



GROWTH PATHS IN SAARC: TESTING THE CONVERGENCE HYPOTHESIS FROM A DIVERGENCE LENS

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Abstract

Convergence hypothesis holds importance to analyze economic growth. This paper attempts to investigate convergence hypothesis for selected SAARC countries including Bangladesh, India, Pakistan and Sri Lanka. Both the hypothesis of absolute and conditional convergences are tested by applying pooled least square with time dummies and cross-section weights methodology for a data set from 1980 to 2016 which is taken from World Development Indicator and International Financial Statistics. The results conclude absence of both the absolute convergence and conditional convergence for these selected SAARC countries. Conditional convergence hypothesis is tested again with the inclusion of control variables consisting of population growth, inflation rate, unemployment rate, exports growth and openness and it again suggests absence of conditional convergence for these SAARC countries. Disparity level for each country is also calculated with reference to average steady state income level and all SAARC countries are found to be below than the average steady state level.

Key Words: *Convergence Hypothesis, Absolute convergence, Conditional Convergence, Pooled Least Square, Disparity Level.*

1. Introduction

Convergence implies as “forces accelerating the growth of nations who were latecomers to industrialization and economic development give rise to a tendency towards convergence of levels of per capita product or per worker product” Baumol (1986:1075). Convergence hypothesis also known as catch up effect narrates that per capita GDP of poorer countries grow faster than the richer countries. It is further explained as a process of narrowing down the gap between per capita income of less developed and developed countries.

When it is categorized than absolute convergence occurs when countries have homogenous features and attain the same level of long term income growth. While due to the distinguished set of endowments of each country or region conditional convergence will occur as the country will converge to its own steady state although the heterogeneous characteristics of countries boost up this convergence. Absolute convergence is defined as “convergence of per capita income by catching up process” and conditional convergence is defined as “the convergence of cross sectional dispersion of per capita income” (Barro & Sala-i-Martin, 1995).

Solow (1956) initially advocated the convergence hypothesis and it was further elaborated by Baumol (1986) and Barro and Xavier-Sala-i-Martin (1991). Barro (2000) justified absolute convergence only for the countries having similar inherent characteristics. While conditional convergence will occur for the economies having homogenous features irrespective of their preliminary level. A detailed analysis of conditional convergence was conducted by Murphy and Ukpolo (1999) for African region and it supported the hypothesis of conditional convergence for

the region from 1960 to 1985. Romer (1986) raised questions about the validity of convergence hypothesis when he presented his endogenous growth theory.

Different methodologies have been applied to test the hypothesis of absolute and conditional convergence resulting in a mixture of supporting and opposing results. Thus, current study is an attempt to contribute in this regard and has tested the hypothesis of absolute and conditional convergence for selected SAARC countries including Bhutan, Bangladesh, India, Nepal, Pakistan and Sri Lanka due to availability of data. This analysis is based on a data set ranging from 1980 to 2016 which is taken from World Development Indicator and International Financial Statistics.

Although these SAARC countries differ from each other on the basis of their size, population, economic development, and divergent social, economic and political arrangements a major contribution of this paper is the calculation of disparity level for each country which helps to find out how far away a country is from the average steady state. A set of control variables including population growth, inflation rate, unemployment rate, exports growth and openness is used to test the hypothesis of conditional convergence for selected SAARC countries. The empirical results are expected to help policy makers in developing relevant policies in this regard.

2. Literature Review

Chowdhury (2004) analyzed per capita income convergence by catching up process and convergence of cross-sectional dispersion of per capita income for 7 SAARC countries from 1960 to 2000 by using World Bank data and concluded absence of convergence among all these countries. Low volume of intra industry trade, low level of growth and weak governance were the leading factors towards absence of convergence among these countries. Jayanthakumaran and Lee (2013) conducted convergence analysis for a set of 5 ASEAN and 5 SAARC countries by time series analysis with two endogenously determined structural breaks. The results presented that relative per capita income series of ASEAN-5 countries were consistent with stochastic convergence and β convergence while statistical results provided no evidence for stochastic convergence and β convergence for SAARC-5 countries. The structural breaks associated with the world oil crisis and the Asian crisis contributed towards convergence for ASEAN-5 countries.

Solarin et al (2014) examined real income convergence between ASEAN countries and SAARC countries with data from 1970 to 2009 by using Univariate Lagrange Multiplier (LM) unit root tests. The results justified conditional convergence among ASEAN countries while absence of conditional convergence among SAARC countries. Mazumdar and Krishna (2008) concluded that convergence in ASEAN was subject to the extent of economic openness while external shocks were producing income deviance among ASEAN. Dobson and Ramlogan (2002) used cross section data for different Latin American countries to check the hypothesis of convergence for these countries. Surprisingly, they rejected conditional convergence hypothesis for Latin American countries due to the misleading results based on cross section data. Karras (2010) examined the convergence hypothesis for different regions and provided a mixture of results some of them in the favor of convergence hypothesis while some of them were rejecting the convergence hypothesis.

Parikh and Shibata (2004) presented a comparison among 14 Asian countries, 30 African countries and 20 Latin American countries for per capita real income convergence due to trade

liberalization by using panel data from 1970 to 2000 for beta and sigma convergence. The study concluded convergence of real per capita income from its mean level for Asian and Latin American countries while divergence of real per capita income from its mean level for African countries. Shankar and Shah (2003) supported the same results for trade openness and concluded that countries experiencing convergence are more focused on promoting an economic union by removing barriers to factor mobility and maintaining a minimum standard for provision of basic services. Suhariyanto and Thirtle (2001) concluded no convergence in agricultural productivity among a set of 18 Asian countries by using cross section and time series tests from 1965 to 1996. A comparison between 18 Asian countries and 5 Africa countries supported the same result although the growth rates among these countries differ.

Rao (1999) supported no convergence among Indian states and widening interstate disparities. The allocation of private investment which is affected by inequitable spread of infrastructure and unequal distribution of public expenditures were the major causes of income divergence among Indian states. Marjit and Mitra (1996) supported the same results of income per capita divergence among Indian states. Paci and Pilgliaru (1997) examined the hypothesis of convergence for European region for a data set from 1980 to 1989 for 12 regions consisting of 109 countries and concluded the absence of convergence in these regions. While the labor productivity convergence was analyzed for these regions and they concluded that labor productivity was converging at the rate of 1.2%. Baumol et al (1994) supported the same results for labor productivity while they supported no convergence for manufacturing sectors in these countries.

Andres et al (1996) analyzed the convergence hypothesis for OECD region by including some control variables i.e inflation rate, exports growth and public sector expenditure. Their study did not provide any notable alteration in the existing literature as the control variables were found statistically insignificant. Nahar and Inder (2002) assessed trend regressions for output gap and squared demeaned output from USA by utilizing data from 1950 to 1998 and used the resultant average slopes for the test of absolute convergence hypothesis for OECD countries. Except Germany, Iceland and Norway all the countries represented higher convergence tendency towards their average income. Milanovic (2003) concluded that convergence did not occur for a set of 17 developed countries during the per war era of 1870-1913 while during inter war period convergences occurred.

Sarkar (1997) concluded that there exists no absolute convergence when a data set of 110 countries including developed and developing countries was analyzed because the gap between the living standard of the developed and developing countries has increased after Second World War. Ahmad (2008) supported his argument of non-convergence by including corruption as a strong leading indicator in his model. Barro and Sala-i-Martin (1997) supported the absence of convergence on the basis of the lack of technological diffusion. Mazumdar (2002) examined the convergence hypothesis for human development index for a data set from 1960 to 1995 for 91 countries classified into 3 groups based on their levels of human development and concluded no convergence for these countries. Konya et al (2008) examined the convergence hypothesis for the world on the bases of human development index from 1975 to 2004 and concluded that poor countries are growing faster than the richer one by improving their human development index.

While same results were rejected for European Union. Konya and Guisan (2008) also supported the same results.

Noneman and Vanhoudt (1996) concluded strong convergence for homogenous countries when the hypothesis of convergence was tested for a set of OECD countries. While the absolute convergence hypothesis for 110 countries from 1960 to 1996 was analyzed based on population weighted per capita GDP (Cole and Neumayer, 2003). Knack (1996) checked the influence of different factors on the speed of convergence and concluded that quality of institutions was the strongest factor contributing in convergence. Control variables including government share of GDP, capital per worker, economic openness and living standard were used to test convergence hypothesis in Sub-Saharan African countries. No sound evidence could be obtained for the

3. Data Description and Methodology

This paper presents convergence hypothesis for selected SAARC countries due to the availability of data. Absolute convergence and conditional convergence are tested for these SAARC countries and the list of these countries is provided in appendix (table 1). Data for this purpose is collected from World Development Indicator (WDI) and International Financial Statistics (IFS) from 1980 to 2016. The brief description of the variables used in this paper is as followings

1. GDP Per Capita (constant prices US\$2010)
2. Population Growth Rate
3. Inflation, GDP Deflator (Annual %)
4. Unemployment Total (% of Total Labor Force)
5. Exports of Goods and Services (Annual % Growth)
6. Openness

In order to analyze the hypothesis of absolute and conditional convergence Pooled Least Squares with time dummies and cross section weights (PCSE) standard errors is applied.

3.1. Empirical Results

3.1.1. Absolute Convergence

The absolute convergence hypothesis tested for specific SAARC countries is as following

$H_0 : \alpha \geq 0$ (There is no Absolute Convergence)

$H_1 : \alpha < 0$ (There is Absolute Convergence)

The null hypothesis states that growth rate of GDP per capita do not depend on the preliminary level of GDP per capita. The alternative hypothesis however states that growth rates and initial GDP per capita are inversely associated thus leading towards convergence. In order to test the hypothesis following model is estimated

$$\Delta \ln (Y_{i,t}) = a - \alpha \ln (Y_{i,t-1}) + \theta t + \varepsilon_{i,t} \quad (1)$$

Where $\Delta \ln (Y_{i,t})$ is the GDP per capita growth rate of the country I at time t , a is the intercept, θt is the time fixed effects and $\alpha = (1 - e^{\beta t} / T)$ where β is the annual speed of convergence. A significant negative value for α implies absolute beta convergence while a positive value implies non-convergence. The estimates for absolute convergence for selected SAARC countries are provided in the following table.

TABLE 3.1. Absolute Convergence for Selected SAARC Countries (1980-2016)

Variable/Regression	SAARC Countries
Constant	2.095196 (21.30)*
Ln Y(-1)	0.421886 (13.28)
Fixed-Effects (Period)	
1980	0.2323923
1990	0.1456707
2000	0.2287033
2010	0.2613415
R ²	0.6514
Adj.R ²	0.5850

*are t-values.

In second column of table 3.1 the estimated coefficient associated with log of GDP per capita is 0.421886 which is positive and significant (t value=13.28).It means that there is inadequate indication to discard the null hypothesis. It can be concluded that absolute convergence does not exist for selected SAARC countries. Chowdhury (2004) supported the same results. Thus, this phenomenon can be concluded as divergence rather convergence. The fixed effect (period) from 1980 to 2010 is positive and R square is 0.6514. Thus, the results indicate the absence of absolute convergence of output per capita for these SAARC countries and R square indicates the goodness of the fit being 65%.

3.1.2. Conditional Convergence

Conditional convergence is defined as the relationship between the growth rate and the gap between the actual levels of GDP versus its own steady state. Conditional convergence is anticipated by neoclassical model while countries tend to their own steady state due to specific country aspects, such as population growth, openness, investment and level of technological advancement. The hypothesis of conditional convergence is tested for selected SAARC countries as following

H₀ : $\alpha \geq 0$ (No Conditional Convergence)

H₁ : $\alpha < 0$ (There is Conditional Convergence)

In order to test the hypothesis of conditional convergence the following model is estimated

$$\Delta \ln(Y_{i,t}) = a - \alpha \ln(Y_{i,t-1}) + Yt + \theta t + \varepsilon_{i,t} \quad (2)$$

Where $\Delta \ln(Y_{i,t})$ is the GDP per capita growth rate of the country I at time t, a is the intercept, Yt are the country fixed effects, θt is the time fixed effects and $\alpha = (1 - e^{\beta t} / T)$ where β is the annual speed of convergence. The estimated results for conditional convergence are provided in table 3.2 as following.

Table: 3.2. Conditional Convergence for Selected SAARC Countries (1980-2016)

Variable/Regression	SAARC Countries
Constant	2.927464 (77.94)*
Ln Y(-1)	0.0444711 (3.22)
Fixed Effects (Period)	
1980	0.014644
1990	0.1171203
2000	0.2437479
2010	0.4257714
R ²	0.9690
Adj.R ²	0.9616

*are t-values

The estimated coefficient for log of GDP per capita is 0.0444711 in the column 2 of table 3.2 which is positive thus indicating no conditional convergence for selected SAARC countries and it is statistically significant (t value=3.22). The same results are supported by Chowdhury (2004), Jayanthakumaran and Lee (2013) and Solarin et al (2014). The period fixed effects from 1980 to 2010 are positive and R square is 0.9690. Thus, it can be concluded that there exists no conditional convergence for selected SAARC countries rather the statistics support divergence for these SAARC countries and the model is quite good because R square is 96%.

Now, calculating annual speed of convergence

$$\begin{aligned}
 \beta &= -1/10 \ln (1+10\alpha') \\
 &= -1/10 \ln (1+10(0.0444711)) \\
 &= -1/10 \ln (1+0.444711) \\
 &= -1/10 \ln (1.444711) \\
 &= -1/10 (0.3679093) \\
 &= -0.36790093/10 \\
 &= -0.0368
 \end{aligned}$$

$$B = -0.0368$$

Annual Speed of Divergence = - 0.0368

Thus, $\beta = -0.0368$ which proves divergence for selected SAARC countries rather than convergence.

4. Disparity Level for Each Country

Disparity level for each country is calculated based on the demeaned values. In order to find the income disparity, the log GDP per capita data for selected SAARC countries is altered by taking deviations from their cross section mean. This practice is similar to introduce time dummies. The fixed effect is expelled from the model and the estimation is used to approximate the individual income effects. Following model is estimated to calculate income disparity.

$$D_{yit} = -\beta_{yit-1} + Y_i + \epsilon_{it} \quad (3)$$

Where y_{it} is $\ln(y_{it}/\bar{y}_t)$ and \bar{y}_t is the mean of y_{it} across the country I at time t . The inverse association among the time demeaned preliminary GDP per capita and the average growth rate are tested (**for details see Appendix, table 2**). The estimated value of β is **-0.43429**. It advocates conditional convergence and indicates a provisional dynamics by each country to their corresponding steady state. The positive coefficient value for a country suggests that the country is growing quicker as paralleled to the sample mean, while a negative value of the coefficient suggests a parting from the sample mean: hence, such country is far behind the other countries.

The empirical results also suggest that countries have diverse steady state which is revealed by a different intercept value for each country. Some of the countries can have positive constants and some can have negative constants and similarly some can be statistically significant and some cannot be statistically significant. Income disparity for each country is calculated which aids to assess income disparities and variances in living standards. The disparity level for each country is calculated as following

$$D_{si} = Y_i/\beta \quad (4)$$

Where D_{si} is the disparity level for each country and is attained by dividing estimated fixed effect of each country by its estimated coefficient of regression equation. Income disparity helps to understand the relative position of a country with regard to its steady state position and provides information as to how promptly a country will approach its steady state.

A positive disparity level indicates that a country's steady state level is above the average steady state level while a negative steady state value indicates that the country is below the average steady state level. Table 4.1 provides the GDP per capita disparity results showing interestingly that all selected SAARC countries have negative value classifying all of them as poorer than average level or below the average steady state level.

Table: 4.1. Disparity level for Selected SAARC Countries.

COUNTRIES	DISPARITY LEVEL
BGD	-1.00196 (0.000)
IND	-1.43145 (0.000)
PAK	-1.43955 (0.001)
LKA	-2.23818 (0.000)

*are p-values

The disparity level for Bangladesh is 100% indicating that Bangladesh is 100% poorer than the average steady state level and this value is statistically significant(p value is 0.000).. Similarly, India is 143% poorer, Pakistan is 144% poorer and Sri Lanka is 223% poorer than the average country and all of these values are statistically significant (having p values respectively 0.000, 0.001 and 0.000). Among the selected SAARC countries, Sri Lanka is found to be the poorest one by having the value -2.23818 (223% poorer than average steady state level) and it is statistically significant (p value is 0.000).

5. Conditional Convergence, Inclusion of Control Variables (Population Growth, Unemployment Rate, Inflation Rate, Exports Growth and Openness).

Fixed effect panel estimation approach is applied to estimate the hypothesis of conditional convergence after including control variables. Control variables play an important role in testing the hypothesis of conditional convergence because the inclusion of control variables helps in understanding the effects of various factors on economic growth. In this study population growth (P), inflation rate, unemployment rate, exports growth and openness are included as control variables. Openness is included in this model because it is an important determinant of aggregate demand. Data for all these control variables is taken from world development indicator and international financial statistics from 1980 to 2016. Keeping in view the neoclassical growth model there is an expectation of an inverse relationship between population growth and economic growth. The relationship between openness and economic growth is expected to be positive. While exports growth, unemployment rate and inflation rate are expected to be the leading indicators for conditional convergence for selected SAARC countries. The results are elaborated in the following table.

Table: 5.1. Conditional Convergence, Inclusion of Population Growth, Unemployment Rate, Inflation Rate, Exports Growth and Openness. As Control Variables for Selected SAARC Countries (1980-2016)

Variable/Regression	SAARC Countries
Constant	18.86295 (12.71)*
Ln Y(-1)	0.0126969 (1.12)
Population Growth	-2.185359 (-10.81)
Inflation	0.0001192 (0.19)
Unemployment Rate	0.0085398 (4.02)
Exports Growth	-0.0007937 (-2.59)
Openness(O)	2.04e-13 (3.30)
Fixed Effects(Period)	
1980	0.0274213
1990	0.3623877
2000	0.6610358
2010	0.9606885
R ²	0.4519

*are t-values

After inclusion of control variables the estimated coefficient for log of GDP per capita is 0.0126969 which is positive indicating no conditional convergence in selected SAARC



countries. This might be due to the fact that the control variables are not strong enough to produce a level difference which can lead towards income convergence among SAARC countries.

Column 2 of table 5.1 indicates that control variables including population growth and exports growth are contributing towards conditional convergence for selected SAARC countries and they are statistically significant (t-values are respectively -10.81 and -2.59). Although inflation, unemployment rate and openness are not contributing towards conditional convergence for selected SAARC countries and inflation is not statistically significant (t-value is 0.19) while unemployment rate and openness are statistically significant (t-values are respectively 4.02 and 3.30). These results for openness are supported by Parikh and Shibata (2004) and Parikh and Shibata (2004). Thus, it can be concluded that although among control variables population growth and exports are significant determinants of conditional convergence for selected SAARC countries but unemployment rate, inflation and openness are not significant determinants. As a whole control variables are not contributing towards conditional convergence of selected SAARC countries with a positive coefficient after inclusion of these control variables.

Conclusion

The hypothesis of convergence is empirically investigated for selected SAARC countries by using panel data from 1980 to 2016. This paper has tested both absolute convergence hypothesis and conditional convergence hypothesis by applying pooled least square with time dummies and cross section weights standard errors for selected SAARC countries. The hypothesis of absolute convergence and conditional convergence both are rejected for these SAARC countries. The study indicates that among all the control variables population growth and exports growth are significantly contributing towards conditional convergence of selected SAARC countries while inflation, unemployment and openness are not the significant determinants of conditional convergence among selected SAARC countries. Thus, overall the control variables are not strong enough to be the leading indicators for convergence among these SAARC countries. Moreover, disparity level for each country is calculated narrating the expanse of each country's dispersion from the mean steady state. The disparity level for all selected SAARC countries indicates that these countries are below the average steady state level or poorer than average level.

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APPENDIX

Table. 1

Countries Name and their Abbreviation

Sr. No	Country Name	Abbreviation
1	Bangladesh	BGD
2	India	IND
3	Pakistan	PAK
4	Sri Lanka	LKA

Table.2

Conditional Convergence for Selected SAARC Countries: Elimination of Dummies and Country Fixed Effects

Variable	Coefficient
β	-0.43429 (4.2317)*
BGD	0.435148 (2.14107)
IND	0.62167 (1.13594)
PAK	0.62519 (2.37779)
LKA	0.972029 (2.51059)

*are t-values