CHAPTER 1

# Introduction: From Postpandemic Recovery to Inclusive Growth and Sustainable Development in South Asia


## Klaus-Peter Hellwig


The marked decline in extreme poverty around the world can be counted among humanity's great achievements since the beginning of the 21st century. According to World Bank estimates, the number of people in the world living with less than US$1.90 per day fell from 1.7 billion in 2000 to around 700 million in 2017. A sizable part of this remarkable success story occurred in the South Asian countries of Bangladesh, Bhutan, India, Maldives, Nepal, and Sri Lanka, where the number fell from 500 million to fewer than 250 million people. Per capita incomes more than doubled in real terms, and the region's share of global GDP grew from less than 5 percent in 2000 to more than 8 percent in 2019. Continued growth at this pace would put the goal of eradicating extreme poverty by 2030 within reach, and it would continue to transform people's daily lives in ways that cannot be captured by GDP numbers. Many South Asians today receive better health care and education than their parents' generation did and have access to expanded and more reliable power grids, financial services, and transportation infrastructure. Mobile phones and broadband Internet are now ubiquitous, connecting people to the world and allowing them to participate in the global exchange of ideas.

However, the global COVID-19 pandemic and the economic repercussions of the Russian invasion of Ukraine have dealt a double blow to the fight against poverty. As with elsewhere in the world, South Asian countries have experienced not just the devastating health effects of COVID-19. As GDP growth has slowed, South Asian countries have also seen an increase in the number of poor households and a decline in per capita incomes. The World Bank estimates that the number of people living with less than $1.90 per day in South Asia increased by 58 million in 2020, accounting for more than half of the global increase in poverty (Mahler and others 2021). The pandemic has also exposed and sometimes exacerbated preexisting vulnerabilities that will pose headwinds to growth if left unaddressed. Also, the effect of the war in Ukraine and related sanctions as well as global spillovers from the exit from the pandemic are having pervasive effects on the region, posing more challenges. In addition, the effects of climate change are increasingly visible in the region and, if left unaddressed, will leave their mark on economic growth and the pace of poverty reduction.

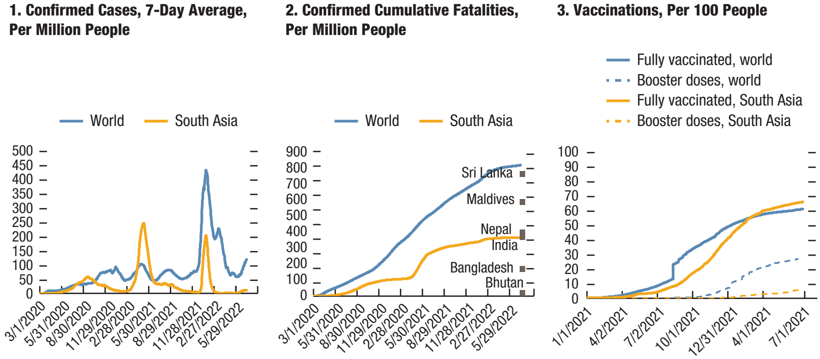
Overcoming these economic challenges to achieve the Sustainable Development Goals (SDGs) in South Asia is the central theme of this book. In the first part, the book discusses policies to make growth inclusive and sustainable, covering a wide range of topics including (1) the expenditure needs to meet the SDGs, (2) improving equity through labor market reforms, social protection reforms, and gender policies, (3) digitalization, and (4) mitigating and adapting to climate change. The middle part explores how trade liberalization and the resulting diversification have helped South Asia narrow the income gap to other regions and highlights the large potential for further income gains from a renewed reform momentum and a better integration into Asian and global value chains. The third part focuses on the role of macro-financial management through improved quality of infrastructure investment, sound monetary policy frameworks, and financial development. Throughout the book, by drawing lessons from South Asia's own history as well as from cross-country comparisons with peers, the analysis shows that finding the right policy design is crucial for the region's rapid growth trajectory. Poverty reduction cannot be taken for granted but is the result of policy choices. Finding the right policies matters not only for the pace of growth but also for ensuring that growth is sustainable, inclusive, and benefits all.

To set the scene, this first chapter starts by looking back at the first two years of the pandemic and takes stock of its effect on South Asia. The chapter then widens the lens to place the current juncture into the broader context of the subcontinent's growth trajectory since the middle of the 20th century—a period of remarkable transformation but also one of stubbornly persistent economic inequalities. Previewing some of the book's main findings, this chapter then discusses the role of policies and the remaining challenges to overcome in shaping South Asia's economic trajectory in the postpandemic era.

## COVID-19 IN SOUTH ASIA

Like many other regions of the world, South Asia was hit hard by COVID-19 (see Figure 1.1). The region was particularly affected by the highly contagious delta variant that emerged in the second quarter of 2021 at a time when vaccination efforts in the region were still at an early stage and hampered by global supply shortages. In early 2022, the omicron variant led to a renewed surge in case numbers, this time also affecting Bhutan, which had previously been spared by major outbreaks. As of the middle of 2022, 47 million cases and approximately 584,000 deaths of COVID-19 were confirmed, around 9 percent of global confirmed deaths. But the humanitarian toll is likely even higher, as health systems were overstretched, limiting access to preventive care and treatment for other medical conditions. Moreover, several studies suggest an undercounting of COVID-19 cases and fatalities (see Anand, Sandefur, and Subramanian 2021). Excess mortality figures reported by the World Health Organization show cumulative deaths through the end of 2021 ranging between 3.3 and 6.8 million in South Asia.

## Figure 1.1. COVID-19's Health Effects and Vaccinations in South Asia




Sources: Johns Hopkins University/Our World in Data; and IMF staff calculations.

Vaccination efforts played a key role in bringing the delta variant under control and keeping the death toll from omicron low despite very high case numbers.[1] Bhutan, having fully vaccinated its adult population by July 2021 and administered booster doses to 70 percent of the population by the middle of 2022, has had one of the lowest death tolls in the world. India, by being one of the leading manufacturers of vaccines in the world and the key supplier of vaccines to COVAX, which provides vaccines to low- and middle-income countries, made a crucial contribution to the global economic recovery.[2] Since the middle of 2022, vaccination rates in all South Asian countries have been above the global average (Figure 1.1, panel 1). However, in terms of administered booster doses, the region is still lagging.

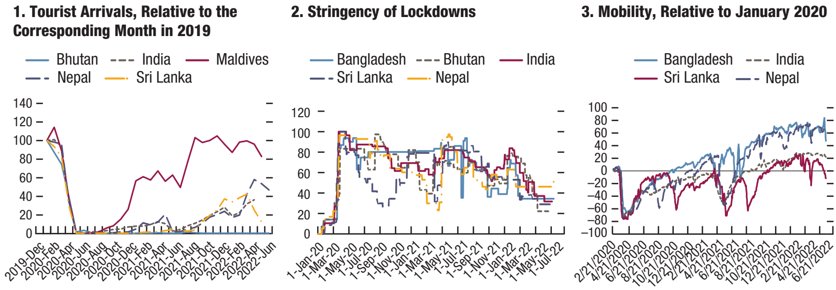
## Economic Effects of COVID-19

The economic fallout from the pandemic in South Asia was severe, particularly in the early stages when the most restrictive lockdowns were in place (Figures 1.2 and 1.3). In India, by far the region's largest economy, real GDP in the second quarter of 2020 fell by 23.8 percent relative to the same period in 2019. In tourism-dependent Maldives, the drop was by more than 50 percent. In Bangladesh and Bhutan, production indices point to a similar pattern. In addition to being large, the economic effect of COVID-19 has also been persistent. In all South Asian countries except Bangladesh, annual real GDP per capita in 2021 remained below the 2019 level. Contact-intensive service sectors were

[1] Watson et al (2022) estimate that vaccinations averted around 3.55 million deaths (as of December 2021) in Bangladesh, Bhutan, India, Maldives, Nepal, and Sri Lanka.

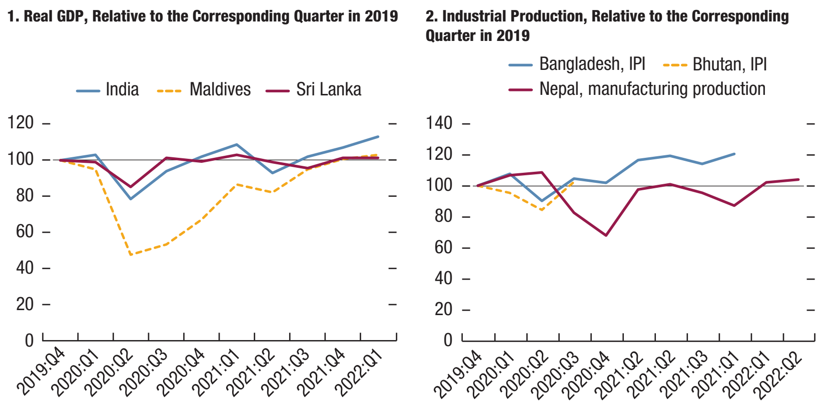
[2] According to India's Ministry of External Affairs, as of November 1, 2023, India has exported around 272 million doses, including around 39 million doses to other South Asian countries (Government of India 2022).

## Figure 1.2. COVID-19's Effect on Mobility in South Asia




Sources: Haver Analytics; Royal Monetary Authority of Bhutan; and IMF staff calculations (panel 1); Our World in Data; Oxford Coronavirus Government Response Tracker; and IMF staff calculations (panel 2); and Google COVID-19 Community Mobility Reports; and IMF staff calculations (panel 3).
Note: The figure shows seven-day moving average mobility, calculated as the simple average of four mobility indices: workplaces, transit stations, retail and recreation, and grocery and pharmacy.

## Figure 1.3. COVID-19's Effect on Economic Activity in South Asia




Sources: CEIC; Haver Analytics; national statistics offices; and IMF staff calculations.
Note: IPI = industrial production index; Q = quarter.

especially hard hit, particularly tourism where activity is still far below prepandemic levels.

The economic effects would have been even more severe without policies to support the economy. Governments increased spending, not just on the health sectors but also on programs to support vulnerable households, including through cash transfers, food rations, and subsidized utility bills. Demand was also stimulated through infrastructure investment. On the revenue side, relief was provided through extended tax filing and payment deadlines and tax exemptions. Fiscal stimulus was accompanied by monetary easing through reduced policy rates and, in some instances, central bank lending to the government. In the financial sector, wide-ranging loan moratoria and low-interest loans provided liquidity support to borrowers, whereas macroprudential measures helped preserve financial stability

(Hodge and Moussa 2021). Studying a large sample of firms in India, Górnicka, Ogawa, and Xu (2021) showed that policy measures have been instrumental in improving liquidity conditions of corporate balance sheets.

Chapters 3 and 4 of this book discuss that low-income households have suffered disproportionately from the pandemic. Workers in South Asia's large informal sector, which relies highly on physical operations and has few employment protections, were hit hard. For example, survey data for Sri Lanka indicate that the decline in sales was much steeper for micro-size enterprises than for other small- and medium-size enterprises and that smaller firms were more likely to close operations and lay off workers (IMF 2022b). Informal workers also had few savings and no access to finance to buffer the shock of a job loss. At the same time, government transfers to support households were lower than in many other emerging market and developing economies.

Chapter 5 discusses how the pandemic also appears to have aggravated existing gender inequities. Deshpande (2020) found that during India's early lockdowns, women were 20 percent more likely to lose their jobs than men were. Survey evidence from Bangladesh and Maldives suggests that women were more likely to reduce their work hours than men were.

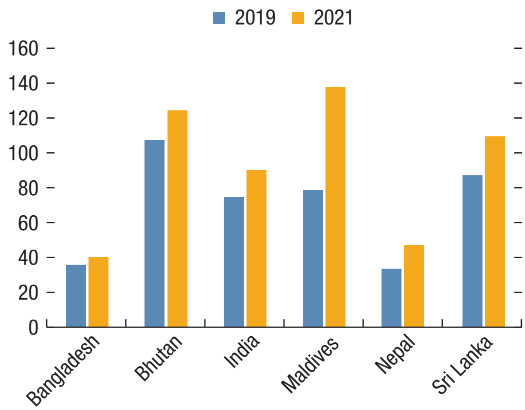
## A Recovery with Challenges and Setbacks

With the COVID-19 crisis of 2020–21 in the rearview mirror, there are many signs that, although the pandemic is far from over, it has become more manageable. A large share of the population has been vaccinated and medical therapeutics and care have improved, slowing the spread and making infections less harmful. Hence, the gruesome trade-offs of the first year of the pandemic, between saving lives and saving livelihoods, have become less pressing. IMF staff project India's economy to grow at 6.8 percent in 2022–23, which is the fastest pace among major advanced and emerging market economies.

Even so, the scars of the pandemic are likely to be felt in the region for many years to come. In the near term, COVID-19 will remain a large uncertainty factor, as new variants are likely to emerge, and the long-term effectiveness of vaccines is still unknown. The global economy continues to be affected by the pandemic, as supply chains, although improving, are still not operating smoothly. In addition to the lingering uncertainty about its trajectory, the pandemic has also exacerbated preexisting challenges and vulnerabilities that could create headwinds along the recovery path.

Balance sheets of the public and private sector, which in some cases had already been under stress before the pandemic, deteriorated throughout the region. A case in point is public debt. Government intervention helped prevent a worse health crisis and protected the economy. However, the drop in tax revenues and higher spending led to widening deficits, resulting in a rapid buildup of public debt in 2020–21 from already-high levels in some countries (Figure 1.4). Governments also took on additional risks to support state-owned enterprises or make loans to support firms struggling during the pandemic.

**Figure 1.4. General Government Debt**
*(Percent of GDP)*




Source: IMF's World Economic Outlook database.

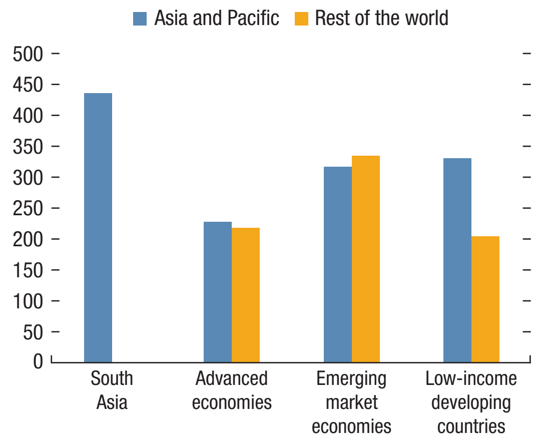
Corporate balance sheets have suffered similarly. In India, for example, nonfinancial corporate debt increased by about 17 percent of GDP from 2019 to 2021 (see IMF 2022a).[3] Firms that borrowed to expand capacity before the pandemic or those that borrowed to stay afloat during the pandemic, sometimes through government programs, could face difficulties repaying their loans. Moreover, the long-term viability of some firms may have been affected by the pandemic, and policies going forward will need to support resolution of nonviable firms so that limited resources are not kept from more dynamic firms. This debt overhang could also make it more difficult to finance new investments, contributing the overall decline in investments observed in the wake of the pandemic (IMF 2022a).

The pandemic has also held back investment in human capital. On average, South Asia's students have experienced far longer school closures than their peers have in other parts of Asia and other continents (Figure 1.5). As we will see in the following, South Asia's literacy rates still lag those of peer countries, making the region less competitive in skill-intensive manufacturing. Learning loss from school closures during the pandemic is likely to exacerbate these challenges with effects that could be felt for decades.

In this still-difficult economic environment, the fallout of Russia's war in Ukraine has dealt another heavy setback to the recovery. Higher global food prices have hit South Asian countries particularly hard, given the high share of food in household consumption (Figure 1.6, panel 1), leading to higher inflation and eroding the real incomes of vulnerable households. Although in some cases (such as in India, Nepal, and Sri Lanka) policy measures have been deployed to curb

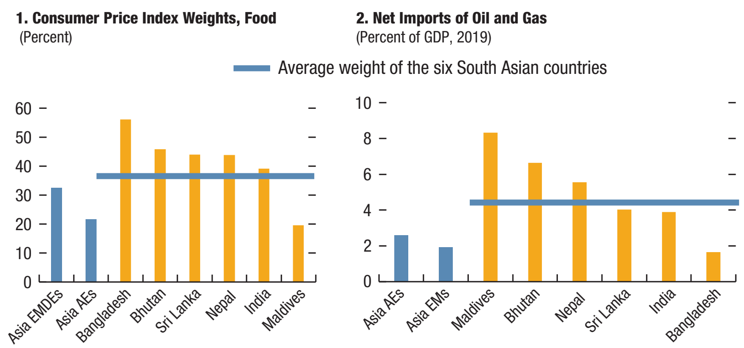
[3] More recently, corporate sector balance sheets in India have somewhat improved, as confirmed by the declining leverage of listed firms and falling delinquency rates across sectors and borrower types.

**Figure 1.5. School Closures as a Result of COVID-19**
*(Average number of days)*




Sources: UNESCO; and IMF staff calculations.
Note: Analysis excludes Pacific Island countries.

**Figure 1.6. The Role of Food and Fuel in South Asia**



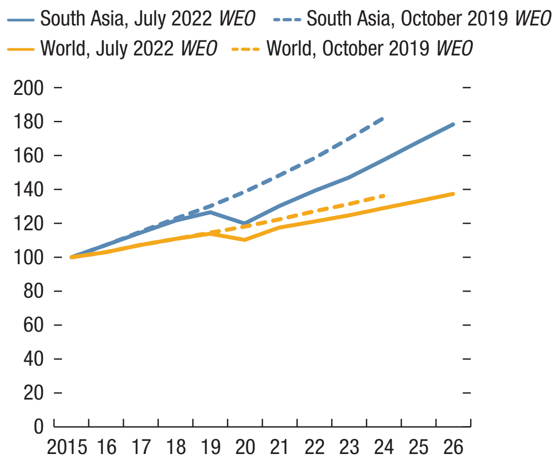

Sources: CEIC; IMF country authorities; and IMF staff estimates.
Note: AEs = advancd economies; EMDEs = emerging market and developing economies.

Sources: IMF Country Desk Survey; and IMF staff estimates.
Note: AEs = advancd economies; EMs = emerging markets.

the effect of inflation, the rise in food and energy prices will likely erode real incomes and push more households below the poverty line. The broadening of headline inflation to core inflation is turning these effects into macro-fiscal challenges as in some cases fiscal measures are untargeted and permanent while fiscal space is shrinking.

Considering the region's dependence on oil and gas imports (Figure 1.6, panel 2), the higher global fuel prices have put pressure on external current account balances. Moreover, Maldives and Sri Lanka have lost considerable earnings from

**Figure 1.7. IMF Staff's Real GDP Projections in *World Economic Outlook* Reports (2015 = 100)**




Source: IMF's World Economic Outlook database.
Note: *WEO* = *World Economic Outlook.*

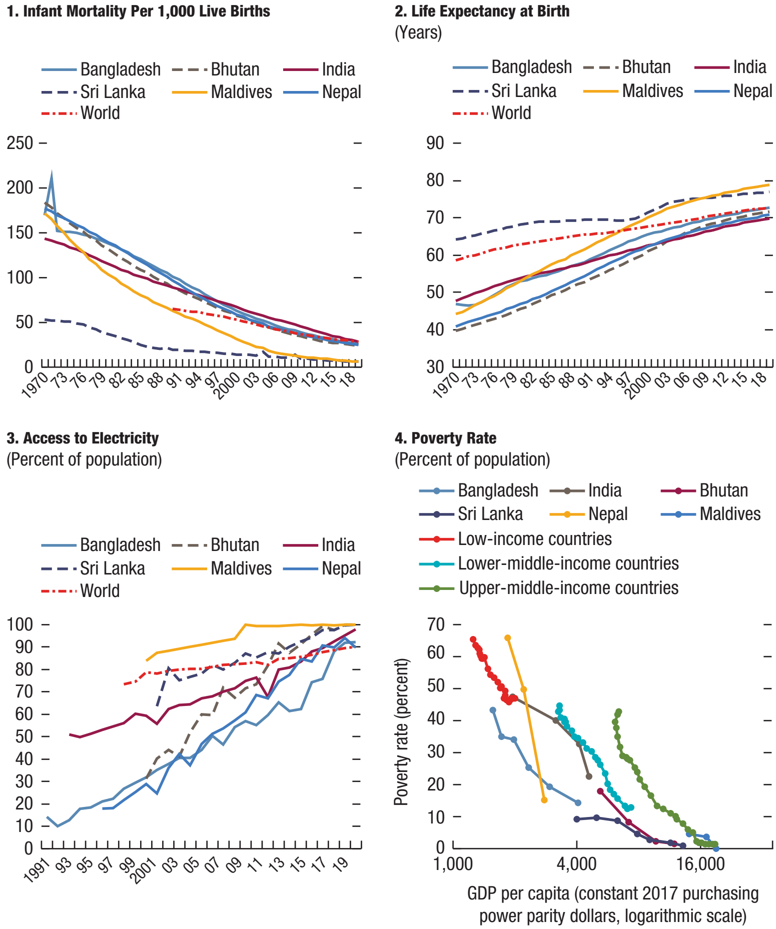
Russian and Ukrainian tourists. These external sector shocks are compounded by a tightening of global financial conditions, as central banks in advanced economies fight inflation by raising interest rates. During the Taper Tantrum of 2013, India was vulnerable to such tightening episodes. Today, sizable reserves and smaller external imbalances suggest improved resilience. Nonetheless, the renewed large outflows in 2022 are a reminder that continued vigilance is needed.

Given the nature and severity of the recession induced by the pandemic and compounded by multiple shocks including Russia's war in Ukraine, output losses are likely to persist. While India is back on a healthy GDP growth plan in 2022–23, downside risks have become more likely to materialize in some countries—particularly in Sri Lanka, which is experiencing a severe balance of payments and sovereign debt crisis. IMF staff projections indicate that real GDP in South Asia and in the world is expected to remain below its prepandemic trends over the medium term (Figure 1.7).

## DEVELOPMENT AND INEQUALITY IN SOUTH ASIA: A LONG-TERM VIEW

How can South Asia return to the growth rates of the past two decades and resume the momentum of poverty reduction in the postpandemic era, and how can this be achieved in an equitable and climate-friendly way and without a renewed buildup of macroeconomic vulnerabilities? To understand the engines of long-term growth and inequality and to identify policies that could help South Asia achieve its development potential, several chapters of this book take a long-term perspective and draw lessons from South Asia's development experience over the past decades.

## Figure 1.8. Selected Development Indicators

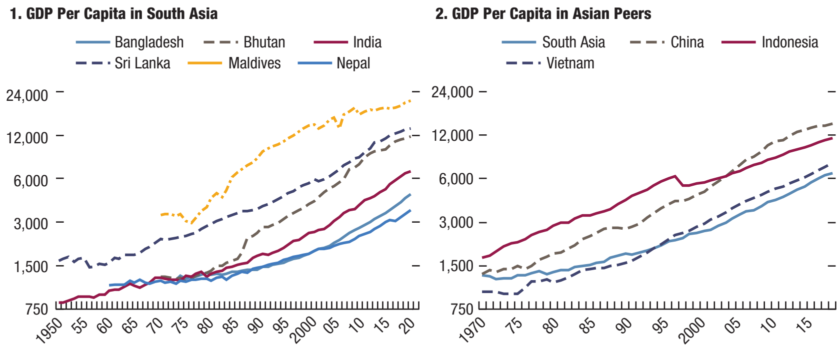



Sources: World Bank's World Development Indicators; and IMF staff calculations.

Hence, this section attempts to provide some context by revisiting the region's economic history and comparing its trajectory with that of other Asian economies. In doing so, we come across many themes previously discussed by other authors, notably Goretti and others (2019) and Lamba and Subramanian (2020).

Over the past five decades, South Asia outpaced global changes along a wide range of development indicators (Figure 1.8). In 1970, infant mortality exceeded the global average in all South Asian countries except Sri Lanka. By 2019, the infant mortality rate was below the global average throughout the region. A child born in Bhutan in 1970 could expect to live 40 years, 19 years shorter than the global average. This gap in life expectancy at birth between Bhutan and the rest of the world had shrunk to less than one year in 2019. South Asians do not just live longer than their parents and grandparents, they are also less likely to be poor and more likely to have access to public infrastructure such as electricity. Panel 4

**Figure 1.9. GDP Per Capita in South Asia and Asian Peers**
*(Constant US dollars, logarithmic scale)*




Sources: Penn Word Tables; and IMF staff calculations.

of Figure 1.8 suggests that poverty rates declined even faster than implied by the pace of economic growth.

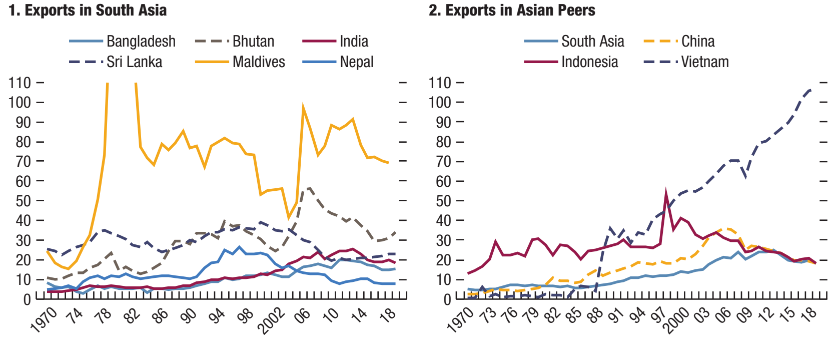
These improvements in human development would not have been possible without economic growth. Indeed, as can be seen from Figure 1.9, South Asia can look back on a growth performance that was remarkable. After India gained its independence in 1947 and Sri Lanka in 1948, real GDP per capita in both grew more than sevenfold. Bangladesh's real GDP per capita more than tripled in the five decades since its independence in 1971. At the same time, growth in the region lagged that of other Asian economies over the past 50 years—except for Bhutan and Maldives, small countries that rapidly transformed as tourism and hydropower expanded.

Figure 1.9 further highlights that South Asia has always been an economically diverse region, and that the growth experience was distinctly heterogeneous across countries within the region. In 1950, shortly after gaining independence, Sri Lanka's GDP per capita was nearly twice that of India. During the 1970s, income levels within the region diverged further, with Maldives and Sri Lanka benefiting from some liberalization, while Bangladesh and India remained stagnant. With reforms in India beginning in the 1980s and in Bangladesh in the 1990s, growth began to pick up, turning into a boom in the 2000s and 2010s.[4] This coincidence of growth spurts and liberalizing reforms suggests that trade openness has been an important part of Asia's growth story. Growth accelerations in Maldives and Sri Lanka in the late 1970s, in Bhutan in the 1980s, and in Bangladesh and India in the 1990s and 2000s coincided with substantial increases in exports of goods and services (Figure 1.10).

However, the ratio of exports to GDP in South Asia has remained below the levels observed in China, Indonesia, or Vietnam, where GDP growth was driven

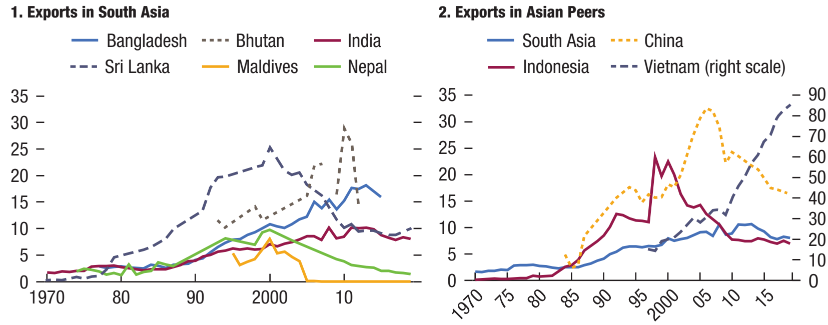
[4] See Rodrik and Subramanian (2005) for a discussion of Indian reforms in the 1980s and 1990s.

**Figure 1.10. Exports of Goods and Services in South Asia and Asian Peers**
*(Percent of GDP)*




Sources: World Bank's World Development Indicators; and IMF staff calculations.

**Figure 1.11. Manufacturing Exports in South Asia and Asian Peers**
*(Percent of GDP)*

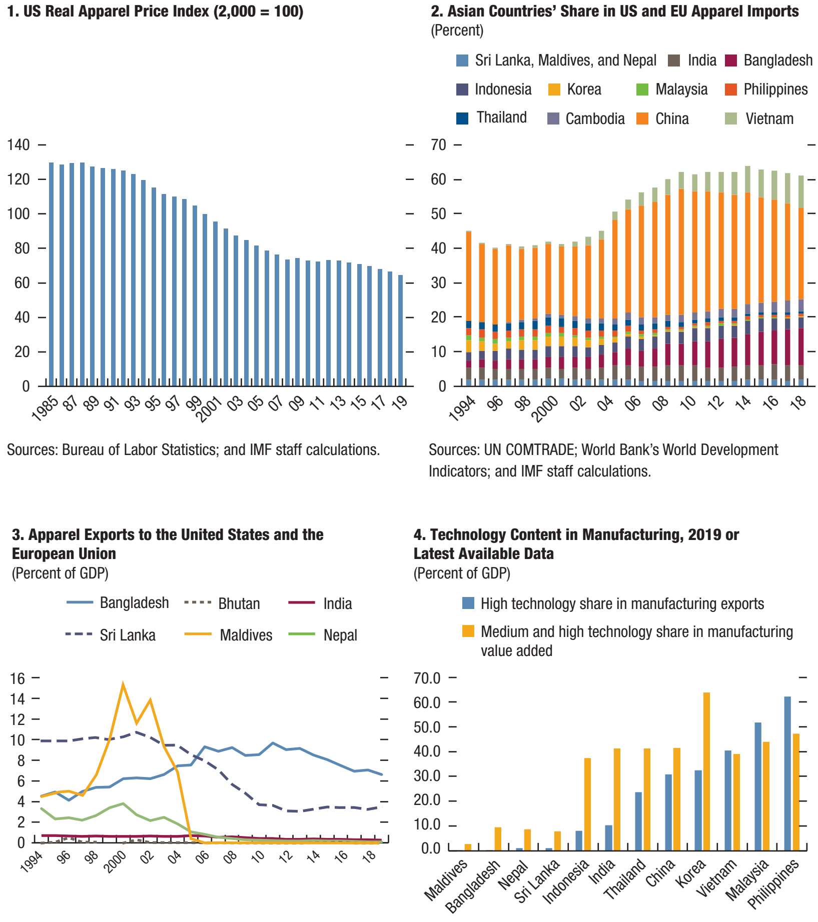



Sources: World Bank's World Development Indicators; IMF's World Economic Outlook database; and IMF staff calculations.

by spectacular export growth. Moreover, in Nepal and Sri Lanka, export growth slowed down dramatically over the past 20 years. In Sri Lanka, exports dropped from 36 percent of GDP in 1995–99 to 22 percent in 2015–19. In Nepal, the drop was from 24 to 8.4 percent. Reinvigorating South Asia's trade through diversification, investment, and integration with other parts of Asia is the topic of Chapters 8 through 10.

This rise and fall of exports in Asia cannot be understood without looking at the manufacturing sector (Figure 1.11). In most Asian countries, the export-led growth was driven by manufacturing exports—as was the more recent decline in exports in Nepal and Sri Lanka. In Maldives, manufacturing exports also fell dramatically in the early 2000s. An important factor of South Asian manufacturing export dynamics may have been the changes in trade policy in advanced economies. The quota system, which had protected South Asian apparel exports to the United States and the European Union, was gradually phased out in

**Figure 1.12. Role of Apparel in South Asian Manufacturing Exports**




Panel 1 sources: Bureau of Labor Statistics; and IMF staff calculations.

Panel 2 sources: UN COMTRADE; World Bank's World Development Indicators; and IMF staff calculations.

Panel 3 sources: UN COMTRADE; and IMF staff calculations.

Panel 4 sources: World Bank's World Development Indicators; and IMF staff calculations.

1994–2005, leaving South Asia more exposed to competition from countries with lower unit labor costs. This competition intensified dramatically as the United States and the European Union reduced trade barriers for other Asian economies such as Cambodia, China, and Vietnam. Hence, for those countries which had previously benefited from quota protections and preferential market access in the United States and the European Union, trade liberalization resulted in negative terms of trade shock. Figure 1.12 shows that, relative to other consumption goods, US prices of apparel dropped by 25 percent from 2000 to 2010.

While Asia's overall share in advanced economy apparel imports increased as a result of trade liberalization in the early 2000s, market shares declined drastically for Maldives, Nepal, and Sri Lanka (Figure 1.12). Bangladesh was the only South

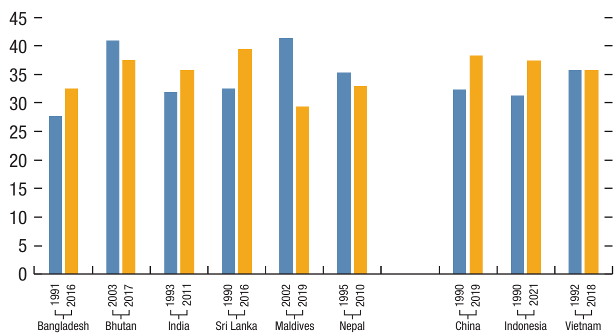
Asian country that expanded its market share in apparel, competing successfully with Cambodia, China, and Vietnam. Unlike other Asian countries with previously significant apparel exports such as Korea, Malaysia, the Philippines, or Thailand, most South Asian apparel exporters found it difficult to diversify into other, more skill-intensive, manufacturing industries. Among South Asian countries, only India has significant high-technology manufacturing exports (Figure 1.12).

## Growth and Inequality

Has growth in South Asia been inclusive? This question matters for several reasons. First, meeting the SDGs means improving the lives of the poorest. Hence, if growth benefits only a few without reaching poor households, then it will be difficult to meet the SDGs. Second, if growth-enhancing reforms lead to an increase in inequality, these reforms are less likely to be politically sustainable. Experience from other countries has shown that reforms are less likely to succeed if some regions or groups are left out. A large body of literature highlights that inequality can hold back growth if those born in poverty lack access to the means necessary to fulfill their potential.[5]

A first look at the data in Figure 1.13 shows that the evolution of household inequality has varied across the region. In Bangladesh, India, and Sri Lanka, inequality measured by the Gini coefficient increased, whereas in Bhutan, Maldives, and Nepal inequality declined, albeit from high initial levels. Gini coefficients are comparable to those of other Asian emerging market economies. Chapter 4 of this book takes a closer look at household inequality and argues that inequality across households is at a level where it poses headwinds to development.

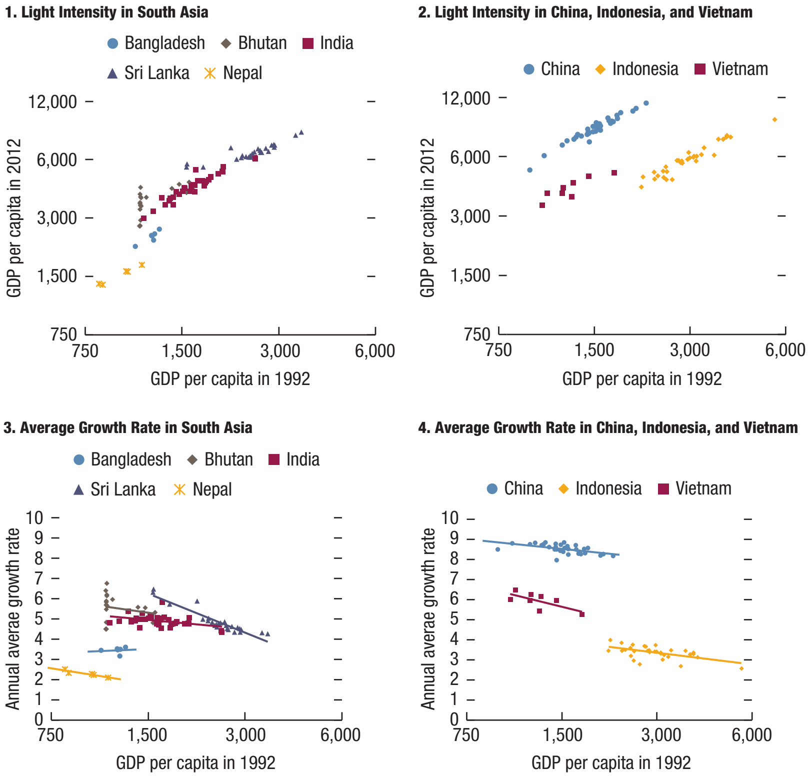
**Figure 1.13. Household Income Inequality**
*(Gini index, percent)*




Source: World Bank's World Development Indicators.

[5] See, for example, Cerra, Lama, and Loayza (2021) for a recent survey of the literature on growth, inequality, and poverty reduction, including additional transmission channels.

**Figure 1.14. Regional Inequality and Convergence: Estimates from Nighttime Light Intensity**

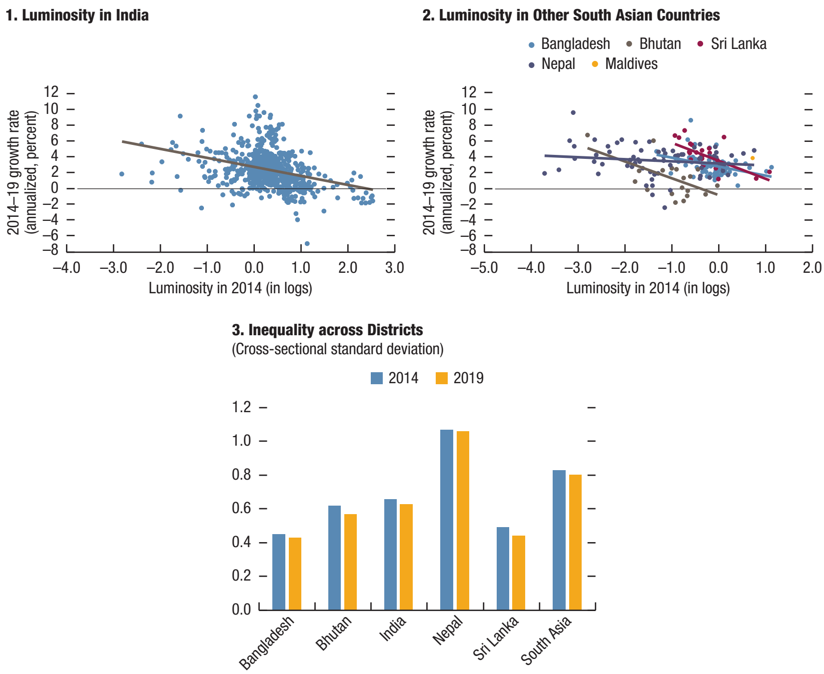



Sources: Lessman and Seidel 2017; and IMF staff calculations.

Assessing regional inequality trends is more difficult because statistical information on incomes at the subnational level is limited for many countries. However, regional GDP per capita can be estimated from the intensity of nighttime lights in satellite images.[6] Figure 1.14 plots these estimates for regions of South Asian countries, comparing income levels in 2012 against 1992. The estimates suggest that within each country except Bangladesh, per capita incomes of the poorest regions grew the fastest, so that income levels converged within countries. However, the figure also shows that there remained substantial regional inequality in 2012, despite this convergence. For example, India's poorest state had only half the per capita income of the richest state, a degree of inequality across regions comparable with that in China and Indonesia. In the rest of South Asia, the gap between richest and poorest regions was smaller.

[6] See, for example, Henderson, Storeygard, and Weil (2012). For an application to South Asia, see Beyer and others (2018).

**Figure 1.15. Nighttime Light Intensity, by District, 2014–19**




Sources: World Bank staff; and IMF staff calculations.

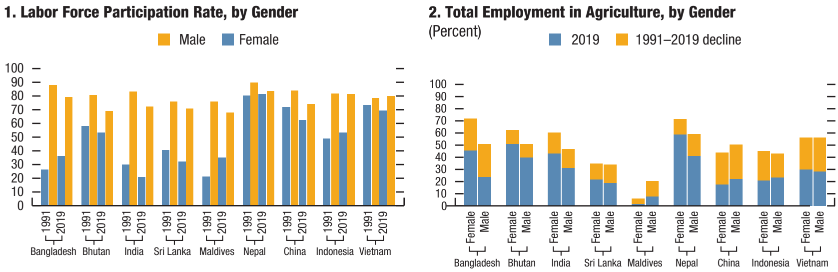
Regional inequality was the smallest in Bangladesh. In a comparison of growth rates, Figure 1.14 illustrates that the degree of convergence in the 1990s and 2000s was relatively highest in Sri Lanka, as can be seen from the slope of the relationship between initial income levels and growth rates. For India, convergence was relatively weak.

Using district-level estimates constructed by World Bank researchers from a different satellite data set for the more recent period of 2014–19, we can compare the evolution of nighttime light intensity in South Asia at a more granular level.[7] Figure 1.15 shows that convergence effects became stronger in the years preceding the pandemic, as districts with low light intensity in 2014 tended to have higher growth rates than districts with higher light intensity. This convergence was most pronounced in Bhutan and Sri Lanka, whereas Nepal, the country with the largest inequality across districts, showed only relatively weak convergence.[8] The figure also shows that convergence is only a part of the story, as growth rates were

[7] The author thanks Robert Beyer for sharing the district-level estimates.

[8] These findings come with the caveat that, for some regions, luminosity may be a weaker proxy for per capita incomes than in other regions. For example, in the mountainous regions of Bhutan and Nepal, the growth in tourism may not have seen a commensurate increase in luminosity.

**Figure 1.16. Labor Market Indicators, by Gender**




Sources: World Bank's World Development Indicators; and IMF staff calculations.

heterogeneous, causing some regions with similar luminosity in 2014 to diverge over the subsequent years. As a result, the overall inequality in luminosity declined only marginally from 2014 to 2019 (Figure 1.15, panel 3).

A particularly important aspect of inclusiveness is gender equity, a topic discussed in Chapter 5. In South Asia, gender disparities are particularly prevalent in the labor market. Figure 1.16 highlights that, except for Nepal, female labor force participation in South Asia is much lower than in China or Vietnam, whereas male labor force participation rates are comparable. There is also a considerable gap in occupations that is less prevalent in other parts of Asia. Women are much more likely to work in agricultural occupations which, as we will see in the following, have much lower productivity than jobs in the service or industrial sectors.

## POLICIES FOR THE POSTPANDEMIC ERA

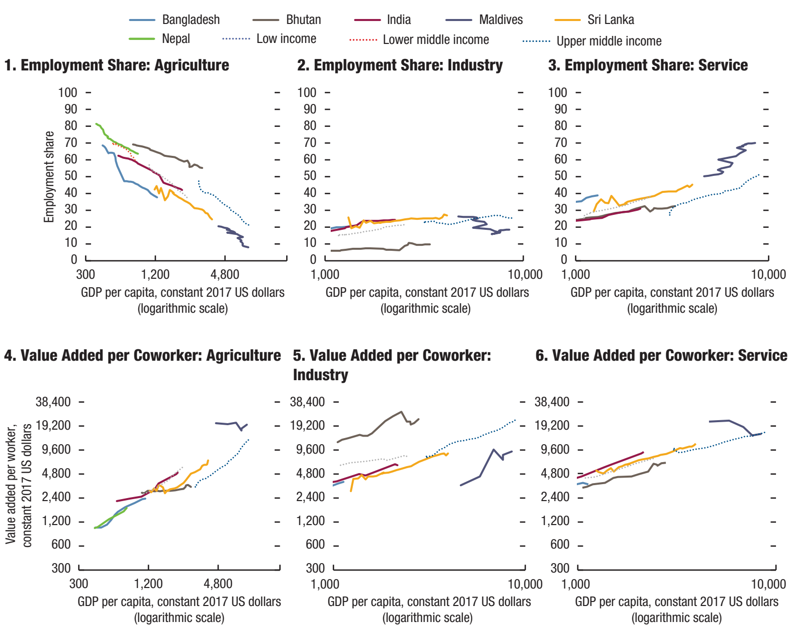
The historical experience of South Asia and the contrast with other regions hold several lessons for policy makers in the wake of the pandemic. First, there is strong evidence that sustained growth is essential for poverty reduction (see Dollar, Kleineberg, and Kraay 2016). Second, the experience of past growth accelerations that came in the wake of reforms suggest that South Asian countries have benefited immensely from economic reforms. Third, reforms in South Asia were typically less profound than in other parts of Asia, and the reform momentum in the region has slowed in recent years. Trade barriers remain high, and governments exercise a large degree of control over economic activity, including through regulation, directed lending by state-owned banks, and production in state-owned enterprises. Incumbent firms have few incentives to innovate and diversify to become competitive in new export markets, and those who do innovate find it difficult to compete for resources to expand their businesses. As a result, the region's economies have difficulties to absorb a growing labor force, pushing many young workers to migrate elsewhere instead of starting new businesses at home. Hence, to unlock South Asia's full potential, reforms to make the region more dynamic and open are needed.

## Fostering Structural Transformation

One important way in which liberalization has unlocked growth in South Asia in the past is by making it easier for economies to shift resources to more productive activities. As Lewis (1954) pointed out, economies grow not just by becoming more productive in each sector but also by shifting labor from less productive to more productive sectors, particularly from smallholder agriculture to manufacturing and services. These forces of structural change are more easily at work in an environment where land, labor, and capital can be easily reallocated between sectors without excessive state control. Figure 1.17 illustrates the mechanics of structural change in South Asia. In all countries, labor productivity in agriculture, measured as value added per worker, has been lower than in the industrial and service sectors. In all countries, the employment share in agriculture has declined over time, as workers moved to more productive activities in the manufacturing and service sectors.

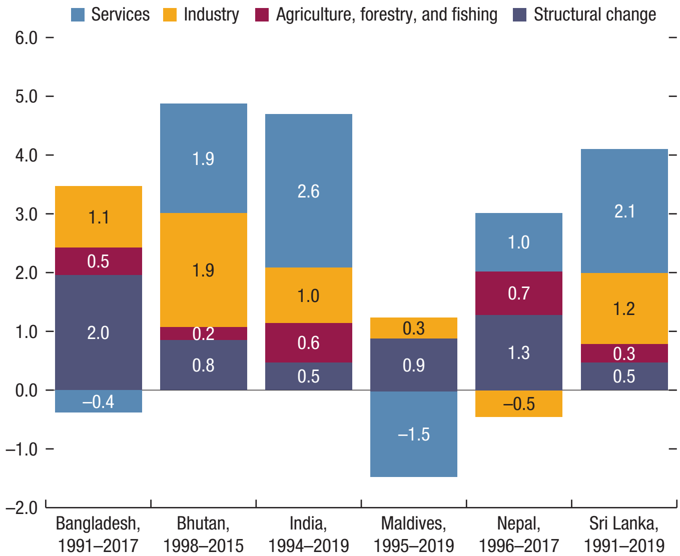
Figure 1.18 quantifies the contributions of structural change and sectoral productivity growth to the long-term change in labor productivity in the region, using the decomposition of McMillan and Rodrik (2011). The contribution of structural change was particularly large in Bangladesh, caused by the large productivity gap between agriculture and other sectors and by the rapid decline in agricultural employment. In India and Sri Lanka, by contrast, structural change

### Figure 1.17. Structural Change and Sectoral Productivity Dynamics




Sources: World Bank's World Development Indicators; and IMF staff calculations.

**Figure 1.18. Decomposition of Long-Term Labor Productivity Growth Rates**
*(Percentage points)*




Sources: World Bank's World Development Indicators; and IMF staff calculations.

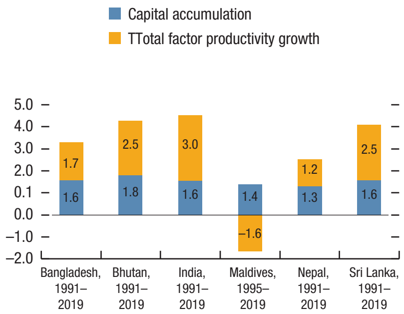
has been less important because most productivity gains occurred within sectors. The speed at which agricultural employment has declined has also been heterogeneous across countries. Whereas agricultural employment shares in Bangladesh, Maldives, and Sri Lanka are low for their level of development, they remain relatively high in Bhutan and Nepal. Given the relatively high absolute agricultural employment shares and the persistent productivity gaps between agriculture and other sectors, the potential for further gains from structural changes are large almost everywhere.

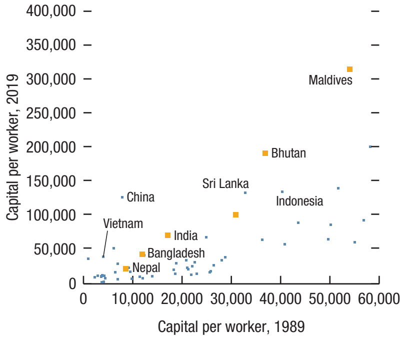
Policy reforms should aim to facilitate the realization of these gains. Labor market reforms, including those discussed in Chapter 3 of this book, would enable the large young rural population to get a foothold in the manufacturing and service sectors instead of seeking work abroad. Cutting excessive bureaucracy to make it easier to start a formal business in productive sectors would also contribute to job creation. Fewer restrictions on owning and selling land would make it easier for less productive farmers to sell their land to start a business. As we have previously seen, agricultural employment shares are especially high for women, so that reforms to foster structural change should include tackling institutional gender disparities.

## Investing in Capital

In addition to structural change, public and private investment have been an important driver of growth in South Asia over the past 30 years, as can be seen

**Figure 1.19. Public and Private Investment as Drivers of Growth**




Sources: World Bank's World Development Indicators, Penn World Tables; and IMF staff calculations.
Note: Estimates are based on Solow decomposition with capital and labor elasticities of output of 0.33 percent and 0.67 percent, respectively.

from panel 1 in Figure 1.19. Panel 2 in Figure 1.19 shows that capital per worker in South Asian economies increased faster than in countries that had a similar capital intensity in 1989—with a few notable exceptions, including China and Vietnam. Going forward, the importance of capital accumulation as an engine of growth is likely to decline over time, unless domestic savings rates increase.[9] Greater financial inclusion, a topic of Chapter 13, would help mobilize savings.

The gains from capital accumulation crucially depend on whether the additional capital is used productively. For public investment, this can be achieved through rigorous project appraisal and selection procedures and through a transparent procurement process (Chapter 11). In the case of private investment, an efficient and stable financial sector is critical for ensuring that savings are channeled toward financing the most productive activities. In South Asia, where public sector banks play a dominant role, institutional reforms are needed to improve the allocation of credit (see Chapter 13).[10]

## Investing in People and Ideas

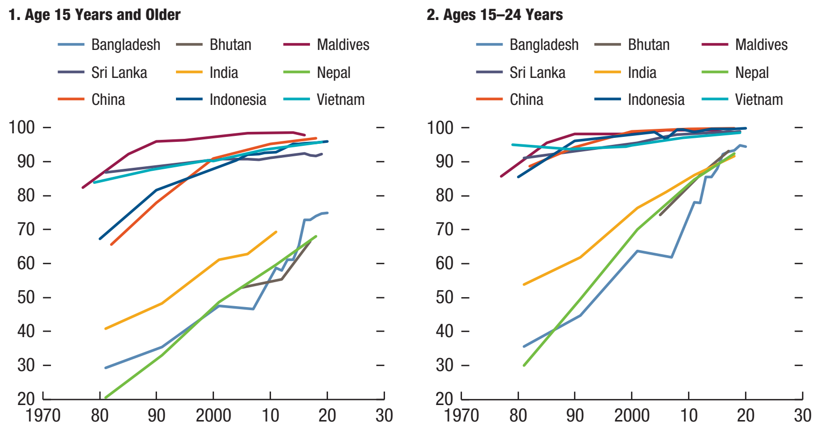
It is noteworthy that, although value-added per worker in agriculture and services has evolved broadly in line with peers, productivity in the industrial sector is below the average of other countries at the same stage of development (see Figure 1.17), despite the relatively rapid capital accumulation.[11] This is consistent

[9] As famously demonstrated by Solow (1956), the growth rate of the capital stock tends to decline when countries become more developed, since a greater share of investment will be needed to replace depreciating existing capital.

[10] See also Schipke and others (2022) for a recent in-depth discussion of India's financial sector.

[11] A notable exception to this pattern is Bhutan, where productivity in the industrial sector benefited from growth of the capital-intensive hydropower sector, while agricultural productivity lagged.

**Figure 1.20. Literacy Rates**
*(Percent)*



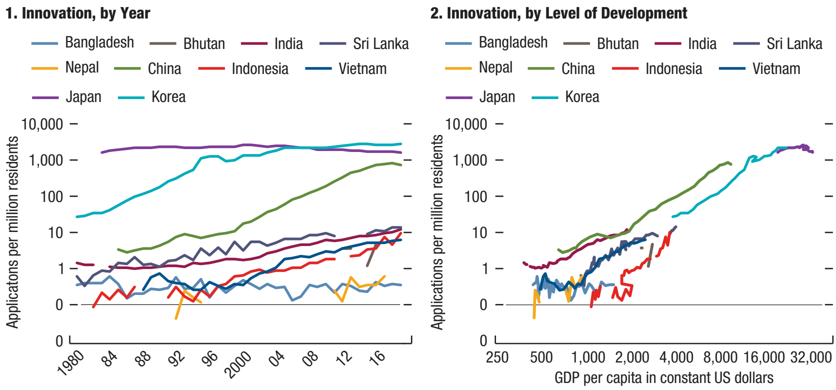

Sources: World Bank's World Development Indicators; and IMF staff calculations.

with our earlier observation that manufacturing activities in South Asia have a relatively low technology content. A comparison of the sources of growth in Figures 1.17 and 1.18 (panel 1) reveals that, for Bangladesh and Nepal, total factor productivity growth is mostly explained by structural change and less by technological improvements.

Given that the growth payoffs from capital accumulation and structural change will eventually decline over time, South Asian countries need to boost alternative growth engines. Perhaps the largest investment gaps are in South Asia's people. Basic skills are needed for workers to switch from agriculture to other sectors. Literacy rates have shown drastic improvements, especially in Bangladesh and Nepal. Overall, except for Maldives, the levels remain far below those observed in faster growing peers such as China, Indonesia, or Vietnam (Figure 1.20). Bhutan had the same literacy rate as Nepal in 2017, despite having more than twice the level of GDP per capita. Sri Lanka, which once prided itself for having one of the highest literacy rates in Asia, has long been surpassed by other Asian countries as literacy rates have stagnated. The higher literacy rates among the young are an indication that over time the gaps in literacy will close. In India, however, the increase in youth literacy rates has been slower than elsewhere.

Investments in the health sector need to be stepped up, too. Notwithstanding the large improvements in health outcomes highlighted in Figure 1.8, there is still a large gap across countries in the region. To meet the SDGs and close these gaps, a big push is required. Moreover, a sound health infrastructure is a key element in managing pandemics. Chapter 2 of this book estimates that the overall spending needs in education, health, and infrastructure (water and sanitation, electricity, and roads) required to meet the SDGs are around 6 percent of GDP in India and 11 percent of GDP in the rest of South Asia.

## Figure 1.21. Patent Applications per 1,000,000 Persons



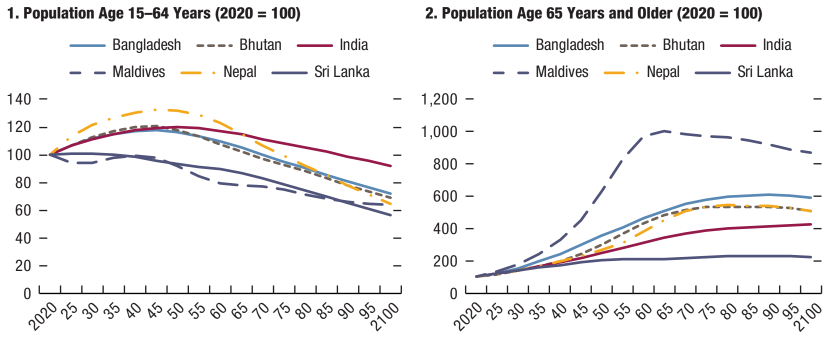

Sources: World Bank's World Development Indicators; and IMF staff calculations.

South Asia also needs to invest more in ideas. The experience of China and Korea has shown that innovation can become an engine of growth for countries that have reached middle-income status and where the labor costs are no longer a comparative advantage. Figure 1.21 documents how Korea has become more innovative over time, surpassing Japan in the number of worldwide patent applications per capita. China has seen a remarkable increase in patent applications which accelerated in the early 2000s. In absolute numbers, South Asia lags far behind China in terms of patent applications per capita. However, relative to its GDP per capita, India is on a similar trajectory as China. The rest of South Asia, however, lags along both measures.

## Managing the Demographic Transition

South Asia's growing population holds a vast potential for sustained economic growth in the decades to come. According to the United Nations, the region's working-age population in 2050 will be 19 percent larger than in 2020. Making the most of this demographic opportunity requires ambitious reforms. As discussed previously, investment in education needs to be fast-tracked, so that the growing number of young people entering the labor market have the necessary skills. Also, labor market reforms should be an urgent priority so that young workers can more easily be absorbed into productive sectors. Chapter 3 reports that youth unemployment rates in South Asia are relatively high compared with those in other developing and emerging economies. Labor force participation needs to improve as well. As we have seen in Figure 1.16, female labor force participation rates in the region are extremely low and have declined in recent decades in Bhutan, India, and Sri Lanka. Removing formal constraints to female employment should be complemented with increased flexibility and policies to

## Figure 1.22. Population Projections




Sources: World Bank's World Development Indicators; and IMF staff calculations.

facilitate access to childcare.[12] These reforms are particularly urgent in Maldives and Sri Lanka, where the working-age population is already at its peak and bound to begin its decline.

Although the increase in the size of the labor force associated with the demographic transition is temporary, the increase in the size of the elderly adult population will be much longer lasting. The region's population age 65 years and older is projected to nearly double by 2040 and more than quadruple by 2075 (Figure 1.22). In many countries, population aging has led to increased private savings and hence to more investment and improved external positions. Facilitating this process requires policies that promote greater access to finance and policies that ensure that private savings are channeled into productive investments. However, population aging also means that public spending on pensions and social transfers to address old-age poverty are likely to increase over time. Fiscal policy planning should take these implicit liabilities into account.

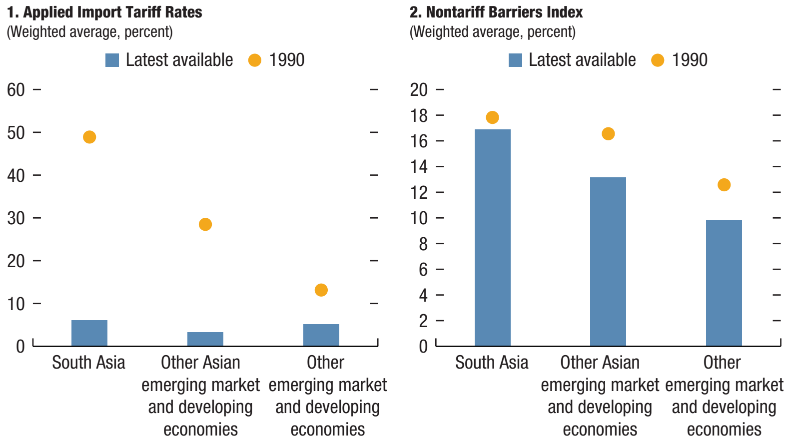
## Fostering Trade Integration

Ample evidence suggests that trade liberalization has benefited the region.[13] Yet, liberalization in South Asia is less advanced than in the rest of Asia. High tariffs and nontariff barriers protect domestic producers, giving them few incentives to innovate or to search for new export opportunities abroad (see Figure 1.23). Meanwhile, as we have seen previously, competition in South Asia's traditional

[12] Khera (2018) found that gender policies in India are most effective if they are combined with greater flexibility in the formal sector.

[13] For example, when studying wages in different industries in India, Mishra and Kumar (2005) found a strong positive effect of tariff reductions on sectoral productivity and wages, which led to a reduction in overall wage inequality in the 1990s.

**Figure 1.23. Tariff Rates and Nontariff Barriers**




Source: Furceri and others 2019.

Source: Estefania-Flores and others 2022.

export destinations has intensified. As a result, exports of South Asian countries accounted for less than 2.5 percent of global cross-border trade in 2017–19.

The link between trade and growth is explored in more depth in the middle section of this book. Chapter 8 documents how the region's gradual opening has brought a diversification into new exports and an increase in economic complexity. The chapter then identifies policies that could help diversify the region's economies further. Key findings include that, to become more diversified, South Asia needs to invest in infrastructure, education, and research and development, facilitate bank credit to productive companies, and become more open to trade.

Chapter 9 documents that South Asia's integration into global value chains lags that of other regions and that trade links within South Asia remain underdeveloped. The authors find that the region's still-relatively-high tariffs and nontariff trade barriers are responsible for the low degree of trade openness and, using the example of India, quantify the growth effects from further liberalization. Chapter 10 takes a closer look at fostering trade ties between South Asia and East Asia. It argues that South Asian economies can reap economic welfare gains from closer integration with East Asia. Policy priorities include gradually reducing trade barriers accompanied by adjustment assistance, investing in special economic zones to promote exports and industrial clustering, pursuing comprehensive free trade agreements and reinvesting in BIMSTEC as a regional organization.

## Addressing Inequality

Although the policies discussed so far (for example, investment in education and financial inclusion) would help reduce poverty, greater trade openness may give rise to inequality, as exporting sectors may benefit more than sectors facing higher import competition. The link between inequality and growth-enhancing policies

is complex and can change over time. For example, Kuznets (1955) famously observed that structural transformation initially tends to lead to higher inequality, as only some workers move to better opportunities in the manufacturing or service sectors. In later stages, structural transformation reduces inequality, as the number of lower-income agricultural workers declines.

Redistribution mechanisms are needed to ensure that the gains from reforms are more evenly spread. Chapter 4 of this book explores policies to reduce inequality from relatively high levels, through better functioning insurance and redistribution mechanisms. In most South Asian countries, the levels of government spending on social protection are relatively low, and transfer schemes suffer from large inclusion and exclusion errors. Hence, reforms should aim to enhance the generosity and coverage of social transfer schemes while improving mechanisms for households to graduate once their income is sufficiently high. Moreover, social protection systems should consider that the nature of risks changes over the life cycle.

## Leveraging Digitalization

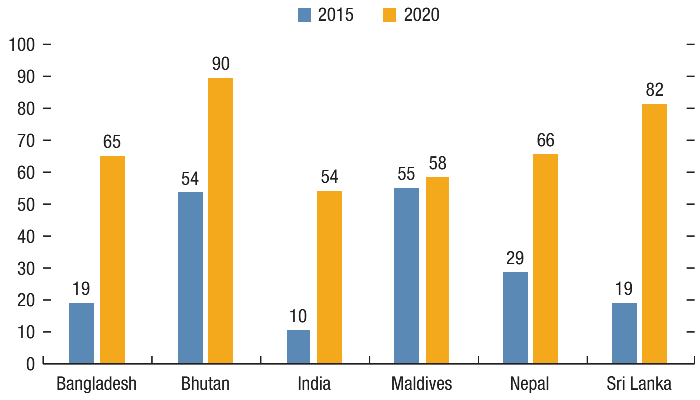
Digitalization offers many new opportunities to promote inclusive growth. Information and communication technology services are a significant source of export revenues for most countries in the region. However, digitalization can also support the domestic economy. In some cases, digital solutions have helped overcome access gaps in the traditional infrastructure. For example, in Bangladesh, where access to commercial banks has lagged, digital alternatives have become a popular substitute with mobile money transactions of more than 20 percent of GDP in 2020. In India, the introduction of Adhaar, the biometric digital identification system, in 2011 greatly facilitated access to bank accounts (Khera 2022). The subsequent take-off of financial inclusion under the government's Pradhan Mantri Jan Dhan Yojana program in 2014 also benefitted from digitalization, through both the reliance on Adhaar identification numbers and the availability of digital technology for low-cost service delivery. After the program was introduced, the share of the population with a bank account increased from 53 to 70 percent (Khera 2022).

The potential gains from digitalization have increased over the past few years, as South Asia has seen a rapid increase in Internet access across the population, a development that accelerated further during the pandemic (Figure 1.24). In India and Maldives, where online banking transaction volumes reached 14.5 and 85.5 percent of GDP in 2019, respectively, the number of online banking transactions more than doubled in 2020, according to the IMF's Financial Access Survey.

Chapter 5 of this book makes the case that digitalization can be an important tool to close gender gaps in the region. As we have seen previously, women are disproportionately affected by a lack of access to finance, so that digitalization can contribute to closing existing gender gaps. At the same time, gender gaps in South Asia are also prevalent in the extent of digitalization.

The benefits of digitalization go beyond the financial sector. According to the McKinsey Global Institute (2019), core digital sectors accounted for 7 percent of

**Figure 1.24. Fixed and Mobile Internet Subscriptions Per Capita**




Source: International Telecommunication Union.

India's GDP and are projected to grow significantly faster than the rest of the economy. In 2020, India's e-commerce sales alone grew by close to 40 percent (see Dabla-Norris and others 2021). Digitalization can also make public administrations more efficient while reducing the risk of corruption (Chapter 6). Customs administrations in most countries in the region now use electronic systems to facilitate customs clearance. Some countries have introduced electronic business registrations (Bangladesh) and online building permit applications (India and Nepal). Evidence from India and Indonesia shows that e-procurement can improve the quality of infrastructure investment (see Lewis-Faupel and others 2016). Electronic taxpayer registrations and e-filing can facilitate the work of tax administrations while reducing the administrative burden on taxpayers (see Dabla-Norris and others 2021). E-filing platforms for at least some tax types now exist in Bhutan, India, Maldives, and Sri Lanka. Also, e-filing is mandatory for all corporate income taxpayers in Bhutan, India, and Sri Lanka and for large businesses in Maldives. Digitalization often reduces the scope for discretion and fraud. In India, the adoption of an electronic platform for managing a social assistance program resulted in a decline of 17 percent in spending with no corresponding decline in benefits (IMF 2019).

## Preserving Macroeconomic Stability

The recent volatility in oil and food prices have underscored the need to be vigilant against risks to macroeconomic and financial stability. Responding to shocks has become more challenging, given that the pandemic has weakened South Asia's public and private sector balance sheets. Climate change will not just pose headwinds to growth. It will also increasingly become an additional economic risk

factor throughout the region with rising sea levels affecting coastlines in Bangladesh, India, Maldives, and Sri Lanka. Changing weather patterns and shrinking glaciers will affect hydropower production in Bhutan, Nepal, and Sri Lanka. Climate change will also disproportionately affect the region's agricultural sector that will continue to employ a large share of the population. Chapter 7 of this book documents South Asia's exposure to climate risks and discusses the mitigation and adaptation policies undertaken by countries in the region.

Considering these heightened vulnerabilities, the role of macro-financial management—the topic of the third part of this book—is more important than ever. Given signs of fiscal dominance in several countries, a credible strategy for fiscal consolidation will be needed to keep inflation expectations anchored. Chapter 11 discusses how the region's large infrastructure needs can be met despite limited fiscal space. It shows that both the quality and quantity of public investment need to increase and, through a simulation exercise, explores the growth impact of various alternative financing strategies. Chapter 12 takes stock of the region's monetary policy frameworks and discusses policies to enhance their effectiveness.

## CONCLUSIONS

South Asia's future holds the promise of continued poverty reduction and rapid economic development that would make the region a powerhouse of the global economy. Unlocking the region's potential, however, requires bold reforms. History has shown that all South Asian countries have benefited from reform episodes, and this chapter has explored ways to build on these earlier successes to unleash a renewed dynamism. The remainder of this book explores the design of reforms in much more detail, making the case for private sector led growth accompanied by strong policy frameworks to keep the region on a stable path and address inequalities, so that prosperity is shared, and no one is left behind.

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