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South Asia's Economic Future With or Without Economic Integration

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Abstract

South Asia has reached the point in its economic and political development from where it can make sustained and steady progress. This will help the region achieve the rates of economic growth that have brought about fundamental changes in the eastern part of Asia. For that to occur, intra-regional trade needs to play a significant role. This paper uses a simple econometric model to estimate the benefits that can accrue to the countries in the region if more trade were directed towards Asian destinations, in particular towards South Asia.

Introduction

Disregarding the current problems in Europe, the fact remains that regional integration helps countries achieve rates of economic growth that would not be possible if they acted alone. Size matters in both trade and economics – a conclusion reached by Adam Smith two centuries ago. This is also the case in South Asia where economic progress, India's remarkable performance in the last couple of decades notwithstanding, is being held back by intra-regional conflict.

This is where the European experience also becomes relevant. The initial European dream was to create a political structure with strong economic foundations. Such an organisational structure will make future conflict practically impossible. The dream was realised. Although

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some historians feel that scholars should ‘never say never’, it does seem unlikely that Europe will ever see a conflict on its soil of the type that twice devastated the continent in the last century. Economic union has played a large role in realising this level of comfort.

This was also the dream that drove Ziaur Rahman, Bangladesh’s second president, to convince the heads of states in the South Asian region a quarter century ago to work towards greater regional cooperation. His was the spirit behind the creation of the South Asian Association of Regional Cooperation (SAARC). The potential of SAARC is yet to be realised partly because the countries in the region are not convinced that this is the way to go. Sometimes, however, simple mathematics helps to clear the mind and this is what is attempted here. The purpose is to develop a simple econometric model to make the case that there are significant economic rewards available by improving trade and economic links among the eight countries of the SAARC region.

Before providing the results of the model, the paper makes a detour. This is for providing a quick overview of the current economic situations in India and Pakistan; indicating how the global economy is evolving and what could be South Asia’s role in it; and suggesting what India and Pakistan can do to take advantage of the opportunities in the global economy. This detour sets the stage for the main part of the analysis which is focused on the gains to be made by increasing trade among South Asian neighbours.

The Future of Indian and Pakistani Economies

After a slight slowdown in economic growth as a result of the Great Recession of 2008-09, the Indian economy has gone back to its growth trajectory of the last decade and a half. The quick recovery was the consequence of two factors. One, the country’s economy is less integrated with the West than that of most East Asian economies. In the case of the latter, the impact of the global slowdown was much more severe. Two, the government was effective in stimulating the economy by judicious use of fiscal stimulus aimed at reducing the impact of the slowdown on the level of employment.

India, today, is the fastest growing economy in South Asia with rates of growth close to those achieved by the ‘miracle economies’ of East Asia in the quarter century between 1975 and 2000. Those growth rates structurally transformed those economies. From essentially rural economies they became industrial powerhouses. The incidence of poverty was also dramatically reduced and the quality of human resource markedly improved. Even though India is now achieving comparable rates of GDP growth, the social and economic transformation is expected to be slower for several reasons. Among them, the more important ones are the size of the population, concentration of high growth areas in a few parts of the country, and the contribution of a few economic sectors to overall growth. In other words, the Indian model of growth is less inclusive than those in East Asia.

Trade, other than the exports from IT and now healthcare services, has been less of a contributing factor in India's growth than was the case for the miracle economies of East Asia. Trade will need to play a more vital role if India is to sustain a high rate of growth. But the emphasis on trade should include refocusing it on the countries in the immediate neighbourhood. Regional integration could play an important part in pushing the sustainable rate of growth even higher. But for that to happen, Pakistan, the second largest economy in South Asia, will need to pull out of its current economic slump.

Pakistan today is passing through an extremely difficult period because of a storm that has gathered around it. The country is dealing with extremism and terrorism that have persisted stubbornly and continue to take a heavy toll on the economy and society. Several shortages have developed in delivery of vital public services such as electricity, natural gas and water that are hurting industrial and agricultural output. The quality of governance has deteriorated to the point where people have lost faith in the state's ability to provide even for the most basic needs². All these developments have affected the performance of the economy. Last year the GDP growth rate was only 1.2 percent; this year it will probably not be more than 4.0 percent. These rates are about a third to one-half of the rates of growth being currently recorded by India. But that has not always been the case. From 1947 to 1988, a period of 41 years, Pakistan's GDP increased at an average rate of 5.5 percent year, one and a half percentage points more than that of India's. As economist Surjit Bhalla estimates in an essay contributed to a volume honouring Montek Singh Ahluwalia³, the annual average industrial growth rate in Pakistan during 1965-2005, a period of 40 years, was 6.5 per cent compared with 5.3 per cent in India. Pakistan achieved a maximum of 10.4 per cent increase in industrial output during this period. India's maximum was only 6.9 per cent. The point of making these comparisons is that nations and economies have their respective crests and troughs in long-run economic performances; there is nothing permanent about the trends that they exhibit at any given time.

If Pakistan manages to navigate out of the storm that it is in, it could see acceleration in its rate of growth to 8.0 per cent by 2025 provided it can settle its relations with India. Peace with India and strong economic ties with the large neighbour can add almost US\$200 billion to Pakistan's gross domestic product (GDP), increasing it from US\$375 billion in 2007 to US\$571 billion a year. This translates into an increase of US\$850 in per capita income by 2025. India's GDP, on the other hand, can increase by US\$1.5 trillion and its per capita GDP by US\$1,140 (Table 1, page 6).

² For an analysis of Pakistan's current economic situation see Institute of Public Policy, Beaconhouse National University, Lahore, *State of the Economy: Pulling Back from the Abyss*, Lahore, 2010.

³ Surjit Bhalla, 'Indian Economic Growth, 1950-2008: Facts and Beliefs, Puzzles and Policies', in Shankar Acharya and Rakesh Mohan, *India's Economy: Performance and Challenges* (New Delhi, Oxford University Press, 2010).

Pakistan has potential in many areas. It has a large and young population, which can be an economic asset rather than a social and political liability depending upon the choices made by those who make public policies. A large population can deliver considerable benefits in a world which is seeing rapid aging of populations. The large and well endowed agriculture sector is working way below its considerable potential. It is not always recognised that Pakistan has the largest contiguous irrigated area in the world, which can produce significant amounts of high value added exports if right public policies are in place with respect to efficient use of water, development of marketing infrastructure and development of appropriate technologies.

Pakistan also has some well-honed skills that can be used for producing machinery parts and components for the large industrial sectors of China and India. Finally, Pakistan's geographic location can turn the country into a hub of international commerce provided relations improve with some of the neighbours, particularly India and Afghanistan. This potential can be realised if South Asia begins to work as a cohesive regional economy.

Global Economic Changes

Analysing ongoing changes in the global economy is a subject on which much has been said and written. The world is passing through another period of what economic historians call the 'catching-up' phenomenon. Asia is catching up with the more advanced regions of the world. The centre of gravity of the global economy is shifting from the Atlantic to the Pacific.⁴ China is in the lead in this change; it has been able to improve its position in the global economy by taking the right set of decisions to deal with the situation created by the Great Recession of 2008-09. China's lead in the global economy is partly the result of the active role it has played in developing the new structure of industrial production, which builds on the Japanese 'just in time' system, but has been taken much beyond the original design. In producing finished products China imports parts and components mostly from the countries in its neighbourhood. Large Japanese manufacturers such as Toyota Motors relied mostly on smaller domestic producers for parts and components. China's different approach has meant developing strong trading and economic relations with the countries in which the suppliers are located. South Asia does not have such a system of production but it can well develop so if its economies become integrated.

The other major change occurring in the global economy is related to demography. Populations in developed countries are ageing rapidly; their demand for services is increasing. These have to be supplied by mostly younger people. Over time, these countries will begin to rely heavily on the more populous parts of the world. Some of these are in South Asia. India has already carved out a niche for itself in the service sector, while Bangladesh

⁴ The author developed this argument in some detail in a two-part working paper published by ISAS in April and May 2010. See Shahid Javed Burki, 'Asia in "Catch-Up Game", Part 1', Working Paper 106, 9 April 2010 and 'Asia in the "Catch-Up" Game: Part 2', ISAS Working Paper 107, 10 May 2010.

has done so in readymade garments. Other countries of South Asia can follow these examples.

The Roles India and Pakistan can play in the Changing World Economy

In indicating the roles India and Pakistan can play in the changing world economy, focus should be on two aspects. First, Pakistan has to change its stance from being a competitor of India to becoming a collaborator with its large neighbour in many fields. Economics, particularly trade, is one of the more important areas in which it should be prepared to work with India. It has to recognise that India is South Asia's anchor economy which, at this time, accounts for 82.0 per cent of the total regional product (Table 1). At the same time, India must also realise that it can gain the status of an economic superpower only if it works closely with the countries in its immediate neighbourhood. It should not overlook neighbours and focus only on extra-South Asian groupings groups such as the Association of Southeast Asian Nations (ASEAN) and the European Union (EU). No large economy has succeeded without first developing strong regional associations. This is as true for the United States, China, and South Africa as it is for India.

If India and Pakistan can work together in economics and trade, they will see considerable and palpable impacts on the structures of their economies. This will be more true for Pakistan than India, which is expected, since the size of the former's economy is only one-eighth of that of the latter's. Some fundamental changes in the structures of both agriculture and industry in Pakistan can be expected as these two sectors begin supplying the larger and rapidly growing Indian markets. The Pakistani motorway system, currently more advanced than that of India's, will get integrated with India's planned system of highways such as the 'Golden Quadrilateral'. The respective national electrical grids will get connected with trade in power becoming an integral part of inter-state commerce. The two countries may finally be able to build the gas pipelines connecting them to the Middle East and Central Asia.

Benefits from Regional Association in Commerce

In spite of the efforts made over the last quarter century to bring about more meaningful economic integration of the South Asian region, not much has been achieved. Intra-regional trade, as a proportion of the total trade of the region with the rest of the world has increased a little, but compared to other world regions, it remains almost insignificant. How much is the area losing out by not focusing sufficient amount of political attention to integration and cooperation? One way of answering this question is to use trade as the driving force for accelerating economic development. Using trade as the basis and historical GDP-trade elasticities for making projections, it is possible to develop some scenarios for the future. This is done purely for illustrative purposes in this paper, not for establishing firm targets. The three scenarios presented here are based on assumptions about the extent of integration

as well as the degree of reorientation of trade with significantly more trade moving to Asia in general (Table 2; Scenario II) and South Asia in particular (Table 3; Scenario III).

Table 1: Scenario I (The Base Case)

	GDP (US\$ Billion)		Population (Million)		Per capita income (US\$)	
	2007	2025	2007	2025	2007	2025
Bangladesh	68	195	159	195	431	1000
India	1177	3978	1125	1382	1046	2878
Nepal	10	24	28	38	357	632
Pakistan	143	375	162	230	883	1630
Sri Lanka	32	78	20	22	1600	3545
Total	1430	4650	1494	1867	957	2491

Notes : (a) The base case assumes the following GDP growth rates: Bangladesh 6.0%; India 7.0%; Nepal - 4.8%; Pakistan - 5.5%; and Sri Lanka – 5.0%.
(b) 2007 is the base year.

Source : The author's calculation based on the data for 2007 from The World Bank, *World Development Indicators*, The United Nations *World Population Prospects*. Same sources are used for Tables 2 and 3.

According to Table 1, the countries in the region continue to focus the direction of international trade and its content on distant trading partners. This is the assumption behind the base case. For India, the United States and the European Union remain the most important markets for its exports and the most important sources of its imports. The same is true for Pakistan. Even though China-India trade is likely to grow at a faster rate than India's overall trade thereby increasing Beijing's share in New Delhi's international trade, India does not become a partner in the China centered system of production that is taking shape. According to this scenario, the growth of India's GDP is sustained at the rate of 7.0 per cent a year in the 18-year period between 2007 and 2025. This is well below the 10.0 per cent growth target Finance Minister Pranab Mukherjee set for the country in his budget for the year 2010-11. The size of the Indian GDP increases more than threefold and income per capita grows 2.75 times. India's share in the combined GDP of the region increases from 82.0 to 86.0 per cent. Bangladesh will be the second most rapidly expanding economy according to this scenario with the rate of increase in GDP averaging 6.0 per cent a year. Nepal performs the least with the rate of growth at 4.8 per cent. Pakistan's performance is between those of India and Nepal. Growing at 5.5 per cent a year, the size of its GDP increases 2.6 times, but its share in the South Asian total output declines from 10.0 per cent in 2007 to only 8.0 per cent in 2025 (Table 1).

The second scenario is based on the assumption that the South Asian countries take greater cognizance of the importance of international trade as a contributor to growth and also of the move in the center of gravity of the global economy to the Pacific from the Atlantic. What

this means is that the countries pay greater attention to the changing structure of the global production system. This will be largely centered on China. New Delhi's policy-makers, taking note of this, are already deeply engaged in building better economic relations with the ASEAN group of countries. They are also participating in the East Asia Summit (EAS), an arrangement that includes ten countries of the ASEAN region as well as Australia, China, Japan, New Zealand and South Korea. This change in strategy adds to the rate of growth of all South Asian countries. India's GDP is 12.0 per cent higher compared to the base case scenario but its share in the regional GDP in 2025 remains the same at about 86.0 per cent (see Table 2).

Table 2: Scenario II

	GDP (US\$ Billion)		Population (Million)		Per capita income (US\$)	
	2007	2025	2007	2025	2007	2025
Bangladesh	68	202	159	195	431	1034
India	1177	4473	1125	1382	1046	3236
Nepal	10	25	28	38	357	658
Pakistan	143	445	162	230	883	1927
Sri Lanka	32	82	20	22	1600	3696
Total	1430	5227	1494	1867	957	2800

Notes : (a) The scenario II assumes the following GDP growth rates: Bangladesh - 6.2%; India - 7.7%; Nepal - 5.0%; Pakistan - 6.5%; and Sri Lanka - 5.3%.
(b) 2007 is the base year.

Source : See Table 1.

The third case builds on the second by assuming that South Asia manages to develop stronger economic contacts among the countries in the area. Compared to the status quo situation in the first scenario, the combined GDP of the region is considerably larger as is income per head of the population— both by as much as 40.0 per cent. The incidence of poverty declines significantly and better services are provided to the citizenry. South Asia is also better integrated with the rest of Asia.

Table 3: Scenario III

	GDP (US\$ Billion)		Population (Million)		Per capita income (US\$)	
	2007	2025	2007	2025	2007	2025
Bangladesh	68	239	159	195	431	1223
India	1177	5551	1125	1382	1046	4016
Nepal	10	26	28	38	357	692
Pakistan	143	571	162	230	883	2479
Sri Lanka	32	88	20	22	1600	3957
Total	1430	6475	1494	1867	957	3468

Notes : (a) the scenario IV assumes the following GDP growth rates: Bangladesh - 7.2%; India - 9.0%; Nepal - 5.3%; Pakistan - 8.0%; and Sri Lanka - 5.7%.
 (b) 2007 is the base year.

Source : See Table 1.

The impact on poverty and quality of life will be pronounced if the third scenario plays out. This is for the reason that economic structures will be profoundly different in this case, particularly in the countries on India's borders. Pakistan, for instance, will be able to develop its agriculture for taking advantage of the huge Indian market. This would have happened had the countries not severed their trade relations soon after gaining independence from the British rule. At that time, close to two-thirds of Pakistan's imports came from India and about the same proportion of its exports went to that country. These proportions declined to about 5.0 per cent when the two countries declared a trade war in 1949 on the issue of the rate of exchange between their currencies. The proportions in trade have remained static in spite of the launch of the South Asia Free Trade Area (SAFTA) in January 2004. With the rebuilding of economic and trade contacts, other sectors can also get aligned. Pakistan can become an important supplier of auto parts to the rapidly developing Indian automobile industry, while India will become the main provider of iron ore to the steel industry in Pakistan. Both countries would buy chemicals from one another such as India procuring urea from Pakistan and Pakistan buying pesticides from India. Bangladesh could get integrated in the much larger textile sectors of the two larger economies, India and Pakistan, taking advantage of their better developed fashion industries. However, to realise the third scenario there will have to be exercise of considerable political will, which has been in short supply for many decades.

Footnotes to Tables 1-3 provide GDP growth estimates based on these three scenarios for the five larger countries of South Asia. These represent, of course, some major assumptions; that is why it is so important to emphasise the illustrative nature of this exercise. These rates are presented in Table 4 below. In terms of the rates of growth, the largest gainer is Pakistan followed by India. Pakistan's GDP growth according to the third scenario is 2.4 percentage points higher compared to the first scenario, while India's is two percentage points better. In

the case of Pakistan, income per capita of the population in the third scenario is 52.0 per cent higher while that of India is 40.0 per cent more.

Table 4: GDP growth rates: 2007-2025, (per cent per year)

2007			
SCENARIOS	I	II	III
Bangladesh	6.0	6.2	7.2
India	7.0	7.7	9.0
Nepal	4.8	5.0	5.3
Pakistan	5.6	6.5	8.0
Sri Lanka	5.0	5.3	5.7

Source : Earlier Tables

It is also essential to underscore that in identifying the determinants of growth for any economy, it is important to include a number of variables – to undertake what economists call multivariate analysis. The scenarios built for this exercise use only one variable as the driver of growth: international trade. Historical elasticities were used to gauge the quantitative impact on growth rates. But even if trade emerges to be the most important determinant, for it to play that role it needs to be supported by a whole host of other factors. Trade economists now emphasise that given the general lowering of tariffs across the globe, ‘trade facilitation’ is a much more important contributor to growth than tariffs. Trade facilitation includes well-functioning physical infrastructure – roads, railways and ports – that takes goods from the points of production to the points of shipping. Even today, in spite of the development of air cargo, 90.0 per cent of trade moves by ships. Producers participating in trade must have a steady and reliable supply of water, electricity and other sources of energy. They must have access to capital at reasonable rates to expand their supplies; availability of human skills in order to be able to compete in international markets; labour laws that do not interfere with the hiring and firing of workers; and availability of information about the markets the producers and exporters target to reach. There must also be good governance so that the rent-seeking behaviour on the part of those whose assistance is needed by traders does not eat into the profits they are hoping to make. To achieve all this means an active and well-intentioned state.

All this notwithstanding, some analysts have argued that of the many determinants of growth in the emerging markets that still have large agriculture sectors (eg. South Asian economies), weather may be a critical variable. Surjit Bhalla points out that ‘surprisingly, rainfall (lagged plus current) alone explains as much as 60 per cent of the variation in the growth of agricultural output...The model for GDP growth also works well: 40 per cent of the variation

of GDP growth is explained by rainfall alone.’⁵ He goes on to suggest that the levels of rates of interest as administered by the Reserve Bank of India (RBI), the country’s central bank, and the rate of inflation, are much more important determinants of growth of the Indian economy than capital accumulation or movement of workers from less to more productive parts of the economy.

Conclusion

Notwithstanding all the caveats mentioned above, easing of tensions among the countries of South Asia, especially between India and Pakistan, will have many positive consequences for the region. The simple model developed for this paper shows that trade alone will add about two percentage points to the rate of growth of the region. As the Europeans have discovered, easing trade restrictions produces a number of other beneficial consequences such as increased tourism and cultural contacts. They also contribute to knowledge accumulation as networking increases among the researchers working in various laboratories and research institutions. Some of the positive outcomes cannot be fully appreciated *ex ante*. That said three of these are worth reflecting on.

Greater intra-regional trade in South Asia will have a significant impact on the structure of the economies of the smaller countries in the region as they develop linkages with large enterprises in India. This would lead to more labour-intensive activities as producers in Pakistan begin to supply parts and components to India’s large industries or as textile producers in Bangladesh get to work for India’s (and Pakistan’s) fast-developing fashion industries. Second, the grant of transit rights by both Bangladesh and Pakistan to India will develop some segments of the service industry. These include warehousing, servicing of vehicles, hotel business, insurance and other related activities needed to move goods and commodities over long distances. Third, by linking the various infrastructural networks such as electricity grids and gas pipelines, the countries in the region should be able to meet one another’s occasional deficits while creating markets for electricity, gas and possibly water. The positive economic consequences of opening up to one another will be enormously significant. There will also be positive outcomes on the political side as well. That, however, is an entirely different subject which those with greater competence in this area should analyse.

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⁵ Same as in 3, p. 42.