. This has persisted in Pakistan for three years but some recent political developments in Bangladesh and India have also affected economic decision-making. The three countries, having undertaken with some success the first phase of economic reforms, now have to start focusing on the second phase. This will need consensus building which, in turn, demands the exercise of a considerable amount of political will.

South Asia, a subcontinent of 1.5 billion people and largely spared from the economic ravages caused by the Great Recession of 2008-09, was expected to move forward at a relatively brisk pace. Led by India, the area's largest and most dynamic economy, it was supposed to see its economy expand by about 8 per cent a year. That would have meant growth of 6 per cent a year in income per head of the population for the next decade or two. Had that ambition been realised, the region would have cut by one-half the incidence of poverty, from about 500 million people in 2011 to about 250 million by the end of the

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decade. People's move towards urban areas would have quickened; by the time the countries in the subcontinent took their population censuses in 2021, more than one-half of the population would be living in towns and cities. With this move there would have been a significant change in the structure of the economy. The share of agriculture in total output would have declined to about 15 per cent of the combined national product while that of industry would have increased to twice the proportion of agriculture or 30 per cent of the combined GDP (gross domestic product). The remaining 55 per cent would have been provided by the service sector and with this sector a significant proportion would have been contributed by such modern services as IT, communication, education, healthcare, entertainment and the retail trade. South Asia seems to be on the move.

This picture of the future is based on the reading of a number of studies done by two development banks – the Asian Development Bank and the World Bank[2] – and by a number of foreign consulting firms, in particular McKenzie. However, much of the euphoria that marked the environment in which these assessments were made has dissipated. According to the World Bank, 'after growing a robust 9.3 per cent during calendar year 2010, activity in South Asia moderated in the first quarter of 2011 – pointing to a projected slowdown in aggregate regional growth to a still buoyant 7.5 per cent in 2011'[3]. There is now a much more sombre mood among the analysts viewing South Asia's future. One important reason for this change is the simple fact that the future read in good times always seems brighter. The second reason is that the series of successes achieved by developing economies in the early phase of development are based on public policies that are easy to carry out, especially when they seek to release suppressed growth. Continuing them beyond the first and relatively easy phase requires the building of consensus that is not readily obtained in societies as diverse as those in South Asia.

That buoyancy can result in the first phase was certainly the case with India in which the rate of economic growth was suppressed below the structural rate of increase for about 40 years from 1947, when the country became independent, to the mid-1980s, when the economy was released from the shackles put on it by the first two generations of leaders. The Indian economy underperformed by 2 percentage points a year for four decades. In the mid-80s when the economy began to be reformed, its GDP should have been twice as large as it was when reforms began to take hold. That was when, in the words of Gurucharan Das, India, awakened by being unbound in the late 80s, sprinted forward.[4] But the reform effort, having

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[2] See, in particular, three reports by the Asian Development Bank, *Key Indicators for Asia and the Pacific, 2011*, July 2011; *India: A Partnership for Inclusive Growth*, May 2011; *Reshaping Global Economic Governance and the Role of Asia in the Group of Twenty*, April 2011. The World Bank in its annual *Global Economic Prospects, June 2011: Maintaining Progress amid Turmoil*, has a chapter on South Asia, pp.115-127.

[3] The World Bank, *Global Economic Prospects, June 2011: Maintaining Progress amid Turmoil*, Washington DC, 2011, p.115.

[4] Gurucharan Das (2002), *India Unbound: The Social and Economic Revolution from Independence to the Global Information Age*, New York, Anchor.

done the easier things, got stalled when more difficult areas had to be tackled by the policymakers. According to one Western India-watcher, 'many analysts had complained that the government, which has been in power for seven years, was doing little to address India's entrenched problems: low agricultural productivity, poor infrastructure, a weak education system that produces graduates with few skills and real estate laws that short change farmers and other landowners'.[5]

In 2009, Finance Minister Pranab Mukherjee, while presenting the budget for the 2009-10 financial year, promised that India would reach double-digit rates of economic growth within a couple of years.[6] That hope is now gone. On 25 August 2011, the Reserve Bank of India issued a blunt warning: economic growth could soon fall below 8 per cent. The growth rate was 9 per cent and 8.5 per cent respectively in the previous two years. Private investments declined last year as did the once robust car sales. The latter indicated some loss of confidence on the part of the middle classes which, nervous about the future, had begun to hold back expenditure on consumption. Indian stocks began falling in November 2010, declining more than 24 per cent from their high. Perhaps the most troubling development was inflation which hovered at nearly 10 per cent even after the central bank raised interest rates 11 times in less than two years. 'In a report published on Friday, 26 August 2011, analysts at Deutsche Bank said India's growth rates could even slip below 7 per cent if the United States and Europe fell into a recession'.[7]

There is also a growing concern about the health of the banking sector. 'Analysts warn that unlike 2008, this time around the economic slowdown comes at a time when banks have already been piling up bad loans, putting extra stress on their balance sheets… A recent report by IDFC Securities suggests that at least 17 per cent of Indian banks' outstanding loan assets could be on the verge of default.'[8] Crisil, the Indian rating agency owned by Standard & Poor's, expects overall bad loans held by Indian banks to raise from 2.3 per cent in 2011 to 2.6 per cent in the year to March 2012.

These worsening economic trends had surfaced before Anna Hazare, an anti-corruption activist, challenged the government to take a number of concrete steps to deal with the problem of corruption. The government initially took a tough stance; Prime Minister Manmohan Singh told Lok Sabha, the lower house of the Indian parliament, that street agitation could not become the basis of legislation in a well-functioning democracy. Hazare was briefly incarcerated but released and allowed to stage a fast in a public square in New

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5 Vikas Bajaj, 'Unrest builds as India adds a slowing economy to its corruption woes', *The New York Times* (27 August 2011), p.B3.

6 For an analysis of the 2010-11 budget, see Shahid Javed Burki, 'The Indian Budget: A Failure to Confront the Challenges', ISAS Brief No.117, 10 July 2009.

7 Vikas Bajaj, 'Unrest builds as India adds a slowing economy to its corruption woes', *The New York Times* (27 August 2011), p.B3.

8 James Fontanella-Khan, 'Indian banks under strain as bad loans rise', *Financial Times* (24 August 2011), p.15.

Delhi. ‘Mr Hazare’s demands are focused on a few main elements: he wants a Lokpal, an anti-corruption and accountability agency, with investigative powers over the federal government and similar independent organisations to monitor corruption in each state; he wants all public officials up to and including the prime minister to come under its ambit, except only the judiciary; and he wants lawmakers to require that all government departments create Citizens Charters, the equivalent of publicly accessible contracts explaining what services each office provides and how long it takes to deliver them’.[9]

Hazare ended his fast on 28 August 2011 after Lok Sabha passed a non-binding resolution accepting most of his demands about the shape of the accountability mechanism he and his followers wanted established. Before the parliament acted, Finance Minister Mukherjee, told the legislators that India was at crossroads. He warned the parliamentarians that the ‘success of Hazare’s tactics could encourage similar movements over issues such as land, health, education and nuclear energy’.[10] Hazare promised to do precisely that as he broke his fast, introducing an element of uncertainty into the country’s political system and the process of economic decision-making. However, the reverse could also happen.

If the Singh government was freed from the pressure under which it had come because of the high-profile cases of corruption involving some of the ministers in the cabinet, there was hope that the stalled process of reforms could be given a jump-start. There seems to be hope that the government may move in that direction. ‘But at last the government is talking up a new round of policy reforms,’ wrote *The Economist* in early August. ‘The country’s most senior civil servants have just advised the cabinet to let foreign chains operate in India’s highly regulated retail sector. A goods and services tax is supposed to be rolled out by next year, to help plug the budget deficit. Long-promised financial reforms are being proposed. A new mining levy will claw back some of firms’ growing profits, supposedly to cover environmental and social costs. Some of these plans will prove to be red dust blowing in the wind. But the government needs to act. It has already frittered away half of its second term since Mr Singh won re-election in 2009’.[11]

While the political turmoil in India is relatively new to the country, it has become a fact of life in Pakistan, South Asia’s second largest economy. The country’s economy has been the most poorly performing in the subcontinent with rates of GDP growth averaging 3 per cent a year since the return of democracy to the country in 2008. In fact, Pakistan’s GDP was increasing at a rate one-half that of Bangladesh and one-third that of India before the slowdown in the Indian economy. Pakistan’s economy was faced with unprecedented stresses, most of them caused by the failure of public policy. There was a serious shortage of

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9 Jim Yardley, ‘Impasse lingers between Indian hunger striker and government’, *The New York Times* (27 August 2011), p.3.

10 James Lamont, ‘Stunned MPs hand victory to Hazare’, *Financial Times* (29 August, 2011), p.2.

11 ‘India’s politics: Dust in your eyes’, *The Economist* (6 August 2011), p.34.

resources at the disposal of the government. In spite of the pressure exerted by the International Monetary Fund (IMF) that provided emergency assistance amounting to US$11.4 billion to reform the tax system, the tax-to-GDP ratio continued to decline. It reached 9 per cent in 2011, one of the lowest in the world. In late 2010, the IMF decided to hold back further tranche releases of the amount it had originally pledged, leaving US$4 billion undisbursed. The government's financial situation came under additional stress when the deterioration of the country's relations with the United States (US) led to the suspension of one part of American assistance – the amount provided to the military for the support it gave to the Americans for their operations in Afghanistan – to Islamabad. In July 2011, Washington held back some US$800 million of promised payments to Islamabad. This was a big blow to the cash-starved country.

Relations between the two long-time allies worsened dramatically following the killing of two young men in broad daylight on a busy street in Lahore by Raymond Davis, a CIA operative. Davis was held in a Pakistani jail for several weeks but was released after intense pressure was put on Islamabad by Washington. The Davis affair in January 2011 was followed by a raid on 2 May 2011 by American Special Forces in a compound in Abbottabad deep inside Pakistani territory. The raid was aimed at killing Osama bin Laden, the long-sought terrorist leader who had managed to live in a city that also is also home to the Pakistan Military Academy. Bin Laden died in the raid. The American operation came without the knowledge of the Pakistani army, plunging the relations between the two countries to an all-time low. A series of aggravations have followed, including the possibility reported by some Western newspapers that 'US spy agencies have concluded that it is likely the Chinese engineers – at the invitation of Pakistani intelligence operatives – took detailed photographs of the severed tail of the Black Hawk helicopter equipped with classified technology designed to elude radar… The members of the Navy Seals who conducted the raid had tried to destroy the helicopter after it crashed at Bin Laden's compound in Abbottabad but the tail section of the aircraft remained largely intact'.[12]

Before the deterioration in relations, Pakistan was rewarded handsomely for coming to the aid of America after 9/11. The total amount of assistance that flowed into the country was estimated at US$21 billion. The bulk of this was for the Pakistani military. American policymakers consider this to be generous compensation for Islamabad's help. Pakistan, on the other hand, maintains that the economic losses from the spread of terrorism in the country are a multiple of the amount the United States has provided. The government has calculated that up to 5 per cent of the gross domestic product is being lost because of terrorism. This translates into US$9 to US$10 billion a year, or four to five times the amount of yearly American assistance to Pakistan.

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[12] Mark Mazzetti, 'U.S. suspects Pakistan let China see crashed copter', *The New York Times* (16 August 2011), p.A3.

In addition to the shortage of resources to finance the government's day-to-day activities, Pakistan has very little available for investments to develop the economy. Recognising the resource constraint, the country's Planning Commission has prepared a strategy that will produce growth from improving the economy's efficiency.[13] This may sound like a reasonable path to take, but efficiency improvements can come only if trained manpower is at hand and institutions that are essential for achieving this goal are in place. Neither is the case in Pakistan at this time. The State Bank of Pakistan, the country's central bank, seems reconciled to seeing the economy underperform in the immediate future. It estimated GDP growth in 2010-11 to be no more than 2.4 per cent, much lower than even the low growth in the previous year estimated at 3.8 per cent. No pick-up was in sight since the government needed to move simultaneously on a number of fronts and does not seem to have the political will to do so. 'In our view, the growth outlook will be shaped by policy responses to several key domestic challenges: (1) energy shortages, which are restricting growth; (2) high fiscal deficit whose financing has become difficult – partly owing to the backlog arising from the non-recognition of power subsidies of earlier years as reflected in the 'circular debt'; (3) build-up of domestic debt raising concerns for macro-stability; and (4) inflationary pressures which are not receding steadily', wrote the bank in its quarterly report for April-June 2011 on the state of the economy.[14]

Weighing heavily on the economy was the continuing acts of domestic terrorism, not all of which could be attributed to the activities of Islamic extremists who had gained a foothold in the country. In July 2011, the city of Karachi erupted into violence because of the rivalry between several ethnic groups which were vying for political power.[15] 'Like no other city, Karachi distils a mix of gun politics, ethnic tensions, sectarian strife, state weakness, militancy and organised crime that makes the whole country so fragile. It is these trends that will determine whether Pakistan's hesitance from military rule to a semblance of democracy will deliver greater stability or deeper fragmentation', wrote Mathew Green for the *Financial Times* special report on Karachi.[16] An estimated one thousand people were killed in the summer of 2011 as a result of the violence in the city.

There was some fear among policy circles in the US that some of the terrorist groups based in Pakistan, including *Lashkar-e-Taiba* (LeT) and the Haqqani group, could be planning 9/11 type of attacks on the US. The group is operating out of North Waziristan in the Pakistani tribal belt bordering Afghanistan. LeT has its headquarters near Lahore, the country's second largest city. A report prepared for the Council of Foreign Relations speculated that were such an attack to take place, the Obama administration would be forced to act decisively. Domestic

[13] Government of Pakistan, Planning Commission, *Pakistan: New Growth Framework*, Islamabad, January 2011.
[14] State Bank of Pakistan, *The State of the Economy, Quarterly Report*, for April-June 2011.
[15] For an analysis of the ethnic basis of violence in Karachi see Shahid Javed Burki, ISAS Brief No.211, August 2011.
[16] Mathew Green, 'The killers of Karachi', *Financial Times* (17 August 2011), p.5.

politics in the US would demand such a response. But the result would be the possible disintegration of the Pakistani state with unimaginable consequences for South Asia and the rest of the world.[17]

Bangladesh, the third large country in the South Asian mainland, was also in the grip of political upheaval that began to adversely affect its economy. The country has done well in the last several years. Its economy, with an annual output of US$100 billion when converted at the official exchange rate, has been growing by nearly 6 per cent a year. The healthy rate of growth has been fuelled by the world's third-largest garment industry (inappropriate, suggest exporter/producer) and by large inflows of remittances from its citizens working abroad. Aid is also plentiful and there are serious efforts – more serious than in the other large countries of South Asia – to help the poor. The incidence of poverty has been declining. But the Prime Minister, Sheikh Hasina, instead of building her electoral prospects on the basis of the performance of the economy, has turned on her political rival, Khaleda Zia. According to the 'Banyan' column in *The Economist*, 'sadly, judging by her recent behaviour, she seems to seek instead to crush the opposition and provoke an election boycott, silencing pesky critics as she goes… More surprising was [her] attack on Muhammad Yunus, thrown out of the Grameen Bank he founded. His most obvious mistake came in 2007, during the two-year interregnum, when he flirted for a while with launching a political party – a 'third force' to break the old duopoly. Rumours swirl in Dhaka, however, that Mr Yunus's other sins included his accepting the Nobel Peace prize that Sheikh Hasina felt should have been hers…'[18]

Table 1: South Asia's Economic Performance and Prospects

	Bangladesh	India	Pakistan
Population (million), 2010	162	1,156	170
GNI (current US$ billion), 2009	94	1,406	170
Growth (%), 2000-09	5.9	7.9	5.2
Growth (%), 2010	5.8	9.7	4.4
GNI (current US$ billion, 2010)	104	1567	183
Growth (%), potential, 2011-15	7.0	8.5	6.0
Growth (%, likely), 2011-15	6.0	7.0	3.0
GNI (US$ billion) potential, 2011-15	146	2,356	244
GNI (US$ billion), likely, 2011-15	139	2,198	212
Difference (potential-likely), US$ billion	7	158	32

Source: Author's calculations based on *World Development Indicators, 2011*, The World Bank, Washington DC, 2011.

[17] Stephen Tankel, *A Pakistan-based terrorist attack on the U.S. homeland*, Council for Preventive Action Contingency Planning, Memorandum #13, Council on Foreign Relations, New York, August 2011.

[18] Banyan, 'In the name of the father, *The Economist* (13 August 2011), p.34.

It would appear, therefore, that the loss of economic momentum in South Asia was largely the consequence of various kinds of political problems that affected, in different ways, the large countries of the region. Data in the accompanying table provide some illustrative quantification on the likely performance of the South Asian economies and their potential from 2011 to 2015. If the numbers presented hold, the three economies could underperform by an aggregate amount of US$200 billion in the next four years. This would be equivalent to a loss of US$150 per capita in income during this period. That is a sizeable loss, about 15 per cent of average income.

That said, there have been some positive developments of note. These are related to the easing of tensions among the area's countries. On 27 July 2011, Hina Rabbani Khar, the newly appointed foreign minister of Pakistan, visited New Delhi to meet her Indian counterpart, S.M. Krishna. The two sides decided to resume the comprehensive dialogue on various issues that was begun in 2004 following agreement between Prime Minister Atal Bihari Vajpayee, then prime minister of India, and Pervez Musharraf, Pakistan's former president. The talks were suspended after the terrorist attack on Mumbai in November 2008 that took 168 lives and was traced back to *Lashkar-e-Taiba*, a terrorist organisation based in Pakistan. The Indians demanded (inappropriate, insisted?) that the talks between the two countries could only resume after the authorities in Pakistan had moved against the people who had engineered the attack. Persuaded that such a move would possibly further destabilise Pakistan, New Delhi dropped that condition. According to Rajshree Jetly, writing for the Institute of South Asian Studies, 'this time terrorism was not allowed to become a stumbling block. New Delhi and Islamabad remained committed to carry on with the talk, which came just two weeks after the triple bomb blasts in Mumbai on 13 July 2011. India resisted from jumping to conclusions or indulging in a blame game until investigations of the July 2011 attacks were completed. In a similar vein, Pakistan also resisted from making any remarks on India's alleged role in aiding the insurgency in Baluchistan'.[19]

There have also been palpable improvements in Bangladesh's relations with its large neighbour, India. These relations have been always tricky ones, according to Iftekhar Ahmed Chowdhury who served as Bangladesh's foreign minister for two years, from 2007 to 2009. '[They are] often fraught with petulance and pitfalls. Despite the Indian support at independence, when Bangladesh found itself geographically 'India locked', it recognised its main foreign challenge was to live in "concord with" but "distinct" from its powerful neighbours'. Chowdhury expects that a raft of documents would be signed during Prime Minister Manmohan Singh's visit to Bangladesh in September 2011.[20]

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[19] For an analysis of the Khar visit to New Delhi, see Rajshree Jetly, 'India and Pakistan Foreign Ministers' Meeting: New Hopes and Expectations', ISAS Brief No.209, 1 August 2011.

[20] Iftekhar Ahmed Chowdhury, 'Come September, Manmohan Comes to Dhaka', ISAS Brief No.214, 15 August 2011.

If the South Asian nations can cast off the burdens of history accumulated over many decades, they can significantly improve their economic prospects. Intra-regional trade in that case could become one of the drivers of economic growth and help the region to overcome its present difficulties and realise its large potential.[21] It may also help in the political stabilisation of the region.

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[21] This argument was developed in Shahid Javed Burki, *South Asia in the New World Order*: London, Routledge, 2011.