

Chapter 4: Harnessing Globalization

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Introduction

The integration of the world economy through rising trade and financial linkages took a hit during the global financial crisis. Now that the recovery is underway, the rapid growth of global trade and financial flows has resumed, indicating that the crisis ended up resulting in only a temporary setback to the forces of globalization.

Of course, globalization is not an end in itself; nor is it an unqualified benefit. The literature seems to have moved towards a consensus that trade liberalization promotes growth, although it can have distributional consequences that favor some groups over others. At a macroeconomic level, however, trade is seen as clearly beneficial.¹ Indeed, there is also some evidence that developing economies that are more open to trade are less susceptible to crises and recover faster from crises that do occur.²

The literature on the costs and benefits of financial integration is more controversial. Theory suggests that financial openness should benefit all countries by promoting more efficient international allocation of capital and also consumption smoothing via international risk-sharing. The strong presumption was that these benefits ought to be large, especially for developing countries that tend to be relatively capital poor and have more volatile income growth. However, the empirical literature is far from conclusive. Indeed, Prasad, Rogoff, Wei and Kose (2003) conclude that, taken as a whole, the vast empirical literature provides little robust evidence of a causal relationship between financial integration and growth. Moreover, these authors conclude that, among developing countries, the volatility of consumption growth relative to income growth appears to be positively associated with financial integration, the opposite of what canonical theoretical models would predict. In theory, access to international markets should allow all countries to smooth consumption by insuring against country-specific income risk.

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¹ For empirical evidence showing that trade openness has a direct and positive effect on economic growth, see, e.g., Frankel and Romer (1999) and Dollar and Kraay (2003). Rodriguez and Rodrik (2002) present a contrarian view but, as summarized in recent surveys by Krueger and Berg (2003), Baldwin (2004), and Winters (2004), the weight of the evidence supports the by-now conventional wisdom that trade is good for growth.

² See Frankel and Cavallo (2004) and Cavallo (2005).

Kose, Prasad, Rogoff and Wei (2008) provide a framework that yields some more nuanced perspectives on financial globalization. These authors argue here that far more important than the direct growth effects of access to more capital is how capital flows generate a number of what they label the “potential collateral benefits” of financial integration. There is now a rapidly growing literature showing that financial openness can, in many but not all circumstances, promote development of the domestic financial sector, impose discipline on macroeconomic policies, generate efficiency gains among domestic firms by exposing them to competition from foreign entrants, and unleash forces that result in better government and corporate governance.

These authors point out some complexities in managing the cost-benefit tradeoff. For developing countries, financial globalization appears to have the potential to play a catalytic role in generating this array of collateral benefits that may help boost long-run growth and welfare. At the same time, opening the capital account without having some basic supporting conditions in place can delay the realization of these benefits, while making a country more vulnerable to sudden stops of capital flows. This is a fundamental tension between the costs and benefits of financial globalization that may be difficult to avoid and ultimately the balance depends on country-specific conditions, including institutional and financial development.

In this paper, we evaluate the extent and nature of South Asian economies with the world trade and financial systems, using this vast academic literature as a reference point. Our analysis covers the following countries-- Bangladesh, Bhutan, India, Nepal, Pakistan, and Sri Lanka. These South Asian economies have participated in the phenomenon of globalization to varying extents. As noted earlier, globalization is not an end in itself and the benefit-cost calculus depends to a significant extent on the structure of a particular economy and the nature of its integration into world trade and finance.

Hence, in the next section of this paper, we begin our analysis by providing an empirical characterization of growth patterns in South Asia. On average, economies in this region have experienced decent GDP growth of 5.5 percent over the last decade. We also examine the composition of growth in these economies, an issue that is particularly relevant in the context of recent discussions of global rebalancing of growth (see Prasad, 2010). We find that in these economies consumption is in fact the main driver of growth and the trade balance is generally negative. Thus, growth looks a lot more balanced and less dependent on external demand than is the case with some East Asian economies such as China. Employment growth, however, remains a challenge for even some fast-growing economies in the South Asian region. We also look at the region’s dependence on external trade from different perspectives.

In Section III, we focus on service sector growth and services exports of South Asian economies. One of the interesting results from this analysis is that growth in the services sector among economies in the region has already outpaced that of many other emerging markets and led to a diverging growth path from the rest of Asia. The importance of services exports to economies in the region may in fact have played a role in allowing these economies to recover more quickly from the global financial crisis than countries whose exports are dominated by manufactured goods, as services exports held up a lot better during the crisis and in the early stages of the global economic recovery.

In Section IV, we provide another perspective on the balance of growth that ties together the domestic and international implications by examining patterns of national savings and investment. An analysis of the evolution of saving-investment balances is especially relevant for understanding the dynamics of global imbalances. In Section V, we broaden this discussion by examining capital inflows to South Asia and the accumulation of foreign exchange reserves. In general, South Asia has had increasing openness to capital inflows but the de facto financial integration of each of these economies with the world economy, as measured by financial flows relative to the size of their domestic GDP, has remained modest. The region maintains relatively large levels of foreign exchange reserves and this should reduce the vulnerability of these economies to external crises. We conclude the paper with a summary of the main findings and a discussion of policy implications in Section V.

Composition of Growth

In this section, we characterize some of the key patterns of growth in the South Asian economies and also examine related outcomes such as employment growth. It is useful to start off with a description of the evolution of the structure of GDP from a national accounts perspective. Table 1 shows the shares of different components of GDP for three years—1995, 2000 and 2009. We show the data for each South Asian economy, averages for the group and some comparative data for other countries and country groups.³

³ We show medians rather than means in these calculations to mitigate the effects of outliers in these small samples. In any event, using means rather than medians made little difference to the patterns we discuss in the text. The reported averages treat each country as a unit; there is no weighting for country size.

Table 1. Shares of Real GDP (in percent)

Country	1995				2000				2009			
	Consumption				Consumption				Consumption			
	Pvt.	Govt.	Invst.	Net X	Pvt.	Govt.	Invst.	Net X	Pvt.	Govt.	Invst.	Net X
Bangladesh	84.5	4.6	18.9	-6.4	73.1	4.2	23.8	-3.8	66.1	5.2	27.0	-0.8
Bhutan	--	--	--	--	51.1	23.5	51.6	-26.2	48.5	25.6	34.8	-9.4
India	66.3	11.1	24.6	-1.5	64.2	12.9	25.9	-1.9	59.5	11.5	34.9	-6.1
Nepal	79.1	8.4	23.2	-12.0	80.2	8.1	22.3	-10.7	76.6	12.4	30.7	-22.0
Pakistan	--	--	--	--	75.4	8.6	17.2	-1.2	69.6	11.0	16.0	1.9
Sri Lanka	74.1	10.5	24.2	-8.9	72.1	10.5	28.0	-10.6	64.3	17.6	23.8	-6.5
South Asia Median	76.6	9.5	23.7	-7.7	72.6	9.6	24.9	-7.2	65.2	11.9	28.8	-6.3
Regional and International Comparisons:												
China	44.9	13.3	40.3	1.6	46.4	15.9	35.3	2.4	35.3	13.3	43.5	7.9
Asian Emerging Markets	58.9	10.7	30.5	-3.4	60.4	10.2	25.4	2.7	57.4	11.4	20.5	8.2
Asian Developing Countries	74.1	8.2	24.2	-8.9	72.6	5.9	25.9	-7.2	67.1	5.9	25.4	-8.0
Germany	59.5	19.6	22.1	-0.9	58.9	19.0	21.8	0.4	58.0	20.0	17.9	3.9
Japan	56.7	15.5	27.7	0.4	56.2	16.9	25.5	1.5	58.1	18.7	19.7	3.0
U.S.	67.7	16.2	17.2	-0.9	68.7	14.4	20.8	-3.9	71.1	16.4	15.2	-2.7
Source: CEIC, IMF's WEO, EIU, and authors' calculations.												
<p><i>Note: GDP contribution shares (in percentage points). Asian emerging countries include China, Hong Kong, India, Indonesia, Korea, Malaysia, Pakistan, Philippines, Singapore, Taiwan, and Thailand. Asian developing countries include Bangladesh, Cambodia, Sri Lanka and Vietnam.</i></p>												

The median share of private (household) consumption in South Asian countries' GDP has fallen from 76.6 percent in 1995 to 65.2 percent in 2009. The median shares of government consumption and investment have increased from 9.5 and 23.7 percent respectively in 1995 to 11.9 and 28.8 percent in 2009. The median share of net exports in GDP has been relatively stable at around minus 7.7 percent.

Of course, these averages mask substantial differences across countries. Among the major South Asian economies, the most dramatic shift in the share of private consumption is recorded by Bangladesh. Its share in GDP fell from 73 percent in 2000 to 66 percent in 2009. Bhutan is the only South Asian economy where private consumption now accounts for less than half of GDP (48.5 percent), while its government consumption is over a quarter of its GDP, much higher than other Asian countries and developed countries in our sample. In Bangladesh, the shares of both investment and net exports rose markedly--by about 4 and 3 percentage points, respectively—from 2000 to 2009. There is a significant decline in the share of private consumption in India's GDP as well--the share fell from 64.2 percent in 2000 to 59.5 percent in 2009, with investment taking up the slack. The share of private consumption and investment in Sri Lanka's GDP have declined as well--the share fell from 72.1 and 28 percent respectively in 2000 to 64.3 and 23.8 percent in 2009, with increases in government consumption and net export. In Nepal, there is a surge in the share of investment, which is offset by a corresponding expansion of the trade deficit. Overall, South Asian countries have similar private consumption, Investment and net exports shares to the average of Asian developing countries, while their government consumption ratios are mostly higher than that of Asian developing countries (except Bangladesh) and close to that of Asian emerging markets.

Table 2 shows average GDP growth rates over the period 2000-09 for each country in the sample. The next five columns show the contributions of different components—total consumption (which is further broken down into private and government consumption), investment and net exports—to overall GDP growth. The last column of the table shows employment growth in the formal sector.

Consumption is typically the largest component of GDP, so it is usually the case that consumption growth tends to track overall GDP growth. On average, total consumption growth (private and public) contributes about 4.2 percentage points to GDP growth, relative to median GDP growth in the sample of about 5.5 percent per annum. In other words, consumption growth on average accounts for over three-quarters of GDP growth among the six countries in the sample.

There are two economies for which the contribution of consumption growth amounts to 90 percent of GDP growth, well above the sample average—Nepal and Sri Lanka. At the other extreme is Bangladesh, where consumption growth contributes about 3.6 percentage points, out of 5.8 percent GDP growth.

**Table 2. Contributions to Growth and Employment Growth, 2000-09
(in percent)**

Country	GDP Growth Contributions						Employment Growth
	GDP Growth	Consumption			Investment	Net Exports	
		Total	Private	Government			
Bangladesh	5.8	3.6	3.2	0.4	1.9	0.2	3.3
Bhutan	6.8	4.9	3.0	1.9	1.5	0.8	--
India	8.4	6.0	5.0	1.0	3.6	-1.4	1.9
Nepal	4.0	3.6	2.8	0.8	2.3	-2.0	--
Pakistan	4.7	3.5	2.8	0.7	0.8	0.4	3.1
Sri Lanka	5.2	4.8	3.8	1.0	1.3	-0.8	1.9
South Asia Median	5.5	4.2	3.1	0.9	1.7	-0.3	2.5
Regional and International Comparisons:							
China	10.2	4.1	2.8	1.3	5.0	1.1	0.9
Asian Emerging Markets	4.6	3.2	2.6	0.6	0.8	0.7	1.7
Asian Developing Countries	6.5	5.0	4.3	0.4	2.2	-0.7	2.8
Germany	0.8	0.5	0.3	0.2	-0.2	0.5	0.4
Japan	1.5	1.0	0.6	0.4	0.2	0.5	-0.3
U.S.	1.9	2.0	1.7	0.3	-0.1	0.0	0.3

Source: CEIC, IMF's WEO, ADB, EIU, and authors' calculations.

Note: GDP growth rates (in percent) are annual averages over the period 2000-09. GDP growth contributions (in percentage points) are averages over the same period. Contributions may not sum exactly to GDP growth because of rounding error because the statistical discrepancy is large. Investment includes private and public investment. Employment growth rates (in percent) are also annual averages over the period 2000-09, except for Bangladesh (only 2000, 2003 and 2006). India's employment data are only available for 2000 and 2005 from ADB. See Table 1 for list of countries classified as Asian emerging markets and Asian developing economies.

What is the relative importance of private versus government consumption in driving GDP growth? Private consumption growth strongly dominates total consumption growth in

most sample countries, with the notable exception of Bhutan (where private consumption and government weight almost equally, with the former being 40 percent and the latter 30 percent). On average, private consumption growth accounts for four-fifths of the total growth contribution of consumption.

Investment growth on average accounts for about 1.7 percentage points of GDP growth. India and Nepal both get relatively high contributions from investment growth, nearly 4 percentage points per annum in the case of India and close to 2.3 percent in Nepal. It is worth noting that only in Nepal investment growth contributes more than 50 percent of GDP growth. Another key fact about India investment growth is that its investment is heavily financed through foreign capital (as we will see later, India now runs a large current account deficit).

Another aspect of the balance of growth is related to dependence on external trade for growth. Here it is important to be careful about the use of the term “export-led growth.” Even if a country has a very high level of exports relative to GDP, it could have a balanced trade account, which would mean that *net* exports were not contributing much to the bottom line in terms of GDP growth (Prasad, 2011).

The penultimate column of Table 2 shows that, on average, net exports makes a slightly negative contribution (minus 0.3 percentage points) to overall GDP growth among the countries in the region. For three of the six economies in the sample, net exports contributed -0.8 percentage point or below to GDP growth. The average contribution of net exports to growth is positive in the cases of Bangladesh, Bhutan and Pakistan.

Overall, South Asia is on a reasonably balanced growth path on average, with about 70 percent growth contributed by consumption and 20 percent by investment and 10 percent by net exports, similar to other Asian countries and developed countries.

Employment Growth

A different way to think about the composition of growth is about how much employment is generated in the process of achieving that growth rate. The last column of Table 2 shows that the cross-sectional median of employment growth over the period 2000-09 was about 2.5 percent. The two economies with the lowest average rate of employment growth are India and Sri Lanka. It is striking that in India net employment growth, at 1.9 percent per annum, was only about one-fifth the pace of output growth. This is consistent with findings by Bosworth, Collins, and Virmani (2007) and Gordon and Gupta (2004). They both show that to date, the rise in India’s output growth has been associated with little rise in overall rates of job creation. And while agricultural output has fallen as a share of GDP, agriculture’s share of total employment remains surprisingly high. The authors point

out that there could be significant productivity gains from further sectoral reallocation of labor, moving from agriculture to other sectors.

Dependence on Trade

Returning to the issue of dependence on export-led growth, we present some additional trade data in Table 3. The first three columns show, for 2000, the ratio of total trade (imports+exports), exports and the trade balance (exports-imports) to GDP.⁴ The measure of exports and imports used here includes goods and nonfactor services. The next three columns show the same three ratios, but for 2009. The median ratio of exports to GDP has increased from about 14 percent to 20 percent during this decade, suggesting a higher level of dependence on exports. But the median ratio of the trade balance (or net exports), which is of relevance to the GDP bottom line, has in fact become much more negative and on average about minus 11 percent of GDP in 2009. This is down from a median of about minus 8 percent of GDP in 2000, reflecting a faster rise of imports from the region during the past decade.

⁴ Data on the trade balance ratio to GDP should in principle match the data reported in Table 1. There are some discrepancies, due to the fact that data in Table 1 are taken from the national income accounts while the data in Table 3 come from the balance of payments.

Table 3. Openness to Trade (in percent of GDP)

Country	2000			2009		
	Total Trade	Exports	Trade Balance	Total Trade	Exports	Trade Balance
Bangladesh	33.2	14.0	-5.2	46.7	19.3	-8.1
Bhutan	69.2	27.1	-15.1	95.4	40.3	-14.7
India	27.4	13.2	-0.9	46.3	20.4	-5.5
Nepal	41.3	13.5	-14.2	41.6	6.8	-28.0
Pakistan	28.1	13.4	-1.2	34.7	13.6	-7.5
Sri Lanka	88.6	39.0	-10.6	64.7	25.5	-13.7
South Asia Median	37.2	13.8	-7.9	46.5	19.8	-10.9
Regional and International Comparisons:						
China	39.6	20.8	2.0	51.4	28.0	4.6
Asian Emerging Markets	80.0	40.0	0.5	56.6	25.7	-4.0
Asian Developing Countries	108.9	54.4	2.1	144.7	71.2	5.9
Germany	66.4	33.5	0.5	80.3	42.5	4.8
Japan	21.2	11.3	1.5	26.1	13.3	0.4
U.S.	25.7	10.9	-3.8	24.4	10.9	-2.7

Source: CEIC, Asian Development Bank's Statistical Database System (SDBS), EIU Country Data, and authors' calculations. Note: Exports include both goods and services; total trade refers to the sum of exports and imports of goods and services. See Table 1 for list of countries classified as Asian emerging markets and Asian developing economies.

For all of the countries in the sample, the trade balance has on average been negative during the 2000s. But there are wide disparities among countries in the region. The largest average trade deficits are recorded by Nepal, Bhutan and Sri Lanka. Nepal's trade deficit rose from 14 percent of GDP in 2000 to 28 percent in 2009, resulting in about equal parts from declining exports and rising imports. India's and Pakistan's trade deficits also grew over the past decade, even though their exports increased. While trade openness has increased in most South Asian economies during the period 2000-09, the increase in the volume of trade has not kept pace with GDP growth in Sri Lanka. Overall, trade growth among South Asian economies appears similar to the patterns observed in the broad group of Asian emerging markets.

Service Industry and Trade in Services

Although the overall trade data suggest that growth in South Asian economies' trade is similar to that of a broader sample of Asian emerging markets, there are still significant disparities in the structure of trade patterns across these two groups. One of the distinctive features of South Asian economies is that they have undergone what some authors have characterized as a services revolution over the past three decades (Ghani, 2010).

How big is the service sector in South Asia? Ghani and Kharas (2010) show that among countries in the region, the service sector's share in GDP has been steadily growing from 40 percent in 1980 to 55 percent in 2005, while the share of manufacturing has stayed relatively stable at around 20 percent. Among the countries in our sample, in 2005 Sri Lanka's service sector accounted for about 60 percent of GDP, while those ratios are about 55 percent for India and Pakistan, and 43 percent for Nepal. Among East Asian economies, by contrast, the share of manufacturing in GDP is about 45 percent, with a growing service sector that on average still accounts for only about 45 percent of GDP.

Ghani and Kharas (2010) also report the contributions of the services sector to GDP growth in Bangladesh, China, India, Korea, Pakistan and Sri Lanka for the periods 1980-1985 and 2000-2007. In the early 1980s, four South Asian countries and Korea had a relatively large contribution to GDP from their service sector, about 40 to 55 percent. In India, the services sector contributed about 40 percent of GDP growth during that period while the corresponding figure for China was only 30 percent. By the 2000s, service sector growth contributed about 60 percent of GDP growth in India. The growth contribution of the services sector remained low in China, at around 40 percent.

Clearly, there has been a divergence in the sectoral distribution of growth between South Asian countries and China. Ghani (2010) concludes that South Asia has witnessed a service-led growth that is very different from the manufacturing-led growth in China or, more generally, the emerging markets of East Asia. More recently, the growth patterns of these two groups have been converging in terms of the sector distribution of growth and the relative shares of services and manufacturing in GDP. The share of service output in GDP has increased significantly in China in recent years, while manufacturing growth has picked up in many South Asian economies, including Bangladesh, India and Pakistan has also been performing better.

It is worth examining further the evidence on what kinds of services are growing faster--modern services (including banking, insurance, financial, and communication related services) or traditional services (including trade, hotels and restaurants, personal, cultural and recreational services, community and social services, transportation, storage, real estate dwelling, and government and public administration services)? Ghani (2010) shows that modern services have experienced average annual growth of more than 9 percent per annum in Bangladesh, India, Pakistan and Sri Lanka during the period 2000-2006. Traditional services have grown at lower growth rates in all the sample countries. These trends suggest that the tradable portion of the services sector is expanding relatively fast in these economies, suggesting another channel through which these economies are likely to expand their integration into global trade and finance.

This conjecture is supported by the data. Countries that had faster service sector value-added growth also experienced faster growth in service sector exports over the last three decades. India's services exports grew at an annual rate of 27 percent during 2001-08; over the same period, the corresponding figures were about 17 percent for Pakistan and about 10 percent for Bhutan, Nepal and Sri Lanka. Overall, South Asia service exports grew by about 22 percent annually according to Ghani and Anand (2009); this exceeds even the rapid growth of East Asian manufactured exports. The share of services exports (in value terms) to GDP in India increased from about 3 percent in 2000 to 8 percent in 2008; the share of services exports rose from 27 percent to 36 percent over the same period (Table 4). In the case of Sri Lanka, the ratio of services exports to total exports rose by 5 percentage points from 2000 to 2008 but the share of services exports in GDP fell slightly over this period.

**Table 4. Service Exports
(in percent)**

Country	2000		2008	
	As percent of GDP	As percent of Total Export	As percent of GDP	As percent of Total Export
Bhutan	7.8	-	4.4	-
India	3.4	26.7	8.2	36.1
Nepal	8.8	-	6.2	-
Pakistan	1.9	13.3	2.5	16.9
Sri Lanka	5.8	14.9	4.9	19.8

Source: United Nations Service Trade Statistics Database, EIU Country Data, and authors' calculations.

Note: Exports include both goods and services.

Most importantly, services exports served as a buffer for South Asian countries during the 2007 financial crisis. While most countries around the world experienced huge declines in goods exports, Bhutan, India, Nepal, Pakistan and Sri Lanka achieved better balance on their trade accounts during this period largely as a consequence of an average increase of about 19 percent in services exports in both 2007 and 2008. Ghani and Anand (2009) come to the same conclusion, noting that services exports are less volatile than goods exports. They also note that globalization of services is still at an early stage and it is likely to grow and/or recover faster even during crisis

Savings-Investment Balances

Having examined the structures of South Asian economies and their trade patterns, we now shift to an analysis of where these economies fit into the debate about global imbalances and the rebalancing of domestic growth. The connection between domestic and global imbalances is through the current account, which represents the difference between national savings and national investment. It is of interest to examine not just the evolution of the current account but its components as well.

Table 5 presents 2009 nominal GDP, current account balances and national savings, both in terms of value (to facilitate cross-country comparisons of magnitudes) as well as ratios to GDP. Most South Asian economies had current account deficits in 2009, with the exception of Bangladesh. At the same time, domestic savings rates in the region are quite high. The ratio of gross national savings to GDP ranges from 17-18 percent in Pakistan and Sri Lanka to 31-32 percent in India and Bhutan.

In India, the household saving rate has increased over the last decade, as documented by authors such as Athukorala and Sen (2004), and Panagariya (2008). Households tend to hold about half of their savings in physical savings (including livestock, land holdings and jewelry), with various forms of financial savings accounting for the other half (Prasad, 2011). Moulick (2008) provides some qualitative evidence on how lack of access to the formal financial system affects saving patterns among poor people in the North East region of India, including the level of household savings and the forms in which savings are held. Basu and Maertens (2007) suggest that expansion of nationalized bank branches during 1970s might help the rise in financial savings. Mohan (2008), however, also notes that while gross financial savings of the household sector have risen in recent years households' financial liabilities have also been increasing rapidly, albeit from a low base. He points to data showing that households' gross financial savings rose from 13.8 per cent of GDP in 2004-2005 to 18.3 per cent in 2006-07, while their financial liabilities rose from 3.8 per cent of GDP during 2004-05 to 6.8 per cent during 2006-07. He attributes both phenomena to financial development as well as the broadening of access to the financial system.

Overall, South Asia's current account and national savings ratios to GDP are close to those of Asian developing countries. South Asian economies do have one significant difference relative to other Asian emerging markets. Economies in East Asia, in particular, tend to have high saving rates but also current account surpluses rather than deficits. To understand the implications of these differences, it is necessary to delve more deeply into the components of the savings-investment balance.

Table 5. GDP, Current Account Balance, and National Saving, 2009

Country	Nominal GDP (USD billions)	Current Account Balance		Gross National Savings	
		Value (USD billions)	As percent of GDP	Value (USD billions)	As percent of GDP
Bangladesh	89.5	2.9	3.3	24.5	27.4
Bhutan	1.1	-0.1	-12.0	0.4	32.3
India	1296.2	-31.5	-2.4	403.1	31.1
Nepal	12.4	-0.3	-2.1	2.6	21.1
Pakistan	162.0	-2.7	-1.6	26.9	16.6
Sri Lanka	42.0	-1.6	-3.9	7.9	18.9
Regional and International Comparisons:					
China	4909.0	297.1	6.1	2567.4	52.3
Asian Emerging Markets	264.0	20.3	6.1	78.0	31.0
Asian Developing Countries	65.7	-1.3	-5.3	16.2	23.2
Germany	3356.5	135.0	4.0	708.5	21.1
Japan	5067.0	140.6	2.8	1171.9	23.1
U.S.	14256.3	-378.5	-2.7	1208.9	8.5

Source: EIU, and authors' calculations. See Table 1 for list of countries classified as Asian emerging markets and Asian developing economies.

Figure 1 shows savings and investment balances for each of the South Asian economies in our sample. Figure 2 shows the corresponding evolution of current account balances. For instance, the top left panel of Figure 1 shows that that savings and investment have both been rising slowly in Bangladesh since the early 2000s. The rate of increase in savings has been higher than that of investment, leading to a rising current account surplus, which rose to 3.3 percent of its GDP by 2009. By contrast, Pakistan and Sri Lanka show no clear trend in savings and investment, but the difference between the two measures widened during the period 2003 to 2008, leading to large current account deficits. Pakistan in fact used to run current account surpluses in the early 2000s. Sri Lanka has persistently run current account deficits during this period. Both countries experienced a sharp contraction in their current account deficits in 2009, partly because external financing dried up during the crisis. The case of Bhutan is an interesting one. Its investment to GDP ratio was above 60 percent in 2002-2004, while its saving rate was substantially lower, implying massive current account deficits. This switched to a current account surplus in 2007-08, before reverting to a sizable deficit in 2009.

India experienced a gradual increase in both saving and investment to GDP ratios over the period 2000-2007, before both ratios leveled off during the crisis. Investment growth exceeded growth in savings for much of this period, resulting in a shift from a current account surplus in 2001-2004 to a modest current account deficit of about 2 percent of GDP in 2008-2009. In other words, despite its high domestic saving rate, India still relies to a modest extent on foreign financing to plug the gap in its saving-investment balance.

Figure 1. Saving-Investment

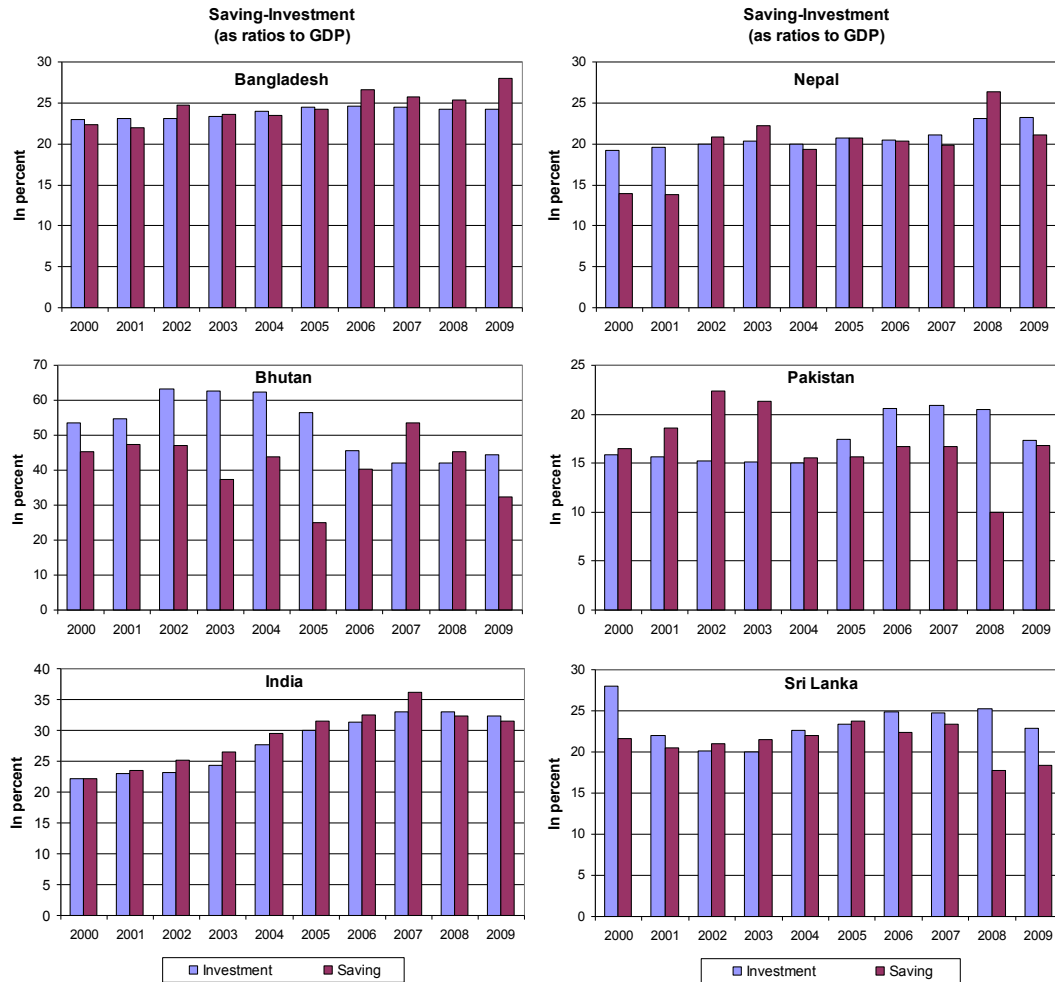
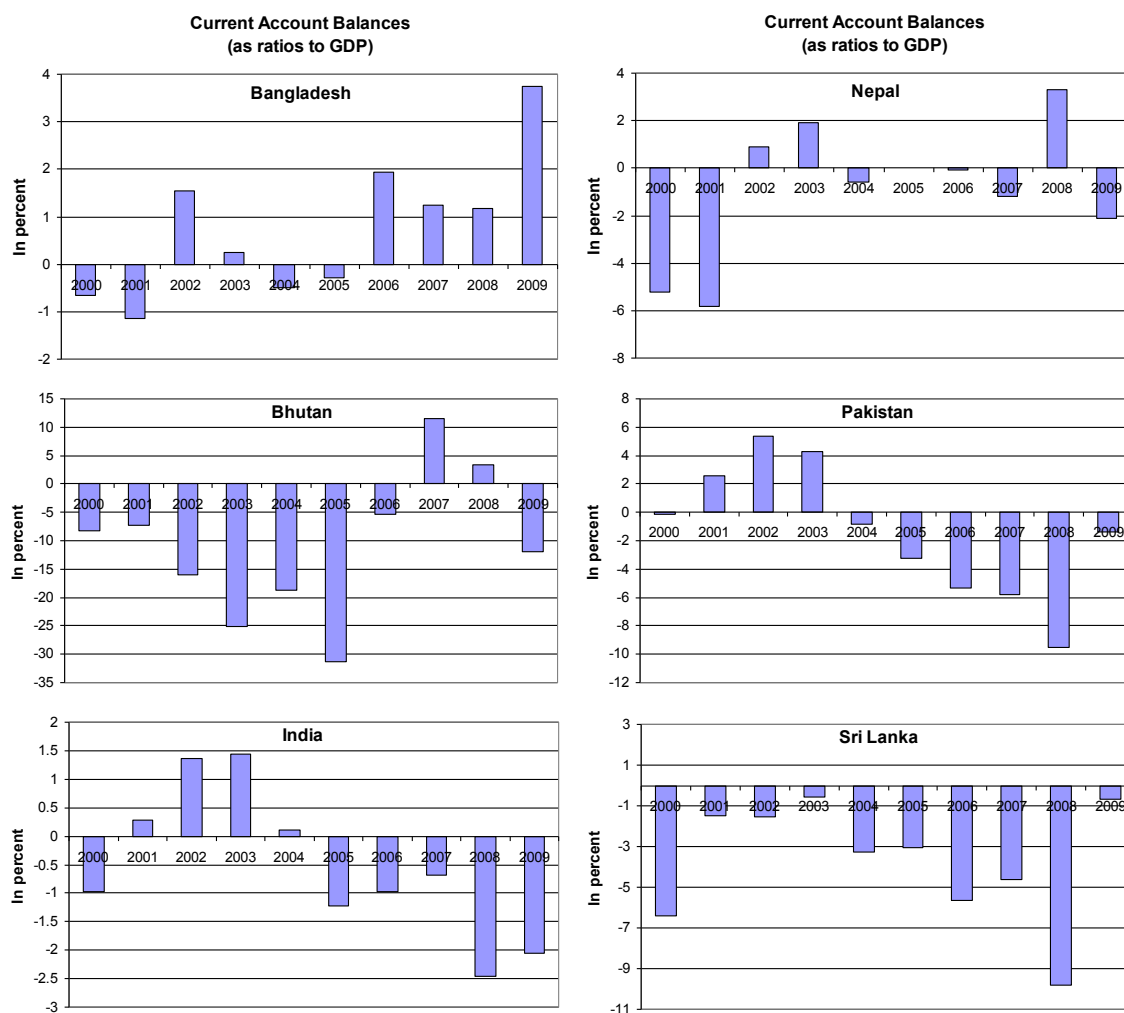


Figure 2. Current Account Balances

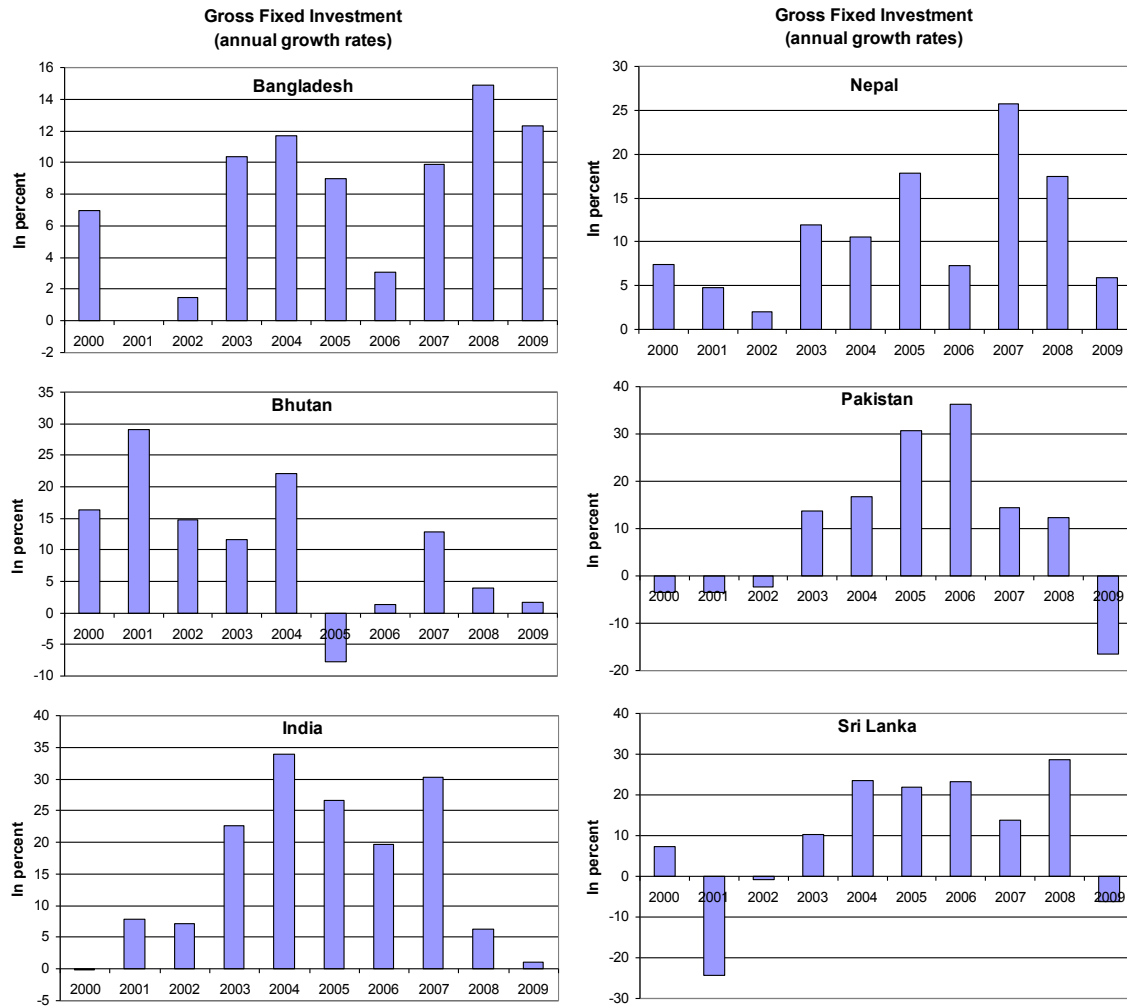


One key question is whether current account deficits finance investment or consumption. In the former case, these deficits are more likely to be sustainable as they add to an economy's productive capacity over the long term. By contrast, deficit-financed consumption booms of the sort experienced by some Latin American economies in previous decades can end in tears, especially if the foreign financing is in the form of foreign currency-denominated debt.

Figure 3 provides a complementary perspective to the overall saving-investment balance by showing annual growth rates of gross fixed investment. Across the region, investment growth is on average high but tends to be very volatile. In Bhutan and Pakistan, investment growth rates have plummeted in recent years, even before the crisis hit. By contrast, investment growth in Bangladesh has held to a moderate but steady pace even during the height of the global financial crisis. One consequence is that Bangladesh

continued to experience strong overall GDP growth during the crisis while Bhutan had negative GDP growth in 2009. As expected, there is generally a positive correlation between investment growth and GDP growth over time for the countries in our sample. Interestingly, while the investment to GDP ratio stayed at a high level, investment growth in India declined in 2008-2009 during the worst of the financial crisis.

Figure 3. Gross Fixed Investments



Capital Inflows and Foreign Reserves

South Asia has gradually become open to capital inflows in the past decade. We now examine in greater detail the levels of financial integration of these economies with the world economy and also the form that this integration has taken. Figure 4 shows the evolution of overall net capital inflows into Bangladesh, India, Pakistan and Sri Lanka.

The level of net inflows into Bangladesh has remained relatively stable over the period 2000-2009. Net inflows into India and Pakistan increased sharply over the 2000s until the crisis hit, when inflows shrank significantly but did not collapse. Sri Lanka has experienced low or slightly negative net inflows for much of the 2000s.

Figure 4. Net Capital Inflow

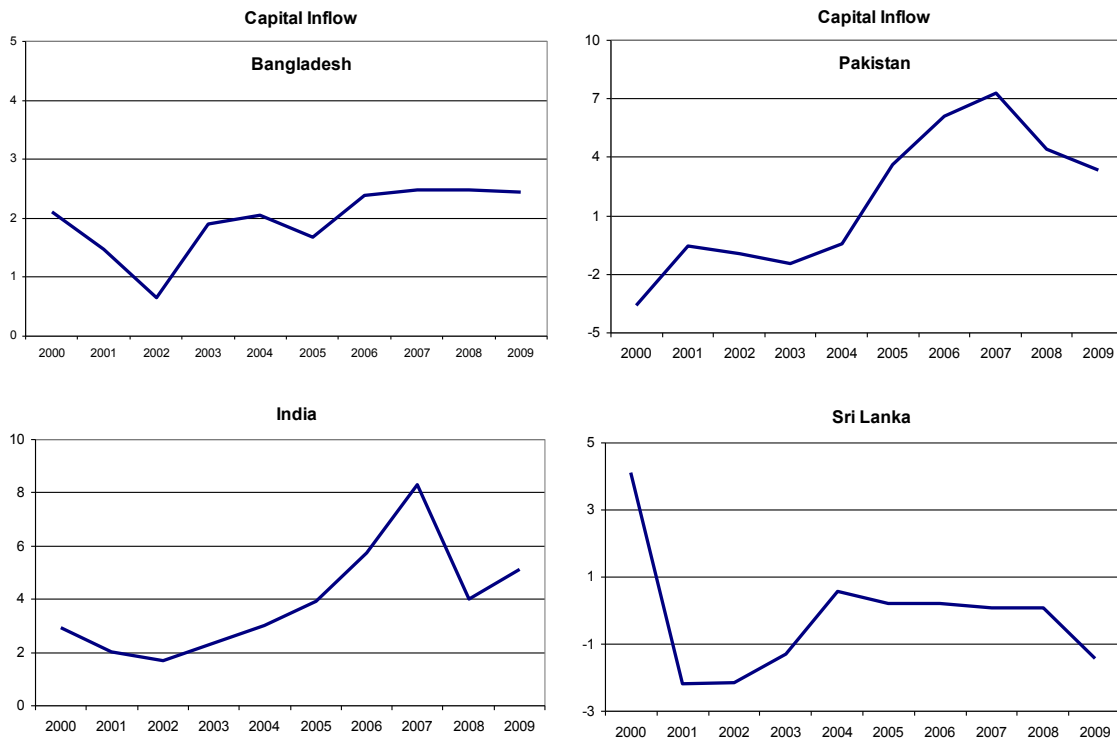


Table 6 looks at total net inflows into expressed as ratios to GDP, for 2000 and 2009, for each of these countries. The table also shows the distribution among different types of capital inflows, as this has implications for judging the potential benefits and volatility of overall capital inflows. The level of net inflows into Bangladesh as a ratio to GDP was roughly the same in 2000 as in 2009, with the category of other investment accounting for the major portion. In India's case, both FDI and equity investment have increased sharply

and now dominate overall net inflows. FDI inflows as a share of GDP rose from 0.8 percent to 2.7 percent while equity inflows rose from 0.5 percent of GDP to 1.6 percent. While portfolio equity flows are considered to be more volatile than FDI, both types of inflows are presumed to have advantages compared to other types of flows, in terms of their contributions to both productivity growth and risk sharing (see Kose, Prasad and Terrones, 2009a, 2009b). By contrast, the biggest increase in the case of Pakistan was accounted for by other investment, which, according to the IMF classification of capital flows, includes currency and deposits, loans, and trade credits. Sri Lanka experienced sharp net outflows of portfolio equity as well as other investment in 2009, leading to a sharp fall from net inflows of 4.1 percent of GDP in 2000 to net outflows of 1.4 percent of GDP in 2009.

Table 6. Capital Inflows into South Asian Economies
(in percent of GDP)

Country	2000					2009				
	Total	FDI	Equity	Debt	Other	Total	FDI	Equity	Debt	Other
Bangladesh	2.1	0.6	0.0	0.0	1.5	2.4	0.8	-0.2	0.2	1.6
India	2.9	0.8	0.5	0.0	1.6	5.1	2.7	1.6	0.0	0.8
Pakistan	-3.6	0.4	0.0	-0.7	-3.4	3.3	1.5	0.0	-0.3	2.2
Sri Lanka	4.1	1.1	0.0	-0.4	3.4	-1.4	1.0	-0.9	0.0	-1.5

Source: CEIC, EIU Country Data, and authors' calculations.

Note: The numbers here are net inflows

Overall, South Asia has had rising openness to capital flows, but de facto financial openness as measured by the ratio of flows to GDP remains small. In terms of potential benefits from these flows, the composition of inflows has become increasingly favorable for India and, to some extent, for Pakistan. Ghani and Anand (2009) show that foreign capital inflows to South Asia—remittances, international syndicated bank lending, private capital investments, and issue of bonds—surged during the early to mid-2000s, but collapsed in the aftermath of the crisis. These authors argue that South Asia is unique in attracting capital flows that are less volatile, noting that the region relies more on remittances than traditional forms of inflows like direct investment, portfolio flows and bank loans. They argue that remittances are less volatile and more persistent, although such flows were of course not totally immune to the global recession.

Nevertheless, greater financial openness does imply greater exposure to the vagaries of international capital flows and the whims of international investors. Foreign exchange reserves provide a way to self-insure against these risks, although such self-insurance can be quite costly.⁵ Indeed, the recent crisis has provided further impetus for emerging markets to consider self-insurance strategies. How do South Asian economies look in terms of their ability to fend off crises using reserves? To examine this, we look at how reserves stocks stack up relative to the size of the economy and the quantity of short-term external debt.⁶

Figure 5 shows individual countries' foreign exchange reserves as a ratio of GDP or a ratio of short-term external debt. The left axis of each panel and pink line show the reserves to short-term debt ratio and the right axis and blue line show the reserves to GDP ratio. Bhutan had a stable ratio of reserves to GDP of about 60 percent during the past decade, which is also the highest reserve/GDP ratio among the sample countries. Both Bangladesh and India have had a growing reserve/GDP ratio over the years, while Pakistan's and Sri Lanka's ratios first increased in early 2000s and declined during the financial crisis.

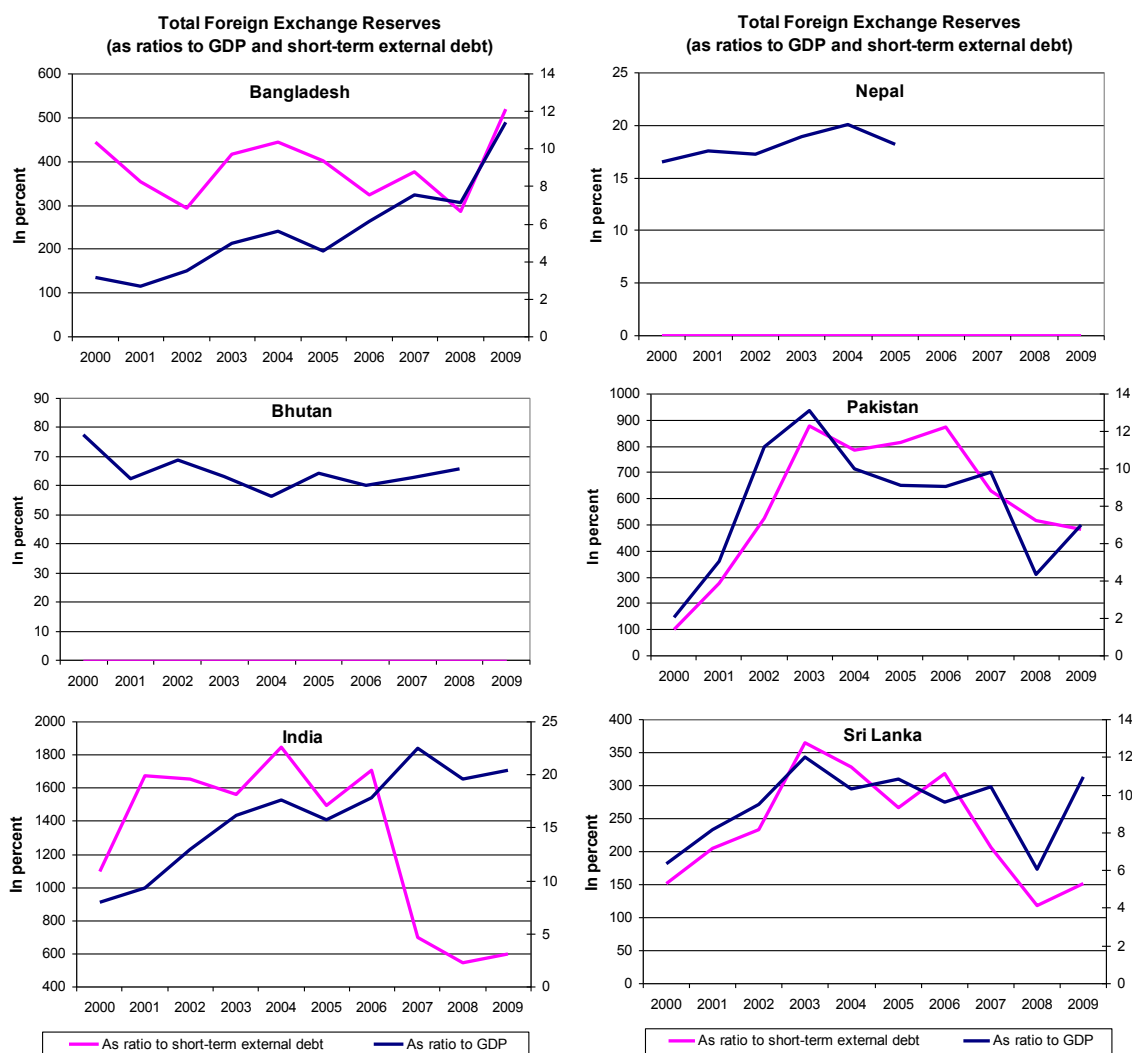
The evolution of the ratios of reserves to short-term debt ratios look similar to the reserve to GDP ratios, except in the case of India, where the former ratio declined sharply in 2007 due to a huge increase in short-term debt in 2007 (from USD 10 billion to USD 38 billion). More importantly, even though there was a dramatic increase in short-term debt,

⁵ Rodrik (2006) estimates the social cost of self-insurance through holding reserves to be about 1 percent of GDP for developing countries as a group. Hauner (2006) presents estimates of the quasi-fiscal costs of holding reserves. Prasad and Rajan (2006) and Prasad (2009b) discuss how China's currency policy that has resulted in rapid reserve accumulation has constrained domestic macroeconomic policies and hampered financial sector reforms, both of which could have long-term consequences for economic welfare.

⁶ Obstfeld, Shambaugh and Taylor (2008) argue that countries may have good reasons to use the ratio of reserves to M2 or the monetary base as a more suitable criterion, especially if they have weak banking systems. Prasad and Rajan (2008) argue that, while foreign exchange reserves provide a useful cushion against financial and balance of payments crises, thus making capital account liberalization less risky, they also create problems of their own. Many emerging market economies, including India, are finding it increasingly difficult to "sterilize" (using government bonds) the liquidity created by inflows; therefore pressures for domestic currency appreciation are building. Furthermore, governments are increasingly questioning the benefits of a policy that, in essence, involves purchasing more low-yield securities from foreign governments financed by higher-yield domestic debt. Also see Jeanne (2007) for a discussion of the costs and benefits of reserves.

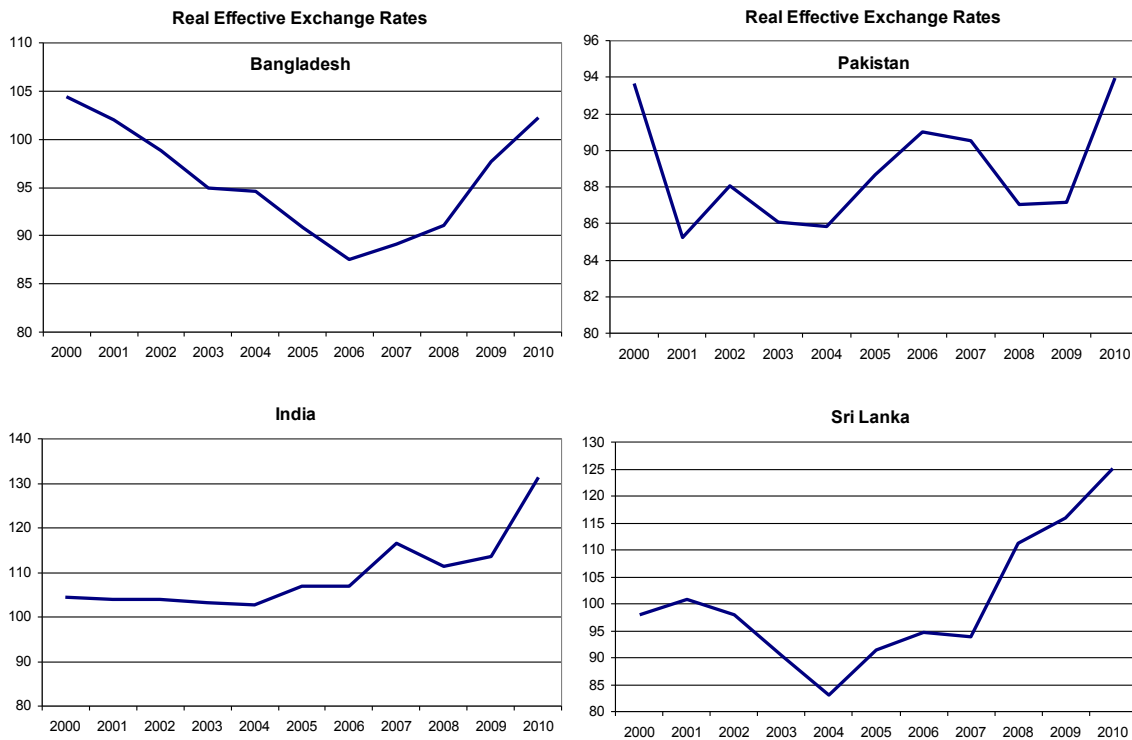
reserves still account for many multiples of short-term debt. In fact, reserves are still close to the level of total external debt of all maturities (short-term debt accounts for only 20 percent of India's external debt; see Prasad, 2009). Hence, reserve adequacy based on standard benchmarks is certainly not a concern for India and other South Asian economies.

Figure 5. Foreign Exchange Reserves



One other concern among developing economies about greater capital account openness is related to fluctuations in the exchange rate, which these economies view as detrimental to their export sectors. To look at this, we examine the trade-weighted real effective exchange rates for a subset of the countries in our sample. There is no evidence of excessive volatility in these exchange rates, although there is an unmistakable trend towards real exchange appreciation in India and Sri Lanka starting in the mid-2000s and similar forces in the other two economies more recently. In any event, there is no evidence of sharp year-to-year fluctuations in real effective exchange rates.

Figure 6. Real Effective Exchange Rates



Concluding Remarks

As is the case for the rest of the world, South Asian economies are increasing their trade linkages with the rest of the world, a process that looks set to continue and that has significant benefits for these economies. The picture on financial integration is more complex. Despite the relatively modest numbers, the reality is that the wave of financial globalization has probably only temporarily receded from the shores of South Asian economies as a result of the global financial crisis. Indeed, countries don't have much of a choice but to manage rather than resist capital account liberalization over time as capital accounts are becoming de facto more open over time irrespective of government attempts to control them (Prasad and Rajan, 2008).

This creates a conundrum for countries with low levels of financial and institutional development (see Kose, Prasad, and Taylor, 2011). But even more generally, the costs and benefits of financial openness are from obvious, as alluded to earlier. For instance, Prasad, Rajan and Subramanian (2007) have documented that non-industrial countries with smaller current account deficits or current account surpluses have, on average, registered higher growth rates than those non-industrial countries that have run larger current account deficits. Furthermore, Aizenman, Pinto and Radziwill (2007) show that developing countries that

tend to rely more on domestic rather than foreign finance for their investment do better in terms of growth. However, there are also many benefits that can be brought by financial integration, such as to growth, financial sector development, institutional quality (Kose, Prasad, Rogoff and Wei, 2009; Kose and Prasad, 2010).

Indeed, the right approach might be to manage capital account opening in a manner that delivers potential direct and indirect benefits while controlling the risks. For instance, Kochhar (2008) argues that India needs to rethink its capital account framework in the light of the need for infrastructure investment. This requires a rapid expansion of the country's real and financial absorptive capacity, including developing the corporate bond market, raising the limits on foreigners' participation in this market, and permitting greater capital outflows. On the other hand, increasing exposure to international capital flows could make countries more vulnerable to sudden stops, especially for countries with significant current account deficits, including India. Therefore, it is important to systematically develop a strategy for opening up a country's capital account in a manner that maximizes the potential benefits while keeping under control the inevitable costs, which may be especially large during the initial phases of the transition to a more open capital account (Kose, Prasad, Rogoff and Wei, 2009; Prasad, 2009).

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