SACEPS Task Force Report on

Common Investment Strategy for South Asia

Executive Summary

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Executive Summary

1.1 The objective of this study is to provide strategic guidelines for a common investment strategy for South Asian economies. By a common investment strategy we mean a common set of investment policies that need to be adopted by countries in the South Asian region. Justification for designing a common strategy is provided by the fact that there is considerable convergence between South Asian economies with respect to both policies and performance.

1.2 The main part of the study has two objectives. First, it gives strong empirical reasons that suggest that investment generation, in particular private-sector investment generation, in the region should be at the top of the policy agenda. Second, it analyzes in great detail the constraints to investment that are holding South Asia back as a high growth region. The in-depth analysis of investment constraints provides the basis of policy recommendations that are detailed in chapter 5 of this study.

Justifying the Emphasis on Investment

1.3 The emphasis on investment is justified by conducting a comparative growth decomposition exercise that shows that slow rates of capital formation have held South Asian growth back relative to other developing countries (chapter 1). The comparative growth exercise assesses the determinants of South Asian growth by benchmarking it against the growth performance of East Asian economies for the last four decades. This comparison is useful as it allows us to ascertain the variables that have held South Asian growth from achieving East Asian rates.

1.4 The comparative growth assessment exercise shows the stark difference between the growth rates of the two regions, which has narrowed down during the last decade. It also shows that there has been considerable convergence in the growth performance of South Asian economies[1].

1.5 A major finding of this chapter is that, during the last three decades, much of the difference in the relative growth performance between the two regions is attributed to East Asia's faster rates of capital accumulation. We find that the during the last two decades the contribution of TFP in South Asia has been catching-up with East Asia, however, the same finding is not true of capital accumulation. Since, investment is a major determinant of capital accumulation this provides an important justification for analyzing the constraints to investment in South Asian economies. This exercise is conducted in chapter 2.

1.6 Chapter 1 also shows that the difference in the efficiency of governance is an important factor behind East Asia's superior growth performance. It shows that East Asia performs far better than South Asia on a host of economic freedom variables. Furthermore, drawing on secondary econometric evidence it shows that poor governance has held South Asia back as a high growth performer.

Analyzing the Constraints to Investment

1.7 In line with the methodology of the study Chapter 2 identifies the constraints to investment in South Asia by benchmarking its investment performance against East Asia. It shows that there has been considerable divergence in the level and rates of investment between the two regions, with South Asia lagging behind East Asia. Furthermore, it shows that the difference between the two regions is particularly stark with respect to private investment performance. This suggests that investment generation in the private sector has to be an important objective of policy in South Asia. The remaining part of the chapter analyzes the determinants of this differential investment performance.

1.8 The main findings of chapter 2 are that differences in investment performance between the economies of the two regions can be explained by the following factors.

[1] The exception is Pakistan whose performance has deviated from the others during the last decade.

- Low growth in South Asia – We find that in the high saving South Asian economies low growth rates reduce investment by lowering the rate of aggregate savings.

- Shallow credit markets – We find that the relative shallowness of credit markets in South Asia compared to East Asia explain a large part of the difference in investment between the two regions.

- Shallow financial markets – Shallow financial markets in South Asia hamper investment performance by lowering the level of aggregate savings that are mobilized by these economies.

- High age dependency – We also find that the high proportions of dependent population in South Asia relative to East Asia help explain the low savings rates that prevail in South Asian economies. By lowering aggregate savings this variable had a significant negative effect on aggregate investment performance in South Asia.

- High levels of public dissavings – We find the high levels of public dissavings in South Asia relative to East Asia to be an important factor behind the savings differential in the two regions. An important finding with regard to public savings is that in South Asia private and public savings are not perfectly substitutable. This suggests that South Asian governments can increase aggregate savings by lowering public dissavings.

- Lower levels of FDI – The FDI inflow differential between the two regions clearly explains an important part of the difference in investment performance. However, we argue that it is difficult to argue the direction of causality. Given the ambiguity in inference we argue that FDI policies should be seen as complementary policies to domestic investment generation policies.

1.9 This chapter also provides first cut evidence that suggests that differences in governance variables may explain a large part of the difference in investment performance. In our view South Asian policy makers must take cognizance of the effect poor governance has had on dampening investment in their respective economies. Identifying governance variables is also important because policy can significantly affect investment, in the short to medium term, by loosening these constraints for investors. However, at this level of analysis particular constraints in this area are difficult to identify. Therefore, we use detailed micro case studies for India and Pakistan to help analyze and identify the manner in which governance constraints manifest themselves in South Asian economies. However, we do find that the quality of infrastructure delivery is emerging as an important constraint to investment creation in South Asia.

Analyzing Governance Constraints

1.10 As pointed out in Para 1.9 detailed analysis of governance constraints is carried out with help of micro case studies of India and Pakistan. Time and resource constraints and paucity of secondary material restricted us from conducting similar case studies for other South Asian countries. Given this constraint we were forced to generalize across South Asian countries from the Indian and Pakistani example. This is an important shortcoming of this study. However, given the similarity in policies (see appendix A) and institutional structure we feel that generalizing on the basis of these case studies will not weaken the conclusions of this study. This is confirmed by the findings of the two case studies, which show that similar governance constraints appear to hamper investment performance across Pakistan and India.

1.11 The case studies show that governance-related constraints are creating disincentives for investment in these two countries in the following ways. First, by increasing both fixed and variable costs poor infrastructure provision and high transaction cost regulatory, fiscal and judicial systems are *directly* increasing the cost of investment. Second, the regulatory and judicial systems in these two countries are dampening investment incentives by increasing investor uncertainty. Third, by rationing access to loans credit markets are increasing investor risk especially for SMEs. Major causes of inefficiencies in the credit market include weak creditors' rights and poor judicial enforcement. Fourth, law and order, regulation and political conflict are creating disincentives for investment by weakening the property rights of investors. Fifth, high market transaction costs, inefficient contract repudiation, credit-rationing and the discontinuity in regulatory costs are lowering the efficiency of investment by distorting competition and inhibiting the incentives for firm growth and investment. This suggests that improving micro governance constraints has to be an important objective of investment policy in South Asian economies.

The Way Forward

1.12 Based on the analysis carried out in Chapters 2 to 4, Chapter 5 presents the broad strategic guidelines of a common investment strategy for South Asian economies. However, these guidelines are suggestive and more detailed work needs to be undertaken to flesh out the substance of these recommendations in each area and across South Asian economies.

1.13 A major objective of investment policy in South Asian economies has to be growth enhancement. Our analysis suggests that there is a strong positive relationship between increases in growth and increases in aggregate savings for the high savings South Asian economies. Growth enhancement can be encouraged through incentives for technology transfers and acquisition and by creating greater competition in these economies. The former can be achieved through encouragement of joint ventures, encouragement of FDI and by providing incentives for firm-level R&D. In our view, growth enhancement also requires considerable investment in education, health and social services. Adherence to trade liberalization is also expected to enhance growth by creating greater competitiveness within these economies. Therefore, in our view South Asian economies should remain committed to trade liberalization.

1.14 Another important objective of investment policy should be to increase the rate of aggregate savings in these economies. An important part of this increase can *potentially* come from the reduction in public dissavings. In chapter 5 we detail a number of steps that can be taken by these economies to both streamline expenditure and increase the buoyancy of revenue collection. Similarly, private savings can be increased by the introduction of financial institutions that utilize social capital, reputations and group insurance to mobilize private savings in rural and low-income urban areas.

1.15 Encouraging FDI inflows should remain an important policy objective. However, there are a number of concerns in this regard. First, there is the concern that competition for FDI within South Asian economies may lead to more and more generous incentives for FDI, which may eventually come at the expense of all economies of the region. This suggests that there is an urgent need to harmonize FDI incentives across the countries of the region. We also argue that strengthening local technology acquisition capability is important if the gains from FDI spillovers are to be maximized. This brings us back to the need to strengthen the domestic investment and growth generation potential of these economies. Furthermore, FDI activities should be tied to activities that create the strongest potential for spillovers. In our view, these activities should include education, training, export-related links and domestic joint ventures in technology intensive sector.

1.16 We find that there is an argument for strengthening regional cooperation in order to increase intra-SAARC FDI inflows, which currently remain far below potential. However, the major impact of these inflows is expected to come from the increase in the efficiency of investment, which is expected to increase in response to the generation of regional spillover effects. In our view, the financial gain from intra-SAARC inflows is limited given the low level of aggregate savings that plague the South Asian region. More importantly, political stability and regional political harmony is imperative for strengthening regional cooperation and maximizing the benefit from higher levels of FDI inflows from within and outside the region.

1.17 Banking sector reforms need to be taken beyond mere liberalization if increased depth is to be given to credit markets in South Asia. We have already argued that shallow credit markets are an important cause of South Asia's poor investment performance. In our view, the state needs to provide incentives for the development of long-term lending institutions. We suggest that this can be achieved through the state subsidizing the inflation risk for private sector banks, which continue to bear the credit and the default risk. We also argue that better management of the banking sector requires the application of risk-adjusted capital adequacy norms, and the imposition of restrictions on lending in the high uncertainty markets. We also argue that there is an urgent need to improve the legal system of debt recovery, which is a *necessary* component of a market-driven banking system. Finally, we argue that considerable investment in required in raising the capacity of regulatory agencies that are expected to manage the banking sector in a liberalized and open economy where price fluctuations are expected to be the norm.

1.18 Lastly, in our view there is an urgent need for South Asian governments to institute far-reaching governance reforms. The reform package should aim to deregulate the economy and increase the efficiency of tax administration, the judicial system and infrastructure delivery. Simplification of tax administration should be an important objective of government and should be based on reengineering and automation of tax administration processes in order to: reduce face-to-face contact between taxpayers and tax officials; streamline the number of steps in a process; and to reduce excessive discretion. Similarly, there is an urgent need to reduce multiplicity and overlapping jurisdiction of state agencies. Alongside this an audit of laws and regulations should be undertaken, on the basis of which redundant laws and regulations should be rescinded. Another important component of governance reforms should be the reform of the judicial system. This reform should aim to increase the accountability of judges through greater information disclosure on performance and by linking remuneration to performance based rewards. Finally, infrastructure efficiency can be improved through the enhancement of competition, privatization and the creation of strong regulatory bodies.