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Markets and Economic Growth in South Asia, 1950-97: An Interpretation

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Abstract: In the context of the theme, markets and economic growth, this paper seeks to examine the role of output as well as factor markets in shaping the pace as well as composition of economic growth in the major South Asian economies. In particular, we seek to explain the slow pace of economic growth in these economies since 1950s using Simon Kuznets-Douglass North Institutional approach to economic growth. This approach emphasizes the evolutionary path dependent character of the growth process focusing on the processes and mechanisms of adjustment and their outcomes for economic growth. Specifically, we argue that product-market distortions emerging from restrictive trade and exchange rate policies under centrally initiated and public sector-oriented industrialisation constituted the major *causal* factor behind the slow pace of growth of South Asian economies. Considerable reduction in inward-orientation in recent years has improved their growth performance. However, the nature of the policy shifts was mainly crisis-driven and not designed as part of the long-term development strategy, as was the case with the star performers in East Asia (especially Korea and Taiwan). The unfinished nature of economic reforms is illustrated by the fact that some measurable progress in unilateral trade liberalisation has not been accompanied by concommital removal of distortions in factor markets undercutting the benefits from such reform. The unwillingness or the incapacity to carry out commensuarte reforms in the factor markets is largely attributable to the "inertia of the past" shaped by adverse political economy rooted in the past strategy of inward orientation.

I. Introduction

A. Questions and Concerns

The paper has two messages. *First*, it argues that product market distortions emerging from restrictive trade and exchange rate policies have been the *cause* for the relatively slow economic growth in South Asia. *Second*, factor market distortions, exacerbated by the compulsion of maintaining such inward-looking trade policy regime, have also contributed to the slow-down, but did not play the causal role. With the passage of time, however, these distortions magnified, ossified and reproduced in the form of institutional constraints, exhibiting inertia even when the countries moved towards a more open-door policy especially in the nineties. Removal of these constraints is crucial to sustain the gains from outward-orientation and to the prospects for achieving high economic growth.

This paper seeks to explain the past. What factors contributed to the relatively slow growth .of the South Asian economies over the 1950-97 vis-à-vis high-growing countries of East Asia? At one level, it is a question of analytical history. At another level, it has implications for future policy. After all, past is not a lost world, but a "renewable resource" whereby interpretation of the past is also an attempt to re-draw an alternative perspective. It is important, therefore, to pinpoint the past pitfalls from which one could, perhaps, draw some lessons for the future.

The issue of what determines long-term growth and decline of nations is one of the central questions of development economics. A first-cut answer to this question is provided by the standard growth accounting, which points to the importance of three factors: physical capital accumulation, human capital accumulation, and technological progress. A growing body of empirical evidence suggests that a range of policies and country-specific institutional factors, in turn, influence the pace of expansion of these three factors. Market-distortions (including the issue of *institutional foundations* of the markets) are important considerations in this context.[1]

Market reform and institutional policies and measures affect growth via influencing investment rate as well as the rate of technological progress. Thus, output-market distortions arising out of inward-oriented trade policy regime determine the price of new capital and hence, total factor productivity (TFP). Similarly, capital market distortions shape the interest rate, which, in turn, affects investment and TFP. Poor financial arrangements lead to limited resource mobility, and influence investment rate. Labor market rigidities may have similar implications for private investment decisions and TFP via influencing the choice of technology.

Not all the markets, however, have the same degree of distortionary implications in terms of long-term growth-inhibiting characteristics. In some contexts such as East Asia (especially Korea and Taiwan) deliberate distortions through the activist approach to capital market--with the centrality of the bank-based allocation of investible funds--contributed more to the high growth performance more than any other factors. In other contexts such as South Asia (as would be argued in the paper) product-market distortions--with the centrality of inward-oriented trade policy regime--may have mattered more than factor market distortions in explaining long-term growth.

Nor all distortions within the same market have similar growth-effects either. Politicization of industrial labor relations, sector-wide tradeunionism, and more importantly a lack of exit policy may have more serious consequences for industrial growth than the presence of minimum wage legislation as such. The policy interventions and economic outcomes would also differ depending on the political/ institutional setting within which particular market relations operate. Thus, it is important to note how apparently the same of set of policies can produce differing results. The policy of allocating investible funds through the banking system, for instance, was crucial to the success of East Asian industrialization, but largely failed in South Asia. The overhang due to debt-default plagues the entire formal financial system--Bangladesh and Pakistan are two extreme examples--has severely undermined their growth potentials.

It is in the backdrop of specific history of development that the present paper poses the question of centrality of the product market distortions in explaining slow economic growth in South Asia. Inward-oriented trade policy-induced distortions in the product market have several stylized features. It kept the exchange rate overvalued, imposed quantitative controls on foreign exchange and imports, established the graded tariffs to contain the excess demand for foreign exchange resulting from overvalued currency. It discriminated against exports, aggravated the

[1] Several variables included on the right hand side of the growth equation indeed capture the extent and nature of distortions in the product and factor markets (for a recent survey, see Temple 1999). They range from openness to international trade, extent of financial integration and deepening to central bank independence and minimum wage legislation, to cite a few examples.

balance-of-payments deficits and led to further tightening of import controls in an unending cycle. Since agriculture is the source of major primary exports, the resultant thrust of the policy had the anti-agriculture bias as well. Such a policy regime also led to inappropriate choice of technology in the context of a capital-scarce economy, favoring capital-intensive (labor-saving) technology over the capital-saving one crucial to the rate of technological progress.

This is not to imply that the other market distortions did not matter in assessment of the failure of past policies. However, the paper contends that factor distortions especially in labor and capital markets were, aggravated by, if not the very product of, government activism triggered by the internal compulsion of maintaining import-substitution strategy. Persistence with this strategy in South Asia since 1950 through 1990--despite the changing international and domestic economic environments--had adverse implications for long-term growth in the region. This persistence cannot be explained without referring to the political economy of inward-looking development strategy. Policy distortions implied by such a strategy have provided the basis for strengthening the economic and more importantly the political power of importers and indentors, bank defaulters and rent-seekers, negative tradeunionism, and control-bureaucracy who flourished under the license-permit Raj.

The forces unleashed by the inward-oriented regime are the "children of autarchy", and cannot be easily dealt with as mere "policy problems" or as abstractions of "market distortions". They persist as negative superstructures retarding the pace market reforms. Their continued presence in economy and polity explains the progressive erosion of the gains from trade liberalization and blunts the prospects for using the powerful instrumental role of international trade and globalization to step up domestic rate of economic growth.

Pressure groups that thrived on the distortions associated with the inward-looking strategy had rather modest political voice in the beginning when these countries initiated the growth process. The situation has changed significantly over the decades of post-Independence. Overcoming factor market distortions goes beyond the issue of *market imperfections*. It has become increasingly interlinked with the question of overcoming *political opposition* on the part of these pressure groups, which appears to be the most important institutional challenge facing the South Asian economies today.

B. Structure and Scope

The paper has seven sections. Section 1 introduces and anticipates the main questions, concerns, and hypotheses underlying the theme of "markets and growth" in the specific context of South Asia. Section 2 provides the specific characteristics that set apart the South Asian economies from the other regional contexts. Section 3 presents the broad analytical framework for studying the interface between shifting policy regimes, market distortions, and economic growth in the light of past development experience of the region. The framework focuses on the centrality of inward-oriented trade policy-induced distortions in the output markets in explaining the growth performance of the South Asian economies over the past forty years. Section 4 identifies the operational variables that capture the overall impact of policy regimes and policy-induced market distortions on the process of economic growth. Three aggregate indicators for judging economic performance are capital accumulation along with its efficient use, the degree of openness to international trade, and agricultural performance. Section 5 tracks the comparative growth performance of the South Asian economies over time measured against the notable performers in the developing world. The underlying idea here is to examine the extent to which these economies could take advantage of the opportunities (*and* respond to the risks) offered by the changing global trading environment, suggesting in effect a measure of their market flexibility. Section 6 brings attention to differential economic performance within the general rubric of inward-looking development strategy and the subsequent reform attempts to re-orient the policy regime. Although the general pattern in South Asia is one of relatively slow economic growth, there is considerable variation among the countries of the region in this respect. Section 7 contains the concluding remarks. Note that two detailed country case studies (India and Sri Lanka) that form the basis of some of the key observations of the paper are given in the appendix for general reference.

II. Characteristic Features of the Economies

Before we analyze the factors that contributed to the relatively slow economic growth in South Asia, characterization of the economies of the region would be in order. Demarcating features of South Asian economies based on international comparison of certain important input and outcome indicators influencing the pace and composition of economic growth are summarized below (Tables 1 and 2).

- The countries are at the lowest-end in international league tabels in terms of per capita GNP or per capita GDP in terms of purchasing power parity;

- The countries were slow-growing during 1950-80, though displayed rise in growth rate of aggregate GDP at constant prices in 1980s and 1990s;

- The countries are still predominantly agrcultural in terms of 50 per cent or higher share of work force in agriculture and allied activities (possible exception: Sri Lanka, Maldives);

- The countries are densely populated in terms of population per sq. km of geographical area and, more pertinently, per sq.km. of cultivated or arable area;

- The countries exhibit predominance of self-employed in total work force with large concentration in agriculture and other rural and urban informal activities;

- Compared to East and South Asian economies, the South Asian economies have been relatively insulated from international trade in goods, technology, non-factor services and capital flows;

- Compared to East and South East Asian economies, the South Asian economies have been marked by a very low rate of human capital formation.

Following from the above features of the South Asian economies, we characterise these economies as being land-scarce and labour-abubndant and the basic *causal* facor behind low per capita income being deficiency of reproducible tangible capital (RTC) and land relative to labour. The problem of economic growth in such economies can be posed as one of providing productive employment to growing labour force at progressively higher levels of productivity which, in turn, would lead to growing levels of per capita real incomes. This can be tackled by *simultaneous* action on two fronts. One, correcting deficiency of RTC relative to land and labour by inducing capital accumulation and technological changes to improve efficiency of resource utilization. Two, building up human capital *and* bringing about upward shifts in he demand for better educated and more skilled labour forces.

Noting that per capita real income equals average per worker productivity multiplied by worker-population ratio (which varies within very narrow bounds), progressive rise in real per capita income defining economic growth involves corresponding progressive rise in average per worker productivity. Treating average per worker productivity as a weighted average of sectoral (agriculture, industry, services) productivity per worker, there are two basic mechanisms bringing about a rise in average per worker productivity: (i) sectoral shifts in work force during the growth process from low productivity agricultural or rural sectors to relatively high productivity non-agricultural (industry, services) or urban sectors, and (ii) raising productivity per worker within sector through technological upgradation. Both the mechanisms operate in a mutually interactive fashion during the growth process. Agriculture requires particular attention in the growth process of low-income, densely populated economies because of its predominant share in work force and lower than average productivity per worker.

III. How Market Distortions Affected Past Growth: A Framework

A. Shift from Planning to Market

The post-Second World War period was marked by the universal faith in the efficacy of benign government intervention and the consequent widespread use of centralised industrial investment planning as a critical instrument of economic development in the then newly independent low-income countries. Intellectual shift from planning to markets has taken place over the last 30 years because of the increasing recognition of economic incentives as being crucial to the process of rapid growth. In a world dominated by uncertainty and imperfect understanding, markets provide an efficient feedback mechanism for evaluating one's decisions and correcting mistakes (Soros 1997). The extent to which this feedback mechanism at the micro-level gets translated into rapid growth at the economy-wide level is governed by the interaction between the functioning of the underlying self-correcting adjustment processes in the various markets for bringing about sectral resource-shifts and the incentive structure in the society in the process of economic change. The sectoral resource shifts or structural change in terms of sectoral shares in gross domestic product and work force take place in response to (i) changes in the composition of domestic demand with rising per capita real incomes, (ii) supply side shifts brought about by uneven impact of technological change across sectors, and (iii) changing structure of international trading opportunities with changes in factor-endowments. The incentive structure critical to rapid growth gets reflected in (a) the price signals emanating from the functioning market forces, (b) economic and social institutions that lay down the formal and informal rules of the economic game including social recognition, prestige and wealth associated with different occupations and economic activities (c) government policies impacting both (a) and (b).

B. Institutional Foundations of Market

The negative side effects of the acquisitive instinct at the core of the market system as well as transaction costs associated with exchange are taken to be governed by (i) the effectiveness in allocation, protection and costs associated with the exchange of private property rights enforced by government and (ii) humanly devised formal constraints (written rules, contracts between individuals and legal entities, common laws, statute laws etc) as well as informal constraints (conventions, codes of conduct, norms of socially accepted behaviour, customs, traditions, etc) which define institutions or rules of the game (North 1990, 1994). North (1994) provides an interesting proposition: political agreements are more difficult to enforce than economic contracts. It is the polity that allocates and enforces property rights. Hence, all societies do not have efficient property rights required for the development and smooth functioning of the markets. The rules of the economic game which we describe as the non-tradable institutional software under (ii) above have to be specific to society, polity and economy and provides the basis of path dependence in economic growth because of the slow-changing character of the informal as well as (often) formal rules of the game in the society. The context-specificity of this non-tradable institutional software impacts the savings- investment behaviour and the rate of economic growth. We attribute differences in the rates of economic growth across different societies to be governed by the differences in property right systems and society, polity and economy- specific institutional software with its inextricable and inherent path dependent features.

C. Organizational Dualism and Market Efficiency

The society-specific and hence non-tradable software is taken to evolve from the situation of what Myint (1970, 1985) has characterised as organisational dualism in low-income countries between (mostly non-agricultural) modern exchange economy and the traditional (mostly agricultural) subsistence economy. This structural feature results in unequal access of resources (capital funds, labour, foreign exchange, infrastructural services) to the advantage of the exchange segment. During the process of economic growth, the relative domain of the exchange economy is expected to expand while bringing about contraction of the subsistence segment. The formal rules of the economic game apply mostly to the modern exchange segment while informal rules pervade mostly the traditional subsistence segment. This is not to deny that cultural norms of behaviour affect both the exchange and the subsistence segments. Myint has persuasively argued that the centralised planning, import-substitution-oriented industrialisation policies and activist government intervention in the factor markets in the underdeveloped countries resulted in accentuation of organisational dualism while, paradoxically, they aimed at reducing dualism by expanding the reach, breadth as well as the depth of the exchange segment. The paradoxical result came about because the governments attempted direct government intervention in economic activities through quantitative rationing in the exchange segment which constricted the operation of the functioning markets instead of correcting unequal access of the traditional segment to resources and thereby did not permit the exchange segment to enlarge in a natural fashion into subsistence economy. The persistence of organisational dualism slowed down the pace of economic growth.

D. Pre-Existing Economic Nationalism

The basic common historical characteristic which deeply influenced the development path of South Asian economies is the British colonial status of the Indian subcontinent and the common legacy of mobilisation of people in order to get political independence.The intellectuals and political leadership of the independence movement regarded the British policy of laissz faire and free trade to be the cause of economic underdevelopment.[2] A reaction to this diagnosis resulted in the attitude of deep distrust of the market forces – both domestic and international and as a corollary, an equally profound faith in the non-market allocation through benign government intervention. This was reinforced by the perceived success of centralised planning in the erstwhile U.S.S.R. and the success of public policy intervention to get the US economy out of the great depression of the 1930s.

The result was the home-grown doctrine of economic nationalism dating back to the pre-1945 period which got reflected in the Indian development strategy primarily but that of other countries of the region in varying degrees as well in three ingredients.

One, autarchic position toward international trade wherein reliance on international trade was to be deliberately minimised by focussing on the development of the domestic market. It is important to note that this autarchic position is intellectually distinct from and pre-dates the famous Nurksian doctrine of balanced growth and export pessimism although both the positions lead to the same outcome for the economy.

Two, progressively increasing role of the public sector was to be the major instrument of centrally planned investment planning for industrialisation and government intervention in order to allocate resources according to social goals rather than private profits.

Three, basic, heavy and capital goods industries were to be given priority in inward-oriented industrialisation strategy in order to maximise long-term growth. The basic dilemma in the implementation of this import-substitution-oriented strategy arose because of tension between the dominant presence of pre capitalist feudal institutions, especially in rural agriculture and the prevalence of private property rights and functioning markets in the urban non-agricultural sectors.

The policy package that emerged had certain and by now well-known features, namely, keeping the exchange rate overvalued (in the then prevailing system of fixed exchange rates), the imposition of various quantitative controls on foreign exchange and imports and the graded tariffs (highest on consumer goods, lower on intermediates and the lowest on capital goods) to contain the excess demand for foreign exchange resulting from overvalued currency. It discriminated against exports and resulted in perpetual balance-of-payments deficits which, in

[2] This was less true of the economic and political thought of the mid-nineteenth century. In Bengal, Rammohan Roy, Dwarkanath Tagore, and most notably Bankimchandra Chattopadhya were strong supporters of the free-trade doctrine. Bankim, who was influenced by Jeremy Bentham and John Stuart Mill, specifically wrote about the importance of viewing openness to international trade as engine of domestic economic growth. (See, *Bangadesher Krishak*-- peasantry of Bengal--included in the Collected Works of Bankimchandra, in Bangla). While these thinkers talked about distributive justice, they also upheld the view that outward-orientation would be beneficial to the Indian economy. It is altogether a different question--subject of potentially interesting research--as to why such early liberal views on development strategy gave away to the increasing prominence of autarchic views.

turn, led to further tightening of import controls in an unending cycle. It has discriminated against agriculture which was the major source of primary exports.

E. Consequences of Persistent Product-Market Distortions

The early results of this strategy were reflected in accelerated industrial production because in the early stages of import-substitution, domestic output aimed at substituting what was earlier imported, could rise faster than the domestic market. The low initial manufacturing base and expanding coverage of the exchange economy in national accounts also added an upward bias. This growth managed to hide the limited size of the domestic market arising from low absolute level of per capita GDP.

Little, Scitovsky and Scott (1970) pointed out the economic consequences of the persistence with import- substitution orientation. One, it increased import dependence rather than reducing it and the growth process became import and foreign exchange intensive. Two, insulation from international competition resulted in inefficiencies in industrialization and made it internationally non-competitive besides widening the technology lag. Both these factors raised the incremental capital output ratio and contributed toward slowing down the growth rate for given rate of investment and limited the capacity of the industrial sector to absorb abundant labour. The focus on industrialisation and the consequent neglect of agriculture further accentuated the trade policy induced bias against agriculture and reduced that sector to the status of residual absorber of labour. Combined with demographic pressures, most countries of the region succeeded in reducing the share of agriculture in GDP much faster than its share in work force. Thus, agriculture became a drag in raising average productivity of labour at the economy-wide level and hence resulted in the persistence with low living standards.

The inward-oriented trade policy-induced distortions in the output markets were combined in the Indian context with an effort to control allocation of private investment at the upper-end of the investment scale and expansion of public sector into directly productive activities initially in basic and heavy industries but eventually in a virtually indiscriminate manner. Apart from the perverse incentives generated by the soft budget constraint in the public sector the industrial licensing resulted in noncompetitive market structures, constricted flexibility in adjusting to the market signals and persistent shortages besides rent-seeking behaviour. The consequent inefficiencies further raised the incremental capital-output-ratio thereby slowing down growth. The inefficient monopolistic public sector activities raised the cost of universal infrastructural services and contributed further to the internationally non-competitive character of the insulated domestic industrial sector.

In other countries of South Asia the degree of inward-oriented policy-indiced distortions was relatively less prominent compared with India, but the developmental lessons were similar. In these smaller economies, the problem was compounded by the context-specific factors. Thus, in Bangladesh although the extent of import-substitution biases was reduced considerably since 1990, the problem was compounded by the very poor governance capacity leading to limited enforcement of efficiency-enhancing measures in both public entities and publicly financed private sector industrial projects. Inability to allocate investible funds through the banking system resulting in large-scale debt deafult and the failure to target subsidies to the selected firms based on export performance criteria magnified the problem of state-managed investment promotion strategy in these countries. The growing list of industries caught up in bad debt as well as those classified as sick industries remains a pointer to the quality of state interventions in these countries.

We argue that product-market distortions emerging from restrictive trade and exchange rate policies under centrally initiated and public sector-oriented industrialisation was a major causal factor behind the slow pace of economic growth in the major countries of the region. There have been variations in the instruments used for public sector expansion. These included setting up new units and industries under public ownership, nationalisation of existing privately-owned units and putting stringent restrictions on the expansion of privately-owned large units. Stark contrast is provided by the booming international trading environment during 1950-72 and inability of the countries of the region (especially India, Pakistan, and Sri Lanka) to exploit the powerful instrumental role of international trade in stepping up domstic rate of economic growth.

F. Government Activism and Distortions in the Labor Market

The foregoing output-market distortions aggravated the formal-informal, organised-unorganised and urban-rural duality in the labour market. These were further accentuated by government activism in labour markets with legislative protection to the workers in the organised or formal sector and the emergence of public sector as a major employer in the organised non-agricultural segment without reference to productive contribution at the margin. Resulting inefficiencies slowed down the pace of absorption of labour into the higher productivity segments of the non-agricultural sector.

To elaborate, activist governments in South Asia have followed social welfare policies in varying degrees to provide extensive legal protection for employment. The idea was to improve the wages as well as conditions of work on the same lines as in the welfare state in the developed countries. In terms of complexity, extent and scope with regard to various facets of legal protection, Indian labour legislation has possibly been by far the most comprehensive followed by that in Sri Lanka, Pakistan and Bangladesh in that order. The legislative provisions have been made applicable mostly to large units possibly because of considerations of enforcement costs. The protective legislative provisions imposed legal restrictions on the employers in terms of wage and non-wage benefits to be given to workers, working conditions in factories, retrenchment and termination and collective bargaining practices and consequently adversely affected their flexibility in terms of adjusting to changing technology and market demand conditions.

The response of the private employers to these restrictions in the organised higher productivity segment was three fold. *One*, they tried to exercise choice of technology in the labor-saving direction. *Two,* they attempted to get out of legal employer-employee nexus by contracting jobs or employing contract labour. *Three*, in view of the applicability of legislative provisions to relatively large-sized employment, the employers chose the size of units at the lower-end of investment so as not to attract the legislative provisions. This often led to fragmentation of capacity, and less than minimum efficient size of units. These tendencies were accentuated by the employment creating policies of the government to provide concessions to the small scale units which were axiomatically assumed to be labor-intensive.

While the private sector production units in the organised sector tried to minimise the employment of labour by often getting around the legislative provisions, public sector units operating mostly in the monopolistic markets coul.d not do so for obvious reasons. With the expansion of the public sector and the availability of soft-budget constraint (subject to the constraint) employment in organised public sector units expanded very fast without reference to their productive contribution at the margin. The consequences were: loss in production efficiency and discouragement of new investors from entering into the organised large scale segment and finally, limited labour absorption into the high productivity organised segment. In the absence of government funded social security, the remaining labour got residually absorbed in the unorganised rural agricultural and urban informal sector. The unintended consequence was the accentuation of organised-unorganised, rural-urban and formal-informal dualism in the labour market.

G. Government Activism and Distortions in the Financial Market

The organisational dualism in the markets for investable funds, reflected in the unequal access to the disadvantage of the traditional subsistence sector, brings about wide differential in the interest rates in the institutional and non-institutional segments of the market for loanable funds. The magnitude of this differential is governed by (a) higher administrative costs of lending to a large number of small borrowers in comparison with those of lending to a small number of large borrowers; (b) greater difficulties in assessing behavioural risk of default (Hoff and Stigliz 1991) for a large number of small borrowers although production risks may not differ for the large and small borrowers. Both these factors lead to a segmentation of and localised monopolistic markets in non-formal credit markets with a wide dispersion around a higher average level of interest rate than in the formal institutional segment.

The formal sector banks and financial institutions are sought to be controlled by the government through government ownership and/or controlling the rate of interest as well as flows of loanable funds through various rationing procedures. The rationing criteria are required to contain excess demand resulting from a low average level of interest rate in order to encourage private and public investment. These rationing criteria often act to the disadvantage of a large number of small borrowers. More importantly, they also impede the growth of formal sector financial intermediation. In India, for example, the government nationalised the large commercial banks and diverted the private financial savings to itself through the instruments of currency reserve ratios and statutory liquidity ratios. These were used for stepping up inefficient public sector investment or re-lent to the large private sector units through publicly owned term lending institutions. The government also tried to divert the credit flows to the unorganised sector through what has come to be known as directed priority sector lending by nationalised commercial banks and directed term lending by public sector financial institutions. These interventions resulted in impeding financial deepening and accentuating financial dualism. Such policies adopted in varying degree in all the countries of South Asia have strong adverse implications for economic growth.

A combined consequence of government activism in markets for labour and investable funds was to raise cost of labour relative to that of capital in the organised segment in a labour-abundant and capital-scarce economies of the region. This tended to induce the choice of higher capital intensity in the formal segment limiting labour absorption further in the higher productivity industrial sector for realised rate of capital accumulation.

H. Crisis-Driven Nature of Policy Reform

Re-thinking on the efficacy of individual components of the above development strategy had been taking place in individual countries over the last 30 years. However, policy action in most cases was triggered by an exogenous shock, an economic crisis or a change in political leadership. Thus, agricultural transformation in the form described as green revolution was initiated in India after the stoppage of PL 480 food aid in the 1960s. In Bangladesh, it was adopted largely as a consequence of 1974 famine and as part of the strategy of reducing political dependence on food aid, resulting in the drive towards increasing cereal production. The first-wave of unilateral trade liberalisation was undertaken in Sri Lanka and Pakistan in the mid 1970 possibly because of the oil price shock. The second-wave of unilateral trade liberalisation was undertaken in both these countries around 1988-89 largely as a consequence of increasingly unsustainable fiscal profligacy, leading to borrowing under the structural adjustment facility (SAF).[3] It was undertaken in Bangladesh in 1987 as part of the SAF as well (reinvigorated again in 1990 as part of extended structural adjustment facility) and in India in 1991 because of the fiscal and foreign exchange liquidity crisis. Changes in political leadership also coincided with some of these changes.

The basic thrust of economic policy reforms has been toward permitting greater role of freer market forces consisting of liberalisation (of controls on domestic transactions and markets) and globalisation (in terms of unilateral trade liberalisation to increase integration with the world economy). It is important to emphasize that major economic policy reforms merely generate more congenial environment for freer play of the domestic and international markets and hence bring about major changes in the formal rules of the economic game and the resulting policy-induced impact on the incentive structure. However, their impact on the pace and composition of economic growth depends on the pace of adjustment in terms of the speed of response of the micro-economic agents which, as North (1990, 1994) has emphasized, depends on the impact of policy reforms on the non-formal rules of the game which exhibit inertia and slow-changing character.

I. Variation within South Asia

It is important to note that there is cross-country variation in South Asia within the general inward-orientation in respect of both initial conditions as well as specific aspects of the policy regime, affecting the functioning of the markets and institutions. Hence, countries may respond differently to changing domestic and global market opportunities. In short, there is a path-

[3] The first IMF-World Bank adjustment program was agreed by the caretaker finance minister Mahbub ul Haque and endorsed by the first Benazir government coming in power in December 1988. Originally designed for three years beginning 1988-89, the $2.1 billion SAF was extended by another year.

dependence in the way policy regime shifted and responded to the changing market and institutional conditions.

IV. Aggregate Indicators for Assessing Economic Performance

The literature on growth empirics lists a range of social, economic, and political factors--ranging over 50 according to one count--as explanators of cross-country variations in long-term economic growth. The significance of these factors does not mean that all of them are necessary for long-term growth acceleration. At most, they provide the possible contour of sufficient conditions, but hardly provide any clue to identifying the most important ones--*necessary conditions*--for growth acceleration in a given country/ region in a particular period. Identification of these necessary conditions (factors) having critical influence on the observed outcome must come from the knowledge of contextual history and development experience.

In the preceding section, we have outlined the broad framework for approaching the problematic of the relatively slow long-term growth in South Asia. The framework suggested the centrality of inward-oriented trade policy induced output market distortions and their consequences in the context of South Asia. The effects of such distortions on economic growth are captured through three critical variables, namely, capital accumulation (and its efficient utilization), openness and agricultural performance. We argue that these three factors are crucial in explaining the growth performance in South Asia during 1950-97.

As explained in the preceding section, the factor market distortions played a role in slowing down the growth rate but in our view did not play the *causal* role. However, the importance of these distortions has increased in the nineties in the backdrop of considerable trade liberalisation that took place across South Asian economies. Removal of these distortions has become critical for stepping up economic growth to new altitudes. The reforms in these spheres are, however, much difficult to achieve.

The exclusion of the variable of "human capital accumulation" from the list of major explanators for South Asia warrants some comments. Standard endogeneous growth models highlight the importance of human capital accumulation in the process of economic growth. The importance of human capital accumulation lies in *sustaining* long-term economic growth once it has been initiated. From this perspective the role of human capital would be crucial in sustaining any high growth strategy premised on integration with global markets in future. However, the focus of present discussion is on the *cause* of slow overall economic growth in the *past forty years* of post-colonial development in South Asia. In search for a causal explanation, we highlighted the relatively high degree of inward-orientation of these economies as the major constraining factor. Lack of investment in human capital, however, cannot be linked in any manner with the inward-looking strategy. After all, a high level of human capital formation is perfectly compatible with autarchic policy, as indicated by the historical experience of the centrally planned economies. It is difficult to explain why South Asia (except Sri Lanka and Maldives) consistently underinvested in human capital formation, especially in elementary education. According to one influential view, the root cause for low investment in elementary education is possibly located in the "deep-seated class biases" that shaped distorted educational priorities (Sen 1996).[4]

A. *Capital Accumulation*

The first critical element relates to the importance of capital accumulation along with the need for ensuring its efficient utilisation in the process of economic growth. Given that the deficiency of reproducible tangible capital and land relative to labour is the basic *cause* of low productivity of labour and hence low per capita (real) income in land-scarce, labour-abundant economies, fastest possible capital accumulation while ensuring its efficient utilisation becomes a key to economic growth. We approximate this through the observed average rate of investment at constant prices and the implicit incremental capital output ratio (ICOR) given the observed rate of aggregate GDP growth.[5]

Interpretation of aggregate (implicit) ICOR, however, has to be done carefully. If we regard ICOR as the weighted average of sectoral ICORs weighted by sectoral shares in incremental output, it can change for a variety of reasons. If there is a shift in the investment allocation towards indirectly productive, indivisible, physical infrastructural projects (which do not add directly to income) involving long gestation lags, aggregate ICOR may legitimately go up during the process of investment without immediately getting reflected in the observed (contemporaneous) growth rate. However, sectoral ICORs may reflect inefficient utilisation resulting from public sector operation as well as indiscriminate import-substitution. The efficiency of utilisation of capital is also governed by the non-tradable institutional infrastructure explained earlier (Section 3) and the resulting incentive structure.

Our *a priori* expectation is that, *ceteris paribus*, relatively open economies with greater participation in international division of labour would typically have higher rate of investment (at constant prices) and lower aggregate ICOR.

B. *Openness*

The second critical element in explaining slow growth would consist of the relatively closed economy character of the South Asian countries. There are no widely accepted objective measures of capturng the openness of the economy to world economy. One widely used crude measure is the trade ratio i.e. ratio of value of exports plus value of imports to aggregate GDP. The absolute value of trade ratio would clearly depend on the composition of the traded

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[4] We owe this sociological explanation to Amartya Sen who pointed out in the 1970 Lal Bahadur Shastri Memorial Lecture entitled "The Crisis in Indian Education" that the "inequalities in education are, in fact, a reflection of inequalities of economic and social powers of different groups in India". His later commentaries on the issue is worth quoting in full given the contemporary relevance: "The educational inequalities both *reflect* and help to *sustain* social disparities, and for a real break, much more determined political action would be needed than has been provided so far by those in office, or by parties that have led the opposition. The traditionally elitist tendencies of the ruling cultural and religious traditions in India may have added to the political problem here" (Sen 1996, p.14).

[5] Again, this explanation would be more pertinent in explaining past economic growth. This is not to deny the role of human capital in sustaining that growth in view of the existing low levels of human capital formation in the countries of the region.

commodities because the numerator consists of gross value of outputs of imports and exports whereas denominator contains gross value added by sector of origin. If intermediate inputs predominate among traded commodities, the trade ratio would be higher than where value of traded commodities consists mostly of final consumer or capital goods. With this qualification in mind, our *a priori* expectation is that, *ceteris paribus,* this ratio would be higher for relatively more open economies and that for a given economy this ratio would tend to increase with increase in openness induced by trade liberalisation.

The second possible indicator of integration with the world economy that we wish to employ is the (gross) elasticity of vulume of country's merchandise exports with respect to volume of world merchandise exports. If this elasticity is either much less than one or is statistically not significant, we infer that the economy is not benefiting from international division of labour. This could happen because of import-substitution-driven policies discriminating against exports. It would be interesting to disaggregate volume index of total merchandise exports into agricultural, manufacturing and mining but this is not possible from the readily available indices for different countries.

The third indicator relates to the rates of growth in income-terms of trade to see whether a given economy is managing to benefit from world trade even though its barter-terms-of-trade might be deteriorating.

The fourth set of indicators would consist of a variety of indices reflecting restrictions on export and import transactions. These are much more difficult to obtain in a consistent fashion for different countries.

C. Agricultural Performance

The third critical element in explaining the slow pace of economic growth relates to the performance of the agricultural sector which provides gainful employment to more than 50 percent of the work force in densely populated economies. This sector invariably has lower productivity per worker than the average productivity per worker for the economy as a whole. Because of both these factors, rise in productivity per worker in agriculture is critical to raising the overall productivity per worker and hence per capita real income.

Import-substitution-driven industrialisation policies discriminated against agriculture and resulted in reducing the share of agriculture in national income much faster than its share in work force. This would inevitably slow down the rise in agricultural productivity per worker in the economy as a consequence.[6]

V. Global Trading Environment and Economic Growth in South Asia

Before we proceed to review the country-specific variation in response to differing domestic policy regimes and external circumstances (see, section VI of the paper), it is useful to start off

[6] The situation was made worse in the absence of commensurate land redistributive and administrative reform. However, the redistributive type of land reform has historically not been carried out in a voluntary fashion.

by taking an aggregate look at South Asia's growth performance vis-à-vis other suitable comparators.

Following Kuznets (1973) we define economic growth as sustained expansion in productive capacity of the economy to supply diverse goods and services to its population. We measure it by long-term trend growth in aggregate or per capital national income at constant prices. We study comparative growth performance both within and across regions by taking into account how the countries have responded to the changing scenario in the global trading environment. Did South Asian countries take the full advantage of the periods when international trade was expanding? Were they able to re-structure their economies in response to changing global opportunities? The hypothesis is that countries that adopted initially a more inward-oriented approach are unlikely to take full advantage of the global trading opportunities in the subsequent period. They are also likely to be less prepared in adjusting to trade shocks, partly because of increased inflexibility of the market structures and institutions distorted by the inward-looking regime.

Examination of long-term growth performance is constrained by the availability of reliable, consistent and comparable estimates of national income at constant prices over time as well as across countries. The *World Tables* and the *World Development Indicators* of the World Bank provide time series estimates for the countries of South Asia starting in 1960 in most cases or later.

A. South Asia in Third World Perspective: Comparative Growth during 1950-80

In measuring long-term economic growth, it is necessary to avoid the abnormal situation during and immediately after the Second World War. Most countries of the region also became politically independent in the late 1940s. Hence, 1950 appears to be a convenient starting point for examining long-term economic growth.

In the absence of readily available time-series of macro-economic national accounts based aggregates from 1950, we adopted a two-pronged strategy. We begin by drawing on the overview of comparative growth performance of the Third World countries between 1950-80 provided by Reynolds (1985) and follow it up with our analysis for the post 1960 period by drawing on the time-series available in the World Bank data sources cited above.

Reynolds (1985) selected a sample of 37 third world countries most of them with a population exceeding 10 millions in 1980 and provided growth rate of real GNP per capita for 1950-80 based on *World Development Report 1982* and decadal growth rates of real GDP per capita for 1950-60, 1960-70 and 1970-80 from UNCTAD. Four countries of South Asia are included in the Reynolds sample. Table 3 provides the growth performance of the South asian economies in an international perspective of other Third World countries during 1950-80.

Two results of Reynold's study are noteworthy from the vantage point of present discussion. *Firstly,* over the entire 30 year period 1950-80, no South asian country was amongst the high-growth economies (top 10 with per capita GNP growth of 3.4 per cent per annum or higher during 1950-80): Pakistan had moderate growth (between 2.5 and 3.2 per cent per annum), Sri Lanka and India had low growth (between 2.5 and 1.1 per cent per annum) and Nepal had no growth (0.7 percent or lower). *Secondly*, median growth rate of high-growth economies improves dramatically during 1970-80 whereas that of no-growth economies deteriorates by each decade and registers equally dramatic decline during 1970-80. *Thirdly*, median growth rate during 1950-60 was not strikingly different across the 4 tiers whereas the matched dispersion widens significantly during 1950-80 (Table 3).

The last two points prompt Raynolds to draw obvious inference: "The most significant development since 1945 is *not* widening of the average gap between third world and OECD countries. Some widening seems to have occurred, but more significant is the sharp pulling apart of growth rates within the third world itself" (Reynolds 1985, p.392).

The differentiation within the third world increased further in the eighties despite improvement in the overall global trading environment.[7] The *Human Development Report 1995* of the UNDP terms the decade 1980-90 as the "lost decade" because much larger number of third world countries experienced further absolute decline in real per capita GDP so that the dispersion may have widened further.

Diversity in growth performance among the third world countries should be appearent from the foregoing perspective. We have all the four possibilities, namely, growth process may not get initiated at all, or once initiated, may experience progressive improvement, or deterioration or fluctuations without trend.[8]

Turning specifically to the South Asian countries in the Reynolds sample, we note that Pakistan was amongst the moderate growth economies over the 3 decades but exhibited wide fluctuations across decades (Table 3). Sri Lanka was above median and India below median among slow-growing economies. However, Sri Lanka experienced gradual improvement and India progressive deterioration across the three decades. Nepal was above median amongst no growth economies and was unable to maintain the growth rate of the 1950s in the subsequent decades. While separate data on Bangladesh is missing in Reynold's study, the available evidence indicates a declining per capita GNP growth over 1955-80. It grew at a rate of about 0.5 per cent per year during 1955-69 and declined by 0.8 per cent per year between 1970 and 1980.[9] Note that the relative status of the countries in terms of movement in per capita growth rate has changed considerably since 1980, indicating differential performance both across countries and over time (see, Table 5).

B. Choice of Periodisation

We divide the entire period from 1960 to 1997 according to major changes in the world trading environment to which all the developing countries of the region had to adjust while maintaining domestic growth promoting impulses.

[7] Trend growth rate of volume of merchandise exports has increased from a low of 2.5% in 1973-83 to 5.66% in 1983-90.

[8] One of the key objectives of the Global Research Project would be to throw light on the major causal factors behind these major types of diversities in growth performance.

[9] Only by 1986, some positive shifts became discernible, when per capita GNP crossed the 1970 level.

The period 1950-73 is generally described as the golden age of capitalism. This is the time when the international trade was booming. The trend growth rate of total volume of world merchandise exports was 7.8 per cent per year during the period compared with 2.6 per cent in 1973-83 and 5.8 per cent in 1983-97. The multilateral trading arrangements were subject to the rules of the game evolved under the General Agreement on Trade and Tariffs (GATT) and the International financial system was governed by the Bretton Woods arrangements involving fixed exchange rates. Industrially developed economies managed to maintain a reasonably full employment following the standard Keynesian prescriptions that contributed toward minimising the length and magnitude of business cycles. Simultaneously, there has been a progressive reduction in trade barriers under the rounds of GATT negotiations. In addition, the emergence of the welfare state in reaction to the state-socialist challenge managed to bring about more equitable distribution of the benefits of steady growth enjoyed by the developed countries (DCs). The continued prosperity in DCs had three major consequences for the less developed countries (LDCs). One, because of the predominance of intra-DC trade in the volume of world trade DCs chose to put a blind eye to a large variety of import restrictions imposed by LDCs under balance of payment (BoP) cover and following the Nurkse-Prebisch-Singer prescriptions. Two, with increasing labour cost in DCs, large number of labour-intensive light manufacturing industries got relocated in LDCs. Three, access to the DC markets was relatively easy due to rising real incomes and lowering tariffs under the various rounds of GATT.

The second period 1973-83 was marked by turbulence in the international trading environment caused by the breakup of the fixed exchange rate system under the Bretton-Woods arrangements and two steep hikes in oil prices by the OPEC cartel resulting in sharp increases in energy costs. These factors led to persistent BoP deficits for the oil-importing countries, resulting adverse impact on economic growth, frequent, unexpected and large changes in currency alignments and the worldwide inflationary pressures.

The most recent period 1983-97 has been one of adjustment to the changed world trading environment and oil price hikes during the previous decade and resumption of growth in world trade. Both the periods 1973-83 and 1983-97 saw the re-emergence of business cycles in the DCs, instability in the primary (especially oil) prices, turbulence in the world financial markets, and the persistence of double-digit rates of unemployment in the European industrial economies.
In the subsequent discussion for brevity we describe 1950-73 as “golden age of global capitalism”, 1973-83 as period of “turbulence and instability”, and 1983-97 as period of “adjustment and growth”. For the decade 1950-60 we draw on Reynolds (1985) while for the subsequent periods, the growth performance is analysed on the basis of the *World Tables*.

Table 4 presents the long-term growth performance (1950-97) of the major South Asian countries in terms of growth rates of per capita GDP. We examine the performance during the decade 1950-60 in the perspective provided by the Reynolds sample. For later periods, Table 7, 8 and 9 present for 1960-73, 1973-83 and 1983-97 respectively per capita and aggregate GDP growth rates at constant prices along with rates of gross domestic investment and savings at current prices averaged over the period to get the idea about the role played by capital flows in financing the rates of gross domestic investment. Five South Asian economies have been placed in the perspective of other rapidly growing economies of East and South East Asia, Latin

America and Africa. The selection of the comparator countries is arbitrary. We have included all the countries of East and South East Asia and China besides three countries from Latin America and two from Africa which grew rapidly in at least one of the three periods chosen.[10]

C. Growth Performance during the Golden Age of Capitalism (1950-73)

We divide the period into two sub-periods: (a) 1950-60, (b) 1960-73. During the decade 1950-60 an examination of the Reynolds (1985) sample shows that the star performers in terms of rapid growth in GDP per capita per cent per annum) at constant prices were Algeria (6.0 per cent) followed by Burma (4.4 per cent) and Taiwan (4 per cent). Others among the top 10 were Brazil (3.6 per cent), Iran, Philippines, Thailand, Venezuela and Zambia (3.3 per cent) and Iraq (3.2 per cent), Mexico (2.8 per cent) and South Korea (2.0 per cent) were moderate growers and Chile (1.9 per cent), Indonesia (1.7 per cent) and Malaysia (1.1 per cent) were slow growers. Among the South Asian countries, India had registered the highest growth rate of 1.9 per cent followed by Nepal and Sri Lanka (1.0 per cent each) and a virtual stagnation (0.4 per cent) in Pakistan. Needless to add, these growth rates were not based on well-documented data or uniform concepts and hence are to be regarded as best guesses based mostly on indicators associated with various types of economic activities.

Two points relating to the decade 1950-60 require mention. One, only Taiwan and Thailand from the East and South East Asia make appearance among rapid growers in the decade with South Korea, Indonesia and Malaysia yet to join the league. Two, among the South Asian countries, India's growth rate compared well with moderate growers in East and South East Asia whereas other countries of the region fared worse in comparison.

During the later phase (1960-73) of the Golden Age prior to the breakdown of the Bretton Woods arrangements, Japan (with 8.5 per cent growth in per capita GDP) and Botswana (with the corresponding figure of 6 per cent) were the top performers. Compared to the decade 1950-60, among the rapid growers, Taiwan improved its per capita growth rate from 4 per cent to 6.4 per cent during 1960-70 in North East Asia, Thailand moved ahead from 3.3 per cent to 4.7 per cent in South East Asia and Brazil from 3.6 to nearly 5 per cent in Latin America (Table 5). There was a distinct slowdown in the Philippines from 3.3 per cent to 1.8 per cent. A remarkable step-up in growth was registered by two of the moderate and slow growers of the decade 1950-60. Thus, South Korea more than tripled its per capita annual growth rate from 2.0 per cent to 6.2 per cent and Malaysia from 1.1 per cent 3.7 per cent. There was some increase in the growth rate of Indonesia from 1.7 per cent to 2.6 per cent while it was virtual constancy in case of Mexico and Chile. Notice that of the star performers, Japan, Taiwan, South Korea and Thailand had opened up and benefited from expanding world trade. The only exceptions were Brazil and China. Turning to the South Asian countries, Nepal and Bangladesh experienced virtual stagnation whereas India and Sri Lanka continued to be slow-growing (despite some step-up in

[10] We understand that the estimates of China's GDP are to be interpreted with caution for three reasons. *One*, they are derived from the net material product concept so that services are likely to be under-represented. *Two*, estimates prior to the opening up in 1978 are less comprehensive in terms of coverage than those after 1978. *Three*, estimates after 1978 would be affected by rising coverage of newer and faster-growing activities with the opening-up. How would these affect growth rates? Increasing coverage of services as well as material products especially in the post 1978 period would tend to impart an upward bias to the growth rates. This might also heighten the contrast between the pre and post-1978 growth rates.

the growth rate for Sri Lanka from 1 to 2 per cent). Interestingly, among the South Asian countries, Pakistan was the star performer during 1960-73 displaying per capita growth rate of 3.5 per cent after virtual stagnation during 1950-60. As would be argued later, better performance of Pakistan vis-à-vis its regional neighbours during the period was mainly driven by its higher emphasis on export performance (by maintaining a dual exchange rate system) as well as greater reliance on private sector initiatives within the general rubric of. import substitution strategy.

D. Growth Performance during the Period of Turbulence and Instability (1973-83)

During the next decade of turbulence (1973-83) Japan and Brazil experienced considerable slowdown in growth, being badly affected by the oil price hikes (Table 8). Japan's growth rate declined from 8.5 during 1960-73 to 2.8 per cent in 1973-83, while that of Brazil dropped from 5.0 per cent to 1.5 per cent. Botswana improved its per capita growth rate whereas Chile's growth rate remained virtually constant. Other oil-importers with star status during 1960-73 like South Korea, Taiwan and Thailand managed to maintain their star status despite marginal declines in growth rates due to oil shocks. Notice again that the relatively open economies of South Korea, Taiwan and Thailand managed to retain their star status despite the oil shock whereas it affected Brazil seriously.

China experienced constancy despite domestic oil reserves whereas similarly placed Malaysia raised its growth rate from 3.7 per cent in 1960-73 to 4.8 per cent in 1973-83. The new entrant into the star league was Indonesia, which improved its growth performance from 2.6 per cent to 4.9 per cent between the two periods. Indonesia used the revenues from oil exports to step-up its growth rate rather than getting into the Dutch disease syndrome.

We turn now to the South Asian countries, all of them being depending on oil imports. Landlocked Nepal continued with stagnation in per capita GDP. Pakistan maintained its South Asian star status (with per capita growth rate around 3.5 per cent during 1960-73 and 1973-83) but is now joined in that position by Sri Lanka. India’s growth rate slightly improves from 1.1 per cent to 1.8 per cent (though with considerable fluctuations) whereas Bangladesh managed to initiate the growth process rising from stagnation in per capita GDP during 1960-73 to 2 per cent during 1973-83. However, the growth rates of regional stars (Sri Lanka and Pakistan) even at their peak performance were much lower than the East and South East Asian stars.

E. Growth Performance during the period of Adjustment and Growth (1983-97)

During the most recent period of adjustment and growth in world trade (1983-97) performers of the earlier two periods from East and South East Asia--South Korea, Taiwan, Thailand, Malaysia, and Indonesia--maintained their earlier remarkable growth performance (Table 9). Thailand's pace of progress on this score was spectacular, with a rise in per capita income from 4.5 per cent in 1973-83 to 7.1 per cent in 1983-97. The next to follow was South Korea with growth accelerating from 5.1 to 6.9 per cent. Taiwan (around 6.2 percent) and Malaysia (around 5.0 percent) experienced virtual constancy in growth rate between the two periods, but faced with the same world trading environment Botswana, Brazil and Mexico experienced considerable slowdown.

Most remarkable, perhaps, is the case of post-reform China, which stepped its growth rate from 5.1 percent to 8.1 percent. This impressive performance coincided initially with de-control and de-collectivization in agriculture, but increasingly being driven by greater openness to international trade and investment, and higher export performance.

In South Asia, while the matched performance was nowhere near that in East and South East Asia, the major countries of the region except Pakistan improved their rate of per capita economic growth. Pakistan experienced a slowdown from 3.5 to 2.5 percent, Bangladesh (2.0 percent plus) and Sri Lanka (3.0 percent plus) maintained their growth rate. Nepal came out of the stagnation to post 2.0 percent growth whereas India came out as the South Asian star with doubling of per capita GDP growth from 1.8 percent to 3.8 percent.

VI. Policy Regimes, Market Distortions and Growth: Lessons from Case Studies

The summary evidence presented in Table 5 earlier indicated changing fortunes of individual countries. Differential performance is noteworthy both across countries for a given period and over time for a given country. This points to the need for tracking the individual country-specific fluctuations and explore the underlying causes behind such fluctuations. This is what we intend to explore in this section.

In the light of the international perspective provided in the preceding section, the problematic of the South Asian long-term growth process can be posed in the following terms. *First*, we need to explain their relatively slow-growing status in the international league during the 1950-97 period. *Second*, we need to explore factors that underlie gradual improvement in growth performance in India and Sri Lanka since 1960 and in Bangladesh since 1973. *Third*, we need to explain the gradual slowdown in the pace of growth in Pakistan, especially since 1980.

The main results of policy-regime specific analysis are presented in Tables 14 through 17. Detailed case studies of two countries of South Asia (India and Sri Lanka) are presented in the appendix (see, annex 1 and 2). Here we summarise the main points.

Note that although we attempt here to explain the differential growth performance of individual economies within the general predominance of inward-looking policies through the prism of shifting policy regimes having bearing on markets and institutional performance. Several messages emerge from the country-specific analysis.

Common Legacy of Pre-existing Economic Nationalism

The ideology of pre-existing economic nationalism played an important role in influencing the political choice in favour of inward-oriented development strategy. India represents the classic example in this context with the presence of all three elements of economic nationalism. The first of these relates to the policy of consciously minimising the reliance on international trade described as “a whirlpool of economic imperialism” by Nehru (1946, p.416). The second of these attaches importance to the "commanding height" doctrine whereby public sector plays a domonant role in industrialisation under centralised investment planning. The third element focuses on the critical role assigned to the basic and heavy industries in accelerating the long-term rate of economic growth. The ideology of economic nationalism was present in varying degree in other countries of South Asia as well. It was strongest in India and weakest in Pakistan, with Sri Lanka and Bangladesh falling in-between.

Contextual Factors Contributing to Inward-Orientation

Apart from the role of pre-existing economic nationalism, several contextual factors strengthened or weakened the tendency of inward-orientation in a particular context. For example, the nationalist leaders of Sri Lanka shared the same ideological milieu of economic nationalism as the nationalist leaders of India. In case of Sri Lanka, however, growing inward-orientation of the sixties was further fueled by the prevailing mood of export-pessimism. Adverse terms of trade shocks experienced by the country during the fifties with respect to its principal items of exports such as rubber, tea, and cocoa played an important part in influencing the policymakers to adopt import-substitution strategy. Similarly, in case of Bangladesh, moderate economic ideology of Awami League (the party that led the Independence struggle) was radicalised in the second half of the sixties during the course of militant student and working class movements against the military rule, with the ascendancy of the 11-points program in 1969, which articulated the idea of nationalisation.[11] As a result, when the country got independence in 1972, nearly all the industrial assets (including those held by rising Bengali entrepreneurs) in large-scale manufacturing was brought under the nationalisation program. According to a close observer of the period, this was done to curb the growth of large bourgeoisie (Sobhan 1982) and the course of events was driven by the dialectic of "intermediate regime" (Sobhan and Ahmad 1980).

Even in case of India, the degree of inward-orientation would have lessened in the second half of the sixties, but for the unfavourable confluence of factors. Thus, attempts to carry out devaluation combined with a selective liberalisation of controls on imports and domestic investment in 1966-67 were vitiated by inflationary pressures originating in the two sucessive droughts in 1965-66 and 1966-67. This was aggravated by the reneging of the promised non-project aid by the World Bank for import liberalisation (Bhagwati and Srinivasan 1975). The situation was made worse in the backdrop of a rising defense expenditure following war with Pakistan in 1965 (leading to the stoppage of foreign assistance from the United States) and with China in 1962. Political reaction was the roll-back on trade liberalisation.

In contrast, the weak ideological links in case of Pakistan was shaped by its recent history. Political leadership in Pakistan had a more liberal view on the issue of participation in the international division of labour. Jinnah, the founding father of Independent Pakistan, had a much less autarchic view than Nehru. Also, external influence of the donors played a much more prominent role in economic life of Pakistan, which, in turn, maintained much closer political and military ties with the Western powers.[12]

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[11] The latter point was not anticipated by the original 6-point program articulated in 1966 when the movement for autonomy was initiated by the League.

[12] Pakistan agreed to become part of military-economic alliances of CEATO and CENTO led by US in the fifties, while India and Sri Lanka remained in the front rank of the non-aligned movement. This, politics of cold war did indirectly shape the directionality of change in the degree of inward-orientation.

Public vs. Private Participation in Industrialisation

Although all the South Asian economies that pursued the road of inward-orientation shared the somewhat fuzzy concept of "mixed economy", there was variation in the public-private mix. In Sri Lanka, socialist ideology was seen as sine qua non for the pre-dominance of public sector. In case of Bangladesh, the pre-dominance of public sector corporations in the modern sector of the economy was shaped partly by default, as the state had to take over the industrial assets left abandoned by the non-Bengali entrepreneurs. In India, as mentioned earlier, while it was the outcome of conscious policy choice, nationalisation was never enacted in relation to domestic manufacturing sector. While there was stringent industrial licensing procedure aspiring to control new investments, it allowed the private corporate sector to function although under greater regulation and control. In Pakistan, the degree of reliance on the public sector was much less apparent: the private sector was to play the lead role in the mixed economy. Indeed, private corporate sector of Pakistan led the industrialisation process during the fifties and sixties. However, given the pre-ponderance of import-substitution and neglect of agricultural development in these countries, both private corporate-sector led industrialisation and public sector led industrialisation triggred backlashes. In India, it led to populist nationalisation of foreign banks and insurance as well as more stringent import control. This move was accompanied by a change in political leadership in 1969, with Indira Gandhi at the helms of state affairs.

In Pakistan, too, the open-door policy spearheaded by private corporate sector came to a temporary halt, as the new political leadership of Zulfiqar Bhutto that took over in 1972 launched a populist program. The new regime, which was in power during 1972-77, aspired to curb the economic power of the corporate sector (the so-called 22 families) which played the lead role in the sixties. As one observer later commented, the regime "set out to roll back the private sector, perceived as the principal enemy of the poor" (Tahir 1999). The idea was to take over all basic industries and selected consumer goods industries through "selective nationalisation". It also abolished the dual exchange rate system (the so-called "bonus voucher" scheme) which was adopted in the sixties to provide export incentives under the overvalued exchange rate regime.

Varying Market Flexibility within the Common Legacy of Import-Substitution

Although the South Asian economies shared the same approach of inward-orientation marked by import-substitution, the economic outcomes were different. Some economies grew faster than others even during the hey-day of import-substitution policy. We attribute this to the varying flexibility within the system of economic management in terms of greater emphasis on invest promotion and export-diversification via increased role of private participation and export incentives. This explains the star performance of Pakistan during the sixties and seventies (excluding the brief deviation of the populist period). Two major factors have contributed to this differing outcome. *First*, with higher availability of foreign exchange via external aid, the extent of import-substitution strategy induced output market distortions was less in Pakistan than in India. Thus, already by the early sixties (starting with the Second Plan spanning 1960-65), the import control system was considerably modified in favour of greater competition in the import trade and deregulation of the licensing procedure. In the beginning of 1964, a number of major import items were put on the “free import list” for the first time. This was a major move towards import liberalisation since now certain items--claiming about 25 per cent of the total volume of imports already by the end of 1964--were allowed to be imported without licence. The move also facilitated the liberalised import of raw materials. Partial import liberalisation helped capacity utilisation. *Second*, Pakistan adopted a conscioius policy of providing export incentives throughout the sixties. The system, known as "the bonus-voucher scheme" was introduced in 1959 and provided import privileges as incentive to exporters.[13] The bonus-voucher scheme was seen as “the key instrument in the export-promotion strategy” (Soligo and Stern 1970). To many observers, the rapid growth of exports was “one of the brightest spots” in Pakistan’s performance in the sixties (Lewis Jr 1970).

Both partial import liberalisation and active export-promotion policies led to greater openness, lower ICOR, and higher per capita growth during 1960-73. Average trade ratio--a proxy for openness--in Pakistan was twice as much as in India (23 as against 10 per cent). It helped to maintain ICOR at a relatively low level compared with India (3.8 vs. 5.6). As a result, although both the countries maintained similar rate of investment in the sixties--gross domestic capital formation was about 17 per cent --Pakistan's economy could grow at a much faster rate. Per capita GDP grew at a rate of only 1.1 per cent as opposed to 3.6 per cent during this period (Tables 14 and 16).

Partial Liberalisation Improved Economic Performance, But..

What has been just observed pertaining to the contrasting experience of the sixties between India and Pakistan holds true for policy regime shifts within a given country as well. Progressive gains from the "first wave of liberalisation" consistently come through the growth evidence for all the countries included our sample. The respective period of the "first waves" of the reform is given below:

- Sri Lanka (1977-82)
- Pakistan (1978-83)
- Bangladesh (1976-81)
- India (1980-91)

In section 3, we have noted the crisis-driven nature of economic reforms. The need for reform was generally triggered by external shocks, natural disasters, or policy-induced crisis. As a result, when selective de-regulation and partial trade liberalisation measures were implemented, they generated favourable output response. Thus, in Sri Lanka, the first period of economic liberalisation represented considerable improvement over the past economic performance. Per capita GDP growth was 2.2 per cent per year during 1960-77 as opposed to 3.4 per cent in 1978-82. In Bangladesh, per capita GDP was 2.6 per cent during the period of partial liberalisation in

[13] The scheme allowed the exporter to get bonus voucher for specified import items (practically all manufactured goods, but only some raw materials). The voucher entitled its owner to purchase foreign exchange from the State Bank at the Official rate of exchange equal in value to a specified percdentage, depending upon the commodity exported, of the amount earned. The voucher was freely transferable and may be sold in the market at a price determined by the market. The bonus scheme discriminated against the traditional exports and favoured manufactured and new primary exports.

1976-81 vis-à-vis 0.5 per cent recorded during the 1960-71 period. In Pakistan, per capita GDP growth was in the order of 4.2 per cent compared with 0.9 per cent in the immediately preceding populist period of 1972-77 and 3.6 per cent recorded during the much longer period of 1960-72. In India, which witnessed relaxation of controls on private investment and imports as well as significant depreciation of the real exchange rate during 1980-91, the similar favourable growth effects of partial reforms were noticeable. Per capita growth rate stepped up from about 1.1-1.3 during the sixties and seventies to 3.4 per cent in the 1980-91 period as a result of the first waves of reform.

In all these cases (except Bangladesh), one common feature in growth acceleration has been increase in openness brought about by partial trade liberalisation, as reflected in higher trade ratios. Thus, trade ratio increased from 10 per cent in 1960-73 to 16 per cent in 1980-91 for India; from 23 per cent in 1960-72 to 33 per cent in 1978-83 for Pakistan; and from 66 per cent in 1960-77 to 76 per cent in 1978-83 for Sri Lanka. The same holds true when one measures the progress in respect of other important indicator of trade liberalisation, namely, increased volume growth of exports. The other common features of the policy regime of the first reform period were selective de-regulation measures encouraging private participation (for instance, removal of ceiling on private investment, partial divestiture, simplification of licensing procedure).

The "first waves" of reform aiming at partial liberalisation did not last long in any of the reform-seeking economies, however. Indeed, one can discern a "phase of backtracking" in nearly all the countries undergoing partial liberalisation.

Short-lived Nature of "First Waves" and the Phase of "Backtracking"

What were the underlying impulses leading to the short-lived nature of the initial reform attempts so much so that one could even observe some degree of retrogression in post-reform economic performance after the initial success? The respective phases of "backtracking" are clearly distinguishable in case of Sri Lanka and Pakistan, and less so in case of Bangladesh. In case of India, the period of backtracking was rather short given the acuteness of the 1991 crisis leading to severe shortage in foreign exchange liquidity and thereby necessitating drastic corrective action. The "phases of backtracking" are given below:

- Sri Lanka (1984-88)
- Pakistan (1984-88)
- Bangladesh (1982-91)
- India (1990-91)

The phase of backtracking appears to have triggered by increasingly unsustainable fiscal deficits during the first period of reform and this trend cuts across all the countries of the sample. Thus, according to one estimate, the budget deficit in Sri Lanka, which stood at 9.3 per cent of GDP in 1970-77, rose sharply to 13.8 per cent in 1978-79. It peaked at 23.1 per cent in 1980, before it was brought back to 13.4 per cent in 1983 (Dunham and Kelegama 1997a). Similarly, expansionary fiscal stance was adopted in India during the second half of the eighties as part of growth-acceleration strategy, eventually proved unsustainable and led to the 1991 crisis (Minhas 1991). In Pakistan, the budget deficit, which stood at 2.1 per cent in the sixties, and 5.3 per cent in seventies, increased further to 7 per cent in the eighties and 6.7 per cent in 1990-98 (Tahir 1999).

The increasing trend in fiscal deficits may have caused by several factors. *First*, selective liberalisation efforts were "rewarded" by the donors who viewed the change in the policy regime in favourable light. Fiscal profligacy could not have been possible without substantial foreign assistance that came with the opening up of the economy. This has happened during the first five years of the Ziaul Haque regime in Pakistan (1978-84), during the first five years of UPP rule in Sri Lanka (1977-82), and during the government led by Ziaur Rahman in Bangladesh (1976-81). All of these regimes received large quantum increase in external aid assistance on concessional terms following the first waves of reform. The case of Accelerated Mahaweli Development Program (AMDP) in Sri Lanka illustrates the nature of the problem (see, annex 2). *Second*, laxity in the reform initiative was partly conditioned by a false sense of stability. Given the crisis-driven nature of policy reform, the priority attention was given to averting crisis. Once the macroeconomic crisis-situation was overcome through a series of sensible pro-liberalisation steps, there was a tendency to revert back to the "business-as-usual", as things began to settle. *Third*, expansionary fiscal stance may have been influenced by worsening domestic political situation, as in the backdrop of growing ethnic conflict in Sri Lanka, rising militarism and insurgency in India since the early eighties, involvement of Pakistan in Afghan Crisis in the early eighties.

Rising budget deficits together with the cost-push effect from domestic and imported inputs, fueled inflation in allthese economies during the post-reform period. The matter was aggravated by the emergence of major balance-of-payment crisis--triggred in part by the declining flow of overseas remittances--noticeable in varying degree in all four countries in the mid-to-late eighties.

Note that retorgression on policies led to slippage in the economic performance. In Pakistan, per capita GDP growth rate declined from 4.2 per cent in 1978-83 to 3.7 per cent in 1984-88 (Table 16). This was accompanied by rising ICOR (from 2.7 to 2.9) and, more importantly, a significant deceleration in the volume growth of exports (frm 13.7 to 7.3 per cent). In Sri Lanka, the macroeconomic effects of backtracking were even more revealing. Per capita GDP growth rate dropped to a minimum of 1.2 per cent per year during 1984-88 (worse than the annual growth rate of 2.2 per cent observed during the inward-oriented phase of 1960-77). Average trade ratio shrunk from 76 per cent in 1978-83 to 62 per cent (again, worse than even the benchmark of 66 per cent observed in the 1960-77 period). The volume growth of exports declined from 7.4 per cent per year in 1978-83 to 6.2 per cent in 1984-88 (Table 15). Similarly, in Bangladesh, the growth rate in per capita GDP dropped from 2.6 per cent in 1976-81 to 1.5 in 1982-91 (Table 17).

In short, the progressive gains of the “first waves” of the reform could not be sustained. The efficiency gains fron liberalisation measures was undercut primarily by the inability to maintain fiscal realism and, consequently, macroeconomic stability. Liberalisation without stabilisation hurt the very process of liberalisation at the end (Dunham and Kelegama 1997a). The "crisis" of reform process, however, showed that potentials for growth-acceleration were much greater in making a shift from inward-orientation to outward-orientation. This is the challenge that was to be taken up by the "second wave" of economic reforms.

Success of "Second Wave" of Economic Reforms: Emerging Lessons

A renewed emphasis on economic reform followed the phase of backtracking. The "second wave" of economic reforms was accompanied by much more comprehensive package of liberalisation policies involving substantial trade and exchange rate reforms, preceded by macroeconomic stabilisation (see, annex 1 for the list of reforms in the Indian context). This package was most successfully implemented in case of India and Bangladesh, followed by Sri Lanka, and remained as unfinished agenda in case of Pakistan.[14] The respective phase of second wave of reforms is given below:

- Sri Lanka (1989-97)
- Pakistan (1989-97)
- Bangladesh (1991-97)
- India (1991-97)

Several results are noteworthy. *First*, in countries where the "second wave" reform measures were successfully implemented, it led to greater openness and higher export growth (India, Bangladesh, and Sri Lanka). The average trade ratio currently stands at 24 per cent in India, 25 per cent in Bangladesh, 74 per cent in Sri Lanka--higher than any other period in their respective economic history. *Second*, greater outward orientation to international trade as well as foreign private investment helped to promote efficient capital utilisation, as reflected in the lowering of ICOR in the nineties in all three counties. It stands at all-time low level in case of India and Bangladesh (3.7 and 4.0, respectively). In Sri Lanka, it has been reduced from 10.8 in the phase of backtracking to 4.8 in the period of second wave of economic reforms. *Third*, outward-oriented economic reforms considerably reduced trade-induced distortions in the output market and helped to generate strong growth impulses. Thus, for the first time since 1960 Bangladesh--once dubbed as the "test case of development" (Faaland and Parkinson 1975)--achieved the per capita GDP growth rate of 3.2 per cent. This was impressive growth performance by any standard. Such a performance not only dispels growth-pessimism, but also shows that a turn-around is possible. It places Bangladesh among the top 20 growth-performers in the developing world, right after India (4.7 per cent) and Sri Lanka (4 per cent).

Success of the second wave of reforms in these contexts brings out the central message. Although the maninsprings of the rapid growth process must lie within the country and shaped by the institutional software mentioned above and the resulting incentive structure embedded in it, experience shows that international trade (in goods and services, technology, capital and skills) has provided the most effective and hence the best available instrument for stepping up and maintaining the higher rate of economic growth.

Next Generation Challenges in Market and Institutional Reforms

[14] Pakistan's economic reform process has been overshadowed by adverse political economy over the entire period of "second wave" spanning 1989-97.

Notwithstanding these commendable succeses, however, uncertainties still persist on several parameters. Vigilance is needed over maintaining low inflation, especially in case of India and Sri Lanka (where inflation is nearer to double-digit). The importance of fiscal prudence can hardly be exaggerated in this context. Although these economies have made greater strides towards reform, changes in the policy framework are still very modest in relation to the need and in comparison to what other reform-seeking countries have already achieved. Among the latter, we may note efficient governance including stability not only in the political domain but in macroeconomic management as well as microeconomic policies, low-cost supply of physical infrastructural services and clearly defined contract and property laws along with impartial and speedy judicial process. Further acceleration in the pace of economic reforms is clearly necessary. This would include macroeconomic discipline which has been loosening in the recent past, deepening policy reforms in terms of further liberalisation of exports and imports as well as controls on domestic transactions. In addition institutional measures such as restructuring the finacial markets (including the more urgent issue of dealing with the debt default), introducing greater labour market flexibility in the organised sector and drastic revamping and restructuring of public sector constitute the second generation and much harder set of reforms.

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Annex 1

Country Case Study: India (1950-97)

The evolution of economic policy regime in India appears to have progressed through six distinct periods (or phases):

- *Period of autarchic industrialisation* conditioned by pre-existing economic nationalism and deep-seated export pessimism, with the dominant industrialising role of the public sector under centralised investment planning and strong reliance on basic and heavy industries (1950-60);

- *Period of growing instability* leading to "first cracks" in the sustainability of the autarchic model with considerable growth deceleration, but failing to usher in even selective liberalisation due to adverse political economy (1960-73);[15]

- *Coping with external shocks arising from oil-price hikes*, made possible by favourable confluence of factors such as opening up of oil-rich gulf countries as new markets for Indian exports, increased flow of remittances from overseas immigrant workers, and "covert depreciation" of rupee against U.S. dollar (1973-80);

- *Phase of hesitant de-regulation*, including selective de-controls on private investment and on transactions in international trade, mostly on non-competing imports (1980-91);

- *Crisis-induced policy shift in 1991*, following foreign exchange liquidity crisis, which was, in turn, triggered by a combination of macroeconomic stability and political instability towards the end of 1980s and rising current account deficits;

- *Period of economic reform (1991-97)*, with focus on stabilisation, on one hand, and liberalisation, on the other, leading to substantive de-regulation on private participation in economic activities (including relaxation of restrictions on foreign private investment), removal of quantitative controls on most intermediate and capital goods imports, considerable reduction in tariff rates, and withdrawal of export restrictions.

Each of these phases is reviewed in turn. The main results are presented in Table 14.

A. High-Point of Autarchic Industrialisation (1950-60)

[15] Note that the autarchic policies of both first and second periods took place in the backdrop of unprecedented expansion in world trade since 1950.

The ideology of economic nationalism evolved in the Indian sub-continent during the pre-Independence freedom struggle against the colonial power. It was a reaction to the laissez-faire trade policy follwed by the British colonial regime and it was deemed to be responsible for the economic underdevelopment. Not only was there a political consensus on this issue but it was also endorsed by the indigenous industry as well as labour. Because of this origin, it was embraced more readily and persisted with much longer in India. Consequently, the Indian strategy of development during the post-Independence period (after 1947) was driven by all the three elements of economic nationalism, namely, consciously minimising the reliance on international trade (which was described as "a whirlpool of economic imperialism" (Nehru 1946, p.416), dominant role of public sector in industrialisation under centralised investment planning and, finally, the critical role assigned to the basic and heavy industries in accelerating the long-term rate of economic growth.

The import-substitution-oriented strategy based on balanced growth of the domestic market subject to the foreign exchange constraint was initiated in the mid-nineteen fifties with the Second Five Year Plan (1956-61).[16] Initially, this strategy yielded positive results. The decade 1950-60 was marked by the initiation of the economic growth process in an economy that had remained virtually stagnant in the first fifty years of the twentieth century. As indicated earlier, the Indian GNP per capita increased at 1.9 percent per annum during 1950-60 (Reynolds 1985). This reflected the early spurt in growth resulting from autarchic industrialisation. Two factors contributed to this early spurt. *One*, a significant step-up in real public sector investment in infrastructure as well as basic and heavy machine-building industries kept up the demand for industrial output. *Second*, as is common in the early stages of import-substitution, domestic output grew faster than the size of the domestic market which, at low level of per capita GDP, did not generate demand for diversified industrial output. This was helped immensely by agricultural growth that took place during the decade driven mostly by area expansion and absence of major drought.

However, the Indian export-earnings remained vitually stagnant in a booming world economy. India's share in world exports which stood at 2 percent in 1950 (compared to 0.9 percent for China and 1.4 percent for Japan) came down to 1.1 percent by 1960 when Japan increased its share to 3.4 percent and China to 2.1 percent. The outcome of autarchic policy was that the volume of Indian exports remained fluctuating around a low growth rate of 1.3 percent per annum when the volume of world exports grew at 7.0 percent per annum. While the dominant opinion at that time among the Indian economists supported the autarchic industrialisation strategy, strong arguments were also presented in favour of imparting a strong export-orientation to the strategy. Notable among the advocates of export-orientation were Cohen (1964), MacDougall (1964) and Manmohan singh (1964) who, as Finance Minister later in 1991, successfully reversed the inward-orientation in the development strategy.

B. Growing Instability and First Cracks in the Autarchic Model (1960-73)

During 1960-73, when the world economy offered significant opportunities for mutually gainful exchange from which Japan and other East Asian economies benefited by actively participating

[16] For a cogent statement of the strategy, see Mahalanobis (1955, 1963).

in it, India remained firmly committed to the ideology of economic nationalism and continued policy aimed at inward-oriented import-substitution driven industralisation. This was reflected in a very low volume growth of India's merchandise exports at 2.3 percent and negligible elasticity of 0.3 of volume of India's merchandise exports with respect to volume of world exports. The average trade-ratio also remained low at 10 percent of GDP. Stagnant export-earnings resulting from overvalued fixed exchange rate combined with a spurt in imports arising also from a step up in rate of investment during 1950-60 resulted in continuing foreign-exchange shortages and progressively stringent import-controls.

A brief experiment of devaluation combined with a selective liberalisation of controls on imports and domestic investment was attempted in 1966-67 (See, UN-ECAFE 1968). This was vitiated by inflationary pressures originating in the two sucessive droughts in the agricultural (July-June) years 1965-66 and 1966-67, which slowed down growth in real public sector investment and the reneging of the promised non-project aid by the World Bank for import liberalisation (Bhagwati and Srinivasan 1975). Political reaction was the roll-back on trade liberalisation. The two successive droughts mentioned above were preceded by war with Pakistan in 1965 (leading to the stoppage of foreign assistance from the United States and slowdown in public sector investment) and with China in 1962 both of which resulted in a rise in defense expenditure. The period ended in yet another drought in 1972-73.

The slow-down in real public sector investment and weather-induced fluctuations in agricultural harvests imparted a downward push to inward-oriented industrialisation and considerable volatility to growth process. Net capital inflow was less than two percent of GDP (the difference between average rate of gross domestic capital formation and gross domestic savings at current prices). Real rate of investment did register impressive 20 percent of GDP but translated itself merely into high ICOR instead of high growth. The outcome was that the GDP in real terms slowed down to a little over 1 percent with considerable fluctuations around a low rate. Thus India's policy-induced insulation from the world economy prevented it from reaping the upside benefits of participation in the booming world trade during this period.

C. Coping with Oil Shocks (1973-80)

The next period 1973-80 was one of turbulence in the world trade resulting from the breakdown of the Bretton Woods system of fixed exchange rates and two oil-price hikes. However, India's insulation from the world economy protected it from vulnerability to external shocks during this period despite virtually total dependence on imported oil. Indian economy remained broadly unaffected with only marginal increase in current account deficits in relation to GDP which were financed mostly by soft loans during both the 1973 and 1979 oil price hikes. In fact, India benefited during this period despite being dependent on oil imports from three unexpected factors.

One, in a managed float exchange rate regime, rupee was linked to pound-sterling which had been sinking so that resulting covert depreciation of the rupee against U.S. dollar helped export performance. Two, oil-rich gulf countries provided new markets to Indian exports. Finally, remittances from immigrants to the gulf countries to provided additional means of support to the balance of payments during this period as well as in the 1980s. As a consequence, India came out lightly from the oil price hikes.[17] However, inward-oriented trade policy from the earlier period persisted during this period as well, with a marginal rise in the average trade ratio from 10 percent to 13 percent arising mainly from a rise in import-GDP ratio. The average rate of per capita GDP growth showed a marginal rise from 1.1 percent per annum (1960-73) to 1.4 percent during this period.

The fluctuations around this higher average were also greater. The sources of volatility in the rate of economic growth were again located in agriculture. The aftermath of the 1972-73 drought at the end of the preceding period resulted in inflationary pressures in the first half of this period. The response was in terms of a severe macroeconomic compression. Combined with a covert depreciation in exchange rate mentioned above, it resulted in a spurt in US dollar-earnings of exports. Helped by remittances from the Gulf migrants during the second half of the period, this period. 1973-80 saw a continuous accumulation of foreign exchange reserves. At the same time, agricultural transformation (green revolution) that was initiated in the mid-sixties in response to two successive severe droughts and cessation of P.L.480 food assistance from U.S. resulted in accumulation of public stocks of foodgrains and moderated the rate of inflation. This period ended with a very severe drought in 1979-80.

The volume growth of exports did show impressive growth of 6.5 percent per annum after the sluggish growth earlier. It also exhibited responsiveness to the volume of world merchandise exports with elasticity rising to 1.5. Like in the previous period, a marginal rise in the rate of investment (at constant prices) showed itself more in high ICOR than in growth rate. During this period, all the three elements of economic nationalism namely, public sector-dominated autarchic industrialisation focused on basic and heavy industries started getting gradually diluted in practice though not in rhetoric out of compulsions on the situation.

D. Period of Hesitant De-Regulation (1980-91)

The decade 1980-91 was remarkable in terms of growth performance. Posting a significant break with the three previous decades, the average rate of growth of per capita GDP in real terms more than doubled from around 1.5 percent per annum to 3.4 percent with a considerably higher stability around the average level. At the aggregate level, this resulted from not much increase in the average rate of investment at constant prices but from a significant decline in ICOR. There was some slowing down in the volume growth of exports combined with some decline in the elasticity of volume of India's exports with respect to world export volume from 1.5 (1973-80) to 1.3. Simultaneously, there was a deterioration in the current account deficit to the extent of nearly 3 percent of GDP on the average (being the difference between average rates of gross domestic capital formation and gross domestic savings).

What were the underlying impulses? *Firstly*, there was a realisation that direct discretionary policy regime evolved over the previous three decades was constricting the dynamic impulses of the functioning markets and hence inhibiting growth. Two official committees--GOI-MOF (1985) and GOI-MOC (1985)--appointed in the early part of the decade recommended selective

[17] See, Mitra and Tendulkar (1994) for the analysis of India's adjustment to oil-shocks using computable general equilibrium framework.

deregulation of controls on private investment and on transactions in international trade. These were accepted and implemented toward the middle of the decade.

Secondly, while the immediate aftermath of the second oil shock was an appreciation of the Indian currency, the second half of the decade was marked by a significant depreciation of the real exchange rate which helped maintain the volume growth of exports over the decade.

Thirdly, trade policy deregulation was made possible because of the accumulation of foreign exchange reserves that started during the previous period but it remained confined to the removal of controls on mostly non-competing imports. In fact, import tariff rates rise during the decade. The persistence with major import controls maintained the higher profitability of selling in the domestic market and possibly resulted in a decline in the elasticity of India's export volume with respect to world export volume despite the fact that growth of world exports picked up considerably since the second half of the decade. *Fourthly*, expansionary fiscal stance was being adopted by the Central as well as State govenments.

Thus, the significant spurt in the rate of economic growth appears to have resulted from a combination of (a) high fiscal deficits imparting an expansionary push from the demand side and (b) deregulation of controls on private investment and imports and increased current account deficits imparting flexibility in supply response and both (a) and (b) resulting in better utilisation of capacity and lower ICOR. However, rising fiscal deficits had been putting pressures on interest rates and prices and the stepped-up growth rate of the 1980s became macroeconomically unsustainable by the end of the decade necessitating corrective action.[18]

E. Crisis of 1991

The immediate trigger for corrective action was provided by a crisis in 1991. This was generated by a constellation of certain circumstances including (a) a combination of macroeconomic instability and political instability towards the end of 1980s, and (b) rising current account deficits reaching 3.5 percent of GDP by 1990-91 both putting pressures on the foreign exchange rate, creating expectations of exchange rate devaluation that resulted in capital flights and the consequent dwindling of foreign exchange reserves. This led to a foreign exchange liquidity crisis when by May 1991, the import cover provided by foreign exchange reserves reached to a disastroously low level of two weeks and the spectre of default on foreign loans appeared imminent. The resulting crisis-gripped atmosphere enabled the new minority government headed by P.v. Narasimha Rao to undertake drastic corrective action.[19]

The Finance Minister Dr. Manmohan Singh who had earlier advocated export-orientation in his Ph.D. dissertation (Singh 1964) decisively changed the economic agenda away from autarchic industrialisation and toward greater integration with the world economy and away from

[18] See, Joshi and Little (1994) for an excellent discussion of factors leading to the crisis.

[19] The warnings about the imminent need for corrective action had appeared earlier. See, Minhas (1987, 1991), Dhar (1990).

dominant reliance on public sector and toward private initiative and market-driven growth, thus marking a distinct break from the ideology of economic nationalism. He put in place a drastic stabilisation programme of reducing fiscal and balance of payment deficits through public expenditure control and exchange rate devaluation. Simultaneously, the government also initiated wide-ranging changes in policies aimed at liberalising the controls on both the domestic and the international transactions.[20] This was done with a view to providing flexibility of adjustment to the private sector in response to market signals, and progressively integrating the Indian economy with the global one.

F. Wave of Reform (1991-97)

The major elements of policy reforms have been as follows:

- Private investment has been freed from the requirement of obtaining industrial license from the government in all industries except a well-defined and small negative list which itself is being progressively pruned over time;

- Drastic reduction in the list of industries earlier rescrved for the public sector;

- Quantitative controls on imports of most intermediate and capital goods have been abolished; those on consumer goods remained but are being phased out under the pressure from WTO and advanced countries;

- Average tariff rates have been brought down with a reduction in the dispersion of rates;

- Restrictions on exports of certain agricultural commodities have been relaxed;

- Restrictions on foreign private investment have been relaxed though not as radically as those on domestic private investment.

The measures listed above considerably liberalised restrictions on private investments as well as on imports and are expected to introduce competition both domestically and through imports of goods, services, technology and capital and thereby bring about improved allocation of resources and reduce their wasteful utilisation which had adversely impacted aggregate growth in real terms in the past.

The outcome is reflected in a variety of aggregate indicators. To start with, increase openness to the global economy is reflected in 8 percentage point rise inthe average trade ratio over a short seven year period 1991-97 compared to just 6 percentage point rise over the previous thirty year from 1960-1991. A major shift toward integration with global merchandise trade is clearly visible. Volume growth of merchandise exports posted a healthy double-digit growth of 12.7 percent per annum along with a distinct rise in elasticity with respect to volume of world exports from 1.3 during 1980-91 to 1.8 during 1991-97. Efficiency gains through trade are also reflected in a significant growth of 16.6 percent per annum in income-terms of trade–more than double the

[20] For details on the policies, see GOI-MOF (1993), Bhagwati and Srinivasan (1993) and IMF (1995).

high growth during the preceding decade. The outcome in growth performance is reflected in a further rise in per capita real GDP growth from 3.4 percent per annum (1980-91) to 4.7 percent (1991-97). This has come about not only from a rise of near two percentage points in the average rate of investment (at constant prices) but, more importantly, in more efficient utilisation of capital which is reflected in a lower implicit ICOR.

G. A Recapitulation

To recapitulate, the story of long-term growth in India has been one of self-imposed insulation from the global economy driven by the ideology of economic nationalism that resulted in slow growth of around 1.5 percent per annum in real per capita GDP for three decades till 1980. Hesitant deregulation in the 1980s did result in a doubling in the growth rate of per capita GDP which became unsustainable by the end of the decade because of large fiscal deficits. The radical changes in the policy framework since 1991 mark a decisive shift away from the ideology of economic nationalism and toward liberalisation and globalisation. This shift has yielded gains leading to higher rate of economic growth. India has, at least, recognised the powerful instrumental role that international trade is capable of playing in the domestic growth process which it had denied itself through self-imposed isolation.

It must, however, be noted that while changes in the policy framework since July 1991 constitute gigantic strides compared to pre-1991 position, they are very small in relation to what other rapidly growing economies including China have undertaken well before India and hence have advantageously positioned themselves to reap the benefits of trade liberalisation under the Uruguary Round. In order to sustain the impressive gains over a short period of 7 years, it is necessary to accept stricter discipline imposed by the World Trade Organisation while keeping the domestic mainsprings of the growth process in well functioning shape. Further acceleration in the pace of economic reforms is clearly necessary.

Annex 2

Country Case Study 3: Sri Lanka (1970-97)

The evolution of economic policy regime in Sri Lanka can be seen to have progressed through five distinct phases:

- Inward-looking phase during the period up to mid-1970s;
- Crisis-induced Policy shift in 1977 following unsustainable budget deficits, a balance-of-payment crisis and consequent change in political leadership;
- "First Wave" of economic reform with more focus on trade liberalisation and de-regulation, but, strikingly, with negligible focus on stabilisation (1978-82);
- Slackening of economic reform and backtracking in trade liberalisation with relatively high budget deficits and inflation (1983-88);
- "Second Wave" of economic reform with balanced focus on stabilisation, trade liberalisation, and privatisation (1989-97) amidst growing political uncertainties.

Each of these phases is reviewed in turn. The main results are presented in Table 15.

A. Phase of Inward-Orientation

As in other South asian countries, the first phase of development in Sri Lanka is characterised by inward-orientation. During the entire period between the early fifties through the mid-seventies, the state pursued an import-substitution (IS) strategty. The nationalist leaders of Sri Lanka shared the same ideological milieu of economic nationalism as the nationalist leaders of India. In case of Sri Lanka, inward-orientation of the sixties was further conditioned by the prevailing mood of export-pessimism. Adverse terms of trade shocks experienced by the country during the fifties with respect to its principal items of exports such as rubber, tea, and cocoa played an important part in influencing the policymakers to adopt IS strategy.

The inward-oriented phased had a number of stylised characteristics. The state pursued quantitative restrictions on imports and stringent exchange contols. Public corporations dominated in almost all sectors of the economy. The focus on industralization accentuated trade policy induced biases against agriculture and plantation sector. The oversized state sector was sustained by the surpluses squeezed from plantation exports (Dunham and Kelegama 1997b; Lal and Rajapatirana 1989; Moore 1990).

The phase of inward orientation in Sri Lanka was characterised by two specific features, which stand out in cross-country comparison within South Asia. First, there has been a marked commitment of the state to social expenditures. This helped to sustain development of human capital at a much faster pace than in other countries of the region. Second, being a small island-economy, the degree of "openness" was much higher to begin with (the trade ratio was 64% in sixties compared with 9% in India, 15% in Bangladesh, and 23% in Pakistan). This may partly explain why the ICOR was lower in Sri Lanka than in other countries (3.1 compared with 3.9 in Pakistan, 5.7 in India and 11.9 in Bangladesh). With lower capital-output ratio and higher level of human development, Sri Lanka could achieve respectable growth in per capita income (2.1%) compared with (say) India (1.1%) with lower investment rates.[21]

B. Crisis of 1977

During the period of 1960-77, GDP grew at a trend rate of 4.2 per cent per annum. However, signs of slow down were already visible by the first half of the seventies, as the annual growth rate of GDP during 1970-77 shrunk to 2.8 per cent. The beginning of the crisis was triggered by a sharp deterioration in terms of trade as well as several years of drought, which led to a decline in plantation output and exports, the country's major source of revenue. This has eventually resulted in unsustainable budget deficits and balance-of-payment crisis. With low growth, high unemployment, food shortage and rationing (and black marketing), there is a widespread sense of social discontent and disillusionment. By 1977, the basic model was in "crisis".[22]

C. "First Wave" of Economic Reform (1977-82)

Several policy measures were undertaken by the new government in the backdrop of widespread popular support for the open economy. The package included devaluation, trade liberalisation, partial liberalisation of financial markets, replacement of food stamps by more targeted food stamps, and deregulation. The openness index, as measured by the trade ratio, increased sharply from the average of 64% in 1960-73 to 78% in 1978-82. The new policy measures had favourable effects on private investment and economic growth. Thus, over the period between 1978 and 1982, GDP growth on average was in the order of 5.5 per cent per year, despite the oil shock of 1979 and declining prices for the country's main export crops. This may be compared to the growth rate of 4.3 per cent observed during 1960-77, and 2.8 per cent recorded in the immediate preceding 1970-77 period.

There is an apparent paradox in the overall economic performance during this period. The estimated ICOR increased sharply from 3.34 observed during the inward-looking phase of 1960-77 to 5.63 in the pro-reform 1978-82 period despite marked increase in trade ratios. This is

[21] Pakistan, of course, had the highest per capita growth rate in the sixties among the countries of the region. As discussed later, this was mainly driven by the very high rate of physical capital accumulation supported by heavy external borrowing. The investment rate, in constant prices, in Sri Lanka was nearly half the level recorded for Pakistan (13.2 as against 24.2, with about 19.6 observed in India during 1960-73).

[22] The crisis assumed political dimension as well, as the ruling party of Mrs. Bandernayake (which long championed the inward-looking model) had to concede defeat in the 1977 general election. A new coalition of political forces of reform led by the United National Party came to power with a landslide victory.

because the efficiency gains from liberalisation measures were undercut by fiscal profligacy made possible by substantial foreign assistance that came with the opening up of the economy. Keynsian-type fiscal injection by way of highly capital intensive infrastructural investments led to the rising, rather than falling, ICOR during the first phase of economic liberalisation.

Thus, budget deficits, which were already at a very high level of 9.3% of GDP during the immediate pre-reform period of 1970-77, soared further to 23.1% in 1980 three years after the reform. Even though the matched indicator declined in the later period, it still remained at a unacceptably high level of 17.4% in 1982. These deficits were fueled primarily by the implementation of an ambitious public investment program. Among the several such projects, special mention must be made of the Accelerated Mahaweli Development Program (AMDP). Initiated in 1970, its implementation was accelerated from thirty to six years.[23] Total expenditure on the AMDP alone was 6 per cent of GDP in 1982 and 1983. The massive undertaking of this kind was made possible by liberal donor support.[24] Needless to say, projects of such nature were highly capital intensive and contributed to the rising ICOR.

Notwithstanding the significant assistance from the donor community, the counterpart contributions to such projects still remained immense. Rising budget deficits together with the cost-push effect from domestic and imported inputs, fueled inflation, the latter having increased from an average of 5.8% in 1970-77 to 26.1% in 1980. Although the inflation rate came down subsequently, it still remained at double-digit levels of 11-17% till the mid-eighties. A major balance-of-payment crisis emerged: the current account deficit (inclusive of trade in services) increased from 2.4% in 1978 to 11.9% in 1982. At the end the crisis was averted only through an unprecedented inflows of concessional aid.[25] The massive capital inflows in the form of concessional aid also led to the appreciation of real exchange rate, the latter being appreciated by 20 per cent between 1979 and 1982. This reduced the gains to exporters of the earlier devaluation initiated during the on-set of reform.

In overall terms, therefore, the progressive gains of the “first waves” of the reform could not be sustained. The major failure of the reform was its inability to maintain fiscal realism and,

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[23] AMDP aimed to build five major dams in a six-year period and promised massive employment, both during construction and in the later phase of land settlement, whereby the plan was to settle 140,000 families. The project was viewed as the vehicle to create employment, bring rice self-sufficiency, and hydroelectricity. It virtually “overshadowed all other aspects of development policy” during that period (for details on the macroeconomic impact of project, see Dunham and Kelegama 1997b).

[24] Cost estimates for the AMDP soared from US $610 million in 1977 to US $860 million in 1980. The aid funded-share as a percentage of total investment in the AMDP rose from 30 per cent in 1979 to 83 per cent in 1985. Why the external donors went ahead with the funding of such projects? According to one view, such infrastructural undertaking also “appealed to the donor community which rewarded policy reforms with concessional aid” (Dunham and Kelegama 1997b). As we shall see later, something similar happened in case of Pakistan and Bangladesh as well when the new leadership that came to power in the latter countries initiated “first waves” of economic reform.

[25] Worker remittances also helped to ease the balance-of-payment crisis, as the latter increased from 0.3 per cent of GDP in 1977 to 5.2 per cent in 1982.

consequently, macroeconomic stability. Liberalisation without stabilisation hurt the very process of liberalisation at the end.

D. Phase of Backtracking (1983-88)

By 1983, a number of reversals in the reform process became apparent. Budgetary transfers to state enterprises increased. A number of ad hoc changes widened the dispersion in the effective protection on different sectors. The government began to rely on non-price measures to promote exports. Ceilings on interest rates were used to ease the problems of financing the public sector deficit.[26] Instability in the macroeconomic balance during the period was reflected in relatively high inflation rate (on average at 11%), deteriorating budget deficit (on average at 12.2%), high current account deficit (on average at 5.7%), and high real rate of interest (on average at 10%). The most striking aspect of this period was the re-emergence of the inward-looking tendency, as reflected in the sharply declining trade ratio, from 78% in 1978-82 to 63% in 1983-88. This was matched by the parallel increase in the ICOR, from 5.63 to 7.76. The latter value of ICOR was more than double the figure estimated during the phase of inward-orientation. The situation was also aggravated by the escalation of the ethnic crisis after 1983 and insurgency in the south from 1987 to 1989.

The political instability combined with acute macroeconomic balance led to the gradual stagnation: growth rate of GDP plummeted from a already low level of 4.8% in 1982 to 2.3% in 1989. The average growth of GDP during the 1983-88 period was 3.9% compared with 5.6% observed during the initial years of reform in the 1978-82 interval.

The impact of backtracking can be seen vividly in the comparison of the macroeconomic targets between 1983 and 1988. The budget deficit in the beginning of this period was 13.4%, it rose to 15.6% in 1988; inflation rate in both the points was 14%. There was some decline in current account deficit-- largely because of increased flow of worker remittance—from 9.2% to 5.6%, but it was still high. With declining aid inflows, it was difficult to maintain a high investment rate; the latter declined from 31% to 21%, with adverse consequences for growth.[27]

Indeed, most of the indicators for judging macroeconomic performance of the economy at the end of the sub-period were even worse than in case of the pre-reform period of 1970-77. A need for "Second wave" of reform with strong emphasis on "restoring the macroeconomic ba;amce" became the order of the day.[28]

[26] For details on the process of backtracking on economic reform during the eighties, see Lal and Rajapatirana (1989).

[27] Note that the budget deficit during the period increased despite drastic cut on the ambitious investment program launched during the 1978—82 period. This means that the government was unable to control primarily the growth in current expenditures. Rising military spending in the face of ethnic crisis and insurgency contributed to this outcome in a major way.

[28] With the re-election of the ruling party under a more populist president, the time for change was highlighted. The re-election of the ruling party was facilitated by the defeat of the insurgents in 1989. However, the authoritarian tendency within the ruling party, which surfaced first during the early eighties amidst macroeconomic crisis, became even stronger during the "second wave" of reform. Such a tendency while trying to emulate "Singapore model"

E. "Second Wave" of Economic Reform (1989 onward)

In the second phase of economic reform, stabilisation received greater attention along with strong emphasis on privatisation and incentive reforms to stimulate private sector investment.[29] There were strong moves towards a more liberalised trade regime. Liberalisation of exchange controls on current account transations and the subsequent abolition of foreign exchange surrender requirements on export transactions were important steps in this regard. The stabilisation phase was fairly stylised and aimed at achieving internal and external balances through tight monetary and fiscal controls, and through reductions in current account of the balance of payments.

Compared with the "first wave" of the economic reform, the second phase of reform was carried out with greater success in macroeconomic management. The budget deficit, which was around 15.6% in 1988, came down to 8.1% in 1993 at the end of Premadasa regime. Similarly, the external current account deficit was reduced from 5.6% to 3.8%. It was also easier to carry out structural reforms such as privatisation amidst macroeconomic stability.[30] Investment and domestic savings rates which were almost secularly declining since 1983, displayed clear signs of improvement for the first time.[31] This has resulted in impressive recovery of GDP growth, from a low of 2.7% in 1988 to 6.9 per cent in 1993. Most growth came from private manufacturing GDP, which grew at a rate of 7% per annum, while the export-GDP ratio increased sharply from 21% in 1988 to 27% in 1993.

Over the entire period of 1989-97, the average annual GDP growth was 5.4% which was considerably higher than that observed under the inward-looking policy regime. While the observed growth rate was about the same recorded during the first wave of reform, it was achieved on a firmer macroeconomic basis.

There are, however, a number of bottlenecks surfaced during the period that undercut the potential gains from economic reform, retarding long-term investment and growth.

(Dunham and Kelegama 1997a) also served the breeding ground of subsequent political instability, undercutting the reform process itself.

[29] Apart from privatisation (which was termed "peoplization" by the new government), a range of export incentives were provided to promote export-led industrialization, and for attracting direct foreign investment. The latter, however, have had very limited success, being assessed in the order of 1% of GDP.

[30] Majority shareholdings of 35 state-owned enterprises were divested and a further 30 were in various stages of divestiture. Because of this measure, the share of public sector in GDP had seen a marked decline.

[31] Investment rate—mainly driven by private investment—increased from 22.5% in 1988 to 24% in 1993. Similarly, domestic savings rate increased from 12 % to 15.5% during the same period.