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The Tortoise and the Hare: Comparing Development in East and South Asia

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Introduction

The old fable of the tortoise and the hare may be an apt analogy for economic development in East and South Asia. In this paper we examine growth and development trends in Taiwan, South Korea, and China (our 'hares') in contrast with India, Pakistan, and Bangladesh (our 'tortoises'). We hypothesize that growth rates between the 'tortoise' and the 'hares' will ultimately converge. The 'hares' that try to sustain high levels of growth, even during economic downturns, will slow down in the future as they attain developed economy 'steady state' growth rates. The most successful 'hare', Taiwan, which did not try as hard as the others to maintain historically high growth rates is, consequently, likely to experience a relatively 'softer landing' *en route* to economic maturity. Our 'tortoises', on the other hand, are likely to experience an upward shift from their sluggish growth rates of the past, approaching those now enjoyed by East Asia, benefiting largely from the 'catch up' emanating from their liberalization policies. However, the least successful tortoise, Pakistan, may have difficulty in achieving convergence, barring major structural change.

Our notion of slowing East Asian growth does not depend on the recent East Asian financial crisis and the ensuing recession.

The 1997–98 crisis did highlight some policy shortcomings such as unwise credit subsidies and deficient regulation of financial markets in the region. However, we believe that the seeds of the region's descent to a lower, steady-state balanced growth path were sown during its rapid economic growth over past decades. Now as the 'hares' close the gap with the currently developed countries and approach the world's technological frontier, it will become harder for them to grow at the 'miracle rates' in the magnitudes witnessed during the 1970s and the 1980s. Japan some time ago reached that stage and its growth has dropped below the roaring rates of the 1950–80 period. Evidence suggests that the East Asian countries are also likely to grow more slowly in the future as they become less adept at finding productive investments. According to some estimates, per capita GDP growth rates for Korea, Taiwan, and China are projected to be 3.5, 3.1 and 6 per cent, per annum, respectively (Radelet, Sachs, and Lee 1977), between 1995 and 2025.

At the same time, it seems reasonable to expect that those South Asian countries which adopt well-sequenced liberalization programmes that strengthen market discipline and facilitate improved productivity performance will grow rapidly in the years ahead. However, this catch-up will not be automatic or uniform across countries and will tend to be held back by inappropriate policy responses in some of our 'tortoise' cases. In this respect India seems most likely to benefit. It is poised to dominate the regional market for labour-intensive as well as, increasingly, high-technology (software) exports as it has liberalized consistently, if with substantial caution, and has experienced less dramatic political economy shocks when compared to Pakistan, Bangladesh, or Sri Lanka.

This paper is an extension of previous work by Ranis and Mahmood (1992) and Ranis (1997), and attempts to combine neo-classical growth theory with political economy variables—including the presence or absence of initial organic nationalism, natural resource endowments, and easy access over time to foreign capital—in explaining the historically divergent growth patterns between South and East Asia and in mapping the future road for the two regions. Our basic proposition is that the issue of accomplishing politically difficult changes in development policy is a function of subtle processes related to political economy. In this paper we aim to make this relationship between initial conditions and policy responses more transparent in the South and East Asian context. In that way, we can not only enhance our understanding of the development process in the region but also examine the future conditions under which South Asian growth rates can be expected to accelerate, while East Asian growth rates are expected to decline.

Our belief is that transition to a higher, steady-state balanced growth path represents a politically difficult process in developing countries, as it requires a shift away from import substitution to export orientation which is generally associated with the gradual withdrawal of political influence by government. It requires radical changes in the 'rules of the game', as economic agents, in particular the new industrial class, have to be persuaded to start operating in a radically different, much more competitive, environment. It is this process which is influenced by our aforementioned initial conditions which help determine the growth path of a country. Of course, we only claim that, by understanding initial conditions, we can better understand policy responses and choices and the resulting growth outcomes, certainly not that such criteria have perfect predictive power or that policy responses can be rendered fully endogenous.

Explaining the Divergence: Policy Choice and Growth

South Asia has clearly failed to come close to its growth potential over the past three decades. For instance, South Asia's GDP per capita in real terms (PPP dollars) was twelve times lower than the United States level in 1990, the same ratio as applied in 1965. East Asia, on the other hand, has made rapid strides. United States income per capita was six times the East

Asian average a generation ago, but is only twice as high now. Several economies in the region, mainly Taiwan, South Korea, and China, that began this period as low or middle-income developing countries, are now very much on the brink of modern economic growth.

Given the divergence in growth performance between South and East Asia, it is clear that a study of differential development patterns over time requires an analysis of why this divergence occurred in the first place. In the context of East Asia, numerous studies have sought to explain policy choices that have created such differing outcomes for the region compared to the world economy as a whole. The literature highlights a range of possible explanations, including trade and industrial policies, technological progress, savings and capital accumulation, governance, education and health spending, geography and culture, financial liberalization, and initial income levels (see for example, Asian Development Bank 1997; Landes 1998; Rodrik 1994, 1998; Sachs and Warner 1995b; Srinivasan 1994; World Bank 1993; Young 1995). Although these studies emphasize different causal factors, they reach the common conclusion that East Asia's unrivalled growth is not a monocausal phenomenon. Economic growth is affected by many factors whose cumulative effect can account for much of East Asia's superior performance in relation to the relatively poor performance of South Asia.

However, these studies only address the explanatory factors behind the transition process; the question remains as to why policy makers in South and East Asia chose different policies, especially given their common beginning with import substitution policies and pronounced governmental intrusion in their economies. One answer lies in the fact that some countries demonstrated persistent enhanced flexibility and commitment to pursuing adjustment in policy regimes, in response to the inevitable exogenous shocks, while others did not. Similarly, some countries embarked on a more or less linear path of depoliticized policy-making much earlier, and others only much later or not at all.

To explain this observed divergence in policy choices that affected both growth and human development (see Table 1), within the two regions largely on the basis of intrinsic cultural or human resource differences, is, in our opinion, inappropriate. Such an approach not only challenges the intelligence of a large body of South Asian decision makers, but is also factually incorrect. Instead, we believe it is more likely that the bulk of the explanation for the observed divergence in policy choice is to be found in a combination of initial typological differences between these sets of countries at the outset. Also, various

Table 1
Basic Human Development Indicators

Most recent estimates (latest year available)	India	Bangla-desh	Pakistan	China	Korea	Taiwan
GNP per capita (US$)	440	350	480	750	7970	13,198
Poverty (% below national poverty line)	35	36	34	6	-	-
Life expectancy at birth (years)	63	61	62	70	72	77
Infant Mortality (per 1000 live births)	70	57	95	32	9	6
Access to safe Water (% of population)	81	84	62	83	84	-
Illiteracy (% of population age 15+)	44	47	59	17	2	6

Source: PRC 1999; ROC 1999; World Bank 1999; and World Fact Book 1999

political and economic forces shaped the adoption or rejection of different institutional and policy changes over time.

Our basic argument, based on the political economy framework developed earlier (Ranis and Mahmood 1992; Ranis 1997), attempts to explain the differential policy choices in the regions, and the resulting growth outcomes, in terms of varying initial conditions—organic nationalism, natural resource endowments and the subsequent ease of access to foreign capital. These conditions not only affect an economy's initial income level but also its policy responsiveness over time, i.e., the extent to which policies accommodate or obstruct the basic evolutionary changes that all successful societies undergo in their transition to modern economic growth. In sketching a stylized political economy explanation of policy choice, we also consider proximate political and economic shocks; this is in the context of fundamental policy flexibility and responsiveness, which lies at the heart of the divergent growth paths that we observe in South and East Asia. Let us first briefly review the initial conditions that were instrumental in creating the divergent policy choices in South and East Asia.

Organic Nationalism

Organic nationalism refers to a community of feelings grounded in a common historical past, a binding cement which may be felt especially strongly, either because of the perceived threat from an outside enemy or due to the ethnic, religious, or linguistic homogeneity in a country. When a country benefits from the existence of organic nationalism it does not have to create some synthetic substitute; this means the government is less likely to over-promise and over-commit itself. In that process, it may ultimately find itself unable to carry out the major restricted but critical developmental functions, losing its credibility in the process. A country with a relatively weak degree of organic nationalism (for example due to ethnic heterogeneity) may be faced with a situation in which it feels it must initially expend its energies in a large variety of areas, leading to over-commitment and difficulty in pulling back at a later point. Substantial geographic, cultural, and sectarian diversity creates a need among typical least developed countries (LDCs) to create synthetic nationalism, which encourages the prolongation of overly interventionist behaviour by governments and thus leads to a relatively longer and more severe import substitution sub-phase and lower growth.

A look at the data also shows that, as a group, ethnically heterogeneous countries were far poorer in 1990 than ethnically homogeneous countries and achieved a much lower growth rate of real per capita income during 1965–90. Moreover, ethnically heterogeneous countries were under-represented among the fastest-growing countries and over-represented among the countries that were unable to raise per capita income markedly during that same period. Although ethnic homogeneity is neither a necessary nor a sufficient condition for growth, it does add to the explanatory power of our argument.

Taiwan and South Korea clearly benefited from relatively strong initial organic nationalism because of their ethnic and religious homogeneity, and the existence of a clearly defined external threat. This helps explain their subsequent policy choices, which resulted in a relatively brief and mild import substitution sub-phase. India and Bangladesh, on the other hand, were faced with a relatively weak degree of initial organic nationalism, given their vast geographical/spatial spread and the multicultural composition of their populations. In an effort to create synthetic nationalism these countries followed a development strategy that emphasized import substitution, protectionism and government intervention for a much longer period after independence. Ultimately, however, these policies led to an over-extension of the government's role, and their isolation from the world economy. For example, India's share in world exports fell from 2 per cent in 1951 to 0.4 per cent in 1980. The relative strength of its import substitution sub-phase delayed its entry into a competitive export led sub-phase and rapid economic growth.

However, once these countries embarked upon a gradual, though cautious, road to reforms (albeit much later in the transition process, i.e., in the early 1990s in the cases of India and Bangladesh) these structural changes helped to jump-start their economies (see Table 2). It is evident that these economies have recently been relatively successful in harnessing market forces for growth and development: encouraging trade and exchange liberalization, improving incentives by rolling back price controls and subsidies, reforming public enterprises, and strengthening their financial systems. The beneficial effects of these policies are now evident, as the past trend of slow growth has been reversed. India and Bangladesh have benefited from the general improvement in their policy environment, with GDP growth rates of over 6 per cent per annum, during 1991–98.

Table 2
GNP per capita (average annual growth rate)

Country	1978–88	1988–98
Bangladesh	2.3	3.1
India	2.6	3.9
Pakistan	2.9	1.6
Sri Lanka	3.5	3.7
Taiwan	11.0	7.5
China	8.5	8.8
South Korea	5.7	5.5

Source: ROC 1999 and 1988; and World Bank 1999

Pakistan, in contrast to Taiwan and South Korea, failed to benefit from a relatively early end to its import-substitution sub-phase as it was unable to emulate the East Asian pattern in the direction of external orientation and a more pronounced use of market mechanisms. Nor has Pakistan thus far been able to emulate the type of development strategy adopted more recently by India. Pakistan's record of economic performance has, instead, been marred by an oscillatory 'stop-and-go' pattern of organizational choices; with more market-oriented episodes of the 1960s halted by a return to import substitution-type policies in the early 1970s. Those policies in turn were followed by a policy reversal once again in the late 1970s, with subsequent unsuccessful attempts to regain the lost growth momentum of the market-friendly 1960s.

Natural Resource Endowments

A second and related initial condition is the overall scarcity of natural resources, which is important in three respects. First, generous natural resource endowments provide greater opportunity and incentive for rent seeking and corruption. Therefore, the larger the natural resource endowments, the greater the rents and the more animated the resulting struggle among various interest groups in trying to appropriate them. Second, natural resource endowments increase the risk of contracting the 'Extended Dutch Disease'. In other words, a large exportable natural resource base may not only result in an over-valuation of the exchange rate, to the disadvantage of non-traditional exports, but also influence the decision making process by taking the pressure off governments, thereby delaying much-needed policy change. Third, the larger the natural resource endowment, the more exposed the system becomes to exogenous fluctuations in terms of trade. The amplitude and periodicity of such fluctuations also affect organizational and institutional change, including the pace and sequencing of the liberalization process.

Recent evidence also shows that natural resource scarce economies tend to grow more rapidly than resource rich economies. For example, countries with primary product exports valued at less than 5 per cent of GDP recorded growth per person of over 3.2 per cent between 1965 and 1990, whereas countries with primary product exports equivalent to over 20 per cent of GDP grew just 0.8 per cent per person per year. Table 3 provides a brief overview of the composition of exports, with primary exports as a proxy for natural resource endowments. India, Bangladesh, and Sri Lanka are rich in natural resources relative to their East Asian counterparts. This acted as a favourable initial condition for the East Asian countries in our view. The overall scarcity of natural resources in China, South Korea, and Taiwan not only forced early attention to human capital and, thus, a broad enhancement of human development, but also helped mitigate some of the stop-and-go policies that bedevilled many other developing countries.

Table 3
Composition of Exports (as a % of total)

	PRIMARY		OTHER	
	1970	**1994**	**1970**	**1994**
Bangladesh	55.4	22.3	44.6	77.7
India	58.2	42.0	41.8	58.0
Pakistan	47.8	16.7	52.2	83.3
Sri Lanka	99.0	33.7	1.0	66.3
Taiwan	2.6 (1981)	0.3 (1998)	97.4 (1981)	99.7 (1998)
China	53.0 (1980)	20.3	47.0 (1980)	79.7
Korea	35.2	8.1	64.8	91.9

Source: PRC 1999; ROC 1999; and Sachs & Warner 1995b

Access to Foreign Capital

This third initial condition acts as a critical dimension that affects the political process underlying policy change. The ease of access to foreign capital is closely related to the natural resource endowment variable and serves to reinforce the 'Extended Dutch Disease' mechanism. Not only does the natural resource bonanza (for example, oil reserves) attract additional investor interest during an upturn, but also the whole society is viewed as a more favourable investment opportunity. Foreign investors and donors are often bullish when natural resources are abundant, especially in externally favourable times, and more likely to be bearish during unfavourable times. Foreign capital not only affects the size of 'under the table' rents which can be fought over and reallocated, but also gives rise to fluctuations associated with the quick entry and exit of short-term foreign capital. That process occurred during the debt crisis of the 1980s and again during the Asian financial crisis of 1997–98, both of which represented exaggerated versions of this pro-cyclical phenomenon.

Natural resources and/or additional foreign capital should of course in theory be potentially helpful, not only to provide additional capacity to buy out opposed vested interest groups but also to facilitate a country's ability to achieve any agreed-upon set of objectives. 'More' should be preferred to 'less'. However, 'more' may, in fact, add to the risks of contracting the 'Extended Dutch Disease' noted above; in that case 'less', in terms of resources, could prove to be 'more' over time. This is not to say that it is preferable to starve a developing country of foreign capital but that such flows have to be used as a tool for promoting the domestic 'ownership' and implementation of reforms that encourages rapid growth with equity. Another way of putting it is that the 'income effect' of additional resources, taking the pressure off needed reforms, can swamp the 'substitution effect' that engenders policy change.

We are interested in examining how this combination of initial conditions has affected policy actions that have permitted East Asian economies to grow at 5.1 per cent per annum over the last quarter century, compared to 1.4 per cent in South Asia. After all, almost all countries in these regions initially experienced some form of import substitution policies, with substantial government intervention penetrating their mixed economies. Much of the success of East Asia has been attributed to its more pronounced external orientation and greater willingness to subject itself to the competitive discipline of the markets. However, this approach has also placed those economies at greater risk through increased exposure to the vagaries of international fluctuations, changes in the terms of trade and business conditions.

Most developing economies inevitably exposed to shocks emanating from the rest of the world are tempted when such external shocks are positive, to attempt to enhance domestic activity through additional monetary expansion and deficit finance. On the other hand, when external shocks are negative

they are tempted to substitute the expansion of the domestic money supply and budget deficits for the decline in externally generated resources. This often leads to the ultimate necessity to re-impose controls and/or to resort to large devaluations. This syndrome is characterized by a general unwillingness to let prices gradually adjust to changing circumstances and instead to try to adjust quantities. For a detailed exposition of this political economy response to weak organic nationalism, natural resource abundance, and ease of access to foreign capital see Ranis (1997). In the next section we analyse the critical political economy dimensions which caused the divergence of South and East Asian policy responses and, thus, their development performance.

Regional Trends and Divergences

East Asia

Over the past half-century, the East Asian economies have made tremendous strides in development; even the financial crisis of 1997-98 did not make a major dent in their performance. Over this period, East Asian governments generally kept fiscal deficits under check. Inflation rates rarely exceeded 10 per cent, compared to episodes of deficit finance and inflation in South Asia. In addition, East Asian policy makers deftly managed exchange rates, by and large avoiding major overvaluations; even during the Asian financial crisis when the Won came under heavy pressure, the South Korean government quickly restored stability that eased foreign payment imbalances. Taiwan was the least affected country in the region, given its large foreign exchange reserves and its willingness to adjust its exchange rate early on and accept a 'soft landing' in terms of reduced growth. It is not our contention to argue that no policy mistakes were committed in East Asia. However, we do believe that the particular initial conditions and their reinforcement by policy change over time allowed them to grow at a remarkable pace for well over the past fifty years as well as to react relatively well to the inevitable external shocks.

Within the East Asian context we clearly see two main patterns of development—the Korea and Taiwan strategy versus the Chinese model. South Korea and Taiwan, exhibiting a strong degree of initial organic nationalism and natural resource scarcity, quickly passed from their import substitution phase in the 1950s and the early 1960s to an export orientation phase. Even though import substitution was clearly in vogue early on, this phase was relatively mild and short-lived. In most developing countries by contrast there exist substantial doubts with respect to the adequacy of human resources, people's ability to bear risk and perform vital entrepreneurial functions. This in turn frequently leads governments to take over these functions on a longer-term basis or to carefully select individuals relatively few in number, and often closely tied to the government, who would be granted the various required permits and favours, usually at subsidized prices. Taiwan's and Korea's initial advantage in human and institutional resources, combined with their natural resource scarcity, helped mould their decisions in favour of an early export-oriented strategy based on an increasingly competitive, human resources-based development path. China, on the other hand, endowed with a sizeable natural resource base, embarked upon the Chinese Communist Party's mission of building a socialist society, which led it into a long phase of import substitution and global isolation until the late 1970s.

Fiscal policy in Taiwan was, from the beginning, aimed at avoiding large-scale deficits initially with the help of foreign aid in the 1950s, but increasingly thanks to the high priority given to deficit reduction by government. Nearly balanced budgets were consistently seen as important. During Taiwan's first economic upturn from 1953 to 1973, the annual real GDP growth rate was high and steady, averaging nearly 10 per cent per annum. Given the relatively limited growth promotion activities of the government, this good performance can be largely attributed to the system's successful shift to a competitive

export strategy during the early 1960s. This change in pattern was also visible from Taiwan's export ratio, which rose from 10 per cent to 35 per cent during the 1960s.

Just as interesting is the fact that Taiwan's policies did not oscillate in response to external shocks; though small government deficits occurred in the early 1960s, they were quickly replaced by government surpluses that reached nearly 6-7 per cent in recent years. Similarly, there was a lack of an oscillatory pattern in monetary policy. On average, the money supply increased at relatively stable rates to yield generally modest rates of inflation of less than 5 per cent per annum. After the two oil shocks of 1973 and 1979, the authorities immediately responded by drastically reducing the growth of the money supply and running large government surpluses. This behaviour was in sharp contrast to the traditional South Asian pattern where deficit financing was seen largely as an instrument for sustaining growth during downturns.

This remarkable absence of growth activism in Taiwan's policies extended also to exchange rate management and trade policies. Unlike South Korea, Taiwan followed flexible exchange rate policies and was, therefore, unaffected by the overvaluation that hit other East Asian currencies that were pegged to the US dollar during the 1990s. Moreover, South Korea's excessive reliance on foreign capital was clearly evident by the fact that in June 1997, Korea's short-term debt had reached more than three times the size of its foreign exchange reserves. In fact, many of its deeply entrenched industrial conglomerates (chaebols) were insolvent but continued to receive loans because of explicit or implicit government guarantees. Korea is thus a clear example of how easy access to foreign capital, at least for a time, can enable the postponement of reforms, setting the stage for a rude awakening when the flow of foreign funds is suddenly reversed. During the Asian financial crisis it became clear that easy access to short-term foreign capital had facilitated rent seeking activities that made South Korea extremely vulnerable to policy oscillation.

During the early period, between 1962 and 1980, South Korea sustained an impressive GDP annual growth rate of over 9 per cent. After the Korean War ended, however, it followed an import substitution industrialization strategy; the government then completed this phase by the mid-1960s and moved to a dynamic export orientation strategy. This change ushered in a 'miraculous' period of growth, assisted by an export boom, which increased the share of Korean exports in total world exports from 0.1 per cent to 2.4 per cent between 1965 and 1995.

The opening up of the Korean economy to international competition was a carefully guided process, given the parallel development of large conglomerates. The South Korean government actively promoted labour-intensive manufacturing industries in the 1960s and early 1970s in order to accommodate the growing workforce. During this period import substitution was, however, still promoted on a selective basis; by 1973, it was still a part of government policy to choose industrial winners, notably in heavy and chemical industries. By the mid-1970s, exports from these more capital-intensive industries accounted for 30 per cent of total exports, reaching 70 per cent by the mid-90s. Rapid growth during this period was made possible by high investment rates, with gross domestic investment rising from 16 per cent of GNP in 1962 to 37 per cent in 1995. To help finance such increases in gross domestic investment, South Korea relied on a significant amount of foreign savings (see Table 4), which declined as domestic savings began to rise.

By the early 1980s, however, growth rates began to slow down from 7.3 per cent during 1977–87 to 6.6 per cent during 1988–97. The second oil shock, combined with a series of agricultural crop failures and domestic political instability, emanating from President Park Chung Hee's assassination, were partly responsible for the slowdown in growth. However, one reason was undoubtedly the misallocated investments of the 1970s in heavy and chemical industries, under South Korea's policy of selecting 'national winners', which was beginning to

Table 4
Korea—Saving and Investment Rates (annual averages)

	Domestic savings (as a % of GNP)	Foreign savings (as a % of GNP)	Investment (as a % of GNP)
1962–66	8.0	8.6	16.6
1971–75	17.6	8.3	25.9
1981–85	25.3	5.2	30.5
1991–95	35.3	1.7	37.0

Source: World Development Indicators 2000

weigh down the economy. The other was a decline in exports, especially in the micro-chip and related high-tech industries. These difficulties and Korea's unwillingness to seek a soft landing by permitting price changes ultimately led to weakness in the banking and financial systems. The lax lending habits that plagued the country created a property bubble, which in turn led to a worsening misallocation of investment. For years, growth was pursued at all costs and was readily financed through domestic financial monetary expansion and foreign savings. Increasing reliance on short-term debt, which rose from 23 per cent of total external debt in 1971 to 51 per cent in 1995, facilitated this momentum which, in the absence of a strong regulatory framework, resulted in South Korea, for a time, experiencing the worst effects of the Asian financial crisis.

China's development experience, in the East Asian context, has been unique. The post-revolutionary Chinese government started out systematically minimizing the role of private enterprise by relying entirely on public initiative and collective enterprise to spur growth. Although various minor forms of private economic activity were gradually tolerated, the strategy of development, until 1978, predominantly involved public control over agricultural and non-agricultural activities and placed heavy emphasis on state control. In progressing from early land redistribution to the collectivization of agriculture under a system of communes, China thoroughly transformed the structure of its rural society, linking change in agriculture to a policy of rural industrialization.

Most estimates of growth of real output in China between 1952 and the early 1970s ranged between 4 and 6 per cent per annum, whereas the corresponding figure for India was only 3.5 per cent. Throughout this period, the Chinese government stabilized the renminbi* and successfully combated inflation. This was achieved by regulating the supply of commodities and releasing them in a planned manner in order to keep prices stable. Moreover, the government indexed deposit accounts to curb inflation. Finally, economic and financial management was unified across the country, increasing accountability and balancing the budget.

The reforms, starting in December 1978, spearheaded one of the most remarkable economic and social turnarounds. Since then (1977–1997), China's annual growth rate has averaged more than 9 per cent per annum, while the poverty rate has continued to decline even as income distribution has worsened. In 1979, the 'household responsibility system' replaced collective farming, reinstating incentives in agriculture. The results were dramatic, with peasants' real incomes growing by almost 18 per cent annually between 1978 and 1984. Outside the agricultural domain, the creation of four 'special economic zones' (SEZs) in 1980 marked the beginning of enhanced regional economic liberalization and greater outward-orientation. China's conservatism during this early phase of reforms is evident from its trial-and-error approach to liberalization; only after the first four SEZs proved successful were another fourteen cities opened up to foreign investment.

China's transition to greater external orientation was initially accompanied by greater policy caution. China's easing, rather than jumping, into the world market is clear from its slower pace of financial liberalization. However, as the external environment has improved throughout the late 1980s and early 1990s, growth activism has gained momentum. China's large foreign exchange reserves and the inconvertibility of the currency on capital account insulated it, to a certain degree, from the worst effects of the Asian financial crisis; however, continued growth activism poses serious doubts about the country's future prospects. In the face of slowing growth—mainly due to Asia's financial downturn, which affected China's export growth—China has tried to sustain its growth rate throughout 1998–99. The government has adopted a counter-cyclical fiscal stance and initiated a programme of domestic demand stimuli, with a fiscal injection totalling $12 billion (1.4 per cent of GDP). Such growth activism is unlikely to be sustainable, especially in the face of the continued drag of the large-scale state enterprise sector and the increasingly ambiguous situation of the township and village enterprises (TVEs). It seems inevitable that China's growth rate will converge downward.

* Chinese currency is called Renminbi (RMB). You would ask for Renminbi when exchanging money or a traveller's cheque.

South Asia

With a population of more than a billion people, South Asian countries present striking contrasts in terms of their human and physical resources and economic performance. Though the countries in the region have made enormous strides in the last fifty years, they have, to date, been largely unsuccessful in harnessing their productive potential and generating rapid and sustained economic growth. The development strategies pursued emphasized import substitution and government intervention for varying lengths of time. With India and Bangladesh experiencing long initial periods of intervention and government control that resulted in stagnant economies, this was followed by gradually increased growth as a result of reforms, which established a more open and market-based economy. Pakistan, however, exemplifies a somewhat different development strategy. It represents a close approximation to the 'typical' LDC case (Ranis 1997) over two terms of trade cycles, where easy access to foreign funds played a vital role in successive governments' ability to entertain populist expansionist sentiments. Government policies in turn resulted in a political economy that generated ups and downs rather than any steady, long-term policy change.

India's relatively weak initial organic nationalism, combined with its relatively more moderate access to foreign funds, made its policy oscillations less severe than Pakistan's. This clearly shows up in India's secularly smooth growth performance. Due to the large number of its nationalities and vast spatial spread, its degree of initial organic nationalism was quite weak (certainly compared to South Korea and Taiwan); consequently, its import substitution phase was quite extensive. India's high degree of ethnic, religious, linguistic, and caste-based heterogeneity made it harder for the government to insulate the system of economic management from rent-seeking distributive demands and patronage disbursement. This heterogeneity relates most closely to the political economy dynamics that precipitated India's slow growth. As diverse elements of loose and uneasy coalitions of dominant proprietary classes lobbied the state in different directions, the outcome was a proliferation of subsidies and controls and a reduction in the amount of surplus allocated to productive physical and human capital investments.

Post-colonial Indian leadership was clearly committed to an active government role in ensuring rapid growth. In keeping with this concern, India adopted a strategy of government planning, grounded in the desire to accelerate growth through increased public sector investment. This spending was used to stimulate demand, thereby creating an environment in which the industrial sector could expand while agriculture was relatively neglected. India put heavy emphasis on import substituting industries and employed quantitative trade restrictions that allowed it to maintain large, mainly inefficient public-sector industries that produced capital goods and infrastructural facilities at the expense of labour-intensive goods. During this entire period India's annual growth rate remained virtually constant, at 3.6 per cent in the 1950s, 3.1 per cent in the 1960s, and 3.6 per cent in the early 1970s.

This period was also marked by a sense of export pessimism amongst Indian policy makers. During the first half of the fifties, while exports were not actively encouraged, machine imports were liberalized in line with the government's policy of setting up basic and heavy industries. The gap between exports and imports was initially met by substantial foreign aid, but ultimately led to India's first foreign exchange crisis in 1956. Though the crisis provided the government with an opportunity to reform the system, it shied away from taking politically difficult decisions to liberalize the economy and subject it to more international competition. Instead, it employed even stricter foreign exchange controls, accompanied by vigourous industrial licensing arrangements. This control system increased economic inefficiency and production costs by diverting entrepreneurial energies away from productive activities and towards dealing with the bureaucratic apparatus, diverting resources into unproductive, rent-seeking activities. An attempt was made to correct the competitiveness of Indian exports in 1966 by devaluing the rupee by 36 per cent. However, the timing, following a poor harvest, was unfortunate; the basic control system was not tackled simultaneously; and inflation was permitted to erode the benefits of the exchange rate adjustment.

Moreover, armed conflict with Pakistan in 1965 resulted in the suspension of Western aid, leading to a reduction in public sector expenditure. During this period of slowing growth and rising unemployment, populist policies acquired strong political support and translated into the nationalization of commercial banks in 1969 and the enactment of restrictive laws against big business.

Such growth activism in the form of large budget deficits and monetary expansion yielded higher rates of inflation, as evident from the greater than 30 per cent increase in wholesale prices during 1956–66, accompanied by stagnant growth. This trend continued throughout the 1960s, with the growth of the money supply remaining at around 7 per cent per annum, reaching 15.6 per cent by 1972–73, and leading to even higher inflation rates, which peaked at 30 per cent in 1974.

This sharp increase in inflation, which came about as a result of the large deficits of the past, coupled with the first oil shock in 1973, led to considerable political turmoil that necessitated balancing the budget and curbing inflation. Indira Gandhi's regime, therefore, embarked upon a number of structural changes in the economy that resulted in the partial de-licensing of industry and initiated the beginning of liberalization. The government froze regular wage increments and increased interest rates to 9 per cent, which helped bring inflation down to 8 per cent by 1976. This gradual easing of government controls that began in 1970 was also extended to foreign trade and the value of the rupee. Such reforms had a positive impact on the current account, which showed a surplus of 1.4 per cent of GDP in 1976. Modest import liberalization and export encouragement led to an increase in exports by almost 20 per cent between 1974 and 1978. Increased remittances from expatriates working in the Persian Gulf also played an important role in sustaining the balance of payments, encouraging the government to take further liberalization measures and reduce controls. The economy responded positively to the new policies, with growth averaging 4.7 per cent annually between 1974 and 1990.

Political forces and economic thinking tended to move in a similar direction in the 1980s, i.e., towards gradual changes in the regulatory structure. Between 1980 and 1985, GDP grew at an annual rate of 5.5 per cent, a definite departure from the historical 'Hindu rate of growth'. This period marks India's transition to a higher growth path as a result of policy changes that were put in place under the pressure of external shocks, particularly those emanating from the two oil shocks.

However, the 1980s also coincided with the failure of public sector enterprises and government subsidies to the public sector; at the same time defence expenditures increased at twice the rate of GNP growth. The government thus had to resort to higher domestic and external borrowing, which pushed external debt from $20 billion in 1980 to more than $60 billion by 1990. This resulted in a sharp rise in the fiscal deficit, which rose to 9 per cent of the GDP by the end of the 1980s. By then, India was again in the midst of severe fiscal and trade imbalances and double-digit inflation, and on the verge of defaulting on its

external debt obligations. This crisis, in turn, acted as a catalyst for the most far-reaching reforms in India's history.

This crisis was different from earlier ones experienced by India since it happened at a time when the world had changed. Russia was no longer a super-power; in fact it was competing for assistance to other developing nations. Therefore, India could no longer rely on foreign assistance for the asking. By the time the minority Congress Government led by Prime Minister P.V. Narasimha Rao had taken office in 1991, the country was at the brink of a severe macroeconomic crisis. Indian policy makers realized that they would have to embark on major structural reforms. The Rao government, with Manmohan Singh as Finance Minister, initiated a fundamental reassessment of the government's role and embarked on India's most ambitious programme of deregulation and liberalization to date.

These reforms concentrated on removing the 'license raj', reducing subsidies and limiting the role of the bureaucracy. Huge subsidies to exporters, support prices for farm products, lower grain prices for consumers and subsidized fertilizers for rich farmers, among other factors, had amounted to a big drain on the country's resources. According to estimates three items—food, fertilizer, and exports—received subsidies to the tune of $15 billion in 1980, and more than 17 per cent of the tax-to-GDP ratio was being off-set by these expenditures alone. Many of the subsidies were directed towards loss-making public enterprises and the industrial class, which had benefited from a system representing an elaborate network of patronage and rent seeking.

The reforms of 1991 began to dismantle the industrial licensing policy for new and old projects, removed barriers to entry for domestic and foreign companies under the Monopolies and Restrictive Trade Practices Act, and took the first steps towards removing wasteful subsidies. By November 1991, a new investment policy was promulgated easing entry requirements for multinationals, and partial convertibility on current accounts was achieved by March 1992. Moreover, the government took steps to limit the scope of the public sector.

What resulted was a significant proliferation of exports and a substantial improvement in the foreign exchange balance. Software exports alone, growing at 50 per cent a year, witnessed a thirty-fold increase between 1991 and 1999. India's real GDP growth rate moved up to 6 per cent per annum even as the reform programme lost some of its steam. It can be argued that India has finally embarked on a path that permits it to begin realizing its true growth potential.

Interestingly, this move towards greater openness in India was duplicated by Bangladesh at about the same time. The Bangladeshi government also launched a programme of structural reforms in the early 1990s to move towards a more open, market-based economy. Fiscal and monetary restraint and improved public resource management were complemented by significant trade reform, deregulation of industry, and exchange rate liberalization, leading to a significant increase in the level of domestic savings and investment, as well as the rate of growth. Between 1990 and 1994, the fiscal deficit fell from 6 per cent to 4.5 per cent; inflation remained moderate in the 3–4 per cent range; and the current account deficit dropped from 5 to 1 per cent of GDP. Per capita growth accelerated to 3.2 per cent a year during 1991–98, compared to 1.7 per cent during 1984–90. Indeed, Bangladesh's growth rate would have been much higher had it not been for the devastating floods and cyclones that ravaged the country during 1998.

India's and Bangladesh's relatively weak degree of organic nationalism (as in the case of China) helps to explain their late transition from the import substitution sub-phase. The country experiences diverge, of course, in that China started on the road to reforms in the late 1970s, while India and Bangladesh failed to pursue such policies to any significant degree until 1991–92. However, within South Asia, Pakistan corresponds most closely to the Ranis (1997) 'typical' LDC case. Easy access to foreign aid funds associated with treaty alliances with the United States, later due to the Afghan war, and extensive remittance receipts further aggravated the situation and acted as the fundamental

cause behind Pakistan's 'yo-yoing' economic policies over time, resulting in its overall poor economic performance.

Unlike India's late graduation from its import substitution phase, Pakistani Field Marshal Ayub Khan in the early 1960s introduced market-oriented policies by loosening some controls on trade, investment, and prices. These policies contributed significantly to the high growth rates of the 1960s, at 6.7 per cent per annum. The strong political alignment with the United States through Pakistan's membership in defence arrangements like the Central and South East Asian Treaty Organizations, as well as the signing of the Indus Waters Basin Treaty in 1961 between India and Pakistan under World Bank auspices, led to large foreign aid inflows. As a result, by the mid-1960s net foreign aid flows were financing over one-third of total investment spending, over 45 per cent of imports, and meeting much of the gap in food grain needs.

During this period, Pakistan's exports increased by 7 per cent annually and the trade balance improved significantly, primarily due to the policy of encouraging exports via an export bonus scheme, combined with import liberalization. This system was used to provide incentives to exporters of manufactured goods, financed by excess profits that could be made on imports due to the overvaluation of the exchange rate. Under this scheme exporters were entitled to purchase foreign exchange equal to 20 to 40 per cent of their foreign exchange earnings at the lower official exchange rate.

The policy response to the exogenous shock of the 1965 war, however, was to try to keep alive the growth momentum of the 1960–65 period through increased government spending. Increased taxes and the perception of unequal sharing of the growth benefits both within West Pakistan and between East and West Pakistan led to the further disintegration of the level of organic nationalism that held the system together. Mahbub ul Haq's famous speech arguing that Pakistan's economy was dominated by twenty-two families who controlled most of its industrial, insurance, and banking assets, was picked up by the erstwhile Foreign Minister Zulfikar Ali Bhutto and became the symbol of criticism of the entire economic system. The events that followed culminated in increased political instability, Ayub Khan's resignation, the 1971 war with India, East Pakistan's separation from West Pakistan, and Bhutto's inauguration as Prime Minister in 1972.

Bhutto reversed the liberalization trend, introducing a system of industrial investment sanctions and nationalizing a number of industries. This led to a 60 per cent drop in real private investment between 1969 and 1977, and a drop in the GDP growth rate from 6.7 per cent during the 1960s to 4.9 per cent during 1972–77. This drop was accompanied by the emergence of full-blown growth activism and the attempt to accelerate growth via expansionary fiscal and monetary policies. However, as could be expected, even though total public sector spending doubled to 12 per cent of GDP between 1971 and 1976, growth remained sluggish.

Rising public spending caused increasing fiscal deficits, averaging around 8 per cent of GDP during 1972–77, compared with only 4–5 per cent during the 1960s. There was a sharp monetary expansion with serious inflationary consequences, 15 per cent per annum during 1970–77, in sharp contrast to the relative price stability during the 1960s upturn. Another aspect of the return to an import-substitution type of policy package was the deterioration in the trade deficit, with the current account deficit reaching 7 per cent of GDP by 1977, up from 2 per cent in 1973. This mainly resulted from the government's wariness of the private sector, which discouraged manufactured exports, and the reduction in competitiveness brought about by high inflation rates which had offset the effect of the 1972 devaluation.

General Ziaul Haq's martial law regime, imposed in 1977, brought an end to Bhutto's import substitution policies. After 1977, the main aim of policy again reverted to restoring rapid growth. A target of 7 per cent was set, and a programme to revive industrial investment, which had deteriorated since the late 1960s, was initiated. Considering the effect of the second oil shock on Pakistan and a fall in international commodity

prices, the effort was a success. At the same time, many of the controls on industry were liberalized or abolished. General Zia's eleven-year rule brought about rapid economic growth that averaged 6.6 per cent per annum and matched the high growth performance of the 1960s. The first half of this period (1978–83) witnessed a substantial rise in worker remittances, which not only acted as a substantial source of economic growth but also provided strong balance of payments support; in fact they were as important a source of foreign exchange as merchandize exports. Unfortunately, these remittances had Dutch Disease consequences, being directed towards consumption activities and providing a negative impetus for growth.

Due to the market-friendly policies of the Zia regime, such as the introduction of a flexible exchange rate and export subsidies, provision of guarantees to private investors, and relaxation of investment controls, private sector investment and exports increased once again. Private manufacturing investment which had declined sharply, from 90 per cent of total investment in 1972 to 25 per cent in 1977 due to the 'socialist policies' of the Bhutto regime, picked up. The pace of industrial sector growth, at around 9 per cent per annum until the mid-1960s, and down to 2.9 per cent during 1970–7, picked up again during the 1980s. Manufactured goods accounted for almost 57 per cent of all exports in 1983–4. However, the manufacturing sector was dominated by cotton textiles, which accounted for 25 per cent of total and over 40 per cent of manufactured exports in 1984–85. Even though the rapid expansion of agricultural output provided new opportunities for large exports and higher growth, this narrow export base emerged as the main weakness responsible for a number of trade problems in the 1990s.

However, the growth momentum of 1977–88 was not financed by savings but by large-scale domestic non-bank borrowing at high interest rates, which postponed inflationary pressures. Therefore, just as in India, by the end of the 1980s, Pakistan was faced with a large and inflexible burden of interest payments on that debt. The economy in the 1990s thus paid a high price for the fiscal excesses of the 1980s. Ultimately, increased defence spending, rising interest payments on the domestic debt, and rising non-development spending during the later years of the Zia regime pushed the deficit above 8 per cent. The debt trap that the country found itself in during the 1990s owes its origin to this decade.

The elections that followed Zia's sudden death in 1988 heralded Pakistan's decade of democracy, which produced four popularly elected governments and three interim governments over the next eleven years. These governments made major policy efforts in the early 1990s to further liberalize Pakistan's economy. Investment controls were greatly relaxed, the foreign exchange regime was rendered virtually free, high tariffs were dismantled, private sector involvement in infrastructure development was greatly encouraged, heavy dependence on foreign trade taxation was reduced and a major privatization effort was initiated. However, weakness in the institutional and governance framework, coupled with political instability that increasingly marred the system during this entire period failed to translate reforms into higher growth.

The absence of long-term investment by the Zia regime and the large domestic debt cast its shadow forward. Even though the country witnessed at least three IMF and World Bank-sponsored stabilization programmes, the budget deficit remained extremely high at around 7 per cent of GDP. As growth waned inflation began to rise, averaging around 11 per cent over the decade. This was due to successive governments' inability to control fiscal deficits and credit expansion, which had become a tool not only for stimulating the economy but also for buying political support. This was evident from the fact that external debt reached 40 per cent of GDP ($25 billion) in 1996, pushing total public debt to 82 per cent, compared to only 54 per cent of GDP in 1980.

The failure of domestic policies in raising the level of domestic savings—which remained abysmally low—and decreasing reliance on foreign capital led to the weakened external payments situation in 1994, when the current account deficit skyrocketed to $4.4 billion. Pakistan had to reschedule

its commercial and official foreign debt in order to cover a $5 billion financing gap. This gap has only recently been met by the debt agreements arranged by the Paris and London Clubs for rescheduling Pakistan's medium- to short-term obligations of more than $5 billion.

It is thus clear that successive Pakistani governments manipulated fiscal and monetary policies to maintain high growth. These policies have been assisted by international capital flows, mainly in the form of foreign aid, over the years. Such easy access to foreign capital, combined with a relative abundance of natural resources, allowed Pakistani governments to follow policies that encouraged interventionist behaviour and generated the oscillatory path described earlier. While there have been some encouraging signs in recent years, it is not clear whether Pakistan is fundamentally ready to take the steps necessary to remove structural impediments, such as corruption and economic mismanagement, and deviate secularly from the 'typical' LDC political economy-dictated pattern.

Trading Places

The divergent growth performance between South and East Asia can thus be explained in a comparative political economy context. The East Asian region's favourable initial conditions allowed policy makers to keep the reform process on track, permitting them, with the exception of China, to reach early graduation and NIC status. More importantly, the response of East Asian policy makers to exogenous shocks has been more or less consistent, with the temporary exception of South Korea, to maintain a steady trend towards liberalization. As a consequence, their economies had been relatively more exposed to the risks and opportunities of the international economy than South Asian countries. This is also why they were more exposed to the recent Asian financial crisis and have recovered equally quickly. But they will have to be satisfied with more moderate rates of growth in the 3–4 per cent range, as those economies near the modern economic growth era. The South Asian countries, on the other hand, have begun to move toward ending their old practice of downplaying the benefits of a more open economy and international trade, while continuing to follow relatively expansionary fiscal and monetary policies that resulted in little or no growth and persistent widespread poverty.

Though the policy package employed by the East Asian countries—relatively mild and brief periods of government interventions to help markets function better—helps to explain their remarkable economic performance, convergence may also be helped by the possibility that laggard poor countries tend to grow faster than more advanced rich countries. It is presumably easier for a country to 'catch up' to its potential long-run level of per capita income. Neo-classical growth theory predicts that a country with a low initial income relative to its own long-run (or steady state) potential level will grow faster than a country that is already close to its long-run potential level. The idea is that the farther an economy is located from its steady state income level, the greater is the gap of reproducible (physical and human) capital and technological efficiency from their long-run levels. This gap offers the chance for 'catching up', via higher rates of capital accumulation, especially with the transfer of frontier technology from the more advanced economies. That is, however, not to say that poor countries always grow faster than rich countries. Indeed, evidence indicates that convergence is likely to take place among typological 'neighbours,' such as within the European Union or among the states of the United States. Only when institutional and policy changes occur to convert geographic 'neighbours' into political economy 'neighbours' can we contemplate followers being on the same production function. This is not likely to happen any time soon, given the different initial conditions that would have to be overcome. Only then will the evidence on a global basis, that poor countries indeed grow faster than rich countries (Sachs & Warner, 1995a; Barro and Lee, 1994; Mankiw, Romer, and Weil, 1992; and Barro, 1991) become relevant to our problem. This helps explain why the more successful East Asian countries in

the past, with their relatively larger capital stocks experiencing diminishing returns and operating near the world's technological frontier, will tend to grow more slowly than the lower-income neighbouring countries of South Asia, which are catching up with the leaders.

Suppose we consider an aggregate production function where GDP is a function of capital (K), labour (L), and a general efficiency parameter A, so that GDP = A * F(K, L). Here the efficiency parameter can be viewed as reflecting the quality of macro and micro policies. If a country follows a more or less linear trend towards the de-politicization of policy-making in terms of the reduction of growth promoting interventions or distortions then there will be a resulting improvement in efficiency (A) or total factor productivity. That effect will be even greater if this process of internal deregulation is combined with increased openness, as countries that are integrated into the global economy are in a much stronger position to take advantage of new technologies and spillover effects and, therefore, more likely to 'catch up' quickly.

This has important implications, for both the tortoise and the hares of Asia. Relatively low levels of income in the 1960s provided East Asian countries with the potential to grow rapidly and to catch up to 'typologically neighbouring' Japan. However, as their incomes increase and they approach developed country status, their growth rates are likely to slow down. This is because aggregate investment is subject to diminishing returns. It will become harder for the countries to maintain high rates of growth, as it entails devising new technology rather than simply relying on borrowed technologies. Their 'catch up' growth rates of 8–10 per cent can, thus, largely be explained through their more efficient use of inputs and/or the wise selection and adaptation of more advanced country technology which brought about an improvement in 'A'. Growth based largely on increased inputs alone is eventually subject to diminishing returns.

Hence, as East Asian countries reach the 'mature' economy stage, technological advances and efficiency gains at the frontier must be adequate to maintain growth even at the more modest

3–4 per cent level. China, South Korea, and Taiwan, the hares of our piece, are likely to face this frontier, and thus lower growth rates, as they approach mature economy status. Their dramatically higher income levels suggest that rates of return on new investment will continue to decline, leading to slower growth. Growth rates can be projected to decline more smoothly in Taiwan than in China and South Korea, because of the dramatic improvements in its social indicators. Also, favourable initial conditions allowed Taiwan to keep growth-promoting government intrusions to a minimum, while at the same time adjusting to external shocks by maintaining relatively flexible prices.

A second conclusion flowing from the above analysis is that South Asia is well placed for rapid growth in the future as it moves to overcome the heritage of its less favourable initial conditions by persistent institutional and policy change. India, whose growth rate may soon exceed East Asia's, is a good example. The reversal of roles may also be helped by the way demographic gifts are likely to be distributed across the region in the future. We refer to the fact that we can expect slower growth in aging societies and faster growth where fertility rates have fallen recently. For a given population growth rate, faster growth in the working-age population (15–64 years) increases the size of the work force which, in turn, generates the bulk of an economy's output and savings. At the same time, for a given growth rate of the working-age population, faster overall population growth implies an increase in the relative size of the dependent population. Thus, a higher dependency ratio (i.e., a population younger than fifteen years and older than sixty-five years of age as a percentage of the 15 to 64-year-olds) implies a lower savings rate. Therefore, the growth of GDP per capita is favoured when the growth of the working-age population outpaces overall population growth. Between 1965–90 the working-age population in East Asia grew 1 per cent faster than the total population, compared to only 0.25 per cent in South Asia. However, due to East Asia's aging population and South Asia's recently falling dependency ratios, these patterns are

likely to change in the future, leading to a convergence effect between the South and East Asian countries.

As South Korea and Taiwan approach mature economy status they can be expected to grow more slowly, while Bangladesh, India, and Sri Lanka can be expected to grow more rapidly. China is an outlier in the sense that it became a force more recently and will take a bit longer before it also slows down. And Pakistan is an outlier because it has yet to overcome both political and economic bottlenecks en route to consistent institutional and policy change.

It is important to note that such forecasts rely upon broad trends but also outline the general direction of changes to come. Radelet, Sachs, and Lee (1997), for example, support our story when they project that per capita income growth in South Korea and Taiwan will slow down to an average of about 3.5 and 3.1 per cent in 1995–2025, from 7.2 and 6.2 per cent in 1965–1995, respectively. In South Asia, however, the recent trends towards increased liberalization will dominate, as the economies are expected to grow at 4.4 per cent in 1995-2025 compared to 1.9 per cent between 1965 and 1995, respectively. However, such convergence will be far from automatic: Sri Lanka and

Table 5
Growth Projections, 1995–2025

	GDP per capita relative to the US (%)		Per capita growth rate (%)	GDP per capita relative to the US (%)	Per capita growth rate (%)
	1965	**1995**	**1965–1995**	**2025**	**1995–2025**
Korea	9.0	48.8	7.2	82.6	3.5
Taiwan	14.2	56.2	6.2	88.0	3.1
China	3.2	10.8	5.6	38.2	6.0
Bangladesh	9.9	8.5	1.6	17.2	3.9
India	6.5	7.8	2.2	24.4	5.5
Pakistan	7.7	7.7	1.6	18.1	4.4
Sri Lanka	10.1	12.6	2.3	25.3	3.9

Source: Radelet, Sachs, and Lee 1997
Note: Projection assumes that all countries maintain the policies adopted in 1995.

Bangladesh have painfully shown how corruption, political instability, and civil war can thwart growth, and Pakistan continues to be at the crossroads. Sri Lanka is the prime example of how this convergence mechanism can break down even when favourable conditions exist. It has a highly developed base of human capital, which should allow it to continue along and even accelerate the process of catching up with the world's economic leaders. However, the continuing civil war in the Northeast has come at an enormous cost—claiming thousands of lives and costing more than $1 billion and 3 percentage points of economic growth each year.

Moreover, widespread corruption continues to act as an impediment for the region's growth prospects. According to a recent study in Pakistan, the extent of damage from corruption may have increased from a quarter of 1 per cent of GNP growth in 1947 to just under 2 per cent by 1997 (Burki, 1998). The hidden costs of doing business in Bangladesh have been estimated at 340 per cent of the estimated official costs (World Bank, 1996). If Pakistan had reduced corruption levels to those prevailing in Singapore, its annual per capita GDP growth rate over the period 1960–85 would have been higher by two percentage points—implying per capita incomes almost 50 per cent higher than existing levels (Wei, 1998). Similarly, if Bangladesh were to improve the integrity of its bureaucracy to Uruguay's level, its GDP growth rate would rise by half a percentage point annually (Wei, 1998). That is not to speak of what additional growth and human development benefits could accrue if the bitter infighting between the leaders of the two main Bangladeshi parties could be set aside.

Indeed, we can expect South Asia to grow at 5–6 per cent if market-friendly reforms, combined with complementary institutional changes, continue to be pursued and adverse exogenous shocks, for example, military tensions between India and Pakistan, civil war in Sri Lanka and the political struggle in Bangladesh, can be kept from escalating. Given the continued, if gradual pace of these reforms, there is indeed great potential for the region's growth, especially in the case of India, less threatened by the aforementioned response to temporary shocks.

India embarked on the process of reforming fiscal, trade, exchange rate, industrial, and foreign investment policy after 1991, when it was faced with a severe fiscal and balance of payments crisis. The step-up in India's growth rate in the 1980s was partly due to efficiency gains in allocation, arising from the rather limited deregulation and liberalization of only a few aspects of the then-prevailing control regime. The post-1991 structural changes, even if slow, have cut much wider and deeper and have produced appreciable results. They have helped growth to rebound to 5 per cent in 1992–94 and to remain over 7 per cent between 1994 and 1996. The 1998–99 period again saw growth crossing the 6 per cent threshold. Unlike previous episodes of growth spurts, this recent episode has not been driven by public investment but is the result of important structural changes which have reduced distortions and increased internal and external competition.

Though the threat always remains that development processes can be derailed by political upheavals or regional tensions, the reform process in India seems to be firmly in place and is now backed by a broad-based political consensus. This is not yet fully the case in the rest of South Asia, although the fundamentals are in place in both Bangladesh and Sri Lanka, and it is decision-making time for the new military government of Pakistan.

It should be noted that, even though reforms in India have mainly concentrated at the central government level, a gradual process of decentralization has also started to take shape as a result of increased support lent by regional political parties in the formation of governments at the centre. This has unleashed a process similar to that in China, where coastal provinces had taken the lead in pushing for reforms, prompting further actions by the central government as others compete with these provinces in efforts to liberalize, engage the domestic private sector and attract foreign direct investment. Decentralization also undoubtedly helps ensure the longevity of the reforms already put in place. Moreover, the increasingly liberal environment in India has allowed Indian companies to make strides in the global marketplace, especially in the field of high-tech computer software and information technology. Given the persistent widening and deepening of reforms, and the integration of India into the world economy, one may project sustained growth rates exceeding 6 per cent annually.

Our South Asian 'tortoise' is indeed at the dawn of a potential new era. The changes associated with rapid past growth among our East Asian 'hares', coupled with the structural reforms sweeping South Asia, plus the change in the 'demographic gift', are shifting development opportunities towards South Asia. A new openness towards increased domestic and external interdependence has already positioned India to take full advantage of the 'new economy' taking shape globally, with the potential of putting the first South Asian 'tiger' on the world map. It is clear that ensuring rapid catch-up by India and other South Asian countries requires further progress in discarding the stop-and-go policies of yesterday, overcoming the heritage of unfavourable initial conditions, and taking the opportunity of learning from the past record of the 'hares'.

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