

## Chapter 2

# South Asia: A Macro Overview

### 2.1 Introduction

South Asia consists of eight countries—Afghanistan, Bhutan, Bangladesh, India, Maldives, Nepal, Pakistan, and Sri Lanka. These countries share social, cultural, linguistic, and economic practices. India is the largest country in the South Asian region by land area, population, and economy; Pakistan and Bangladesh are the second and third largest countries, respectively. India occupies over 70 % of the landmass of the region. Its territorial and maritime boundary touches all South Asian countries except Afghanistan. Bhutan and Nepal are landlocked; Maldives and Sri Lanka are island states.

South Asia has contributed significantly to the world population—mainly dominated by India—and has the world's largest working age population. The World Development Report 2012 estimates the world economy at US\$75,803 billion in terms of purchasing power parity (gross national income). South Asia's share is \$5,103 billion. The compositional analysis of output for South Asian economies in 2012 reveals that the services sector (55 %) dominates industry (27 %) and agriculture (18 %).

Most countries in South Asia were under British rule and won independence only between 1945 and 1950. After independence, like most developing economies, South Asia adopted closed macroeconomic policies with import substitution (IS) industrialisation policies to varying degrees, under which self-reliance and indigenous efforts were encouraged.<sup>1</sup> This is because South Asia's economic policy after independence was influenced by the colonial experience—which many

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<sup>1</sup> The Prebisch–Singer thesis—of the secular deterioration of terms of trade—for developing countries drew their attention. Developing countries had learned from developed countries that they needed to orient their economies towards industrialisation to improve their terms of trade. Accordingly, they designed IS policies to protect all sectors of the economy. This meant high tariffs and various forms of licensing to control entry into domestic 'infant' industries and increase savings, foreign exchange savings, and investment (Dornbusch 1992).

leaders considered exploitative—and by those leaders' exposure to British social democracy and the progress achieved by the Soviet Union's planned economy. Domestic policy tended towards protectionism. There was strong emphasis on import substitution industrialisation, economic interventionism, a large public sector, business regulation, and central planning. Trade and foreign investment policies were relatively liberal. For instance, the five-year plans of India resembled central planning in the Soviet Union. At the same time, the state was assigned a dominant role in the economy, particularly in the infrastructural sectors of communications, transport, and power (Srinivasan 2002). These import substitution strategies, coupled with the large public sector, resulted in rent-seeking activities<sup>2</sup> and uncompetitive production processes (Bhagwati and Srinivasan 1975).

India allocated imports on the basis of firm capacity, which led to rent seeking through capacity expansion (Krueger 1974). But the dominance of the public sector and of the licence-based system might have hampered the full swing of competition under the IS policy and thereby made the economy relatively uncompetitive. A select group of individuals and companies accumulated illicit wealth through political patronage, favouritism in appointments and award of contracts, tax evasion, acquisition of state and private land, allocation of public resources such as spectrum, mining rights of oil, and gas concessions—to the detriment of the larger population. The growing trend of alliances between public office holders, bureaucrats, and big businesses in South Asian countries has caused large-scale corruption and, consequently, frustration, resentment, and disenchantment among the middle classes, which in turn threatens the policies that unleashed the potential of South Asian countries. With the exception of Sri Lanka, which had undertaken significant liberalisation in the late 1970s, anti-trade policies remained dominant in the region for nearly four decades.

The IS policy severely affected economic performance in the South Asian region, which was among the slowest-growing regions in the 1960s and 1970s. As per the World Bank database, GDP grew at 4.2 % per year in the region during the 1960s; world GDP grew at 5.4 %. However, since the early 1980s, liberalisation efforts have been made and deregulation aimed at eliminating incentives for rent-seeking activities.

The decade-wise growth of South Asian economies has been very impressive—over 5 % during 1980–2000 and around 7 % over 2001–2010. Growth has averaged around 6 % per annum over the past two decades. Real GDP growth in the region is forecast to be a little over 5.5 % for the financial year 2012 and improve thereafter. This strong growth has lowered poverty and improved human development. Yet, poverty remains widespread—more than 500 million people in South Asia live on less than \$1.25 a day.

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<sup>2</sup> See Krueger (1974) for rent-seeking activities in India.

East Asian economies performed poorly in the 1960s. Beginning in the mid-1970s and until the 1990s, their exports and economy grew.<sup>3</sup> This persuaded policymakers to liberalise trade and investment.<sup>4</sup> The literature holds that important ideological factors for change in this region were the collapse of the former Eastern Europe bloc and the transformation of former socialist planned market economies (Bandara and McGillivray 1998; Tendulkar and Bhavani 2007). In the second half of the 1980s, trade policies began to be unilaterally liberalised; such liberalisation became more systematic in the 1990s.

The outcomes of the reform measures are broadly positive. South Asian countries have achieved higher per capita income growth, trade growth, and investment growth in the reform period.<sup>5</sup> The present chapter briefly reviews economic reforms and economic performances of five major South Asian countries. This chapter is structured as follows. Section 2.2 discusses the economic reforms in South Asia. Section 2.3 reviews economic performances of South Asian countries. Section 2.4 deals with major issues or difficulties to growth.

## 2.2 Economic Reforms in South Asia: Country-wise Analysis

During the 1970s, South Asian countries faced various economic challenges—low level of economic growth and per capita income, growing fiscal imbalances, balance of payments problem, and declining foreign exchange reserves (Bandara and McGillivray 1998; Tendulkar and Bhavani 2007; Rodrik and Subramaniam 2004). During the 1980s, South Asian economies realised that the inefficiency in their economic system arose from their closed-door policy and rent-seeking activities and began reforming their economy, including trade and finance. In the 1980s and 1990s, the region learned from many developed and emerging economies and moved away from a purely socialistic model of development—based on the planned model—and adopted market reforms to make the business environment in South Asia congenial and to integrate with the rest of the world.

Except in Sri Lanka, which began market reforms in the late 1970s, the pace of reforms in India, Pakistan, and Bangladesh accelerated only in the 1990s. The reform process in all these countries followed the so-called Washington Consensus

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<sup>3</sup> During 1981–1991, GDP grew annually at 9.1 % in the Republic of Korea, 5.7 % in Malaysia, and 8.2 % in Thailand; exports of goods and services grew annually at 11.3, 11.8, and 15.5 %, respectively. The 1997–1998 economic crisis reduced GDP and export growth in the 1990s. During 1991–2001, GDP grew annually at 5.4 % in the Republic of Korea, 6.1 % in Malaysia, and 3.2 % in Thailand; exports grew annually at 15.9, 10.5, and 8.5 %, respectively.

<sup>4</sup> The empirical evidence from recent literature suggests that the potential gains from trade liberalisation are substantial (e.g. Francois et al. 2003; Laird et al. 2003).

<sup>5</sup> All these countries have major socio-economic problems like poverty, unemployment, income inequality, and regional imbalances, and all are dependent on external aid/assistance.

of the IMF and World Bank. However, and naturally, the relative emphasis on the components of the reform agenda differed. Although the reform process in South Asia is gradualist and incomplete, economic performance has been impressive overall. The following section gives a brief overview of the reform process in each of the countries.

Overall, the reforms followed in South Asian countries<sup>6</sup> can be divided into two parts: domestic reforms and external sector reforms.

On the domestic front, the agenda included:

- Fiscal reforms<sup>7</sup>
- Disinvestment and privatisation of state-owned enterprises (SOEs)
- Privatisation and opening up sectors to private sectors
- Financial sector reforms leading to deregulation of interest rates
- Development of infrastructure
- More generally, enhancing the role of market forces in the economy's resource allocation processes (Srinivasan 2002; Rodrick and Subramanian 2004)

The external sector reforms included:

- Removing import-weighted average tariffs
- Abolishing quantitative restrictions on imports
- Exchange rate reforms
- Easing capital flow
- Allowing FDI gradually

On the South Asian regional front, the movement towards the regional economic integration from the South Asian Association of Regional Cooperation (1985) to South Asian Preferential Trade Agreements (1995) to South Asian Free Trade Agreement (2004) witnesses the higher level of intra-regional trade liberalisation and economic cooperation among the member countries.

## ***2.2.1 Economic Reforms and Developments in India: A Brief Review***

### **2.2.1.1 Overall Policy Reforms**

India's growth experience had invited the serious attentions of policymakers, as the economic growth averaged a modest 3.6 % and per capita growth of meagre 1.4 % per year during 1950–1980. The poor economic performance was considered an

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<sup>6</sup> Here we are only focusing on five South Asian countries such as India, Pakistan, Bangladesh, Sri Lanka, and Nepal.

<sup>7</sup> Fiscal reforms include rational tax reforms such as rationalisation and simplification of tax rates and slabs, debt management policy, and fiscal consolidation.

outcome of state-led import substituting industrialisation (Ahluwalia and Little 1998; Joshi 1998; Acharya 2009). In the late 1970s, India suffered from a grossly overvalued exchange rate because of tight import controls as well as a varied, but generally very high, tariff structure. There was a consensus that quantitative restrictions on imports were dysfunctional and should be phased out. In addition, tariffs had to be reduced over time, and the exchange rate had to be devalued to provide incentives for domestic production as tariffs were cut. The 1980s saw some partial steps to address this problem. The exchange rate was managed in a way that achieved a steady depreciation in real terms, eroding the impact of quantitative restrictions. There was also some limited relaxation in quantitative restrictions but little progress on tariffs. In fact, where quantitative import licensing was reduced, tariffs were actually raised to shift from quantitative restrictions to tariffs.

Economic reforms started in the early 1980s. In July 1991, in the middle of a crisis of balance of payments and foreign exchange liquidity, a comprehensive liberalisation and privatisation process started. Import licensing was abolished for capital goods and intermediates, which became freely importable in 1993, simultaneously with the switch to a flexible exchange rate regime. In 1991, the fixed exchange rate was devalued by 25 % (in two successive steps) to a more reasonable level. Since import controls were to be liberalised, it was logical to shift to a system that allowed greater exchange rate flexibility. This was done in two stages. In 1992, a dual exchange rate was introduced. There was one fixed rate, at which exporters were expected to surrender 30 % of export earnings. This was used to finance essential imports such as petroleum and to meet government debt servicing obligations. And there was a floating rate, at which all other transactions took place based on the demand and supply of foreign exchange. In 1993, the dual exchange rate was replaced by a single exchange rate, which was effectively market-determined. Quotas and nontariff barriers were also reduced. Since then, there have been attempts to integrate the Indian economy with the rest of the world in a variety of ways—removing quantitative restrictions,<sup>8</sup> reducing tariffs,<sup>9</sup> and making the exchange rate flexible.<sup>10</sup>

Starting in February 1994, many current account transactions were also permitted at the market exchange rate. The pace of reforms gathered momentum over the period 1991–1996 when controls over trade were relaxed extensively. Some of the major reform measures included:

- Reduction of the fiscal deficit
- Flexible exchange rate system
- Phased reduction of import licensing (quantitative restrictions)
- Policies to encourage direct and portfolio foreign investment
- Build-up of foreign exchange reserves

<sup>8</sup> In 2001, quantitative restrictions, which were in place for most consumer goods, were abolished.

<sup>9</sup> India has reduced tariffs considerably—from 35.3 % in 1997–1998 to 20 % in 2003–2004.

<sup>10</sup> The exchange rate system was transformed in less than 2 years from a discretionary, basket-pegged system to a largely market-determined unified exchange rate.

- Virtual abolition of industrial licensing and promoting more competition
- Freer access to foreign technology
- More remunerative procurement prices for cereals
- Reduction in protection to the manufacturing sector
- Phasing in of Basel prudential norms
- Reduction of reserve requirements for banks (CRR and SLR)
- Deregulation of interest rates and setting up of institutions like SEBI and NSE (Rodrick and Subramanian 2004; Ahluwalia and Little 1998; Joshi 1998; Tendulkar and Bhavani 2007; Acharya 2009)

Recently, India has taken several steps to enhance its economy's growth, including:

- Initiating the process of enhancing the scope of the Fiscal Responsibility and Budget Management Act,<sup>11</sup> 2003
- Announcing the New Manufacturing Policy
- Promoting more export-oriented units
- Allowing more foreign investment in retail sector
- Setting up the Financial Sector Legislative Reforms Commission

The reform process in India centred on fiscal reforms, trade and industry policy reforms, and financial sector reforms. A few major initiatives are explained below.

Fiscal profligacy was seen to have caused the balance of payment crisis in 1991 and a reduction in the fiscal deficit. Therefore, it was an urgent priority at the start of the reforms. The combined fiscal deficit of the central and state governments was reduced from 9.4 % of GDP in 1990–1991 to 7 % in both 1991–1992 and 1992–1993, and the balance of payment crisis was over by 1993. Reforms in industrial and trade policy were a central focus of much of India's early reform effort. Prior to the reforms, industrial policy was characterised by multiple controls over private investment. These controls allowed private investors to operate only in some areas and often determined operation scale, new investment location, and even technology. The industrial structure that evolved under this regime was highly inefficient and needed to be supported by a highly protective trade policy, often providing tailor-made protection to each sector of industry. Industrial policy has seen the greatest change, with most central government industrial controls being dismantled. Previously, only the public sector could operate in 18 industries, including iron and steel, heavy plant and machinery, telecommunications and telecom equipment, minerals, oil, mining, air transport services, and electricity generation and distribution. Now, only defence aircraft and warships, atomic energy generation, and railway transport are reserved for the public sector. Industrial licensing by the central government has been almost abolished, except for a few hazardous and environmentally sensitive industries. Previously, under the Monopolies and Restrictive Trade Practices Act, industrial houses needed clearance

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<sup>11</sup> Under this Act, the central government to eliminate revenue deficit by March 2009 and to reduce fiscal deficit to an amount equivalent to 3 % of GDP (0.3 % annually) by March 2008.

to make large investments. That requirement, to discourage the concentration of economic power, was abolished. The Act is to be replaced by a new competition law, which will attempt to regulate anticompetitive behaviour in other ways.

India's financial sector reform programme included early, wide-ranging reform in banking and capital markets.<sup>12</sup> Reforms in insurance were introduced later. Banking sector reforms included:

- Measures for liberalisation, like dismantling the complex system of interest rate controls, eliminating prior approval of the Reserve Bank of India for large loans, and reducing the statutory requirements to invest in government securities
- Measures designed to increase financial soundness, like introducing capital adequacy requirements and other prudential norms for banks and strengthening banking supervision
- Measures for increasing competition like more liberal licensing of private banks and freer expansion by foreign banks

These steps have produced some positive outcomes: the share of nonperforming assets in the portfolio has dropped sharply, and over 90 % of banks now meet the new capital adequacy standards.

### 2.2.1.2 External and Trade Reforms

Trade policy reform has also progressed, although slower than industrial liberalisation. Before the reforms, trade policy was characterised by high tariffs and pervasive import restrictions. Imports of manufactured consumer goods were completely banned. For capital goods, raw materials, and intermediates, certain lists of goods were freely importable. But for most items where domestic substitutes were produced, imports were possible only with import licences. The criteria for issue of licences were non-transparent; delays were endemic and corruption was unavoidable. The economic reforms sought to phase out import licensing and to reduce import duties (see Nataraj and Sahoo 2006a, b, 2007). Although India's tariff levels are significantly lower than in 1991, they remain among the highest in the developing world—because most other developing countries have also reduced tariffs in this period.

Liberalising norms for FDI was another important part of India's reforms. This was driven by the belief that this would increase the total volume of investment in the economy, improve production technology, and increase access to world markets. The policy now allows 100 % foreign ownership in a large number of industries and majority ownership in all except banks, insurance companies, telecommunications, and airlines. Procedures for obtaining permission were greatly simplified by listing industries that are eligible for automatic approval up to

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<sup>12</sup> Extensive financial sector liberalisation was started following Narasimham Committee Report in 1991.

specified levels of foreign equity (100, 74, and 51 %). Potential foreign investors investing within these limits only need to register with the Reserve Bank of India. For investments in other industries or for a higher share of equity than is automatically permitted in listed industries, applications are considered by a Foreign Investment Promotion Board with a record of quick decisions (see Chaps. 3 and 4 for details).

India has accumulated over US\$200 billion worth of foreign exchange reserves in recent years and freed many capital account transactions. In 2002, second-generation reforms focused on reducing the fiscal deficit, improving infrastructure, reforming labour laws,<sup>13</sup> and energising states to accelerate reforms.<sup>14</sup> Since 1991, India has also substantially liberalised trade in services. In 1999, foreign investment was allowed in the insurance sector. India raised its FDI limits in many important sectors including telecommunications, banking and insurance, and civil aviation.

India had committed to the WTO that it would remove all BOP-related quantitative restrictions in phases by the end of March 2001. Accordingly, it rationalised tariff rates during the 1990s. The maximum import duty rate on certain items before the 1990s was over 300 %. The peak import duty on nonagricultural imports was gradually reduced from 150 % in 1991–1992 to 10 % now (subject to certain exceptions). The government has continued to reduce applied MFN tariffs on nonagricultural products to meet its goal of reaching ASEAN tariff levels on these products by 2009. As a result, the overall average applied MFN tariff has fallen from over 32 % in 2001–2002 to less than 16 % in 2006–2007, widening the already large gap between the average tariffs for nonagricultural products (12.1 %) and agricultural products (almost 41 %). The use of import restrictions maintained under GATT Articles XX and XXI has declined; around 3.5 % of tariff lines are subject to such measures. Since 2002, India's use of antidumping and countervailing measures has declined, although it is still one of the largest users of these instruments (Nataraj and Sahoo 2006a, b, 2007).

### ***2.2.2 Economic Reforms in Bangladesh: A Brief Review***

Bangladesh was established in 1971. Its government followed an inward-oriented policy by nationalising all large manufacturing units and introducing various regulations and controls on the economy. From the early 1980s, the government began withdrawing food and agricultural subsidies, privatising SOEs, liberalising the financial sector, and withdrawing quantitative import restrictions (Ahmed 2002). These were a part of structural adjustment policies under the auspices of the World Bank and the IMF in the 1980s and early 1990s. The effort started with the

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<sup>13</sup> Domestic labour laws no longer apply to special economic zones (SEZs) in India.

<sup>14</sup> Rodrick and Subramanian (2004) distinguish the reforms of the 1980s and 1990s by describing the former as 'probusiness' and the latter as 'pro-market'.

World Bank structural and sectoral adjustment loans (SALs and SECLs) in 1980. The IMF introduced a 3-year structural adjustment facility (SAF) in 1986. Major reform initiatives were undertaken in agricultural, trade, fiscal, and industrial policy; the financial sector; public enterprises; and privatisation. These reforms gained momentum in the 1990s. The broader economic reforms are listed below.<sup>15</sup>

Agricultural policy reforms include:

- Liberalisation of input markets
- Curtailing the role of government agency in input distribution
- Deregulation of input prices
- Reduction of subsidies on agricultural inputs
- Liberalisation of agricultural import
- Liberalisation of output markets with producers' price incentive
- Gradual elimination of distribution of food at subsidised price
- Price stabilisation through procurement policy
- Liberalisation of import of food grain

Privatisation and public enterprise reforms include:

- Denationalisation
- Reduction of excess labour in SOEs
- Rationalisation of jute mills
- Improving operational performance of public utilities
- Privatisation of selected public manufacturing and commercial enterprises

Fiscal policy reforms include:

- Expand the base of the value-added tax (VAT)
- Reform personal and company direct taxes
- Strengthen the tax administration
- Adjust prices for public goods and services while improving their operational efficiency
- Limit the growth of current expenditures to less than the growth of nominal GDP
- Reduce subsidies and administrative costs
- Improve project aid utilisation
- Reduce the operating deficit of Bangladesh railway

Financial sector reforms include:

- Implementing reforms aimed at a market-oriented system of monetary management
- Privatisation of NCB and allowing banking in the private sector
- Interest rate liberalisation
- Strengthening commercial bank loan recovery programmes

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<sup>15</sup> A research proposal from the Institute of Development Environmental and Strategic Studies (IDESS), Understanding Economic Reform: A Case Study on Bangladesh.

Bangladesh's economy has grown in the past decade despite the global volatile environment. It is considered that the growth is due to prudent macro fiscal and monetary policies. Recently, the government has prioritised high growth by formulating policy to:

- Reduce infrastructural deficit
- Implement massive reform in priority sectors such as education, health, social security and welfare, ICT, and public financial management<sup>16</sup>

Trade and industrial policy reforms include:

- Reduction of maximum tariff rates
- Rationalisation and simplification of the tariff structure
- Elimination of quantitative restrictions on imports
- Simplification of industrial regulations

Bangladesh substantially reduced tariff and nontariff barriers starting from the mid-1980s. It became one of the fastest liberalisers in the region (World Bank 1999). The country reduced tariff slabs from 24 in 1986 to 12 by 1993–1994, 6 by 1996–1997, and 4 by 2005–2006. It reduced the maximum tariff rate from 350 % in 1991–1992 to 50 % in 1995–1996, 42.5 % in 1997–1998, and 25 % in 2005–2006. As a result, the average tariff protection fell from 89 % in 1990–1991 to 25 % in 1995–1996, 22 % in 1999, and 17 % in 2003. Other major reforms included further relaxation of restrictions on private investment, financial liberalisation with deregulation of interest rates, and fiscal reforms including the introduction of the value-added tax and reduction in subsidies (World Bank 1997).

Political uncertainty in recent years in Bangladesh has constrained economic growth and reform, especially in governance. Whether political priorities will be dictated by economic motives is an open question.

### ***2.2.3 Economic Reforms in Pakistan: A Brief Review***

During 1960–1980, Pakistan's economy grew at almost 6 %—better than other South Asian economies. The performance is mainly attributable to widespread initiatives by the private sector, sound economic management, substantial capital inflows, etc. Also, the economy moved towards liberalisation, deregulation, and privatisation during 1980. But, in 1990, the economy faced major challenges—stagnant tax-to-GDP ratio, double-digit inflation, low levels of investment, deteriorating infrastructure, poor social sector indicators, and poor governance of institutions—and could not sustain its high growth trajectory.

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<sup>16</sup>Ministry of Finance, Government of Bangladesh, Bangladesh: Sustaining Growth Amidst Adverse External Environment.

Given the problems of macroeconomic fundamentals, the economy introduced major structural reforms in the agricultural, industrial, external, and financial sectors. The agricultural sector reforms included enhanced availability of water and its efficient use, more market-based environment for input and output prices, providing physical infrastructure and support for research and extension work, and improving farm-to-market links. Other reforms were allowing foreign equity participation up to 100 %, liberalising the foreign exchange regime and import policy, convertibility of rupee on current account, and removing quantitative and nontariff barriers. On the financial front, monetary management was reformed and changed to a market-based system. It included abolition of credit ceilings and credit deposit ratios, phasing out of directed and concessionary credit, removing of caps on interest rate, and initiation of auction of public debt (Mahmood 1999; Mahmood et al. 2008). Notably, there was a general reduction of direct regulation of prices, greater dependence on the market for resource allocation, and a reduction in the public ownership of the means of production in favour of the private sector, via denationalisation and privatisation of manufacturing units and banks (Mahmood 1999).

Financial sector reforms in Pakistan were also initiated early in the 1990s when private domestic banks were allowed to set up shop along with the nationalised commercial banks. Further reforms were undertaken since 1999 when nonperforming loans were tackled in a decisive manner and minimum capital requirements raised (Hussain 2004). Although several reform measures were carried out prior to 2001, the economic reform programme had its formal genesis in 2001—when Pakistan signed a 3-year arrangement with IMF under the Poverty Reduction and Growth Facility (PRGF) programme. Since then, eight programme reviews have been completed successfully. The key to restoring growth has been the authorities' determined implementation of sound financial policies and structural reforms including tax reform, financial sector reform, investment policies including FDI policy, and enterprise reform. These policies have reduced distortions and increased efficiency and lifted uncertainty off the future course of economic policies.

Pakistan's economy is in a crisis. Pakistan's central bank has expressed concerns over increasing government borrowing, inflationary pressure, lack of government interest in economic reform, and reduced export competitiveness, which in the medium term might impact the ability to earn foreign currency for spending on directly needed imports.

Like other countries in South Asia, Pakistan undertook limited reforms in the 1980s. Since the mid-1980s, Pakistan has considerably liberalised its trade regime and rationalised its tariff structure. Quota restrictions were removed in the 1980s and the restricted list in the 1990s. During 1983–1984 to 1993–1994, 724 items were removed from the negative list. As part of the IMF structural adjustment programme and ADB commitments, Pakistan reduced its maximum tariff rate from 125 % in 1989–1990 to 45 % in 1997 and to 25 % in 2007. Many other reforms accompanied trade and foreign investment reform.

Pakistan needs some reforms immediately: reducing government expenses and stopping unchecked hiring in public sector organisations, reducing internal and external debt, checking inflation, improving employment opportunities, and

providing the private sector a competitive market to play its role in national development. The challenge might be to bring political parties on a common ground for economic reform and improve the government's willingness and capacity to deal with such issues.

### ***2.2.4 Economic Reforms in Sri Lanka: A Brief Review***

In Sri Lanka's economic history, the 1970–1976 period is considered the worst phase and popularly called the closed economic period, or a trade-restricted period, or a period of socialist orientation. In 1971, Sri Lanka experienced its lowest ever growth rate—0.2 %. In 1977, Sri Lanka became the first among all South Asian economies to open up its economy to the outside world; it remains one of the most outward-oriented economies in the region.<sup>17</sup> The first round of reforms during 1977–1979 included significant trade and financial reform, a public enterprise privatisation programme, exchange rate realignment, and incentives for nontraditional exports (Athukorala and Jayasuriya 2004). The dual exchange rate system, which had been in operation since 1968, was abolished, and the new uniform rate was placed under a managed float. The other elements of the macroeconomic policy mix included significant interest rate reform and a number of measures to ensure fiscal prudence. During the 1980s, the second wave of liberalisation was initiated with a major reduction in import tariffs. The Fiscal Management Responsibility Act, approved in 2002, established the objective of reducing the budget deficit to 5 % of GDP by 2006. Current applied tariffs for most goods range between zero and 15 %; the tariff is 30 % for agricultural and food products, consumer goods, chemicals, and other intermediate goods. Further, Sri Lanka requires the least import documentation in the region.

In addition, Sri Lanka's investment regime is relatively open to foreigners, with a few exceptions—where investment either is subject to non-automatic approval or is reserved for Sri Lanka nationals. Full foreign ownership is permitted in banking, insurance, finance, construction, mass transportation, telecommunications and information technology, and petroleum distribution (TPR 2010).

Despite a brutal civil war that began in 1983, economic growth has averaged around 5 % in the last 10 years. Due to the global recession and escalation of violence during the final stages of the war, GDP growth slowed to 3.5 % in 2009 and foreign reserves fell sharply. 'Mahinda Chintana' (Mahinda's Thoughts) guides government economic policy. Mahinda Chintana policies focus on poverty alleviation and steering investment to disadvantaged areas, developing the small and medium enterprise (SME) sector, promoting agriculture, and developing Sri Lanka to become the regional hub of ports, aviation, commerce, knowledge, and energy. The government has developed a 10-year development framework to boost

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<sup>17</sup> Its trade as a percentage of GDP (more than 40 %) is the highest in South Asia.

growth through a combination of large infrastructure projects. Sri Lanka's economy is pursuing its post-war resurgence and is expected to grow strongly in the immediate term. It is all set to enact important policy reforms to reach its full economic potential. Sri Lanka has set the goal of improving its business climate but must follow through with reforms to decrease bureaucratic red tape; increase transparency, particularly in government procurement; and increase the predictability of government policies. Sri Lanka must also continue to improve its fiscal discipline. The 26-year conflict and high government expenditure have contributed to Sri Lanka's high public debt load (83 % of GDP in 2009).

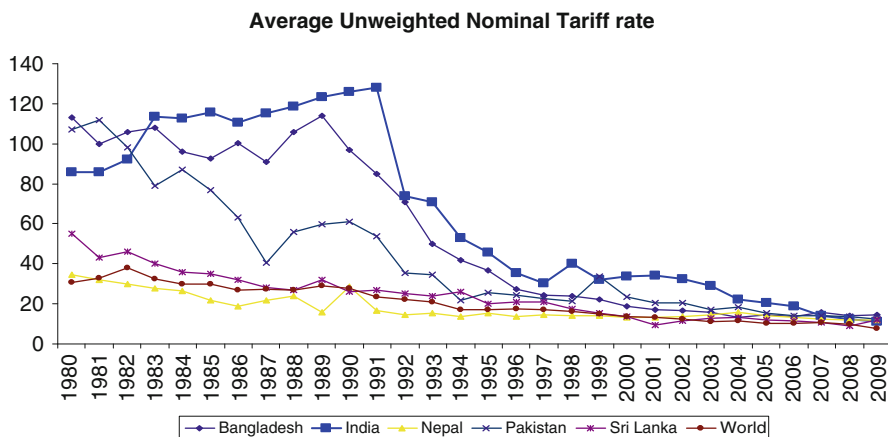
## ***2.2.5 Reforms in Nepal: A Review***

Until the 1980s, the economy was guided through industrial licensing and commercial, fiscal, and financial and foreign exchange regulation policies. After three consecutive years of BOP deficit (1982–1983 to 1984–1985), Nepal went for the SAF programme with the IMF in 1986 for 3 years along with the structural adjustment loan (SAL) programme of the World Bank and initiated most of its economic reforms. It has carried out various components of economic reform policies including fiscal, trade, and FDI policies during the past decade.

Nepal also initiated financial sector reforms: removal of entry barrier, enactment of Finance Companies Act 1985 and its amendment in 1992, abolition of pre-emption of bank resources in the form of statutory liquidity requirement, and establishment of prudential norms of the Basel Accord. Reforms in the conduct of monetary policy are also carried out. In the reform process, all types of subsidies including fertiliser, irrigation, food transportation, and interest were completely withdrawn. Nepal completed its accession to the WTO and became the 147th member in April 2004. Now, Nepal is among South Asia's most open and trade-dependent economies.

### **2.2.5.1 External Sector Reforms**

Quantitative restrictions on imports have been fully removed. Customs duties have been rationalised and substantially reduced. As a result, trade-weighted nominal rate of protection indicates a substantial fall in protection, from about 80 % in the mid-1980s to about 40 % by 1993–1994 and further to around 15 % by 2007–2008. Reforms have also been executed on the foreign exchange front. The Nepalese rupee is fully convertible on the current account and capital account is partially liberalised. As a result, Nepal obtained the status of IMF Article VIII in 1994.



**Fig. 2.1** Unweighted average nominal tariff rate (%) (Source: Author's compilation from various sources)

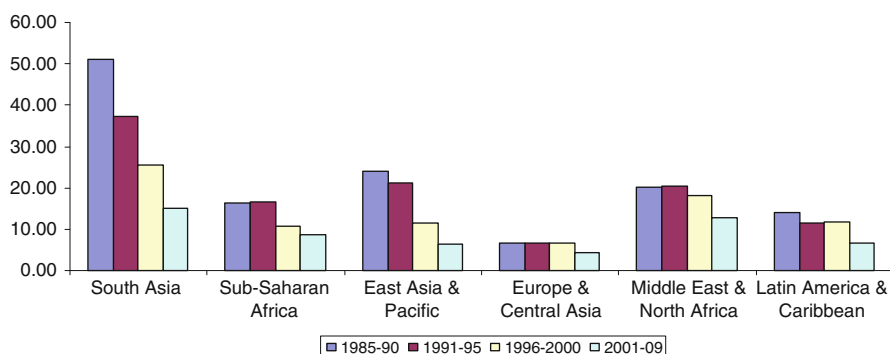
Overall economic reforms, particularly external sector reforms, have been significant in reducing trade/import barriers in South Asia. This is indicated in reduction in both unweighted nominal tariff rate<sup>18</sup> and average applied tariff rate<sup>19</sup> (reference). Unweighted nominal average rate across South Asian countries varied considerably during the 1980s and 1990s but declined since the mid-1990s following widespread trade liberalisation and reduction in tariff rate. During the 1980s and 1990s, India and Pakistan had a higher nominal tariff rate than other South Asian countries; recently, the unweighted average tariff rate has been converging among South Asian countries (Fig. 2.1). This shows that the South Asian region has been slowly integrating with world economy.

Similarly, the average applied tariff rate which was close to 50 % (highest in the world) during 1985–1990 in South Asia has fallen to average 15 % during 2001–2009. Compared to other regions, applied tariffs in South Asia are still high. Even sub-Saharan Africa has lower tariff protection for domestic industry. Europe and Central Asia have the lowest tariff protection compared to other regions. Therefore, tariffs in South Asia can be reduced further (Fig. 2.2).

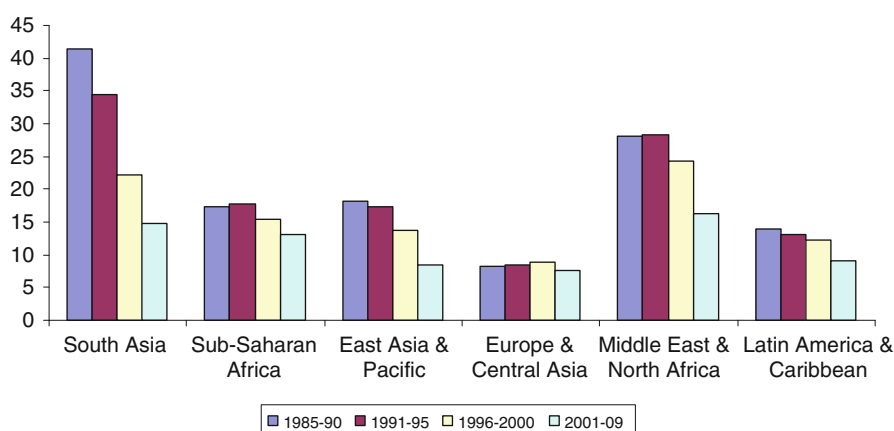
Similarly, the trends in applied tariff rate, most favoured nation (MFN) also has come down significantly from around 45 % in 1985 to around 14 % in 2009 (Fig. 2.3). However, among South Asian countries, Sri Lanka and Nepal have the lowest average MFN tariff rates in the region (WTO 2012).

<sup>18</sup> The unweighted average tariff is a measure of the overall degree of protection in the tariff schedule. It is a useful overall measure but can disguise very high protection levels in some sectors. The tariff is defined as a percentage, so the average can range from 0 to  $\infty$ .

<sup>19</sup> The average applied tariff rate is the unweighted average of effectively applied rates for all products subject to tariffs calculated for all traded goods.



**Fig. 2.2** Average applied tariff rate, all products (%) (Source: World Development Indicators 2011)

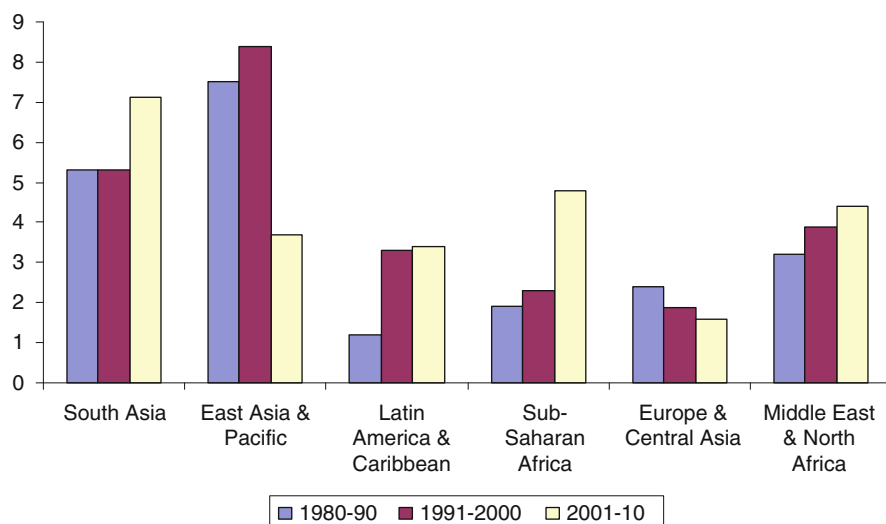


**Fig. 2.3** Average applied tariff rate MFN, all products (%) (Source: World Development Indicators 2011)

## 2.3 Macroeconomic Performance of South Asian Countries

Evidently, all five South Asian countries have been consistently following economic reform policies that emphasise the market economy and integrate their economies with the rest of the world. This section reviews the economic performance of South Asian countries vis-à-vis other regions over 1980–2010.

South Asian economies enjoyed rapid growth from 1990 until the onset of global financial crisis in 2008. The growth rate improved steadily and was the highest in the world for 2000–2010 (Fig. 2.4). During the 1980s and 1990s, East Asia and Asia Pacific had higher GDP growth than other regions. South Asia was the second highest growing region. But during the 2000s, the trend reversed in favour of South Asia. As shown, during the period 2000–2010, South Asia increased their GDP



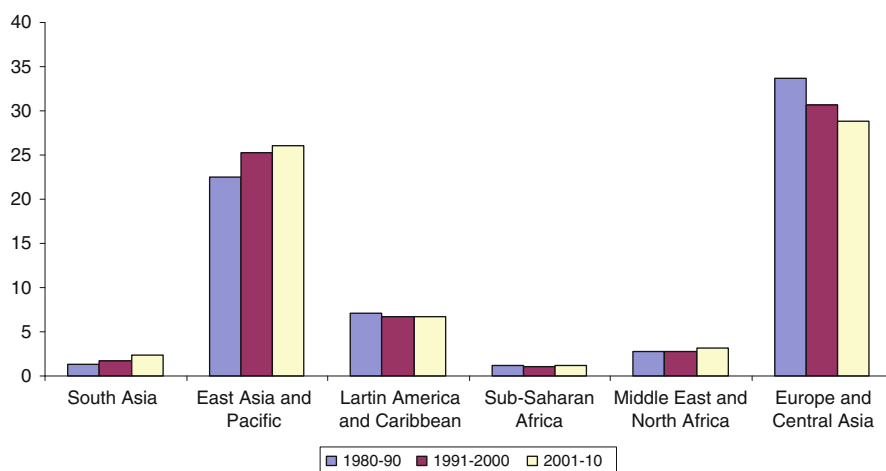
**Fig. 2.4** Decade-wise annual average growth rate across regions (*Source: World Development Indicators, World Bank 2011*)

growth rates by roughly 2 percentage points per more than in the 1980s or 1990s. Indeed, South Asia grew more rapidly than any other region during 2000–2010.

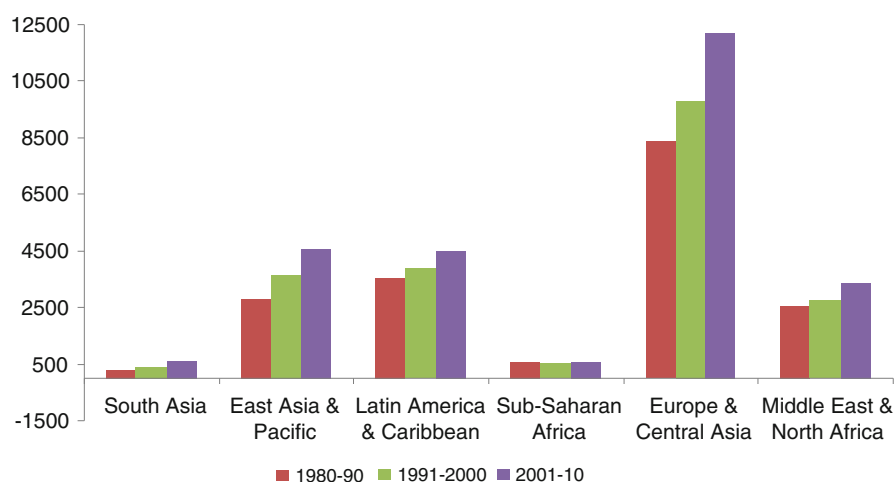
Due to higher growth in the 1990s and 2000s, South Asia's share in world GDP has increased from a meagre 1.4 % during the 1980s to 1.7 % during the 1990s and further to 2.4 % in the 2000s. Still, South Asia's share has been lower than other regions'—except for sub-Saharan Africa, whose share has been constant over 1980–2010. On the other hand, the share of Europe and Central Asia has declined steadily over time. East Asia and Pacific countries have increased their GDP share from 22 % in the 1980s to 26 % in the 2000s (Fig. 2.5).

Although South Asia is now one of the fastest-growing regions in the world, its per capita income is one of the lowest (except that of sub-Saharan Africa) but increasing over time. Comparative figures of per capita income across region (at US \$2000 price) are presented in Fig. 2.6. It is evident that real per capita income for South Asia increased from around US\$290 in the 1980s to US\$390 in the 1990s and further to US\$600 in the 2000s. Europe and Central Asian countries are ranked first, and Latin America and Caribbean are second; they are followed by East Asia and Pacific regions. Per capita income in sub-Saharan Africa has stagnated.

Notwithstanding significant economic reforms, the global competitiveness of South Asian countries is low. According to the Global Competitiveness Report 2010–2011, the rank of India, Pakistan, Sri Lanka, Bangladesh, and Nepal out of 139 countries is 51, 123, 62, 107, and 139, respectively (Table 2.1). Similarly, they have performed poorly on infrastructure, institutional development, and labour market efficiency. Therefore, the region needs to implement a few quick reforms in the coming years to sustain its growth.



**Fig. 2.5** GDP share, across regions (*Source:* World Development Indicators, World Bank 2011)



**Fig. 2.6** Per capita income level across various regions (at US\$2000 price) (*Source:* World Development Indicators, World Bank 2011)

**Table 2.1** Global competitiveness ranking of South Asian Countries 2010–2011

| Indicators                   | India | Pakistan | Sri Lanka | Bangladesh | Nepal |
|------------------------------|-------|----------|-----------|------------|-------|
| GCI                          | 51    | 123      | 62        | 107        | 130   |
| Institution                  | 58    | 112      | 55        | 115        | 130   |
| Infrastructure               | 86    | 110      | 70        | 133        | 139   |
| Labour market efficiency     | 92    | 131      | 104       | 108        | 126   |
| Financial market development | 17    | 73       | 52        | 66         | 106   |

*Source:* Global Competitiveness Report 2010–2011, World Economic Forum

### ***2.3.1 Macroeconomic Performances of India***

The World Bank (2011) ranks India second in the world in terms of both population (1.17 billion) and arable land (12 %). In 2010, India was ranked the eighth largest economy in terms of real GDP (US\$963 billion) and ninth in terms of nominal GDP (US\$1,727 billion) (World Bank 2011). It is also the fourth largest economy in the world with respect to the purchasing power parity (PPP). India is expected to be the third largest economy by 2035 and the second largest economy by 2050 (Goldman Sachs 2007).

India is the largest economy in South Asia in terms of both GDP and population. The GDP share of India in South Asia increased from 73 % in the early 1990s to over 78 % in the late 2000s. This is because India was the fastest-growing economy during the 1990s and 2000s in South Asia. India's average economic growth, which was 5.5 % in the 1980s, increased to 6.5 % during 1995–2000 and further to nearly 9 % in the last half of the 2000s. As a result, average real GDP of India (at 2000 price US\$) increased from US\$291 billion during 1990–1994 to US\$797 billion over 2005–2010. Similarly, average per capita income in US dollar almost doubled during the same time (Table 2.2). Therefore, economic growth has been substantial in India in the reform period.

The industrial and services sectors were the main drivers of growth in India, particularly in the 1990s and 2000s. The agricultural sector grew at 5.8 % during the first half of the 1980s, declined to just 1.8 % during 2000–2004, and then bounced back to 3.6 % in the last half of the 2000s. Therefore, the agricultural sector growth rate remained most volatile over 1980–2010.

Comparatively, industrial performance improved steadily, except in the first half of the 1990s. Industrial growth rate which was 5.3 % in the first half of the 1980s increased to 6.2 in the second half of the 1990s and further to 8.8 % in the second half of the 2000s. On the other hand, the services sector growth follows the industrial growth trend. The results of this performance had a significant bearing on the sectoral contribution to GDP. The agricultural sector's contribution to GDP declined gradually in the previous three—from 33.92 % in the first half of the 1980s to 26.2 % in the last half of the 1990s and further to 17.84 % in the last half of the 2000s. However, the industrial sector's contribution to GDP remained more or less constant over 1980–2010. Similarly, the manufacturing value added as a percentage of GDP stagnated, at roughly 16 % over the past three decades. On the other hand, the declining contribution by the agricultural sector is replaced by increased contribution from services sector (Table 2.2).

Further, both domestic savings and capital formation as a percentage of GDP rose over 1980–2010. The gross capital formation as a ratio of GDP increased from around 20.6 % in the early 1980s to above 35.7 % in the last half of the 2000s. Domestic savings also show a similar pattern. However, it is important to notice that the savings–investment gap has also widened during the 2000s, compared to the 1980s and the 1990s. On the fiscal front, India has not done well. Both inflation rates (CPI) and fiscal deficit have remained high, although the inflation rate was

**Table 2.2** Key macroeconomic indicators for India

| Indicators                                    | 1980–1984 | 1985–1989 | 1990–1994 | 1995–1999 | 2000–2004 | 2005–2010 |
|-----------------------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|
| Population (in millions)                      | 718.47    | 798.77    | 882.78    | 965.51    | 1,048.23  | 1,132     |
| GDP growth (%)                                | 5.47      | 5.91      | 4.70      | 6.55      | 5.94      | 8.53      |
| GDP (2000 constant US\$, billion)             | 175       | 227       | 291       | 392       | 516       | 797       |
| Share in South Asia (%)                       | 73        | 73        | 73        | 75        | 76        | 78        |
| Per capita GDP (2000 constant US\$)           | 238       | 276       | 319       | 391       | 473       | 673       |
| Agriculture, growth rate (%)                  | 5.8       | 3         | 3.3       | 3.1       | 1.8       | 3.6       |
| Agriculture, value added (% of GDP)           | 33.92     | 30.06     | 29.07     | 26.20     | 21.46     | 18.3      |
| Industry, growth rate (%)                     | 5.3       | 6.3       | 5.2       | 6.2       | 6.8       | 8.8       |
| Industry, value added (% of GDP)              | 25.50     | 26.36     | 26.29     | 26.60     | 26.44     | 27.90     |
| Manufacturing, value added (% of GDP)         | 16.64     | 16.49     | 16.17     | 16.41     | 15.30     | 15.33     |
| Services, growth rate (%)                     | 5.5       | 7.4       | 5.7       | 8.9       | 7.6       | 10.2      |
| Services, value added (% of GDP)              | 40.58     | 43.58     | 44.64     | 47.20     | 52.10     | 53.59     |
| Gross domestic capital formation (% of GDP)   | 20.6      | 23.17     | 22.93     | 24.2      | 26.6      | 35.7      |
| Gross domestic savings (% of GDP)             | 18.30     | 21.52     | 22.44     | 22.82     | 25.39     | 31.8      |
| Inflation (%)                                 | 10.51     | 7.83      | 10.24     | 8.85      | 3.93      | 8.00      |
| Fiscal deficit (% of GDP) <sup>a</sup>        | NA        | -7.81     | -7.62     | -7.29     | -9.29     | -6.70     |
| Current account balance (% of GDP)            | -1.13     | -2.06     | -1.37     | -1.24     | 0.45      | -1.71     |
| Total forex reserves in months of imports     | 5.96      | 4.89      | 4.06      | 5.50      | 9.50      | 8.96      |
| Trade over GDP (%)                            | 14.51     | 13.42     | 18.34     | 23.49     | 30.31     | 45.87     |
| Manufacturing exports (% merchandise exports) | 54.2      | 68.8      | 74        | 75.8      | 74.4      | 64.3      |
| Short-term debt (% of total reserves)         | 28.6      | 60.9      | 70.6      | 18.4      | 6.20      | 14.3      |

Source: World Development Indicators, World Bank 2011

<sup>a</sup>International Monetary Fund, Economic Outlook

lower during the first half of the 2000s. The rate of inflation reached its lowest level in the first half of the 2000s (3.93 %) and increased to 8 % in its last half (Table 2.2).

On the external front, the performance is mixed. Trade as a ratio of GDP has increased steadily from around 14 % in the 1980s to over 45 % during 2005–2010. Similarly, the total foreign exchange reserve in terms of months of imports has also increased steadily from around 5 months in the 1980s to over 8 months during the 2000s to over a year now. However, current account deficit as a ratio of GDP has been negative and deteriorated during the last half of the 2000s. The growth experience of India's economy over the past few decades has been well elaborated with great economic insights by prominent studies like Ahluwalia (2002), Panagariya (2004), Virmani (2004), Bosworth et al. (2007), and Acharya (2009), among others. Most of the studies have highlighted the positive impact of economic reforms, which has led to dent poverty levels; a few have lamented India's gradualist approach to reforms and delay in implementing the reform measures announced.

### 2.3.2 *Macroeconomic Performance of Pakistan*

Pakistan is the second largest economy and second populous country in South Asia. In terms of population, Pakistan is the sixth largest country in the world, and it is the second largest Muslim country after Indonesia. Pakistan's GDP (at 2000 price) increased from around \$32 billion in the first half of the 1980s to \$106 billion during the last half of the 2000s. In 2010, Pakistan's economy was the 47th largest in the world in nominal terms and 27th largest in PPP terms.

The GDP share of Pakistan in South Asia increased from 13 % in the early 1980s to over 14 % in the first half of the 1990s; it declined to 11 % during 2005–2010. Economic growth was better in the 1980s than in the 1990s or 2000s. The GDP growth rate in Pakistan was 7.3 % during 1980–1984 but 3.41 % in the first half of the 1990s.<sup>20</sup> However, the growth rate recovered moderately to around 4.5 % in the 2000s. As a result, the GDP share of Pakistan in South Asia increased from 13 % in the early 1980s to over 14 % in the first half of the 1990s; it declined to 11 % during 2005–2010.

The industrial and services sectors have largely contributed to the deceleration of growth in the 1990s and 2000s. The former grew by an average annual rate of 8 % in the 1980s, slowed to an average of 4.5 % in the 1990s, and thereafter increased to 5.7 % in the 2000s. Similarly, the services sector also slowed from an average growth of 7.5 % in the first half of the 1980s to 6 % in the second half of the 1980s and further to 4.5 % in the 1990s. In the 2000s, the services sector growth

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<sup>20</sup> The economy recovered during the 1980s via a policy of deregulation as well as an increased inflow of foreign aid and remittances from expatriate workers.

remained low compared to the 1980s with the average of 5 %.<sup>21</sup> The slowdown in GDP growth rate over 1990–2010 compared to the 1980s was attributed to internal conflict, serious lapses in implementation of stabilisation policies and structural reforms, adverse law and order political instability, social insecurity, and the interrupted business climate (Sahoo 2006, 2012).

The sectoral contribution to GDP has undergone significant change over time in Pakistan. Like India, the share of agricultural sector's contribution to GDP has come down by around 10 % during 1980–2010. The share of both industry and services has increased by the same percentage. Table 2.3 reveals that the industrial sector's contribution to GDP (on a 5-year average scale) increased gradually, increasing from a 23 % in 1980–1984 to 26 % in 2005–2010, except the period of the 1990s. Similarly, the services sector's contribution to GDP has demonstrated an increasing trend over time, increasing from 47 % in 1980–1984 to 52.8 % in 2006–2010. A similar trend is also shown for the industrial sector's contribution to GDP over the last three decades. As a whole, in Pakistan, the sectoral contribution to GDP has moved away from the agricultural sector to the industrial and services sectors.

Further, both domestic savings and capital formation as a percentage of GDP have shown a volatile trend over 1980–2010 compared to India. The gross capital formation as a ratio of GDP has remained constant during the 1980s (17.5 %) and declined in the second half of the 1990s and early 2000s. However, domestic savings also show an upward trend from the early 1980s until the last half of the 2000s. The current savings rate and capital formation of Pakistan are much lower than India. Moreover, it is important to notice that the savings–investment gap has declined over time except in the last half of the 2000s. On the fiscal front, Pakistan has done well compared to India. However, the inflation rate was high during the 1980s and 1990s; it was well above 12 % in recent times.

Pakistan performed worse than India on the external. Trade openness also demonstrates a moderate level of economic openness (expressed as trade over GDP) over time; it stagnated at 34–37 % in the three-decade study period. On the other hand, Pakistan has had a persistent current account deficit, except for the period of 2000–2004. Similarly, the State Bank of Pakistan's foreign exchange reserve, which fluctuated widely in the 1990s and could finance only 2.90 months' imports in the 2000s, can finance less than 2 months' imports. Short-term debt as ratio of total foreign exchange reserve was very high during the 1990s. Low foreign exchange reserve, high foreign debt, and a continual current account deficit created a macroeconomic imbalance for Pakistan during the 1990s and 2000s. Over the years, various empirical studies such as Kemal (2004), Zaidi (1994), and Looney (2012) have tried to explain the economic strengths and weaknesses of Pakistan's economy.

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<sup>21</sup> A steady decline in gross capital from the second half of the 1990s also contributed to the slowdown in economic growth.

**Table 2.3** Key macroeconomic indicators for Pakistan

| Indicators                                    | 1980–1984 | 1985–1989 | 1990–1994 | 1995–1999 | 2000–2004 | 2005–2010 |
|-----------------------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|
| Population (in millions)                      | 87.48     | 100.00    | 113.63    | 128.52    | 144.99    | 166       |
| GDP growth (%)                                | 7.30      | 6.43      | 4.54      | 3.41      | 4.34      | 4.81      |
| GDP (2000 constant US\$, billion)             | 31.4      | 42.9      | 55.5      | 67        | 79.3      | 106       |
| Share in South Asia (%)                       | 13        | 14        | 14        | 13        | 12        | 11        |
| Per capita GDP (2000 constant US\$)           | 363       | 419       | 470       | 499       | 527       | 637       |
| Agriculture, growth rate (%)                  | 2.92      | 5.9       | 3.95      | 5         | 2.1       | 3.75      |
| Agriculture, value added (% of GDP)           | 30.02     | 27.08     | 25.73     | 26.53     | 23.78     | 20.92     |
| Industry, value added (% of GDP)              | 22.91     | 23.62     | 24.93     | 23.80     | 24.42     | 26.3      |
| Industry, growth rate (%)                     | 8.6       | 7.8       | 5.5       | 3.9       | 5.7       | 5.8       |
| Manufacturing, value added (% of GDP)         | 15.52     | 16.45     | 16.97     | 15.91     | 15.77     | 18.4      |
| Services, value added (% of GDP)              | 47.07     | 49.30     | 49.34     | 49.66     | 51.80     | 52.8      |
| Services, growth rate (%)                     | 7.5       | 6.04      | 5.06      | 4         | 4.62      | 5.4       |
| Gross capital formation (% of GDP)            | 18.72     | 18.63     | 19.72     | 17.75     | 16.8      | 19.90     |
| Gross domestic savings (% of GDP)             | 7.37      | 9.26      | 15.42     | 14.83     | 16.68     | 12.78     |
| Inflation rate (CPI, %)                       | 8.43      | 6.10      | 10.54     | 8.89      | 4.23      | 12.07     |
| Fiscal deficit (% of GDP) <sup>a</sup>        |           |           | –5.7      | –5.3      | –2.6      | –5.1      |
| Current account balance (% of GDP)            | –2.63     | –2.82     | –3.98     | –4.07     | 2.25      | –4.53     |
| Total forex reserves in months of imports     | 3.04      | 1.90      | 1.72      | 1.47      | 5.10      | 3.89      |
| Trade over GDP (%)                            | 34.44     | 34.59     | 37.29     | 35.53     | 30.44     | 35.27     |
| Manufacturing exports (% merchandise exports) | 60.4      | 70.6      | 81.5      | 84.6      | 84.6      | 76.8      |
| Short-term debt (% of total reserves)         | 47.2      | 158.7     | 216.2     | 140.1     | 28.2      | 12.4      |

Source: World Development Indicators, World Bank 2011

<sup>a</sup>International Monetary Fund, Economic Outlook

### 2.3.3 *Macroeconomic Performances of Bangladesh*

Bangladesh is the third largest economy and third populous country in South Asia after India and Pakistan. The size of Bangladesh's economy (at 2000 price) increased from around \$22 billion in the first half of the 1980s to an average of \$72 billion during the last half of the 2000s. Bangladesh won independence from Pakistan in 1971 through a war that had major impact on institutional and physical capital. The economy was ravaged by acute food shortages and famines during the early years. According to Faaland and Parkinson (1976), Bangladesh was designated a 'test case' for development.

Table 2.4 provides the macroeconomic performance of Bangladesh over 1980–2010 and indicates that its GDP growth rate was constant at an average of 3.2 % during the 1980s. However, it increased to 4.6 % in the first half of the 1990s and further to 5.01 % in the second half of the 1990s. In the 2000s, the GDP growth rate of Bangladesh improved to above 6 %. In spite of some fluctuations in agricultural growth rate, the volatility in long-term GDP growth in Bangladesh is found to be remarkably low among developing countries (World Bank 2003).

Therefore, growth of GDP has been accelerating in each successive period since the latter half of the 1980s. The relatively low GDP growth rate during the 1980s was caused by low growth in the agricultural and services sectors. The higher industrial and services growth are also reflected in their increasing sectoral contribution to GDP. For instance, the industrial sector's contribution to GDP increased from 21 % in 1980–1984 to above 28 % in the 2005–2010 and by over 7 % during 1980–2010. Similarly, the manufacturing value added as a percentage of GDP increased from 14 % in the 1980s to above 17 % in the 2000s. On the other hand, the services sector now contributes over 52 % to the GDP. Therefore, like India and Pakistan, Bangladesh is now also led by the industrial and services sectors. Although Bangladesh has achieved consistent higher growth over time, its per capita income remains quite low. The per capita income of Bangladesh at 2000 price increased from US\$257 in the first half of 1980–1984 to over US\$330 during 1990–1995 and further to over US\$496 during the last half of the 2000s.

The higher GDP growth rate in the 1990s and 2000s resulted from the higher savings rates, higher capital formation, lower level of inflation, and higher trade growth. The average gross domestic savings rate in the period of 1980–1984 was only 6.28 % of GDP; it increased to 15 % in the second half of the 1990s and further to 17.4 % in the first half of the 2000s (Table 2.4). In fact, domestic savings rate in Bangladesh is second highest after India.

Similarly, gross capital formation steadily increased from around 16 % in the 1980s to above 24 % in the last half of the 2000s. The savings–investment gap<sup>22</sup> was higher during the 1980s—10.27 % of GDP in 1980–1984 and 7.21 % of GDP in

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<sup>22</sup> The savings–investment gap is calculated here by deducting the gross capital formation (percentage of GDP) from the gross capital formation (percentage of GDP).

**Table 2.4** Key macroeconomic indicators for Bangladesh (5-year average)

| Indicators                                    | 1980–1984 | 1985–1989 | 1990–1994 | 1995–1999 | 2000–2004 | 2005–2010 |
|-----------------------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|
| Population (in millions)                      | 85.1      | 97.4      | 110       | 122       | 136.3     | 144.7     |
| GDP growth (%)                                | 3.24      | 3.20      | 4.60      | 5.01      | 5.43      | 6.16      |
| GDP (2000 constant US\$, billion)             | 22        | 26.3      | 32        | 40.4      | 52.2      | 72        |
| Share in South Asia (%)                       | 9.2       | 8.5       | 8         | 7.7       | 7.7       | 7.1       |
| Per capita GDP (2000 constant US\$)           | 257.8     | 270       | 291       | 330       | 388       | 496       |
| Agriculture, value added (% of GDP)           | 31.48     | 31.71     | 28.38     | 25.89     | 23.03     | 19.2      |
| Agriculture, growth rate (%)                  | 2.66      | 0.56      | 3.5       | 3.35      | 3.5       | 4.0       |
| Industry, value added (% of GDP)              | 21.13     | 21.20     | 22.76     | 25.11     | 26.10     | 28.2      |
| Industry, growth rate (%)                     | 3.44      | 5.68      | 6.9       | 7.18      | 7.6       | 7.70      |
| Manufacturing, value added (% of GDP)         | 14.05     | 13.47     | 14.12     | 15.62     | 15.73     | 17.5      |
| Services, value added (% of GDP)              | 47.39     | 47.09     | 48.86     | 49.00     | 50.87     | 52.6      |
| Services, growth rate (%)                     | 3.9       | 3.66      | 3.8       | 4.7       | 5.5       | 6.5       |
| Gross domestic savings (% of GDP)             | 6.28      | 9.20      | 11.98     | 14.63     | 17.88     | 17.4      |
| Gross capital formation (% of GDP)            | 16.55     | 16.41     | 17.52     | 20.73     | 23.34     | 24.4      |
| Inflation (%)                                 | 13.38     | 8.84      | 4.89      | 6.50      | 4.48      | 7.55      |
| Trade over GDP (%)                            | 20.27     | 18.19     | 20.89     | 30.29     | 34.79     | 44.8      |
| Fiscal deficit (% of GDP) <sup>a</sup>        | -7.4      | -5.9      | 0.3       | -2.1      | -3.4      | -3.4      |
| Current account balance (% of GDP)            | -2.90     | -2.24     | 0.23      | -1.23     | -0.09     | 1.75      |
| Total forex reserves in months of imports     | 1.44      | 2.35      | 4.81      | 2.80      | 2.23      | 3.3       |
| Manufacturing exports (% merchandise exports) | 64        | 72        | 83        | 90        | 92        | 88        |
| Short-term debt (% of total reserves)         | 74.1      | 18.5      | 13        | 10        | 25.6      | 27        |

Source: World Development Indicators, World Bank 2011

<sup>a</sup>International Monetary Fund, Economic Outlook

1985–1989—than in the 1990s and the first half of the 2000s. This indicates domestic savings are inadequate to finance domestic investment.

Inflation was higher during the first and second halves of the 1980s than in the first and second halves of the 1990s and 2000s. Moreover, a lower fiscal deficit as a ratio of GDP in the 1990s and 2000s accompanied the lower inflation rate. In fact, compared to other countries in South Asia, Bangladesh had a budget surplus during 1990–1994.

Trade has contributed significantly to GDP. Total trade as a percentage of GDP increased from around 20 % during 1980–1984 to 30 % during 1990–1994 and further to 44.8 % during 2004–2010. The current account balance improved steadily in the 1990s and 2000s. The foreign exchange reserve increased from 1.44 months in 1980–1984 to 4.81 months in 1990–1994, declined to 2.33 months during 2000–2004, and increased to 3.3 months.<sup>23</sup> More importantly, external vulnerability represented by short-term debt also shows constant improvement over time (Table 2.4). Therefore, the wide-ranging policy reforms since the beginning in the 1990s have positive impact on the economic growth of Bangladesh.

### ***2.3.4 Macroeconomic Performances of Sri Lanka***

Sri Lanka, a small island country situated to the southern tip of India, became independent in 1948 from the British government. It is the 4th largest economy in GDP terms in South Asia. From US\$7 billion in the early 1980s, GDP in 2000 constant prices increased to US\$10.8 billion in the early 1990s and to US\$23.3 billion US\$ during 2005–2010. Sri Lanka's GDP share declined steadily from 3 % in 1980–1984 to 2.7 % during 1990–1994 and further to 2.3 % in the last half of the 2000s. However, its per capita income is the highest in South Asia—it rose from US \$463 (at 2000 prices) over 1980–1984 to over US\$613 during 1990–1995 and further to over US\$1,146 during the latter half of the 2000s.

The internal and external shocks the country faced made its pattern of economic growth irregular. Average economic growth was better in the first half of the 1980s than in the last half (Table 2.5)—due to civil unrest during 1987–1989. However, average economic growth increased since the 1990s, except for 2000–2004 due to external shocks. Over 2005–2010, GDP growth increased by over 6 %—higher than in the 1980s. Per capita income in Sri Lanka increased from US\$257 (at 2000 prices) during 1980–1984 to over US\$330 during 1990–1995 and further to over 496 US\$ during the last half of the 2000s.

The services sector has been the highest contributor to GDP in Sri Lanka over the past three decades. Its contribution increased from 44.98 % in 1980–1984 to 57.8 % in 2005–2010 (Table 2.5). Likewise, both the manufacturing and industry

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<sup>23</sup> The increase in foreign exchange reserve in Bangladesh is due mainly to higher inflow of remittance.

**Table 2.5** Key macroeconomic indicators for Sri Lanka (5-year average)

| Indicators                                    | 1980–1984 | 1985–1989 | 1990–1994 | 1995–1999 | 2000–2004 | 2005–2010 |
|-----------------------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|
| Population (in millions)                      | 15.38     | 16.45     | 17.52     | 18.36     | 19.01     | 20.0      |
| GDP growth (%)                                | 5.12      | 3.17      | 5.58      | 4.94      | 3.96      | 6.36      |
| GDP (2000 constant US\$)                      | 7.1       | 8.8       | 10.8      | 14        | 17.1      | 23.3      |
| Share in South Asia (%)                       | 3         | 2.8       | 2.7       | 2.7       | 2.5       | 2.3       |
| Per capita GDP (2000 constant US\$)           | 463       | 528       | 613       | 763       | 892       | 1,146     |
| Agriculture, value added (% of GDP)           | 27.71     | 26.74     | 25.47     | 21.82     | 16.00     | 12.3      |
| Agriculture, growth rate (%)                  | 3.44      | 1.14      | 3.4       | 1.9       | 0.56      | 4.9       |
| Industry, value added (% of GDP)              | 27.31     | 26.73     | 25.79     | 26.94     | 27.83     | 29.9      |
| Industry, growth rate (%)                     | 3.76      | 4.8       | 7.2       | 6.3       | 3.3       | 7         |
| Manufacturing, value added (% of GDP)         | 15.46     | 15.33     | 15.10     | 16.25     | 17.71     | 18.55     |
| Services, value added (% of GDP)              | 44.98     | 46.52     | 48.74     | 51.24     | 56.17     | 57.8      |
| Services, growth rate (%)                     | 7.3       | 2.8       | 5.9       | 5.7       | 5.4       | 6.4       |
| Gross fixed capital formation (% of GDP)      | 28.80     | 22.91     | 23.97     | 25.25     | 22.56     | 27.08     |
| Gross domestic savings (% of GDP)             | 12.11     | 10.43     | 13.44     | 17.51     | 16.08     | 17.17     |
| Inflation rate (CPI, %)                       | 17.1      | 8.56      | 13.0      | 9.46      | 8.8       | 11.55     |
| Fiscal deficit (% of GDP) <sup>a</sup>        | NA        | NA        | -7.7      | -7.6      | -8.44     | -7.62     |
| Trade over GDP (%)                            | 73.79     | 62.17     | 73.04     | 79.58     | 80.14     | 63.0      |
| Current account balance (% of GDP)            | -9.37     | -5.99     | -5.03     | -3.69     | -2.53     | -4.2      |
| Total forex reserves in months of imports     | 1.97      | 1.54      | 3.10      | 3.47      | 2.56      | 3.57      |
| Manufacturing exports (% merchandise exports) | 27.4      | 48.8      | 69.8      | 73.8      | 73.8      | 69.5      |
| Short-term debt (% of total reserves)         | 66.7      | 112.8     | 43        | 30.7      | 41        | 42        |

Source: World Development Indicators, World Bank 2011

<sup>a</sup>International Monetary Fund, Economic Outlook

value added as a percentage of GDP rose over the past three decades, except for 1990–1994. In fact, Sri Lanka had the highest industrial sector's contribution to GDP in South Asia. Recently, its industrial value addition to GDP increased to 29.61 %. In contrast, the agricultural sector's contribution to GDP shows a significant reduction (around 15 %) in the past three decades. For instance, in 1980–1984, the agricultural sector contributed 27.71 % of GDP, but it reduced to 12.3 % in 2005–2010. Therefore, the services and industrial sectors have taken over from agriculture to lead Sri Lanka's economy now, as in Bangladesh, India, and Pakistan.

Other macroeconomic indicators such as gross fixed capital and savings show a mixed trend. For example, gross fixed capital formation as a ratio of GDP has declined from the peak of the early 1980s (29 %) drastically in the later periods because of the ethnic war that continued until 2002. Sri Lanka has been unable to return to its early 1980s peak. Besides, the savings–investment gap in Sri Lanka over the past three decades was very high over 10 % on average and the highest in South Asia, except during 2000–2004. Inflation rate and fiscal deficit were high over three decades in Sri Lanka; this performance is not better than in India and Pakistan.

On the external front, the performance of Sri Lanka is comparable to other South Asian countries. For instance, trade openness ratio for Sri Lanka shows a fluctuating trend over time although it has remained very high. Trade openness ratio which was very high in the early 1980s (74 %) declined to 62 % in the last half of the 1980s, but thereafter it increased to 80 % in the period 2000–2004. In recent times, it has again declined to an average of 63 % of GDP. Further, Sri Lanka has had a persistent current account deficit and low foreign exchange reserves. Both high current account deficit and fiscal deficit have been the major contributors of high inflation rate in Sri Lanka.

### ***2.3.5 Macroeconomic Performances of Nepal***

Nepal is a landlocked country between China in the north and India in the south. It is one of the least developed countries in the world, with an unemployment rate of 46 % and a poverty rate of 24.7 % (CIA Fact Sheet 2011). Nepal is predominately an agriculture-based economy, although the agricultural sector's share has come down from 61 % in the 1980s to 35 % during 2005–2010 and by 26 % overall in the past three decades. In 2000, GDP in constant prices increased from an average US \$2.3 billion in 1980–1984 to an average US\$3.4 billion during the early 1990s and, further, to US\$7.2 billion on average in the last half of 2005–2010. Nepal is the poorest in South Asian per capita income terms. Real per capita income increased from US\$145 in the beginning of the 1980s to above US\$210 during the last half of the 1990s and further to above \$251 during 2005–2010. The macroeconomic performance of Nepal is presented in Table 2.6.

Economic growth was better in Nepal than in other South Asian countries over 1985–1995. During the 1990s, GDP growth rate was higher in Nepal than in the 1980s and 2000s. Its GDP growth rate was 3.95 % in the first half of the 2000s—far

**Table 2.6** Key macroeconomic indicators for Nepal (5-year average)

| Indicators                                    | 1980–1984 | 1985–1989 | 1990–1994 | 1995–1999 | 2000–2004 | 2005–2010 |
|-----------------------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|
| Population (in millions)                      | 15.80     | 17.79     | 20.08     | 22.7      | 26.1      | 28.63     |
| GDP growth (%)                                | 3.30      | 4.89      | 5.44      | 4.25      | 3.95      | 4.23      |
| GDP (2000 constant US billion \$)             | 2.3       | 2.9       | 3.7       | 4.7       | 5.8       | 7.2       |
| Share in South Asia (%)                       | 0.98      | 0.95      | 0.95      | 0.91      | 0.87      | 0.71      |
| Per capita GDP (2000 constant US\$)           | 148       | 165       | 187       | 210       | 220       | 251       |
| Agriculture, value added (% of GDP)           | 61.00     | 51.04     | 45.80     | 41.18     | 38.73     | 34.5      |
| Agriculture, growth rate (%)                  | 3.8       | 3.4       | 2.8       | 2.4       | 4.1       | 2.7       |
| Industry, value added (% of GDP)              | 12.51     | 15.90     | 19.28     | 22.57     | 19.64     | 16.85     |
| Industry, growth rate (%)                     | 4.4       | 11.1      | 9.2       | 5.4       | 3.4       | 2.4       |
| Manufacturing, value added (% of GDP)         | 4.44      | 6.04      | 8.00      | 9.53      | 8.85      | 7.5       |
| Services, value added (% of GDP)              | 26.50     | 33.07     | 34.92     | 36.25     | 41.63     | 48.6      |
| Services, growth rate (%)                     | 2.5       | 4.56      | 6.8       | 5.5       | 3.8       | 5.35      |
| Gross capital formation (% of GDP)            | 18.2      | 21.5      | 20.8      | 24.6      | 22.6      | 29.8      |
| Gross domestic savings (% of GDP)             | 10.07     | 11.89     | 9.74      | 14.28     | 12.01     | 9.5       |
| Inflation (%)                                 | 10.55     | 11.13     | 11.36     | 7.91      | 3.35      | 8.8       |
| Fiscal deficit (% of GDP) <sup>a</sup>        | NA        | NA        | NA        | NA        | -1.81     | 1.20      |
| Trade over GDP (%)                            | 30.97     | 32.68     | 41.24     | 58.25     | 49.21     | 46.20     |
| Current account balance (% of GDP)            | -3.21     | -5.54     | -7.16     | -5.23     | 0.49      | 1.91      |
| Total forex reserves in months of imports     | 5.66      | 3.73      | 6.08      | 5.16      | 7.34      | 6.62      |
| Manufacturing exports (% merchandise exports) | 47        | 68        | 84.6      | 74.4      | 72.2      | 69.2      |
| Short-term debt (% of total reserves)         | 9         | 2.5       | 1.4       | 1.2       | 1.2       | 1.6       |

Source: World Development Indicators, World Bank 2011

<sup>a</sup>International Monetary Fund, Economic Outlook

below that in the 1990s. Although it has increased to over 4 % in 2005–2010, it is lower than that of India, Bangladesh, Pakistan, and Sri Lanka. While agricultural growth has been stable, the growth rate of both industry and services fluctuated over time. The average agricultural growth rate, which was 3.8 % in the first half of the 1980s, dropped to 2.7 % in the last half of the 2000s. On the other hand, the average growth rate of industry and services peaked in the last and first half of the 1980s and 1990s, respectively—although both sectors have grown much more than the agricultural sector over three decades. In terms of contribution to GDP, agriculture's share declined significantly, while that of services increased by the same margin. Industry share fluctuated between 12 and 19 % over the period 1980–2010.

Likewise, the savings rate in Nepal is the lowest among the economies in South Asia. It declined from a high of 14 % in the second half of the 1990s on a 5-year average basis to only 9.5 % of GDP now. On the other hand, gross capital formation remained quite high compared to savings rate. Average gross capital formation as ratio of GDP increased from around 20 % in the 1980s to 22 % in the 1990s and further to above 29 % during 2005–2010. Like other countries in South Asia, Nepal has a high savings–investment gap—almost 11 % during 2005–2010. On the other hand, it demonstrates the lowest inflation rate and fiscal deficit among South Asian countries over time.

On the external front, Nepal has performed better than Pakistan and like Sri Lanka, India, and Bangladesh. Nepal is better than Pakistan in trade openness. Its average trade ratio increased from 31 % during the first half of the 1980s to above 58 % in the second half of the 1990s but declined during the current decade. At present, Nepal's total trade represents 46.20 % of its GDP, which is higher than that of Bangladesh, India, and Pakistan. Its foreign exchange reserve is comfortable, as is the ratio of its short-term debt to foreign exchange reserve.

## 2.4 Concluding Remarks

Overall, we find that Bangladesh, Sri Lanka, and India had higher GDP growth rates during the reform period compared to the 1980s. Both Pakistan and Nepal had higher growth during the 1980s. While the higher growth in India during 1991–2002 was accompanied by substantial growth in the services sector and a marginal improvement of the agricultural sector, the growth in Bangladesh, Sri Lanka, and Nepal was supported by both higher industrial and services sector growth. However, per capita income growth also slowed down in Pakistan during the 1990s, whereas it improved in India, Bangladesh, Sri Lanka, and Nepal. Other important macro indicators like gross domestic savings and gross domestic capital formation improved in all these countries except Pakistan. Following economic reforms, particularly trade reforms in these countries during the 1990s, export and import growth has substantially improved. Further, India, Bangladesh, Sri Lanka, and Nepal have improved considerably on the external sector front such as the

current account balance, capital account, foreign exchange reserves, and overall improvement in BOP during the post-reform period.

There has also been an improvement in most of the macro indicators except the fiscal deficit, on both the domestic and external sector front. Indeed, the South Asian region has been one of the fastest-growing regions in the world in recent years. The above analysis suggests that with the exception of Pakistan, the South Asian countries have registered higher trade growth during the 1990s than the 1980s. Though Pakistan failed to accelerate its export growth in the 1990s, it has managed to maintain a constant rise of exports in absolute value. All the countries except Pakistan have also experienced higher economic growth during the 1990s, with more open macroeconomic policies emphasising export promotion.

In the second half of the twentieth century, South Asia's economic growth lagged far behind that of Southeast Asia and Northeast Asia. The lesser performance of South Asian economies is attributed to inward looking policies, statist policies, poor economic management, and political drawbacks. An eminent economist described India's slow growth of the past as 'the Hindu rate of growth', implying that there were inherent weaknesses in India that did not enable it to move faster. India was also characterised as 'the sleeping Elephant' in contrast to the 'Asian Tigers'.

This changed when India and other South Asian economies adopted outward looking economic policies. Sri Lanka was the earliest to undertake structural reforms in 1977. India's later move in the 1990s changed India's growth momentum. India undertook significant economic reforms and opened its economy. The economic growth increased rapidly to reach 10 %. This uplifted the growth momentum of the region, and South Asia was viewed as the new and emerging growth centre together with China. However, the global slowdown and the lack of a new wave of economic reforms have retarded growth in the region and in India in particular. One of the glaring weaknesses of India's economic growth was the continued persistence of a high level of poverty. Even Pakistan, Bangladesh, and Nepal initiated wide-ranging reforms to enhance their growth and development.

Most studies on South Asia in recent times, including by the World Bank, are confined to economic policy measures affecting the growth of the region. In fact, the factors holding back economic growth in South Asia are broader issues of political economy. State control of many economic activities requires to be relinquished. Loss-making state enterprises need to be reformed or privatised. More incentive structures for investment are needed. In brief, second and third waves of reforms are needed in South Asian countries to release their growth potential.

There is serious political opposition and ideological resistance to undertake pragmatic economic policies. Nepal, for instance, is unable to exploit its vast hydropower generation potential due to political protest. Ethnic and religious conflicts continue to distract the state from economic policy changes. The lack of law and order and the rule of law deter foreign investment.

Economic growth in South Asia can be sustained only with reform of these political economy factors that have a direct bearing on economic policies and performance. This is especially pertinent for both Sri Lanka and Pakistan. It is

evident from the analysis above that the success of the economic reform measures in South Asia is widespread. Even though the contribution of agriculture to GDP across the region has declined, the industrial and services sectors have continued to drive the growth prospects of the region. Despite the many challenges faced by the region, there is enormous potential and the future prospects look bright. South Asia's growth trajectory is all set to be one of the defining stories of the world economy in the near future.

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