

External sector management in South Asia

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The most important and common feature of external sector management in South Asia is their deliberate effort towards greater integration with the world economy.

Such integration is popularly known as globalization .Joseph Stiglitz, a Nobel laureate economist, defines globalization as "closer integration of the countries and peoples of the world."

From the viewpoint of economic dimension, globalization essentially implies increasing integration of product and factor markets across national boundaries.

A similar view is that economic globalization "refers to the integration of national markets, characterized by a relatively unrestricted movement across national borders, on a significant scale, of goods and services, capital, labour, technology and information".

It is generally acknowledged that the pace of economic globalization in its multifaceted dimensions has intensified since the 1980s .The scope of this paper is limited to the consideration of the directions of policy changes in South Asia which impinge on trade, foreign direct investment (FDI) and other financial flows, the resultant changes in the degree of integration of South Asian Countries through these chanel and consequential growth performance. Moreover, the article does not deal with intra-regional integration in South Asia which could be considered as a potentially important element of external sector management but so far has proceeded at a slow pace. A few policy relevant questions are raised at the end.

Policy changes in South Asia: Since the mid-1980s and more pronouncedly since the early 1990s, South Asian countries have introduced a variety of policy changes to actively encourage integration into the global economy. Particularly relevant in this context are the changes in policies related to external trade, exchange rate, foreign direct investment (FDI) and foreign exchange transactions. The important highlights of these changes are briefly presented below.

Trade policy changes

- 1 Virtual elimination of quantitative restrictions on imports.
- 1 Reduction in the highest rate of custom duty.
- 1 Reduction in dispersion among duty rates.
- 1 Reduction in the number of import duty slabs

1 Simplification of import clearance procedure through, inter alia, removal of import license requirements.

1 Incentives for exports through bonded warehouse, import duty drawback and allowing back-to-back import LCs.

1 Direct or indirect subsidy for selected export items.

1 Allowing exporters to retain certain proportion of their foreign exchange earnings in foreign currency accounts.

1 Establishment of export processing zones with specially favourable tax treatment.

1 Concessional interest rate on export credit.

1 Participation in regional/ sub regional trading arrangements and bilateral agreements.

Exchange rate policy changes

1 Initial start with single currency peg.

1 Widening of band within the framework of single currency peg.

1 Adoption of peg to trade-weighted basket of currencies.

1 Finally, adoption of floating exchange rate system with active intervention by the Central Banks to stabilize the real effective exchange rates.

FDI related policy changes

1 Opening most manufacturing sectors to FDI

1 Allowing FDI in banking, telecommunications and other services.

1 No restriction on repatriation of profits and capital

1 Relaxation of restrictions on equity participation by foreign investors.

1 Institutional arrangements to promote FDI inflows.

Trade Imports and Exports % of GDP					
Year	1990	1995	2000	2005	2010
Bangladesh	25	28	30	32	32
India	20	22	23	24	24
Nepal	15	16	17	18	18
Pakistan	18	17	16	15	14
Sri Lanka	28	29	30	31	32

Exports (% of GDP)					
Year	1990	1995	2000	2005	2010
Bangladesh	8	11	13	15	16
India	9	12	14	16	16
Nepal	11	11	11	11	11
Pakistan	14	14	14	14	14
Sri Lanka	16	16	16	16	16

Imports (% of GDP)					
Year	1990	1995	2000	2005	2010
Bangladesh	17	17	17	17	17
India	11	10	9	8	8
Nepal	4	5	6	7	7
Pakistan	4	3	2	1	0
Sri Lanka	12	13	14	15	16

Foreign direct investment (\$ millions)			
Countries	1990	2005	2010
Bangladesh	3	803	917
India	237	6586	34159
Nepal	6	7	88
Pakistan	245	2183	2022
Sri Lanka	43	272	478

Portfolio Investment Flows (\$ millions)						
Country	1990		2005		2010	
	Surplus	Deficit	Surplus	Deficit	Surplus	Deficit
Bangladesh	0	0	0	1	0	0
India	147	0	3968	11988	16338	38,872
Nepal	0	0	0	0	0	0
Pakistan	0	0	1082	451	-1,200	524
Sri Lanka	0	0	0	-216	1,000	-1,948

Bank and trade-related lending (\$ millions)			
Countries	1990	2005	2010
Bangladesh	-	42	-11
India	1,658	4338	12,971
Nepal	-14	-	0
Pakistan	63	158	-227
Sri Lanka	10	-69	-72

South Asian Countries: Growth of GDP, 1990-2012					
Year	1990-94	1995-2000	2000-10	2011	2012
Bangladesh	5.7	4.8	5.8	6.7	6.3
India	5.7	5.8	6.8	6.2	5.0
Nepal	5.8	4.8	3.8	3.8	5.5
Pakistan	6.2	3.8	5.1	5.0	3.7
Sri Lanka	4.0	6.8	7.8	6.0	6.2

Foreign exchange transactions:

1 Despite some degree of liberalization, varying degrees of restrictions prevail.

1 Capital account transactions are subject to more stringent restrictions, particularly with regard to outward payments.

The above elements constitute the broad picture. There may be some differences across countries.

Overall it would be a fair generalization to state that policy initiatives have favored greater integration with the global economy. However, mention should be made of some qualifications. Sometimes there is a gap between de jure liberalization and de facto implementation. For example, tariff reduction is undermined by a variety of para tariff measures or non-tariff barriers. Boards of Investment do not effectively function as one stop service provider. Some political leaders as well as bureaucrats remain loyal to protectionist mentality.

Degree of integration of South Asia: Looking at data for selected years for the countries of South Asia since 1990s, the picture that emerges is the following:

1 Integration through trade has proceeded at a fairly rapid pace. This is reflected in exports plus imports as proportions of GDP (table 1). Pakistan and Sri Lanka experienced a fall in trade as proportion of GDP between 1990 and 2010, nevertheless the proportion of Sri Lanka was still the highest in the region. Some countries particularly Nepal and Sri Lanka have experienced considerable year-to-year fluctuations, in respect of both exports (table 2) and imports (table 3).

1 All the countries have witnessed fairly dramatic increase in FDI inflows in absolute term (table 4).

1 As regards other financial flows, India is the only country which has been able to attract fairly large amounts in the forms of bonds, equity investment as well as bank and trade-related debt flows. Very recently, Bangladesh, Pakistan and Sri Lanka also could get limited access to these flows (tables 5 and 6).

Impact on economic growth: The degree of integration of South Asian countries with the global economy has increased. The earlier discussion on the potential gains and risks suggests that the impact of such enhancement on growth is not necessarily unidirectional. As a result, a large number of studies have been devoted to empirical investigation of the impact. The findings of these studies can be summarized as follows:

1 An overwhelming majority of research has found a positive effect of trade openness on economic growth.

1 FDI is also generally found to exert a positive effect on growth, though evidence in this regard is somewhat less robust compared to trade.

1 Short-term capital flows such as portfolio and equity investments and bank debt do not have a significant effect on growth and, in fact, have sizable adverse effect in times of crisis and more so in countries with weaker institutions.

It is obvious that within this scope of this article it is not possible to deduce incontrovertibly defensible conclusions with regard to the impact of greater integration on growth in South Asian countries because of multiple determinants of growth. However, the evidence apparently conforms to the above findings.

South Asian growth picture: Bangladesh, India and Sri Lanka experienced higher growth rates both during 1990-2000 and 2000-2010 periods than during 1980-1990 period (table 7).

1 The growth rate in Nepal was higher in 1990-2000 period compared to 1980-1990 period, but lower in 2000-2010 period.

1 In Pakistan only, the average growth rate was lower in both 1990-2000 and 2000-2010 periods in the backdrop of a fall in trade as proportion of GDP in 2010 compared to 1990.

Key policy issues: In light of what is what is admittedly sketchy analysis in this paper, the following policy questions appear to be relevant for external sector management.

1 It is generally acknowledged that the simultaneous pursuit of stable exchange rate, independent monetary policy and financial openness constitutes an impossible trinity. So, what policy anchor should the Central Banks choose and should it remain invariant over time?

1 South Asian countries have generally followed a sequence of liberalization to which even the International Monetary Fund is agreeable [12]. The stipulated sequence is that countries should liberalize trade policies first and then FDI policies. Capital account liberalization should be the last choice. Now, the question is whether there are elements in the policy frameworks, particularly those relating to trade and FDI, which can be further liberalized?

1 In the above context another important question is how can the gap between de jure policy and de facto implementation be eliminated?

1 Another important question is, are there domestic factors which stand in the way of reaping the potential benefits of integration? These may relate to inadequate and unreliable infrastructure, weak governance, corruption and civil strife, among others.

1 In recent times some effort is being apparently made to attract non-FDI flows. Here it would be worth reminding that the East-Asian economic crisis of 1997-1998 was substantially triggered by dramatic reversal of these flows which had earlier contributed to accelerated growth. Five East Asian countries (Indonesia, Malaysia, Philippines, Republic of Korea and Thailand) received a staggering net inflow of bank credit amounting to \$56 billion and portfolio equity amounting to \$12 billion in 1996, followed by net outflows of \$27 billion and \$4 billion respectively in 1997 leading to significantly negative growth of GDP in 1998. Very recently a number of developing countries including India faced large outflows in the wake up anticipated tapering off quantitative easing programmes in source countries leading to pressure on exchange rates and slow-down of growth. So the question is to what extent should South Asian countries liberalize their capital account policy regimes and how to balance the potential trade-off between higher growth and greater instability?

1 There is a question relating to the functioning of institutions involved in external sector management particularly Ministry of Finance, Central Bank and Board of Investment. How effective they are in carrying out their mandates and to what extent they coordinate their actions?

1 A final question relates to the consistency among the obligations of South Asian countries arising from membership of the World Trade Organization as well as multiple bilateral, sub regional and regional agreements.

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