

The Rising Tide: South Asia's Place in the New World Order

In the last few decades, rapid growth and development in Asia have profoundly impacted the topography of global economic power. Following the Asian Tigers' emergence in the 1970s and China's subsequent rise, the South Asian region has displayed strong and consistent growth, due in no small part to India's growing preponderance in the world economy. Broad-based economic reforms undertaken by its constituent states since the early 1970s have improved integration at both intra- and inter-regional levels and have expanded regional trade and FDI (Foreign Direct Investment) volumes. South Asia's average growth rate during 2003-2008 was approximately 8 per cent, and despite the protracted ill-effects on the global economy of the recent financial crisis, the region is projected to grow quite strongly into the future.¹ Certainly, numerous challenges remain to be met: the persistence of poverty, difficulties associated with facilitating regional integration, and inherent structural and institutional weaknesses in these economies are significant in this regard. Nevertheless, there is reason to be optimistic about South Asia's future economic prospects, not only because these issues are beginning (however slowly) to be addressed, but also due to a range of emerging growth opportunities. Key among these opportunities are the 'demographic dividend' created by South Asia's current demographic transition, a rapidly growing middle class, increased global integration, service sector developments and the regional benefits derived from India's continued and increasing economic successes.

The Demographic Dividend

South Asia is currently undergoing a demographic transition, resulting

from a change over time from high mortality and fertility rates to low ones. This has important growth implications: as the generation born just after the fall in mortality but just before the fall in fertility approaches working-age, the region experiences a significant swell in its labour-force. Indeed, it is estimated that by the year 2020, South Asia will have the youngest population in the world.² The opportunity for increased economic growth which the demographic transition affords is termed the 'demographic dividend', a phenomenon which arises out of an increase in a country's working-age to non-working-age ratio.

South Asia's working-age population is projected to grow by an average of 18 million people per year for the next twenty years.³ If this excess labour is productively employed, the potential benefits to be reaped by the region are extensive. Apart from Sri Lanka, whose relatively early and rapid mortality and fertility declines have already generated a demographic dividend, the working-age to non-working-age ratio is still rising for the South Asian States, and is estimated to peak at various times over the next four decades. Thus, these economies require a favourable policy environment to capture the maximum possible benefits of this demographic change.

Bloom *et al.* consider some important factors in this regard.⁴ The ability of government institutions to provide a sound base for facilitating the demographic dividend is one. Particular attention must also be paid to labour legislation to ensure that the extra labour generated by the demographic transition is productively employed. The study suggests two alternative paths in

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this respect: a 'low road' approach, which consists of expanding low-wage jobs to absorb the excess labour, and a 'high road' approach, which seeks to develop more highly-skilled forms of employment in the services, industrial and agricultural sectors.⁵ Macroeconomic management and trade policy are two other factors that contribute to an enhanced demographic dividend. Curbing inflation and maintaining a favourable domestic environment for the expected savings and investment increases are important, as is developing the export industry to increase employment opportunities. Another consideration is education policy: the burgeoning services sector in South Asia requires highly-skilled workers. The demographic transition provides an ideal opportunity for swelling the ranks of this type of worker through effective investment in education. Such investments enhance the possibility of achieving a 'high-road' form of employment for a larger cohort of workers.

The Rise of the South Asian Middle Class

Demographic change in South Asia has also occurred along income lines. A significant decline in poverty has pushed a large number of people who formerly survived on less than \$2 a day into the ranks of the middle class. This effect is particularly marked in India, a country home to a significant proportion of South Asia's poor, and where strong growth has generated improvements in income over

several years. Sri Lanka is the other South Asian State expected to experience a large middle-class expansion within the next decade. South Asia's middle class has grown at an average rate of 12 per cent per annum over the last decade, rising in absolute terms from 24 million in the year 2000 to 72 million in 2010.⁶ It has been estimated that, by the year 2025, South Asia could boast a middle class of 1 billion people, or 55 per cent of its population.⁷ This is a notable increase from its current proportion of 4.5 per cent and, even more significantly, represents approximately one-quarter of the global total. India's middle class could, by the same year, become the largest in the world in absolute terms.⁸

The ways in which a large and growing middle class can contribute to economic growth processes have been frequently documented.⁹ Firstly, strong links exist between the degree of entrepreneurship in an economy and the size of its middle class. Secondly, members of the middle class contribute significantly more, at least in absolute terms, to aggregate savings and human capital investment than do their poorer counterparts – middle-income groups typically save sizeable amounts for retirement, housing and their children's education, thereby providing ample resources for capital investment. Another consideration is the relationship between the size of the middle class and levels of domestic consumption. Growth in the middle class raises demand for consumer durables and other manufactured goods. This increase in the size of the domestic consumer base encourages capital investment and fosters the development of international trade.

There is also the possibility that, once the middle class reaches a critical mass, it creates a virtuous cycle of higher consumption, higher firm profits, higher savings and investment, higher growth and, consequently, a larger middle class. A contributing feature is the middle-class' willingness to pay

more for high-quality goods, which encourages product differentiation among firms and, consequently, higher profits.

Increased Global Integration

South Asia has made significant strides in trade participation and financial openness in recent decades. Imports and exports have grown strongly – the region's average export growth rate rose from 5.3 per cent during 1997-2001 to 14.3 per cent during 2002-2006.¹⁰ Similarly, import growth increased from 2.2% during 1997-2001 to 24.6 per cent during 2002-2008.¹¹ Notably, the region's export growth rate during 2002-2008 of 19.3 per cent is significantly higher than the global average of 11 per cent.¹²

Another important development has been an expansion of the region's base of trade partners. Traditionally, most South Asian states supply agricultural and manufactured products to Western markets. More recently, however, strong trade linkages have developed between these States and other developing States, notably in Africa, the Middle East and other parts of Asia. Developing countries received 38.1 per cent of South Asia's exports and provided 43.8 per cent of its imports in 1985. By the year 2006, these shares had increased to 42.7 and 49.1 percent, respectively.¹³ Trade with China has, in particular, been expanding quite strongly since the early 2000s – aggregate trade between China and the group of SAARC (South Asian Association for Regional Cooperation) States was valued at approximately US\$ 80.5 billion in 2010, for example.¹⁴ Seeking to further expand the scale of these mutual benefits, India and China have agreed to a bilateral trade target of US\$ 100 billion for the year 2015.¹⁵ Encouragingly, South Asia also experienced a doubling of its intra-regional trade figures from 2003 to 2008.¹⁶

Furthermore, FDI flows to South Asia have increased steadily over

the last decade. FDI grew from US\$ 6.7 billion at the start of the 2000s to US \$22 billion in 2006/07.¹⁷ Between the periods 2003/04 and 2006/07, FDI inflows more than doubled for the region's three largest recipients: India, Pakistan and Sri Lanka.¹⁸ Although South Asia's share of FDI inflows is only about 5 per cent of inflows to developing States in Asia and about 3 per cent of inflows to developing states in the world, it is increasing over time, indicating the growing attractiveness of the region for investment relative to its other developing counterparts.¹⁹

An interesting development in South Asia's process of financial integration with the world is its slow but definite emergence as a source of outward FDI. In 2006/07, FDI outflows from South Asia amounted to nearly US\$ 10 billion. Of this, US\$ 9.67 billion came from India, US\$ 0.11 billion was from Pakistan and US\$ 0.03 billion was attributed to Sri Lanka.²⁰ In fact, India is beginning to be viewed as a significant source of intra-regional FDI. This represents another means by which the States of South Asia can aid each other's growth through closer cooperation.

Service Sector Development

The importance of service sector development to South Asia's growth prospects is well-documented. Services now account for the largest share of regional GDP (Gross Domestic Product) – approximately 55 per cent in the year 2008.²¹ Indeed, the South Asian States display enormous potential for growth through service sector development as against through alternative sectors. This is because, firstly, there is significant demand for services in the global market, as well as numerous opportunities for globalisation via the services route. Services currently account for over 70 per cent of global GDP – more than twice the contribution of the manufacturing sector.²² Secondly, the production of services involves an extremely large cost differential amongst countries – one which favours South Asia.

Furthermore, a confluence of economic factors has created an environment in South Asia that is conducive to services production. Key among such factors is the existence of a workforce that is relatively highly-skilled (as a result of a strong tradition of higher education in India, for instance) and speaks English fluently (a hallmark of the region's colonial past). A large and widespread diaspora that has gained exposure to and familiarity with the rapid advances in technology is another significant advantage; this diaspora played an invaluable role in the formation of India's IT (Information Technology) and information services sectors.

The development of services production among the South Asian economies has equally led to increased participation by these States in global services trade. As an indicator, during 1991-2006, South Asia's trade in services grew at 16.1 per cent, notably surpassing its merchandise trade growth of 12.7 per cent.²³ The composition of services exports diverges quite markedly across the region: in India and Bangladesh, computer, communications and other services dominate commercial services exports; Nepal, Pakistan and Sri Lanka demonstrate high levels of transportation and travel services; and the Maldives' service exports are dominated by travel services.²⁴

Despite the considerable progress already made by the region in terms of service sector development, however, much scope for further progress remains. In particular, what is required is a more concerted effort at achieving regional integration and inter-State cooperation to further the development of this sector. The benefits of agglomeration afforded by the services sector suggest that, in the absence of such cooperation, these countries will be unable to reap the greater part of potential economic gains from services developments occurring within the region.

India's Success Story: Regional Spillovers

India's emergence as a significant player in the global economic arena represents one of South Asia's most important opportunities for regional growth and development. The nature of such potential is multiform. Firstly (and arguably most importantly), we consider India's booming service sector. Beginning in the late 1980s with a burgeoning software industry, India's service sector has expanded over time to embrace IT-enabled (including Business Process Outsourcing (BPO)), pharmaceutical, biotechnological and medical services. As an indicator of the speed of Indian service sector growth, the country's services exports tripled between 2002/03 and 2005/06, increasing from US\$ 20 billion to US\$ 60 billion.²⁵ Furthermore, India accounted for 60% of all global software outsourcing in 2008.²⁶

Importantly for the region, as Indian IT and other service sector firms continue to move up the production value chain, they are themselves beginning to outsource more routine procedures regionally. South Asian States which demonstrate low wages and a sufficiently skilled workforce therefore benefit considerably from continued developments in the Indian service sector. Regional service sector developments are thus no longer confined to India, but rather, have extended to the other South Asian States, notably Pakistan and Sri Lanka. The notion that South Asia could become a global ICT (Information and Communication Technology) outsourcing hub is, consequently, garnering attention. In order to realise such an aim, however, considerable efforts are required to deepen the degree of regional integration within South Asia, as well as to improve the regional infrastructure necessary to sustain a vibrant service sector. Endeavours to improve education and to lower establishment costs to foster a favourable business environment are also desirable.

Furthermore, Indian service-sector firms are increasingly moving towards economic activity that involves knowledge production. For example, certain Indian pharmaceutical companies have begun to develop new drugs, rather than merely producing low-cost, generic versions of existing drugs, as was previously their practice. If, in this manner, India is able eventually to establish itself as a centre of research and development, the potential spillover benefits to the region – in terms of knowledge and technology transfer – would expand considerably. Yet again, however, the realisation of these benefits depends crucially on state's ability to integrate effectively, both amongst themselves and with India.

A second Indian 'success' which could benefit the region is its emergence as a source of FDI outflows. As previously discussed, capital inflows to South Asia have been on the rise in recent years. Equally, however, growth in the Indian economy has spurred a culture of Indian investments overseas. India's FDI outflows have grown appreciably in the last five to ten years: for instance, they grew from US\$ 5 billion in 2005/06 to US\$ 12.8 billion in 2007/08.²⁷ Notably, much of India's FDI is directed towards developing States, a significant proportion of which are regionally located. India is Sri Lanka's third-largest source of FDI at present, for example. As is the case with service sector development, however, deepened regional ties are desirable to ensure that higher levels of Indian FDI flow intra- rather than inter-regionally.

Conclusion

Despite the continued challenges posed by poverty, global economic volatility and the slow progress of regional integration, the unique and important opportunities currently afforded to South Asia

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have poised it on the brink of a period of significant economic growth. If appropriately harnessed, these opportunities could establish the region as a growing economic power of considerable note. Its success in this regard will, however, depend crucially upon India's continued economic achievements and the region's ability to absorb the consequent spillover benefits. This, in turn, relies upon a far greater level of regional integration than is currently being experienced. Yet, despite the relative slowness of the process, greater attention is now being paid to achieving just this. If, during the next few years, South Asia is able to overcome geopolitical concerns and improve regional integration, particularly with India, to a more desirable level, it could well fulfil its potential of becoming Asia's newest economic 'miracle'.

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