

ISAS Special Report

No. 04 – 6 September 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isasec@nus.edu.sg
Website: www.isas.nus.edu.sg



Explaining South Asia's Relative Economic Backwardness¹

Shahid Javed Burki²

Economists have now begun to accept that their discipline – even when two of its components, microeconomics and macroeconomics, are put together – does not fully explain all human behaviour. It also falls well short of providing an all-encompassing theory to explain the wealth and poverty of nations. In 1984, economics Nobel laureate George Stigler suggested that economics was on its way to becoming the queen of social sciences. He called his discipline an ‘imperial science’ which will conquer the entire land of social sciences. In 2006, an American economist published a book titled *Freakonomics* that became an instant bestseller.³ The reviewers applauded the book for using principles of economics to explain daily life.

However, a funny thing happened while the discipline was on its way to finish off other social sciences: economists themselves gave up the effort and began to enrich their subject by bringing in other forms of enquiry. As one student of the discipline wrote, ‘over the quarter century since Stigler’s article, it has become clear that economics has as much to learn from other disciplines as it has to teach them. Today the field of behavioural finance uses insights from psychology and sociology to understand financial markets. Corporate scandals and greed driven financial crises have led to calls for blending ethics into economics.’⁴ And then

¹ This short paper is based on the talk given by the author at the launch ceremony hosted by the Institute of South Asian Studies of his book *South Asia in the New World Order: The Role of Regional Cooperation*, London, Routledge, 2011 on 23 August 2011.

² Shahid Javed Burki is Visiting Senior Research Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore. He was former Finance Minister of Pakistan, and former Vice-President of the World Bank. He can be contacted at isassjb@nus.edu.sg. The views expressed are those of the author and do not necessarily reflect those of the institute.

³ Stephen D. Levitt and Stephen J. Dubner, *Freakonomics: A Rogue Economist Explores the Hidden Side of Everything*, New York, William Morrow, 2005.

⁴ Prakash Loungan, ‘People in economics: The human face of economics’, *Finance and Development*, Vol. 48, No. 2 (June 2011), p.43.

there are the disciplines of history, political science, sociology and anthropology. Without their help as explanatory factors the question about how people, nations and states behave would remain a big puzzle.

There is an advantage to the use of a multidisciplinary approach to understand the puzzle of South Asia.⁵ It is a puzzle since, notwithstanding the bursts of economic activity in different countries at different times, South Asia has failed to sustain a fast rate of growth over a long period of time. Unlike East Asia including China, South Asia's growth performance has been uneven. For decades after attaining independence – from 1947 to the late 1980s – Pakistan was South Asia's fastest growing economy. Having started much poorer than India when the two countries attained independence, Pakistan overtook its neighbour since India during most of this period was growing a rate the some Indian economists called the 'Hindu rate of growth'. Since then India's growth rate has been three times the rate of increase in Pakistan's gross national income. Consequently, India's income per head of its population was estimated by the World Bank for 2009 to be 22 per cent higher than that of Pakistan in terms of both the nominal exchange rates (US\$1,220 for India, US\$1,000 for Pakistan) as well as purchasing power parity terms (US\$3,280 for India, US\$2,680 for Pakistan). The East Asian incomes, having started at about the same level in the 1960s and the early 1960s as South Asia, are now nine times as high for South Korea (US\$27,240) and twice as high for China (US\$6,890) in purchasing power parity terms compared to South Asia's average of US\$3,000.⁶

This raises a number of questions. Some are concerned about the role of the state, some are about the introduction of different ideologies in the making of public policy, some are related to the neglect of trade as a driver of growth, and some are about the indifference towards the development of the area's abundant human resource. As Professor Tan Tai Yong pointed out at the launch of my book, *South Asia in the New World Order*, there are also questions about the way the region could benefit from the enormous change that is underway in the West. South Asia's large and young population could balance the aging and declining populations in many western countries.⁷

But some of the questions also relate to the failure of the area to develop a regional economic identity. Why are not the countries in the region doing what other nations around the globe have demonstrated works very well for them. Why are not they working together to ensure a better future for their citizens? Or, to ask the opposite question, why are some of the countries in the region spending so much on their militaries and so little on improving human and physical infrastructure that would do so much to improve the well being of their people? The answers to these questions come not from economics but from history. An important reason

⁵ Shahid Javed Burki, *South Asia in the New World Order: The Role of Regional Cooperation* (London, Routledge, 2011).

⁶ The World Bank, *World Development Indicators, 2011*, Washington D.C., 2011, Table 1, pp.10-11.

⁷ Tan Tai Yong, 'Opening Remarks at the Book launching: South Asia in the New World Order', Mimeo, ISAS, 23 August 2011.

for the region's under-performance is that most of the countries in the area carry heavy burdens of history. These must be cast-off. To remove them, they must be understood in the context in which they were placed, by now, on the tired shoulders of the South Asian states.

Having used history to explain why the South Asian states find it so difficult to work with one another, economics can help to motivate some of the policymakers who see no advantage in moving in this direction. I carried out a study a few years ago for the United States Institute of Peace to estimate the economic cost of the long-enduring Kashmir dispute for Pakistan.⁸ The assumptions I used for doing the calculations were heroic but they produced a result which was quite staggering. Even if the cost to the country of the dispute was one-half or one-third of what I said it was and if the amount spent in the name of Kashmir had been put to economic use, the size of the Pakistani economy today would be significantly larger.

Upon the advice of General Jahangir Keramat who was Pakistan's ambassador to the United States (US) at that time, I discussed the findings I was highlighting in the Kashmir study with then President Pervez Musharraf in Islamabad. His response surprised me. Having invested so much of his own time in trying to win back Kashmir for Pakistan, I thought he would defend his past actions. He did not. 'You write regular columns for the Pakistani papers', he said. 'Why don't you write about your conclusions in these columns? That would help to change the Pakistani mindset.'⁹

The Indian and Pakistani governments could follow a similar approach to the one I had adopted in my Kashmir study. To take two examples: one from Pakistan and the other from India. Pakistan is not prepared to grant transit rights to India so that the Indian businesses can send their exports and bring in their imports by land from Afghanistan and points beyond. To settle this issue and to better inform the people, the Pakistani policymakers could get cost-benefit analysis done to evaluate the impact of the Indian trade flowing through their territory. Pakistan today has a well developed but underused motorway system that connects Lahore on the Indian border with Peshawar on the border with Afghanistan. This could become a source of profit for the country if Indian trucks were allowed to make use of it.

Opening Pakistan's territory for India's transit trade would bring about significant structural changes in the Pakistani economy. It would also add new economic activities to the cities of Lahore and Peshawar. Perhaps an example from the distant US would help to underscore the benefits of border trade for the areas located on or near the frontier. As various analysts are pointing out in the context of the presidential race which has picked up in the US with the entry of the governor of Texas in the field, 'Texas passed California a decade ago as the country's biggest exporter, fueled by border trade with Mexico' which passes through the

⁸ Shahid Javed Burki, *Kashmir: A Problem in the Search of a Solution*, United States Institute of Peace, Washington D.C., 2007.

⁹ See Pervez Musharraf's, *In the Line of Fire: A Memoir*, New York, Free Press, 2008 for his earlier position on the issue of Kashmir.

frontier towns and cities¹⁰. In other words, border trade with Mexico helped the state of Texas to overtake New York which at that time was the richest in the country. Benefits such as these could be quantified in a study that carefully looks at present and future advantages of opening up the Pakistani territory for India's transit trade. If such an analysis suggests that Pakistan's GDP (gross domestic product) would increase by x per cent a year, then the policymakers will at least know what the cost is for the country for adopting a negative policy stance with reference to this important issue.

On the Indian side, serious and dynamic analysis should be undertaken for the costs and benefits of the excessive use by the country of the many types of non-tariff barriers it employs to provide protection to some of its producers. Do we know enough about them to determine whether these constraints are helping or hurting the economy? If trade economists are right in their thinking, these government-imposed obstacles are costing the Indian consumers much greater welfare loss than benefitting the producers for whom these devices are being used.

India and Pakistan have also not given much attention to developing the institutions for improving regional economic cooperation. The purists among economists – and the group includes Jagdish Bhagwati, the Indian-born economist, who once called the formation of regional arrangements, the spaghetti bowl approach to multilateral trade¹¹ – do not accept the notion that regional arrangements are an efficient way of promoting economic development. However, such arrangements have worked well for many regions in the world. ASEAN (Association of Southeast Asian Nations) has done a great deal of good for the countries of East Asia. While promoting trade was not one of the motives for the creation of this arrangement, it has now become its important objective. *Mercosur*, a derived Spanish word which means 'southern markets', has contributed to economic stability and growth of the countries in Latin America's southern cone. The best example of success in promoting regionalism, of course, is the European Union (EU). The EU evolved gradually into a currency union for some of the countries of the continent. In fact, an argument can be made that the EU proved to be too successful an arrangement since it opened up the financial markets in the better-off countries for those that had inherently weak economies. This is behind the current European crisis. The rapid expansion of EU – a development more motivated by politics than by economics – has hurt the Union.

Notwithstanding the burdens imposed by history, it would be better for India and Pakistan to develop economic relations covering trade and possibly also investment flows within a regional context. But for that to happen, the two countries will have to put some effort into this enterprise. New Delhi does not seem to be much interested in promoting the South Asia

¹⁰ Sheila McNulty, 'Governor's claims of "miracle" irk Texans', *Financial Times* (19 August 2011), p. 3.

¹¹ Jagdish Bhagwati, 'U.S. Trade Policy: The Infatuation with Free Trade Agreements' in Jagdish Bhagwati and Anne O. Kruger, *The Dangerous Drift to Preferential Trade Agreements*, Washington D.C., American Enterprise Institute, 1995.

Free Trade Arrangement, SAFTA. One reason for this is to exclude Pakistan from the arrangement. There are many in India – particularly in the country’s bureaucracy – who believe that including Pakistan in a regional trade will be a distraction and not serve India’s interest which is to create a healthy environment within which it can develop good economic and trade relations with the countries in its immediate neighbourhood as well as those, like the ASEAN nations that are not far from it. It does not believe that it has as yet the kind of relationship with Pakistan that could help it concentrate on trade and economic cooperation. While participating, albeit half-heartedly, the SAARC (South Asian Association for Regional Cooperation) and its offshoot SAFTA, India has simultaneously promoted the development of BIMSTEC, another regional organisation that has Bangladesh, Bhutan, India, Myanmar and Thailand as its members. Some have called BIMSTEC, SAARC without Pakistan.

India is more interested in what some analysts and policymakers call the ‘look east’ approach.¹² This will tie the Indian economy closer to the economies of the ASEAN region. However, it is doubtful that this policy would bring as much benefit to India as a policy that focuses on South Asia. No large country has realised its economic potential without working with the countries in its immediate neighbourhood. This worked for the US, Brazil, China and South Africa. This will also work for India.

At the same time there has to be change in the mindset in Islamabad. Ever since its creation in 1947, Pakistan has considered itself to be a rival of India. That made little sense then; in 1947 India was four to five times Pakistan’s size in terms of its population and economy. It makes even less sense now. With the emergence in 1971 of what was once its eastern wing as the independent state of Bangladesh, Pakistan is much reduced in size. With a poorly performing economy now for nearly a decade while India is galloping ahead, Islamabad must recognise India’s predominance in the region. India’s smaller neighbours must begin to treat it as the region’s anchor economy.

Experience from other parts of the world suggests that in any formal or informal regional economic arrangement, the smaller countries benefit more. This will also be the case if such an understanding were to develop in South Asia. Experience also teaches another lesson: regional arrangements that have one large country at their centre only work when that country is prepared to give a bit more than it takes. This is what the US did and is doing with respect to the North American Free Trade Area, NAFTA. This is also the spirit shown by Brazil in the *Mercosur* and by Indonesia in the ASEAN. India must recognise that by being more accommodating in SAFTA it will not only help to infuse life into the arrangement. It will also benefit itself over the long-run.

At the launch of my book, Professor Kishore Mahbubani, Dean of the Lee Kuan Yew School of Public Policy, National University of Singapore, suggested that South Asia suffers from

¹² S.D. Muni, ‘India’s “Look East” Policy: The Strategic Dimension’. ISAS Working Paper 212 (1 February 2011).

what he called ‘three gaps’. These are between its economic potential and actual achievements, between the entrepreneurial successes of the members of its diaspora and those who work in the domestic economies, and – most importantly – between the potential of an ASEAN type of regional arrangement and what it had really achieved by setting up its own regional institutions. The ASEAN has demonstrated the enormously positive impact of regional agreements on increasing trade.¹³

Once trade begins to flow among the countries of South Asia without too many constraints it will profoundly influence the structure of their economies. Over the last several decades, parts and components have begun to dominate international trade. Globalisation has led to a fundamental restructuring of the global production system. A significant number of the final products that enter international trade are made from parts and components manufactured in different parts of the world. Such a system should also work in South Asia. It is not inconceivable to have Pakistan and Bangladesh become major suppliers of manufactured inputs for the production of final products by the large-scale industries in India. Pakistan, for instance, could become linked with the automobile industry in India, exporting several parts and components to the country.

In dealing with trade, it is important to broaden the scope of flows to include services as well as investment. These were not covered by SAFTA. India has a much higher rate of domestic savings than Pakistan. Some of these could flow across the border into capital-scarce Pakistan. India has better developed health services sector which could be used by the people in Pakistan who need advanced healthcare.

Including services within the scope of SAFTA would help Pakistan to develop itself into a ‘commerce-transit’ country used by its neighbours and the countries nearby to send goods by land to their various destinations. This will lead to the development of a number of relatively new economic activities such as warehousing, trade forwarding, insurance of goods and people in transit, repairing and maintenance of transport equipment in use, and providing services to the people involved in long-distance travel.

Change in the structure of the global economy covers a number of subjects. Of these, two are particularly important. The first relates to the process of catching up by the economies that are advancing rapidly but are still not in the same league as the world’s leading economies. The second is the changing role of the state in economic management. These two have acquired even greater salience after the global economy was hit by what is now called the Great Recession of 2008-09. China overtook Japan earlier this year in terms of the size of its economy. The economists at the International Monetary Fund believe that it will surpass the US as early as 2015. However, while some serious questions have been raised by the damage done to the economies by the withdrawal of the state from performing a number of functions

¹³ Professor Kishore Mahbubani, ‘Book launching: South Asia in the New World Order’, Mimeo, ISAS (23 August 2011).

– regulating the financial sector, for instance – it was not expected that the content of debate about the role of the state will change so radically, particularly, in the Anglo-Saxon world. Few serious analysts expected at the height of the Great Recession that the role of the state would be redefined in the way to reduce its relevance for shaping the economy rather than increasing its output, reach and promotion of human welfare. But the increasing concern with mounting debts in the West has prompted a move towards budgetary retrenchment. If this happens, the state might not be able to invest as much as is required in producing the skills and improving the capacity to do research, innovation and, development as needed by the ‘new economies’ – the economies that are dependent less on material inputs and more on knowledge.

If such a change in the role of the state does occur, it will open up opportunities for South Asia. The subcontinent not only has a very large population, but its population is also very young. South Asia could leap-frog into the future by skipping the phase of intensive industrialisation and move straight into modern services. Regional integration would help in this respect. Even with large and young populations, India has begun to experience skill shortages as it expands its information technology sector. There are, however, surpluses available in Pakistan that it could tap.

My hope in writing this book was to increase awareness in the countries in South Asia – especially among its policymakers – of the opportunities that are available to their countries. They are there to be realised if those who make policy move away from political imperatives that have their roots in the past and begin to concentrate on the economic side of the relationship. This can only be done by political leaders with vision and enterprise. This task must not be left to the bureaucracies that have the inherent tendency to live in past and emphasise in helping to design the future. I hope this ambition behind the book will be realised if not immediately than over not too long a period of time.

Would this hope be realised? In his remarks at the book launch, Dr Iftexhar Ahmed Chowdhury, Senior Research Fellow, Institute of South Asian Studies, provided an eloquent answer to this question? ‘Signs indicate that our peoples, particularly our youth and burgeoning middle classes, want to emerge out of the morass of petty irredentist squabbles’, he said. ‘They want to be part of a system, a society of states, where there exists the enabling ambience for development, where a sense of justice and equity prevail, where women are empowered, the environment protected and governments learn it is better to live with an inconvenient idea than to try and suppress it. Is all this too tall an order? I do not think so. After all, has it not been aptly said that man’s reach should exceed his grasp; what else are the heavens for?’¹⁴

.

¹⁴ Dr Iftexhar Ahmed Chowdhury, ‘Book launching: South Asia in the New World Order’, Mimeo, ISAS (23 August 2011).