



## Chapter 16

# SOUTH ASIAN ECONOMY IN 2060

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South Asian economies have grown rapidly during the last two decades recording an average growth rate of 6 percent annually. Incidence of poverty has been reduced although the absolute number of poor has increased in the last two years because of the external shocks and internal turbulence in some countries. The private sector has been the principal driver of the economic turnaround as increased competition resulted in improved efficiency with productivity growth accounting for half of overall growth. Structural reforms in trade, taxation, investment and foreign exchange regimes over more than a decade have contributed to this growth in productivity. Integration in the global economy through trade, investment, technology transfer and movement of labor picked up speed since 1991 and has begun to pay dividends. The scope for further gains remains vast as both trade/gross domestic product (GDP) and foreign direct investment (FDI)/GDP ratios are low. Despite these favorable outcomes and a resilience to face external shocks, the region has the highest number of poor in the world, human development indicators place it in the lowest category, income and regional inequalities are on the rise and social cohesion is still an elusive goal. This paper argues that the growth and poverty reduction record could have been better if the potential of regional economic cooperation had been exploited, bilateral relations among neighboring countries were warmer and hostilities and trust deficits between countries was absent. An expanded market with economies of scale in production, better connectivity through infrastructure, trade facilitation and communications and an ease of movement for people and ideas offered enormous opportunities that were missed over a long period of six decades.

### **Intraregional Trade: Failure and Future Prospects**

South Asia historically had high intraregional trade. In 1948 as much as one-fifth of the trade took place within the region but at 6 percent today it is the least integrated region in the world. In contrast, East Asia and the Pacific's intraregional trade has risen to 52 percent. Even Sub-Saharan Africa carries out twice as much intraregional trade as South Asia. Cross-border investment is negligible and while there is an overall liberal environment for foreign investment flows, there are a host of formal and informal

restrictions on flows originating from within the region. Common historical and cultural heritage would – in other parts of the world – have eased the movement of the people, educational exchanges, access to each other's media and cultural resources, the sharing of scientific and technological knowledge and other forms of cooperation but none of this has happened. For example, Indian and Pakistani Punjab, Assam, and Sylhet, and Northern Sri Lanka and Tamil Nadu despite being geographically contiguous have not derived any benefits from their proximity to each other and drifted apart during the six decades following independence.

Trade facilitation with other regions and hubs such as Dubai has been a consistent policy goal of each of the South Asian countries individually, yet when it comes to trade across borders within the region, all kind of hurdles have been imposed. Issues of phytosanitary, health and environmental standards, quality testing and adherence to specifications are raised, causing considerable delays, lengthened travel times and higher transaction costs. Truck crossings, where allowed, take several days and allegations of harassment by the border officials are rampant. Nontariff barriers on India–Pakistan trade have therefore diverted normal trade flows to informal networks or border trade or are routed through third parties such as Dubai and Singapore, which raise costs for end-users. There is another compelling reason for promoting regional economic cooperation. All the countries in South Asia are characterized by leading and lagging regions. Growth poles extending to contiguous areas across national borders will expand markets of goods and services, facilitate larger capital flows, improve infrastructure and generate additional opportunities for earnings in the lagging regions. This strategy would force the respective national governments to invest in regional public goods and expansion of productive capacities in intraindustry goods and services.

### **Demography: Positive and Negative**

Looking to the future, particularly the long term, South Asia's challenges are many but at least four of them will make a material difference to the social and economic outcomes in the next fifty years. The first challenge is the demographic – South Asia will be the only region of a sizeable population with more than 50 percent of its population in the productive employable age bracket. The flip side is that this region can ease its unemployment problem by supplying young workers to the rest of the world in an environment of ageing populations and the rise in dependence ratios. Whether this challenge can be transformed into a dividend will depend upon the priorities, policies and programs that the governments of these countries are able to conceptualize and implement.

South Asia can be well positioned to reap the benefits of favorable demographics. To the extent that these countries invest in education, particularly technical and vocational education, expand access to higher and professional education and upgrade the quality and relevance of instruction, there is a strong likelihood of this demographic transition paying dividend. This dividend may elude us however, if South Asia fails to meet the goal of educating a growing younger population, equipping them with marketable

skills and facilitating their mobility across the borders. The challenge is quite daunting as two thirds of the world's illiterate population resides in South Asia and the addition of new entrants to the labor force every year equals the entire population of a midsize country. A study by Goldman Sachs shows that with the continued movement of labor from rural agriculture to urban industry and services India will earn an "urbanization bonus" (Goldman Sachs 2007a). Based on current trends, a massive 700 million people – roughly equivalent to the entire current population of Europe – will move to cities by 2050. This will have significant implications on demand for urban infrastructure, real estate and services. The movement of surplus labor from low productivity to high productivity and services contributes about one percentage point to annual GDP growth. Productivity in industry and services is more than four times that in agriculture, which employs nearly 60 percent of the labor force. A turnaround in manufacturing productivity has been central to the ratcheting up of productivity growth.

The dependency ratio is forecast to decline to below 50 by 2020. Savings rates tend to increase with falling dependency ratios, rising incomes and greater financial sector development. Empirical estimates for India indicate that savings tend to increase about 0.8 percent for every 1 percent fall in dependency. Assuming that the response is lower in other South Asian countries, the falling dependency ratio should be able to raise the savings rate by at least 6 to 7 percent by 2020. To the extent that investment rates rise *pari passu* the structural shift in growth paths could produce a rise of around 2 percent.

### **Climate Change: Tough Choices**

The second challenge is coping with climate change and its consequences for agriculture, food production and energy supplies. Over 500 million people in South Asia have no access to electricity while growth is typically associated with carbon emissions. How South Asia can balance its energy needs and growth while addressing global warming is a serious dilemma for policymakers. A recent World Bank study on the impact of climate change on South Asian countries provides an authoritative account of what we can expect in the coming decades.

The study postulates that the imperatives of climate change and policies adapted to contain carbon emissions may slow progress toward many development goals, such as eradicating poverty, combating communicable diseases and ensuring environmental sustainability. Geography coupled with high levels of poverty and population density has rendered South Asia especially vulnerable to the impacts of climate change. High population levels translate into increased resource demands on an already stressed and largely degraded natural resource base. With an estimated 600 million people subsisting on less than \$1.25 per person a day, even small climate variations can cause irreversible losses and tip a large number of people into destitution.

The region spans a variety of climate zones, including arid deserts, parched rangelands, freezing alpine mountains and humid tropical islands. The projected impact of climate change will be heterogeneous, suggesting that there can be no one-size-fits-all approach to building climate resilience across South Asia. Responses will need to be customized to

specific risks and circumstances. Indeed, over 50 percent of South Asians – more than 750 million people – have been affected by at least one natural disaster in the past two decades. The human and economic toll has been high, with almost 230,000 deaths and about \$45 billion in damages. The region shares common geological formations and river basins, leading natural hazards to frequently transcend national boundaries. With climate change the frequency and incidence of such natural disasters is projected to increase.

The monsoon is the most significant climate event in the region's economic calendar. It carries over 70 percent of South Asia's annual precipitation in a brief four-month period. A buoyant monsoon heralds bountiful harvests and financial security, yet when monsoons fail – or are excessive – suffering and economic loss are widespread. If climate projections are indicative of future trends, the risks associated with water-related climate variability are likely to worsen. The Himalayas are a vital life-sustaining resource for South Asia, supporting the approximately 1.5 billion people who live directly in the floodplains of its many rivers – the Indus, Ganges, Brahmaputra and Meghna. With rising temperatures, the ice mass of the Himalayas and Hindu Kush is retreating more rapidly than the global average posing an unprecedented threat to water supplies, lives and economies in the region. With melting glaciers, flood risks would increase in the near future. The floods in Pakistan in August 2010 that caused a major devastation to human lives and property are a preview of the damage that extreme climatic events can bring about. In the long term, in absence of replacement for the water provided by glaciers, water shortages could result at an unparalleled scale. Reduction of yields for major crops by as much as 20 percent and an even sharper decline in agricultural incomes are part of the worst-case climate scenarios for the region as well as a growing scarcity of water. Avoiding this future will necessitate balancing more variable water supplies with the accelerating demand for water and would require significant adjustment to the region's agriculture.

South Asia also has long and densely populated coastlines with many low-lying islands. In the severe climate-change scenarios, sea-level changes could pose an existential threat, potentially submerging much of the Maldives and inundating 18 percent of Bangladesh's total land – directly impacting 11 percent of the country's population. Saltwater intrusion from sea-level rises in low-lying agricultural plains could lead to food insecurity, further increase the prevalence of water-related diseases and reduce freshwater supplies. Many of the region's primary cities, such as Chennai, Cochin, Karachi, Kolkata and Mumbai – the engines of regional growth – are located on the coast and threatened by rises in sea levels. The immediate impact of sea-level rises would be felt in coastal communities and ecosystems but the ripple effects could be felt beyond borders if there is a large-scale displacement of populations in the densely inhabited coastal areas and erosion of protective coastal ecosystems.

### **Reaping the Benefits of Technology: The Sooner the Better**

The third challenge facing the region in the future is the speed with which South Asia is able to reap the benefits of technology and to use this as an engine of growth

and human development. Recent economic theory and the related empirical evidence suggest that one of the major reasons why some countries find themselves in poverty traps are differences in the endowment of knowledge and the capability of poor countries to absorb new knowledge. The only way to break out of these poverty traps is the successful absorption of technology through a technically trained and highly educated manpower.

The capacity of South Asian countries to assimilate, adapt and widely diffuse emerging technologies is constrained by the shortages of skilled, technical and vocational manpower, outdated educational systems and neglect of research and development (R&D). A highly competitive world has raised the demand for skilled workers and professionals, yet the record of many South Asian countries in terms of meeting this demand is not very encouraging and the deficit in skills remains one of the major obstacles to successful technological diffusion. While the global average for technical and vocational education and training (TVET) enrollment is 10 percent, in South Asia this rate is only 1 percent. In addition to poor enrollment, the TVET system in South Asia also suffers from other constraints such as a gender gap.

The gross tertiary enrollment in South Asia is one of the lowest in the world, second only to Sub-Saharan Africa. East Asia has managed to raise the enrollment threefold from 7 to 24 percent in four decades while South Asia's ratio went up from 4.2 percent to 10.5 percent. The region is also characterized by disparities in access to higher education by females and the choice of disciplines by the enrolled students is also a matter of concern – only one-fifth of the tertiary level students in South Asia go for science and technology subjects compared to 40 percent in East Asia. Not only is access limited, but quality and relevance are also not up to mark. A low availability of well-qualified and competent teachers is amongst serious constraints hindering the expansion of quality higher education in the region. Additionally, the curriculum is outdated and has poor linkages with industry. As a result, the majority of graduates face difficulty in finding decent productive jobs.

Wage inequality has risen in South Asia and is a powerful contributor to rising total inequality. The skilled labor force and professionals are enjoying a huge premium, with the wage dispersion much wider than ever before and likely to grow further. Empirical estimates show that between one-third and one-half of overall income inequality can be accounted for by sharp differentials in wages at both ends. These inequalities have been wrongly attributed to liberalization policies pursued in the South Asian countries since 1991, but the real culprit is the premium skilled labor fetches in the market relative to the unskilled. Economic theory suggests that the rising premium earned by skilled manpower would attract investment in supply of these skills, but flawed public policies and capital market failure have not yet produced the desired response.

The domestic economies of South Asia are suffering from a mismatch between the supply of university and college graduates produced and the current and prospective demands of their employers. A study of fresh university graduates in India shows that only 10 percent of them were as good as those produced in any world-class institution, while about 50 percent of them were simply unemployable in their own country for

the jobs for which they had been trained. The proliferation of institutions of higher education with poor academic standards, assessments based on rote memory and teachers of dubious quality are producing armies of unemployable youth. Industries, including agribusiness and services in contrast continue advertising for jobs that remain unfilled. As a result, unemployed youth have become an attractive source of recruitment by terrorists, extremists, narcotic agents, war lords, criminal syndicates and mafias of all sorts.

Information communication technology (ICT) tools can help South Asian countries leapfrog the literacy and skills gap by augmenting the delivery of innovatively designed, learner-focused contents and enable masses to read and write within a short period of time and for others to acquire marketable skills. As teachers always need to update their knowledge and skills to transfer them, online resources provide audiences with excellent opportunities to learn through a rich resource base. There are several examples of innovative approaches being practiced in South Asia – transforming the illiterate to semi-literate or functionally literate. Their coverage and outreach are limited however as they are run by nongovernmental organizations (NGOs) and civil society organizations and the replication of successful models and experiments can only be undertaken with the active involvement of the government.

R&D activities in South Asia – both by the public and private sectors – are negligible in scale and lackluster. South Asia spends only 0.65 percent of its GDP in R&D, which is less than half of what the East Asia and Pacific region spends and the private-sector contribution in this effort is quite insignificant. Universities and institutions of higher learning have very little links with the industry or other economic sectors and as a result the stock of R&D personnel in South Asia is the lowest among developing regions. The location of R&D centers by many Fortune 500 companies in India would definitely give this a boost, but the inclusion of the countries of the region as the feedstock for these companies would assure persistent and reliable supply of a larger pool of low-cost, highly skilled scientists, researchers and technologists.

### **Overcoming Bilateral Problems: Prospects for Regional Integration**

The fourth challenge is the nature of bilateral political relations between the states of South Asia and the interrelated security concerns. If – and that is a big if – the perpetually adverse bilateral relations are normalized and all the countries manage to live in peace and harmony, without attempting to covertly or overtly destabilize the other, the prospects offered by regional economic cooperation are highly attractive. South Asia's geography has the potential to accelerate growth, as it has the world's second largest proportion of populations living in border areas, second only to Europe. High population density and better access to markets can facilitate growth by allowing South Asia to take advantage of agglomeration economies. Empirical studies using gravity model and simulations show that there is a significant trade creation effect under South Asia Preferential Trade Agreement (SAPTA) with little or no evidence of trade diversion effects on the rest of the world.

A removal of trade barriers by opening up access to larger regional markets stimulates competition, which could help boost allocation and productive efficiency by facilitating industrial restructuring. A regionally integrated South Asia would attract many global firms to locate their capacities within the region to meet the demand from South Asia's burgeoning middle class. These capacities can be used as the platform for these firms to supply their global requirements as economies of scale are exploited and average cost declines. Regional integration should not be construed narrowly in trade and economic terms, but must extend to travel and tourism – as Nepal and Sri Lanka are benefiting presently from integrated tours destined for India; educational and scientific collaboration; think tanks and joint research projects and the sharing and dissemination of practices and innovations in agriculture, biotechnology and ICT. In this regards, professional associations organized at the regional level can play a critical role.

An Asian Development Bank (ADB) study in regional economic integration argues that India, with 80 percent of the region's GDP and 75 percent of the population, would find it in its national interest to take a proactive role in promoting regional trade and investment integration and should take on principal responsibility for leading the effort. Confidence-building measures, a less condescending attitude by Indians and display of leadership qualities by the Indian government, businesses, media and opinion makers will gradually nurture a political climate in which the other countries feel confident and respond positively. This hasn't happened to date because narrow, parochial political considerations have dominated the course of events. Hopefully a rising influential civil society in the countries of the region could tip the balance in favor of this endeavor and act as a countervailing force to politicians in these countries.

### **Three Scenarios for the Future**

It would be foolhardy to speculate as to what the world would look like in 2060. After all we failed to predict the timing, intensity and spread of the global financial crisis of 2007–2008. Only two decades ago, China and India were considered by the rest of the world as objects of pity for the poverty and misery of their population with development economists struggling to find prescriptions that could help these countries overcome what seemed at the time like intractable and insurmountable problems. Nobody had predicted at that time that China would overtake Germany and the US to become the world's top exporter.

With these strong caveats in mind let me speculate three scenarios for South Asia in 2060. Under the first “win–win” scenario, countries get their act together; develop mutual trust and confidence; act in concert on external threats; invest in regional public goods, infrastructure, education and skill formation; mitigate and adapt to climate changes and pursue sensible macroeconomic policies with a clear emphasis on equity. The outcomes of this scenario are quite obvious: rapid economic growth rates will raise the living standards across the region; reduce the incidences of poverty below 10 percent; contain income inequalities across geography, gender and classes;

push over half a billion people to the level of the Southern European middle class and achieve food and energy security with alternate renewable sources playing a leading role. Millions of skilled and technically qualified Indian, Pakistanis and Bangladeshis will be sought after and find productive employment in North America, Europe, Japan, Korea, Australia, the Middle East and elsewhere.

The second “lose–lose” scenario is the polar opposite of the first. If income inequalities – whether leading/lagging regions, urban/rural, male/female and top decile/bottom decile – continue to persist, dissatisfaction and despair will spawn widespread political discontent and disenchantment and institutions of governance become dysfunctional and discredited. Under this scenario, conflicts, terrorism, wars and local insurgencies supported by rival regional countries will transform South Asia into the laggard of the world and an area of highest risk to global peace and stability. Hordes of unemployed and unskilled youth will join the ranks of antisocial, antistate elements creating a clear and present danger to the established governments in the region. It is unclear whether these would be Naxalites, Maoists, Taliban, Al-Qaeda, Jihadis or Tamil Tigers, but in some form and shape worse than what we are confronted today, they would loom large on the horizon. Additionally, the highly educated and skilled men and women of South Asia will migrate to other parts of the world, depriving the countries in South Asia of talent and investment. Political instability, internal security conditions and perpetual external threats will have serious repercussions on the economic conditions in these countries. Incidence of poverty and income inequalities will take a turn for the worse and dependence on foreign assistance and charity will increase. Unstable economic conditions will be exacerbated by the food and energy shortages caused by climate change as governments would be unable to cope.

The third or “muddling through” scenario is based on the assumption that conditions will neither be as sanguine as the win–win scenario nor as bleak as depicted in the lose–lose scenario. The countries in South Asia will continue to make modest progress as they have done in the past and even if their share in global trade and investment will not be significant, workers’ remittances will become a substantial part of foreign capital inflows. Interstate rivalries and intrastate tensions would not pose major disruptive shocks, but keep simmering. The potential benefits from globalization would, by and large, remain unrealized – South Asian intellectual capital would thrive and augment, not in the service of the region but in the extraregional environment. Environmental degradation and climate change effects would be managed without causing serious economic dislocations but the demand for income-elastic food, commodities and energy would be lower due to greatly limited additions to the ranks of middle income groups. The pressure therefore on food, water and energy resources would be mitigated to some extent.

Which of the three scenarios actually materializes by 2060 will depend upon the series of policy decisions, institutional changes, resource preservation or accretion and choices made by society at large. If good sense prevails, the past vitriolic narrative is swept away, and the external environment remains benign, the probability of the

win–win scenario is reasonably high. On the other hand, the game of blaming each other for one’s own weaknesses and deficiencies, finding scapegoats for failures, and keeping doors to each other shut will further vitiate the atmosphere and increase the likelihood of the lose–lose scenario.

As the structural, cyclical and behavioral variables in the above equation are too many and their future interactions not clearly known, it may be safe to bet on the “muddling through” scenario, combining some elements of the optimistic and pessimistic scenarios and in some way offsetting some of the incongruities inherent in them. This conclusion may be open to criticism in that it does not add much to our existing knowledge, but given the shortcomings of the human mind, poor understanding of human ingenuity and my own limited mental horizon, this is the best contribution I can make at this juncture.