

Regional Integration in South Asia

Trends, Challenges and Prospects

Edited by Mohammad A Razzaque and Yurendra Basnett



The Commonwealth

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The Commonwealth

Commonwealth Secretariat
Marlborough House
Pall Mall
London SW1Y 5HX
United Kingdom

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Published by the Commonwealth Secretariat
Edited by Cenveo Publisher Services
Typeset by Techset Composition
Cover design by Tattersall Hammarling & Silk
Printed by Charlesworth Press

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Copies of this publication may be obtained from

Publications Section
Commonwealth Secretariat
Marlborough House
Pall Mall
London SW1Y 5HX
United Kingdom
Tel: +44 (0)20 7747 6534
Fax: +44 (0)20 7839 9081
Email: publications@commonwealth.int
Web: www.thecommonwealth.org/publications

A catalogue record for this publication is available from the British Library.

ISBN (paperback): 978-1-84929-122-4

ISBN (hardback): 978-1-84929-121-7

ISBN (e-book): 978-1-84859-914-7

Foreword

This publication is the result of work undertaken by the Commonwealth Secretariat in collaboration with policy analysts and researchers from institutions with outstanding reputations in this field. It is a fine example of our Commonwealth approach and convening power.

In recent years South Asia has demonstrated remarkable economic growth, averaging more than 6 per cent per annum since the early 1990s. During the same period, the efforts of individual countries in the region to become more fully integrated into the global economy have been effective. Measures have included ambitious unilateral trade liberalisation, mainstreaming of trade in national development strategies, and more active participation in multilateral and regional trade talks.

Trade performance of the region has also been impressive, with the value of exported goods rising from US\$65 billion in 2000 to US\$370 billion in 2013. Even when the rapid trade expansion of India is excluded, the rest of South Asia has posted a robust annual compound export growth rate averaging around 10 per cent. However, the intra-regional trade in goods is less impressive, and is estimated at only US\$20 billion. Indeed, South Asia remains one of the least integrated regions in the world.

There is now widespread recognition that greater progress towards effective regional integration in South Asia can make a very significant contribution towards accelerating economic growth, generating employment, and reducing poverty. This is particularly critical for global development since South Asia has among the highest poverty levels in the world, with more than 500 million people living on less than US\$1.25 a day.

Supporting regional trade and integration to advance economic and social development in developing countries is an important objective for the Commonwealth Secretariat's work on international trade. South Asia is a dynamic region and includes five Commonwealth member states: Bangladesh, India, Maldives, Pakistan and Sri Lanka. Its unfolding socio-economic transformation, buoyed by tremendous growth and development potential, offers immense scope for regional co-operation. Commonwealth Secretariat advocacy for deeper South Asian integration has, over recent years, included undertaking analytical studies, supporting stakeholder consultations, and maintaining collaborative partnerships with a network of experts and think-tanks working in related areas.

Broad consensus on the agenda for taking forward regional co-operation makes this an opportune moment for South Asia, and there are promising signs of strengthened political commitment. As stakeholder demand for effective regional co-operation

gains momentum, this study offers valuable contributions to the policy discourse. By presenting analyses and policy recommendations from leading experts in region, it provides a useful stocktake of the issues at stake and perceptive insights as to the way forward.

With its focus on regional integration this publication goes beyond discussions of trade expansion based on tariff liberalisation alone; it includes issues such as improved regional connectivity, investment, infrastructure, energy development, supply chains, and food security. It also includes individual country perspectives on regional and bilateral trade arrangements within the region. We trust it can be of real value to policy-makers and other stakeholders, particularly in South Asia, as they work to advance deeper integration in the region and prosperity in which all can share.

Deodat Maharaj

Deputy Secretary-General

(Economic & Social Development)

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Abbreviations and acronyms

ADB	Asian Development Bank
ADD	anti-dumping duty
AFTA	ASEAN Free Trade Agreement
AIA	ASEAN Investment Area
AICO	ASEAN Industrial Cooperation
ASEAN	Association of Southeast Asian Nations
ASYCUDA	Automated System for Customs Data
CD	customs duty
CEPA	Comprehensive Economic Partnership Agreement
CIF	cost, insurance and freight
CoE	committee of experts
COMESA	Common Market for Eastern and Southern Africa
CTH	change in tariff heading
EAC	East African Community
EDI	electronic data interchange
FAO	Food and Agriculture Organization
FDI	foreign direct investment
FTA	free trade agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GMS	Greater Mekong Subregion
GTAP	Global Trade Analysis Project
HS	Harmonized System
ICP	Integrated Check Post
ICT	information and communication technology
LCS	land customs station
LDC	least developed country
LPI	Logistics Performance Index
MFN	most favoured nation
MRA	mutual recognition agreement
NAFTA	North American Free Trade Agreement

NER	North Eastern Region
NTB	non-tariff barrier
NTM	non-tariff measure
PTA	preferential trade agreement
PTM	para-tariff measure
RCA	revealed comparative advantage
REC	regional economic community
RMG	ready-made garments
RoO	rules of origin
RoW	rest of the world
RSA	rest of South Asia
RTA	regional trade agreement
SAARC	South Asian Association for Regional Cooperation
SADC	Southern African Development Community
SAFAS	SAARC Framework Agreement on Trade in Services
SAFTA	South Asian Free Trade Area
SAPTA	SAARC Preferential Trading Arrangement
SASEC	South Asia Subregional Economic Cooperation
SATIS	SAARC Agreement on Trade in Services
SITC	Standard International Trade Classification
SL	sensitive list
SPS	sanitary and phytosanitary measures
SME	small or medium-sized enterprise
T&C	textiles and clothing
TBT	technical barriers to trade
TLP	Trade Liberalization Programme
TRQ	tariff rate quota
UNCTAD	United Nations Conference on Trade and Development
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
VECM	vector error correction model
WTO	World Trade Organization

Chapter 1

Regional Integration in South Asia: An Overview

Mohammad A Razzaque and Yurendra Basnett

1.1 Background

South Asia is increasingly becoming an important and large market in the global economy, with the region witnessing steady economic growth accompanied by a growing large, young and dynamic workforce and a middle-class population. Since the 1990s, the region has registered an annual average output growth of 6 per cent, while consideration of the past decade (2000–10) alone would result in an even more impressive performance of about 7.5 per cent, which is much higher than the corresponding global GDP growth of 2.8 per cent and more than one percentage point higher than the average growth achieved in developing countries as a group.¹ This remarkable economic growth has contributed to declining poverty incidence and improvements in other socio-economic indicators. Nevertheless South Asia continues to render one of the highest poverty levels in the world: a recent World Bank estimate suggests more than 500 million people in the region are living on less than US\$1.25 a day.

There is a broad-based consensus that promotion of regional integration and co-operation including enhanced intra-regional trade will constitute an effective avenue for accelerating economic growth, employment generation and poverty reduction, advancing the well-being of South Asian citizens. In fact, the issue of regional integration and co-operation has been on the agenda of policy-makers and under active consideration for a long time, as reflected in the establishment of the South Asian Association for Regional Economic Cooperation (SAARC) in 1985; the setting up of the SAARC Preferential Trading Arrangement (SAPTA); and finally moving towards the implementation of a South Asian Free Trade Area (SAFTA) by 2016.

Notwithstanding these developments, South Asia remains among the least integrated regions. The proportion of intra-regional trade in South Asia to SAARC countries' global trade, currently estimated to be 5 per cent, appears to be the lowest among major regional integration schemes.² Unilateral trade liberalisation and implementation of various bilateral deals over the past decades have resulted in a significant opening up of individual South Asian economies, as evident in the region's rapid rise in trade-orientation, measured by trade-to-GDP ratio, from 19 per cent in 1990 to 52 per cent in 2012. But this has not translated into raising the significance of intra-regional trade.

Although the share of intra-regional trade in South Asia has remained relatively unchanged since the beginning of the 1990s, it is important to note that, in absolute

terms, members' merchandise exports within the region over the past ten years have increased from around US\$2 billion to US\$20 billion, yielding an annual average growth of 16 per cent.³ During the same time, South Asian global exports grew at a rate of 18 per cent per annum. Given their comparative advantages and established market niches, most South Asian countries are trading more with global partners. Particularly as the relatively large countries in the region – Bangladesh, India and Pakistan – manage to achieve relatively high export growth from world markets, the share of intra-regional trade can be low.⁴ Nonetheless, in absolute terms, the current volume of intra-regional trade is abysmally low. If the region can achieve an annual average growth of intra-regional exports of 10 per cent, which is quite realistic given recent performance and current low base of trade volume in the region, such exports will reach more than US\$40 billion by 2020 and US\$110 billion by 2030. This suggests that enormous potential exists for regional trade.⁵

A related issue is promoting exports and thereby regional integration through trade-policy-induced mechanisms. This is being attempted through the implementation of SAFTA, which will dismantle tariffs imposed on goods' movements across regional borders. However, it is worth noting that not all trade taking place globally among countries belonging to the same preferential arrangements is actually preferential in nature. Indeed, only a very small proportion of within-preferential trading arrangement (PTA) trade, 16 per cent, can be attributed to preferences exchanged under their regional integration initiatives, according to the 2011 World Trade Report of the World Trade Organization (WTO). In other words, more than four-fifths of the trade among regional partner countries tends to take place, not because of tariff preferences, but on the basis of the most favoured nation (MFN) principle, even when they belong to a particular trading bloc. This is because many countries belonging to PTAs are actually 'natural trading partners'. There are numerous empirical studies to show that distance between countries (as reflected in the transportation costs) has significantly large negative effects on trade and that, potentially, neighbours are able to engage in trading activities with relatively low transportation and transaction costs.

By contrast, it is widely recognised that even without tariffs, countries in South Asia have formidable trade barriers between themselves on regional trade flows. Such restrictions are widespread and cover all spectrums of cross-country flows including goods, services and capital movement. South Asian nations tend to impose more stringent barriers on intra-regional trade flows compared to their imports coming from the rest of the world. This is particularly true when goods are channelled through land borders, which are exclusively accessible by neighbouring countries. These barriers, coupled with weak trade facilitation measures at ports and land borders and poor transport infrastructure in carrying goods, make the cost of trading so excessive that South Asian countries are often more like distant trading partners rather than neighbours. The advantages of being neighbours should be translated into quick and easy access to each other's markets (both by sea and land routes). Poor and inaccessible land routes and other trade-related barriers restrict the participation of many traders and constrain the trading of many products. Failure to address these problems also has serious consequences for consumer welfare.

Regional co-operation is receiving heightened policy attention that goes much beyond the traditional emphasis on expanding intra-regional trade through protected regional markets. It is recognised that regional integration through improved logistics, trade facilitation and connectivity, and the removal of all non-tariff barriers results in an effectively larger market with trade expansion buoyed by scale and agglomeration economies. This can also facilitate geographic separation of production processes across neighbouring countries to develop regional supply chains. Indeed, by fostering regional co-operation East Asian countries were able to create a regional supply network linked to global market demands. The rise of India as a major source of trade and economic activities gives similar opportunities to smaller and poorer developing countries in South Asia.

The potential of services is also important to enhance intra-regional trade flows, as services account for more than half of the economic activities in the region. Regional trade in services can lead to efficient services supply for many other activities, including production processes in manufacturing, thereby promoting overall competitiveness of the region. One can also argue that since most services sourced from the rest of the world tend to be more expensive, the scope of regional trade is much greater. The SAARC Agreement on Trade in Services (SATIS) was signed in 2010 and its successful implementation should generate substantial gains for the region.

Productive regional integration will also require greater co-operation in investment and transport connectivity, given the region's need for sustaining high growth and helping people to achieve basic energy and food security. Investments are important to generate both growth and tradeable goods and services, for which effective co-operation would aim to mobilise both intra-regional and extra-regional resources for productive utilisation. There are issues concerning a regional policy framework and, with it, consistent national investment regimes. The weak and poor state of trade facilitation is just one small component of transport connectivity. Functional regional connectivity will require surface transport links throughout the region, which will require dealing with policy barriers and inadequate infrastructural facilities. Finally, higher economic growth and demographic pressure mean that energy and food security are two critical issues for South Asia. There is ample scope for regional co-operation in this respect and the role of intra-regional trade can be crucial here.

1.2 About this volume

Supporting regional economic integration that would foster trade flows between countries, providing important boosts for economic growth while generating employment opportunities for developing members, is an important objective of the Commonwealth Secretariat's work on international trade. South Asia is an important dynamic region with five Commonwealth members: Bangladesh, India, Maldives, Pakistan and Sri Lanka. While India has become one of the most important emerging market economies in the world, other individual South Asian countries have also been experiencing impressive growth performance. The Commonwealth Secretariat maintains a strong involvement in the region by undertaking and supporting policy research and facilitating discussions on regional co-operation and trade policy

issues. Research and analysis sponsored by the Secretariat has featured prominently in regional integration discourse. The analytical work carried out over the years has been used to provide informed inputs into the issues under discussion, to review the progress made on effective regional integration efforts in the region and to offer practical recommendations, by bringing out individual country perspectives on implementation-related and outstanding bilateral and regional integration issues. This volume brings together some selected papers from that body of work, along with a few others that were originally prepared elsewhere but reinforce the central theme of regional integration in South Asia.

1.2.1 Chapters in the volume

The 24 chapters compiled in this volume are organised into four parts: Looking at the horizon: potential gains (Part I); Key areas for co-operation (Part II); Country perspectives of regional co-operation (Part III); and Case studies on bilateral co-operation (Part IV).

Part I. Looking at the horizon: potential gains

After this overview, the four chapters in Part I shed some light on the gains that could result from South Asian regional integration from different perspectives. Since the 1990s, India has posted robust economic growth. Despite the recent slight slow-down there are high hopes that economic activities will pick up. Given India's massive significance, one important question is then whether India acts as a growth pole for South Asian countries. Rashmi Banga in Chapter 2 examines this issue empirically. The findings suggest that the effect of India's growth has been rather limited. The weak integration of the region is a plausible explanation for this. However, this also points toward the potential gains South Asia could achieve through better and more effective integration with such a large emerging economy as India.

In Chapter 3, Selim Raihan and Mohammad A Razzaque review the likely welfare gains from SAFTA for individual South Asian countries. Their simulation results show that, with the exception of Bangladesh, which experiences dominant adverse implications of trade diversion arising from its high MFN tariffs, South Asian nations stand to gain positively from SAFTA. The chapter further considers the implications of improved trade facilitation measures along with SAFTA tariff liberalisation. The results suggest that gains from regional trade facilitation for all countries are much higher than the gains from mere tariff cuts from promoting intra-regional trade in goods.

In Chapter 4, Bipul Chatterjee and Joseph George consider the impact on consumer welfare of regional trade liberalisation. They argue that the net result of economic 'non-co-operation' among South Asian nations will have high costs for consumers. A quantitative assessment of potential consumer welfare gains from full trade liberalisation under SAFTA is then presented. The authors' results show consumer welfare gains of more than US\$1.9 billion per annum to the region by way of savings on aggregate consumer expenditure. The chapter includes the main observations gathered from a perception survey analysis, examining the opinion of key stakeholders

in the region on the role and relative importance of consumer welfare aspects in trade negotiations under SAFTA.

Can countries in the region build productive supply chains based on industrial units located in different countries? Many commentators argue that since South Asian countries compete among themselves in global markets by exporting similar products, they lack complementarities in production to promote regional trade and integration. In Chapter 5, Rashmi Banga and Mohammad A Razzaque take this issue seriously, using an analytical approach that maps out production and export structures of different South Asia countries' textile and clothing sector. The findings challenge perceived notions by providing evidence of a significant and unexploited scope for intra-regional trade in the sector that would actually enhance the competitiveness of the region overall.

Part II. Key areas for co-operation

Part II contains nine chapters addressing key areas of co-operation that would result in effective regional integration. Dealing with non-tariff barriers (NTBs), and promoting investment, trade in services, connectivity, and production integration are considered among the priorities. Given the huge importance for the region and the potentials that exist, food and energy security issues are also of paramount importance.

It is widely perceived that NTBs have severely restrained potential opportunities of trade expansion and undermine the overall spirit of co-operation among SAARC members. In Chapter 6, Mustafizur Rahman and Mohammad A Razzaque examine various concepts and the typology of NTBs to relate them to the context of South Asia. They examine cross-country experiences in addressing NTBs and document how they are being addressed within the SAFTA architecture. The authors argue that, in many regions, NTBs were successfully dealt with by putting in place appropriate institutions and mechanisms and suggest that SAARC members could draw on these examples.

In Chapter 7, Jodie Keane, Jane Kennan, Sheila Page and Christopher Stevens draw on experiences from other regions to suggest how South Asia can address NTBs. The chapter finds that the most important barrier is the lack of information about standards, official procedures and requirements, and the way in which regional arrangements are implemented. Therefore, priority must be put on sensitising officials and policy-makers on transparency and national policies and procedures. The authors also suggest there is an important role for private sector initiatives in dealing with obstacles to trade.

Despite putting in place a liberal investment regime with policy-induced incentives for foreign investors, South Asia has failed to become an attractive place for FDI flows. Except India, no countries in the region fetch a considerable amount of foreign inflows. Intra-regional cross-border investment projects have been extremely limited as well. In Chapter 8, Khondaker G Moazzem provides an assessment of the current state of national and regional policies and institutional arrangements for enhancing

regional co-operation for investment. The chapter finds that regional institutional provisions are weak and puts forward suggestions for the development of an effective policy framework for enhancing intra-regional investment.

In Chapter 9, Selim Raihan examines the issues and concerns related to the liberalisation of trade in services in the region. The author first highlights the challenges South Asian countries face in achieving liberalisation of services trade under the multilateral trading framework and then draws their linkages to regional services integration. The chapter argues that individual South Asian countries lack established and well-functioning regulatory and institutional frameworks when it comes to expanding services trade.

Despite economic and cultural similarities, falling tariffs and geographical proximity, excessive costs of trading act as a formidable challenge for trade expansion in South Asia. High transportation costs, poor institutions, inadequate cross-border infrastructure, and the absence of regional transit trade all contribute to the region's weak integration. In Chapter 10, Prabir De provides a comprehensive assessment of regional connectivity and trade facilitation measures, identifying the prospects and challenges and providing some policy perspectives to ameliorate the situation.

In Chapter 11, John Serieux makes an assessment of how South Asian least developed countries (LDCs) compare with others in supply chain development. Of most concern appears to be the transaction costs of doing business in South Asia LDCs and their uneven governance indicators. The region is also structurally quite different from East Asia, which is noted for its development of supply chains. Nevertheless, the chapter finds that there are already opportunities to develop forward and backward linkages within and across existing region-wide industries. Success will require complementary policies to improve transport and logistics services, attract regional and extra-regional FDI and improve finance systems to allow for greater participation of local small- and medium-sized enterprises. The chapter argues that South Asia may be able to use its proximity to East Asia to develop regional branches in South Asia of larger Asia-wide (or global) supply chains.

What are the benefits of increasing trade and regional integration among South Asian countries and improving food and nutrition security through free movement of agriculture and food commodities? How should the region proceed to see these benefits? These are the questions that are broadly addressed in Chapter 12 by Ramesh Chand. Improving food security in the region will require actions to improve trade facilitation and better infrastructure connectivity. The author also argues that India, as the largest country with the dominant economic position in the region, has a special responsibility to advance South Asian economic integration.

In Chapter 13, Leena Srivastava, Neha Misra and Shahid Hasan consider the energy challenges in the South Asia region. The authors build a case for a stronger regional energy co-operation to accelerate the development process. Despite tremendous benefits to be derived out of regional co-operation on energy, such co-operation has failed to materialise. The chapter argues that it is high time for policy-makers, civil society, non-governmental organisations and financing institutions to push for a greater integration of the South Asia energy sector.

In Chapter 14, Machiko Nissanke and Sophie van Huellen assess the economic implications of commodity price cycles for South Asia. They find that India serves as both an important supplier and market for the commodity imports and exports of its neighbouring countries. At the same time, India's reliance on its neighbouring countries for exports and imports is low, and it is therefore more engaged in trade with countries outside the South Asian region. As a result, the region's overall pattern in commodity trade with the outside world largely reflects that of India. The chapter argues that the South Asia region should adopt global measures to address the commodity super-cycles.

Part III. Country perspectives of regional co-operation

Part III contains six chapters that provide country perspectives on regional co-operation, including: countries' experiences in negotiating SAFTA; multilateral trade issues that have a bearing on regional trading arrangements; and reflections on issues affecting regional integration prospects.

Zaidi Sattar in Chapter 15, using the Bangladeshi perspective, analyses the tariff and non-tariff barriers that impede intra-regional trade in South Asia. The author argues that, although Bangladesh remains in compliance of SAFTA schedules, the existence of para-tariffs hampers its integration within South Asian trade. The chapter posits that an integral part of the SAFTA trade liberalisation process must be opening up trade in services – for example banking and finance, tourism, health and education – to increase inter-industry linkages and cross-border investment within South Asia.

In Chapter 16, Nisha Taneja, Shravani Prakash and Samridhi Bimal analyse the tariff and non-tariff barriers that South Asian imports face with India, and provide suggestions on how to address them. The persistence of high barrier levels to the Indian market, particularly those related to cumbersome and non-transparent regulations and the lack of trade facilitation, undermine regional trade. The chapter argues that India could alleviate these barriers by bringing down its SAFTA sensitive list to zero, improving transparency of non-tariff measures and further committing to undertaking asymmetrical responsibilities in the region.

In Chapter 17, Usman Khan provides the perspectives from Pakistan on regional trade issues. The chapter identifies some of the NTBs that are impeding Pakistan's trade relations with India, Bangladesh and Sri Lanka. Trade between the countries is predominantly inter-industry trade and a very limited level of intra-industry trade currently takes place. The chapter explains that this low level of regional trade results from years of political uncertainty and increasing levels of distrust between the nations, excessive non-tariff-barriers, limited cross-regional investment flows, weak export competitiveness of the region and inadequate supply capacities.

In Chapter 18, Ratnakar Adhikari and Paras Kharel provide Nepal's perspectives on constraints to increased trade flows, and how SAFTA can be strengthened to help address the barriers. The chapter finds that Nepal's trade with South Asia remains concentrated with India, and that restrictive trade provisions contribute to Nepal's deteriorating trade balance. Nepal also faces severe supply-side constraints, including a lack of adequate trade infrastructure. The chapter argues that alleviating constraints

will require more resources than simply domestic resource mobilisation, which alone will not be sufficient.

Indra Nath Mukherji, in Chapter 19, provides Sri Lanka's perspectives on regional trade and argues, inter alia, that obstacles to trade result from technical regulations and industrial standards varying from one country to another. The chapter examines the nature of Sri Lanka's tariff barriers, the incidence of other import charges or para-tariffs on imports, the nature and incidence of NTBs, initiatives taken under regional and bilateral agreements, and the reform process initiated, and suggests ways forward.

South Asia is a large, rapidly growing neighbouring market for Maldives. In Chapter 20, Ismail Nashid considers what SAFTA means for regional trade integration for Maldives, and how the country should be further integrated in the region to reap the benefits of South Asian growth.

Part IV. Case studies on bilateral co-operation

Within SAARC countries, bilateral trade deals and co-operation feature prominently. Along with SAFTA, certain member countries have also negotiated and implemented bilateral free trade agreements. In other cases, in the absence of any formal deal, countries have provided special consideration in boosting trade relations. The four chapters in Part IV provide some selective case studies in this respect.

In Chapter 21, Md. Abul Basher explores the trade prospects between India and Bangladesh with emphasis on how the latter, faced with a growing bilateral trade-deficit, can expand its exports to the former. It reviews the trade policy of Bangladesh, composition and trends of bilateral trade between Bangladesh and India and analyses trade data to ascertain the trade complementarities between the two countries. The chapter discusses and provides policy recommendations on the NTBs that hinder Bangladesh's export to India.

The trading relations and economic co-operation between India and Pakistan are considered to be one of the most important determinants of the South Asian regional integration initiative. There have been several initiatives taken by India and Pakistan for strengthening bilateral relations, of which Pakistan's recent decision to offer India MFN status is of great importance to the two countries and the region. In Chapter 22, Selim Raihan and Prabir De present a comprehensive assessment of India–Pakistan trade relations, analysing the modalities of co-operation, and providing simulation results of potential economic benefits to both countries and to the South Asian region. Their results show that exchange of MFN status leads to welfare and trade gains, and, when combined with improved trade facilitation measures, such gains become even more substantial.

In Chapter 23, Saman Kelegama, provides some perspectives on trade and investment between India and Sri Lanka by reviewing the findings of in-depth studies on the Indo–Sri Lanka free trade agreement. The chapter highlights the impediments and constraints that have prevented the bilateral trade agreement moving to a higher stage of a Comprehensive Economic Partnership Agreement (CEPA). The chapter presents the benefits of CEPA for Sri Lanka and India.

Finally, Chapter 24, by Arif Zaman, looks afresh at the premise, performance and potential for trade between Pakistan and India. It argues that stronger economic relations between India and Pakistan will be important for regional integration and stability in South Asia. The author argues that there remain vast untapped trade and investment possibilities between the two countries that can be gainfully exploited.

1.3 Taking forward South Asian integration: An agenda for immediate action

There are some key areas that could form the immediate basis for moving forward regional economic co-operation in South Asia. Such an agenda should include, as a minimum, the following:

- address real barriers to trade;
- promote regional value chains for goods and services;
- create a functional, regional market for services;
- leverage investment to deepen regional integration;
- prioritise regional co-operation on energy;
- prioritise co-operation on a regional transport network; and
- address bilateral and regional approaches to regional trade.

1.3.1 Harmonise real barriers to trade

What are the issues?

One important issue to consider is that tariffs may not be the most obstructing factor in the movement of goods from sources of production to regional markets or beyond. Over the next few years, tariffs under SAFTA will come down to at least 5 per cent. The impediments are caused by what can be broadly categorised as NTBs. They include measures related to price controls, financing, quality control procedures, technical regulations, etc.

In South Asia, non-tariffs barriers are ubiquitous, emerge in different forms and have debilitating effects on trade (both in goods and services). Consider a comparison. In Singapore and Thailand it takes about 2 to 3 hours to clear goods at ports. The same process takes 2 to 3 days in most South Asian ports. Such delays impact not only the trade competitiveness of individual countries, but the whole region through intra-regional trade-related activities. Landlocked countries such as Afghanistan, Bhutan and Nepal have to rely on ports in neighbouring countries and therefore are also severely affected by port-related inefficiencies. While Rahman and Razzaque (Chapter 6) analyse the presence and implications of NTBs in South Asia, particularly in trade between Bangladesh and India, the associated problems have been highlighted throughout the volume, whether examining regional or bilateral trade.

What should be done?

Addressing this problem will require designing innovative regional solutions, as in many respects manifestations of most NTBs are unique to South Asia. Because, unlike tariffs, NTBs are difficult to quantify, they exist in a grey area and are subject to ambiguous interpretation. This also makes them harder to address, and therefore the need for re-doubling efforts. Traders regularly complain about being asked for additional papers or 'signatures' when the original procedure does not require them. Processing documents and involved procedures often stretch logic and imagination. All this is detrimental to trade flows. In addressing NTBs successfully, the human element will also be as important as procedural and technological aspects.

There exist a number of studies and reports that have documented NTBs in South Asia. More fact-finding missions, though important and needed, will yield marginal benefits. What is urgently required is the development of a regional action plan to systematically address these problems. It has been argued in the volume that such an action plan should include:

- *Enhancing SPS-TBT-related capacities* by: (a) strengthening national capacities in relevant areas through capacity building of standardisation institutions (for both goods and services); and (b) putting in place mutual recognition agreements (MRAs) whereby certificates issued by standardisation/accreditation institutions of one country will be accepted by those of another country. This is already taking place between India and Bangladesh, and India has offered to support LDCs in the region. Countries should explore scaling up what is working while ensuring such capacities are harmonised and standardised across the region.
- *Supporting the South Asian Regional Standards Organisation (SARSO)* by ensuring that it houses the best skills and technology available to achieve its objectives. The success of SARSO is critical to harmonise and standardise regulations on all tradeable goods. It is also very important to ensure that SARSO has a high buy-in from the entire region. This will be achieved if the functioning and outputs of SARSO are perceived to be benefitting each member country.
- *Facilitating regular interaction between national customs officials.* The SAARC 'Agreement on Mutual Administrative Assistance in Customs Matters' provides a blue print for more effective co-operation, which needs to be put into practice and regularised. Customs across the region needs to be modernised and a fully financed regional customs modernisation plan should be developed.
- *Addressing infrastructure-related bottlenecks by creating 'one-stop' border posts.* Anachronistic border posts and border crossing practices pervade the region. For example, the practice of off-loading goods in a 'no-man's' land or crossing one border and having to travel miles to cross the other border. Both infrastructure and practices need to be urgently modernised.
- *Institutionalising a dispute settlement mechanism* that enjoys trust, is transparent and has a permanent panel. Here, examples of such mechanisms in other regions can be assessed to identify best practices. Chapter 7 by Keane et al. provides a discussion on global best practices in addressing NTBs.

- *Implementing the global trade facilitation deal seriously.* In 2013, World Trade Organization (WTO) members agreed on a multilateral agreement on trade facilitation. Its fundamental objective is the simplification and harmonisation of international trade procedures with respect to the activities, practices and formalities involved in collecting, presenting, communicating and processing data and other requirements for the cross-border movement of commodities. The deal aims to streamline customs procedure, reducing inefficiencies and thereby cutting trading costs. As part of the agreement, technical assistance and financial support will be available for developing countries and LDCs. As an internationally binding agreement, it could be an important vehicle for reducing regional trading costs. South Asian countries should take advantage of this global agreement when dealing with the major constraints of intra-regional trade.

1.3.2 Promote regional value chains for goods and services

What are the issues?

One thing that separates the growth experience in the two regions of Asia – East and South – is the presence of highly sophisticated regional value chains in East Asia that are largely absent in South Asia. John Serieux, in chapter 11, describes that:

a single product assembled and exported from China is likely to embody knowledge-intensive designs originating from Japan, inputs produced from capital or skill intensive production processes in South Korea, Taiwan, Hong-Kong or Singapore (the Asian newly industrialised countries), and inputs produced from more labour-intensive methods in one or more of the ASEAN 4 countries (Indonesia, Malaysia, Philippines and Thailand).

Such depth of economic collaboration in production processes is rarely found in South Asia – at the national, industry or firm level.

The value of facilitating regional supply chains will be predicated by economics, i.e. the benefits of dispersing production processes in different parts of the region (the regional division of production) must outweigh the costs associated with doing this. Benefits will include increasing the region's economic competitiveness through specialisation, mobilisation, better usage of dispersed resources (skills, labour, finance and technology), building production capacities and creating regional inclusive growth. The costs are numerous; the high costs of trade, weak infrastructure, lack of connectivity, etc. are discussed throughout this volume.

What should be done?

Weak economic connectivity in the region is one reason for the lack of productive regional supply mechanisms. Addressing this issue will create a broader economic climate that will allow for the emergence of regional value chains. Here, we focus on factors directly specific to regional supply chains, and those that do not relate broadly to trade-related constraints. Governments and the private sector should build consensus and actions around these issues.

- *Analytical work for informed inputs.* There is not much information available about the potential of regional supply chains based on production units in different South Asian countries. Perceived notions are often not based on any solid analytical work and can be quite misleading, for example that countries in the region do not have complementary production and trading activities (see Chapter 5). Therefore, industry-specific useful analytical work is needed to understand the scope of reinforcing competitive advantages of any regional production network based on regional sourcing of inputs.
- *Regional public-private sectors dialogue.* One line of continuous inquiry should be: does the private sector in the region see sufficient economic potential for creating/facilitating regional supply chains? Industry-specific information, as already mentioned, will help assess the scope of firm-level collaboration in identifying production and trade opportunities. The relevant policy and institutional support required can then be identified. Regular regional consultations (involving the private sector, policy-makers and other stakeholders) will help develop consensus, and, by identifying the specific public policies needed, may trigger deeper integration.
- *Creation of public goods specific to regional value chains.* Regional value chains that are present or emerging need to be buttressed with regional public goods so that the movement of goods along a supply chain is seamless and incurs the lowest possible transaction cost. This is paramount to create a global competitive edge. This will require the presence and availability of modern physical infrastructure and policies at the national level that have implications for regional supply chains, and will also be critical in aiding or undermining competitiveness.
- *Availability of cost-effective finance and insurance for regional supply chains.* Very often the lack of access to cost-effective finance and insurance can add substantial costs and thereby undermine the possibility of involvement in regional supply chains. Consequently, producers resort to procuring locally; even if this means working with lower-quality products. The emergence of regional supply chains will depend on how these costs for producers are transformed; finance and insurance costs are important in such calculations.
- *Targeted national industrial strategy.* Integrating into regional value chains will require national production capacities, particularly in LDCs where such capacities are at varying stages of development. A national industrial strategy should seek to address national-level constraints in integrating into regional value chains. Regional co-operation can also facilitate the growth of certain sub-sectors in LDCs for their effective participation in supply chains.

1.3.3 Create a functional, regional market for services

What are the issues?

The services sector is important to the economies of the region in terms of its contribution to GDP, trade and in attracting foreign direct investment. As has been identified in this volume, there is a lack of appropriate national, institutional and

regulatory frameworks to underpin the process of services sector liberalisation in South Asia. Moreover, progress on regional co-operation in trade in services remains slow. SATIS, which came into existence in 2010, provides the regional framework for improving regional trade in services.

There have been no commitments to liberalisation under SATIS yet. This could be because the framework only recently came into existence, and countries need time to formulate their interests and offers. However, since most South Asian countries (except Afghanistan and Bhutan) are members of the WTO and hence party to the General Agreement on Trade in Services (GATS), a more promising start to SATIS would have been an automatic inclusion of member countries' GATS commitment to both WTO members and non-members in the region. But, more critically, SATIS risks being an excessively procedural and technical exercise, without sufficient attention being paid to how it can transform the trade in services landscape in the region. There is a danger of missing a real opportunity in a sector in which the region enjoys considerable comparative advantage globally.

What should be done?

- *Articulate the vision.* The first action would be to articulate lucid goals on trade in services, complemented by the methods of achieving such goals. The region needs to be more ambitious and bolder on trade in services while still being sensitive to its differential capacities. It could consider creating a common, regional market, in a sequenced manner, for such services sectors as telecommunications, transportation, and finance and business, which are also important for trade in goods.
- *Support the vision.* The first point will require up-to-date information, i.e. on bilateral and regional trade in services, and national regulatory systems and capacities. It will also require strengthening the capacities of officials.

1.3.4 Leverage investment to deepen regional integration

What are the issues?

Foreign direct investment flows to South Asia are one of the lowest in the world, and intra-regional investment remains miniscule. In 2011, total foreign direct investment into the region was US\$35 billion, a mere 1.6 per cent of global flows, and the stock of foreign direct investment in South Asia was only 2.3 per cent of total global stock. Despite the relatively liberal policies on foreign investment in most of the countries in South Asia, both global and regional investment flows remain weak. Intra-regional trade can perhaps partly explain this discouraging situation of regional investment.

A regional framework for co-operation on investment is virtually non-existent (see Chapter 8) and there is no systematic mechanism to discuss issues of investment. Rather, it remains an afterthought for the SAARC committee on trade. Investment will certainly be required for promoting intra-regional trade and will need to be leveraged for developing regional value chains and regional infrastructure.

What should be done?

- *Establish a separate subcommittee*, within the SAARC framework, to deal with investment-related issues.
- *Develop a regional investment policy framework* supported by consistent national-level investment regimes.
- *Improve national-level information on investment opportunities*. Potential sectors can be identified to link investment with the development of regional value chains.
- *Promote both intra- and extra-regional FDI with investment incentives*.
- *Conclude and implement regional initiatives on investment*, including the SAARC Arbitration Council and the SAARC Limited Multilateral Agreement on Avoidance of Double Taxation and Mutual Administrative Assistance in Tax Matters.

1.3.5 Prioritise regional co-operation on energy

What are the issues?

High population and economic growth in South Asia, coupled with rising standards of living, will place huge demands on energy consumption. The region is projected to have one of the highest rates of growth in energy consumption in the world, largely because levels of per capita energy consumption have been low when compared globally. Nissanke and van Huellen in Chapter 14 show that energy consumption in the region has increased by almost 300 per cent between 1970 and 2008. Regional supplies have been unable to respond to rising demand, which is being met largely by imports. The rising global prices are thought to have contributed to a large trade, budget and energy deficit for the economies of the region.

The situation is not sustainable and is likely to sap growth potential. A more sustainable and pro-growth solution could be found within the region and by using regional sources, but this will require proactive, collaborative and innovative approaches to regional co-operation on energy. Srivastava et al. in Chapter 13 review the current state of limited co-operation, and provide direction on what needs to be done to improve regional co-operation on energy.

What should be done?

- *Develop a blue print for a regional electric grid.*⁶ A preliminary study and a high-level political consensus already exists on the possibility of generating and transmitting electricity between Bangladesh, Bhutan, India and Nepal. A subregional forum, the South Asia Subregional Economic Cooperation (SASEC), which includes these countries, provides the platform for bridging consensus. If SASEC is able to deliver a subregional electric grid, it could provide the stepping stone for including all SAARC countries.
- *Prepare a business case for a subregional electric grid.* The business case will include robust analysis on whether and how the subregional electric grid would provide

energy security and sustainability for the participating countries. Questions that need to be answered include: what are the costs? How can it be financed? Is there scope for mobilising private-sector investments?

- *Facilitate co-ordination and harmonisation of legal and regulatory frameworks* with the aim of increasing regional trade of energy in addition to increasing energy efficiency. This will require a review of existing national regulatory frameworks, and the learning and sharing of practices and experience.
- *Mobilise resources* through regional initiatives for investment in energy development and distribution.

1.3.6 Prioritise co-operation on regional transport networks

What are the issues?

Cross-border transport networks enlarge the market size, and help economies to grow further through greater opportunities for trade and production. Inter-country land transport linkages remain underdeveloped in South Asia; Chapter 10 provides recommendations on how to overcome the challenges. The Intergovernmental Agreement on the Asian Highway Network established technical specifications for the regional road network. The Asian Highway Network now extends through 32 member countries and comprises 142,000 km of highways. South Asian countries are struggling to maintain their Asian Highway routes due to limited finances and institutional capacity. The poor quality of regional road networks increases transport time and operating costs, which deters growth in regional trade. Lessons from other regions, for example the Greater Mekong Subregion, point to the importance of a regional co-operative framework in leveraging investments for regional road networks.

The South Asia region suffers from railway gauge mismatch, and limited railway infrastructure in its landlocked countries. There are some successful bilateral arrangements regarding passenger and freight trains between countries, for example the Maitree Express between Kolkata and Dhaka and Samjhauta Express between Delhi and Lahore. Major barriers to intra-regional movement by railway include the lack of standardisation of technologies, inadequate loop lengths, missing links of shorter lengths in the border areas, lack of physical infrastructure at interchange points, load restrictions on bridges, lack of co-ordination for gauge conversion programmes on different railway systems and capacity constraints.

What should be done?

- *Promote a regional transport corridor.* An integrated South Asia will require integrated overland connectivity and associated soft infrastructure at borders. Corridor approaches in other regions have been successful in co-ordinating regional infrastructure development.
- *Build a South Asian railway network.* Expanding and connecting the railway network is central to deepening regional integration. This will require establishing an uninterrupted and harmonised railway network throughout South Asia.

- *Finance cross-border transport projects.* Connecting South Asia requires a large investment, and regional co-operation is imperative for leveraging such resources. The financing scheme should aim to raise resources from the public sector, multilateral development banks and the private sector on a public–private partnership model.
- *Harmonise rules, regulations and standards.* Regional infrastructure will benefit greater trade only if rules, regulations and standards are also harmonised.

1.3.7 Harmonise bilateral and regional approaches to regional trade

What are the issues?

Given the diversity of the region, a mix of bilateral and regional approaches is required to promote South Asia's integration. For example, increased India–Pakistan trade, an outcome of improved bilateral trade relations, can be instrumental in promoting intra-regional trade, investment and connectivity. Pursuing such an approach demands better co-ordination between different levels of integration so that the outcome, irrespective of whether it comes from bilateral or regional integration, is a deeper integration of the South Asia region as a whole. This volume includes analysis on both regional and bilateral integration processes and identifies their associated challenges and opportunities. The following list makes some general recommendations on how to create complementary bilateral and regional approaches.

What should be done?

- *Address important issues through greater regional action:* NTBs, promoting intra-regional export responses from both the goods and services sectors, building supply chains, mobilising investment, developing infrastructure and energy, and improving trade dispute settlement mechanisms.
- *Overcome the impediments caused by border-specific NTBs through bilateral co-operation.*
- *Ensure bilateral co-operation provides building blocks for deeper regional integration.* Bilateral deals should not result in complicated trade policy regimes within South Asia.
- *Take successful bilateral co-operation schemes to the regional level.*

Economic co-operation among South Asian nations holds great promise for boosting regional trade, promoting economic growth and achieving development objectives. The economic performance of individual countries in the region has been impressive and performance can be improved further if more trade takes place regionally. While constraints over tariff barriers have been addressed, making significant progress on a free trade area, it remains a priority to address non-tariff issues in order to reduce trading costs and to facilitate the movement of goods across borders and the related financial transactions. Addressing these issues is far more difficult than tariff liberalisation. Nevertheless, it is promising that they are receiving policy attention against the backdrop of a broad consensus that the region needs to achieve deeper

integration rather than mere policy-induced incentives for promoting trade in goods. Implementation of a comprehensive regional integration programme – including, inter alia, improved trade facilitation measures, effective transport networks and connectivity, and co-operation in such areas as services trade, investment, and energy – can unleash major avenues of trade for regional as well as global markets. Investment in regional co-operation itself can generate large-scale and productive economic activities. Indeed, given its potential, it is time for South Asian nations to prioritise deeper regional integration as part of their individual economic and social development visions, and to attach the political will that regional integration merits.

Notes

- 1 Individual South Asian countries in most cases have achieved impressive GDP growth during the period of global-financial-crisis-led economic slowdown. The annual average growth rate during 2008–12 for Afghanistan, Bangladesh, Bhutan, India, Maldives and Sri Lanka has been more than 6 per cent. For the two other countries, Nepal and Pakistan, the corresponding growth rates are 4.35 and 2.68 per cent respectively.
- 2 The significance of intra-regional (or intra-preferential trading agreements – intra-PTA) trade in global trade is on the rise. Excluding the European Union, the share of intra-PTA trade has increased from 18 per cent in 1990 to 35 per cent in 2008. With the inclusion of the EU, the corresponding figure will rise to 50 per cent. Considering the regions, intra-PTA trade is 70 per cent for the EU, 49 per cent for NAFTA, 25 per cent for ASEAN, 16 per cent for CARICOM and 6 per cent for COMESA.
- 3 All figures are based on official trade data. Informal or unofficial trade flows are believed to be quite substantial in South Asia. It is also possible that trade liberalisation measures may have contributed to some of the earlier informal trade being channelled through the formal mechanism giving rise to the volume of official trade. It is, however, to be noted that most significant trade reforms were carried out in the 1990s, while the growth in official trade reported here corresponds to the 2000s.
- 4 This is also true of relatively small members, such as Sri Lanka and Maldives. Being landlocked economies, Bhutan and Nepal are critically dependent on intra-regional trade.
- 5 A lower growth of intra-regional trade of 5 per cent per annum will result in a regional export volume of US\$30 billion in 2020 and US\$48 billion in 2030. If South Asian countries can manage to match their performance from the most recent past 10 years, i.e. achieving a growth of 16 per cent per annum, intra-regional exports can reach a staggering high of US\$65 billion by 2020 and close to US\$300 billion by 2030. All these figures mentioned here correspond to goods exports only. The services sectors, including tourism and energy, are not taken into consideration.
- 6 Addressing energy needs in South Asia will require all available sources – conventional and renewable. The premium will be on whether the sources are clean and efficient. Although a regional electric grid is suggested, the north-eastern part of South Asia (which includes Bangladesh, Bhutan, India and Nepal) is endowed with huge hydropower potential, and hence it would be a mistake to overlook this source, which is cleaner and is likely to be efficient.

PART I. LOOKING AT THE HORIZON: POTENTIAL GAINS

Chapter 2

Has South Asia Benefitted from Growth in India?

Rashmi Banga

2.1 Introduction

India has experienced accelerated growth rates since the 1990s and has become one of the fastest growing emerging economies of the world. With the rise of the South, especially the BRICS countries, many have argued that South–South integration can sustain the growth of the South in the future. In this context, this chapter examines whether India, given its geographical location, can be the driver of growth for South Asia and become its growth pole.

The theory of growth poles leading to regional development dates back to the 1950s, when Perroux (1950, 1970, 1988) put forward his theory of active units, which assumed that under certain conditions actors have the capacity to change their environment. Perroux argued that the poles of development, which are the centres of most intense activity, could produce polarisation in leading sectors determined by their proximity in economic space, resulting in growth in the corresponding close sectors. Friedman (1966, 1972) applied these ideas to physical space as opposed to economic space to arrive at the much discussed ‘core-periphery model’. Since then there has been much interest generated in the regional growth models, which have been based on the fundamental condition of geographical proximity.

This chapter examines the extent to which growth in India is linked with the growth of its surrounding region. It estimates both long-term and short-term relationships between the growth of India and the growth of the rest of South Asia as a region and with the growth of individual countries in the region. To explain the existing/non-existing growth linkages, an in-depth analysis of the composition of trade between the countries is also undertaken.

To investigate the linkages in these growth rates, the standard procedures of multivariate time series analysis are followed. Growth series of India, the rest of South Asia, Bangladesh, Bhutan, Pakistan, Nepal and Sri Lanka for the period 1970–2009 are examined for the existence of unit roots. This is followed by co-integration of growth rates analysis and tests of causality of relationship. For each group, the Johansen maximum likelihood test for co-integration is conducted for testing long-term relationships in growth rates, followed by estimation by vector error correction model (VECM) and Granger causality test (Wald test).

The data on GDP (at constant US\$) is collected from the World Development Indicators (2010). To take into account the structural breaks that may have occurred in the growth series of the economies, the co-integration analysis is undertaken using Zivot and Andrews (1992) tests for one structural break and Clemente et al. (1998) tests for more than one structural breaks. Growth linkages in the post-structural breaks have also been examined.

The rest of the chapter is structured as follows: Section 2.2 presents a brief review of literature with respect to growth linkages; Section 2.3 examines the trends in growth rates and trade in the region; Section 2.4 discusses the methodology adopted for estimating growth linkages; Section 2.5 presents the results; and Section 2.6 concludes and provides policy directions.

2.2 Brief review of existing literature

The theory of growth poles has been extensively used to explain North–South trade. Findlay (1980) concluded that trade acts as an engine of growth for the South but the pace of this engine is set by the growth in the North. Taylor (1983) came to the same conclusion through a structuralist model which allowed for capital flows to the South. Studies estimating econometric models, such as those carried out by Beenstock (1988) and Samiei (1988), have also supported that there is a stronger influence of the growth in the North on that of the South than the other way around.

However, the rise in growth of some developing countries, irrespective of the slowing down in the North, especially since the 1990s, has led to the ‘decoupling’ argument. Hoffmaister et al. (1998) used time series analysis to show that growth in the North is also affected by growth in the South. They concluded that the improved resilience of the South not only allowed growth to continue at high levels during 1991–93 despite the downturn in the North, but also helped to limit the severity of that downturn. However, they argue that the increased resilience of the South and the boost to the North stem mainly from the improved performance of some of the emerging economies in Asia.

Examining the growth linkages between the North and the emerging South, Akin and Kose (2008) concluded that the impact of the North on the growth dynamics of the emerging South declined in the period 1986–2005, relative to earlier periods, but both the North and emerging South economies exhibited more intensive intra-group growth spillovers. Further, they found that, in contrast to the emerging South, other developing countries continued to be significantly affected by growth in the North. On similar lines, Kose et al. (2008) found convergence of business cycles within the OECD countries and within the emerging economies (including non-Asian countries) but found that there was a decoupling of business cycles between the two groups. In other words, the business cycles of developed countries and emerging economies remained largely independent of each other. Fidrmuc and Korhonen (2009), using dynamic correlation analysis, concluded that most of the developed countries showed low or even negative dynamic correlation with China and India for the traditional business cycles (cycles with periods of between 1.5 and 8 years); however, the co-movement of these business cycles increased after the global financial crisis of 2007. Therefore, they concluded that there may be, in the future, increased interdependencies between developed countries and these two key emerging economies.

The economic crisis of 2007, which led to a slowdown in the growth of the North, has shifted the focus of debate from whether the North is the growth pole for the South to whether the emerging economies can be the drivers of growth for the South. In his Nobel lecture, Arthur Lewis (1979) argued that if growth in the North slowed down sharply then South–South trade could be an important instrument to sustain the growth of the South. The growing markets in some of the countries of the South could generate demand for the South and fill the gap left by the contracting markets of the North.

Many studies have argued that India could play the role of growth pole for other developing countries of Asia (Kaplinsky and Messner 2008; Jenkins et al. 2008). However, very little empirical evidence exists of the linkages in the growth rates of these emerging economies with the growth rates of other developing countries. For instance, with regards to China, Reisen (2010) found that a slowdown of one percentage point in China's growth would reduce low-income countries' growth rate by 0.56 percentage points and middle-income countries' growth rate by 0.36 percentage points for the period 1990–2009.

In this context, this chapter estimates the extent of linkages in the growth rates of India with South Asia as a region as well as individual countries in South Asia. It estimates both long-term and short-term relationships between the growth rates and undertakes tests to identify the direction of the causality in the growth linkages.

2.3 Trends in growth rates in India and the rest of South Asia

2.3.1 Trends in growth

South Asia as a region has witnessed a steady growth since the 1970s, with rising average annual growth rates from 2.5 per cent in the 1970s to 5.3 per cent in the 1980s and further still to 6.7 per cent in the 2000s. However, India accounts for the major portion of this growth. Average annual growth rates decelerated in the rest of South Asia – excluding India – from 5 per cent in the 1980s to 4.3 per cent in the 1990s and improved slightly to 4.9 per cent in the 2000s (Table 2.1). India, on the other hand, had an increased average annual growth rate from 5.4 per cent in the 1990s to 6.9 per cent per annum in 2000–09. Within the individual countries of South Asia, it can be seen that growth has been very uneven. While Bangladesh has experienced a rising average annual growth rate since the 1970s, average annual growth rates declined in Bhutan and Pakistan in the 1990s compared with the 1980s; and average annual growth rates declined in Sri Lanka and Nepal in the 2000s compared with the 1990s.

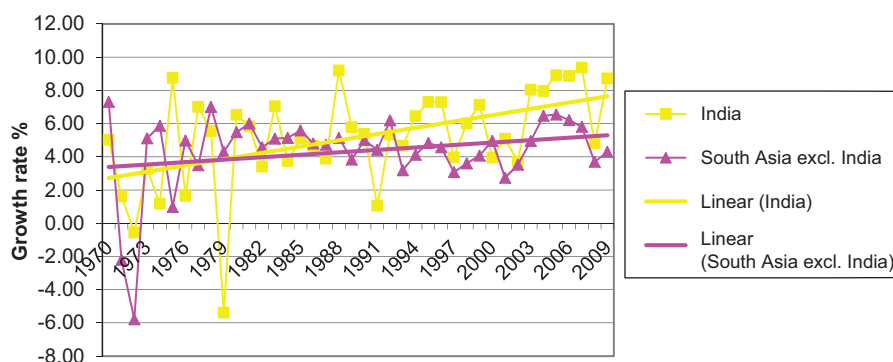
A close look reveals that the difference in the trend growth rates of India and China has declined steadily since 2000, while that of India and rest of South has grown steadily since the 1990s (Figure 2.1).

All South Asian countries, apart from India, experienced less than one percentage point increase in their average annual growth rates in the 2000s compared with the 1990s. In fact average annual growth rates declined in Nepal and Sri Lanka in the

Table 2.1 Average annual growth rates: South Asia

	South Asia	South Asia excluding India	India	Bangladesh	Bhutan	Nepal	Pakistan	Sri Lanka
1970–79	2.58	3.10	2.81	1.27		2.54	4.68	4.12
1980–89	5.30	5.03	5.52	3.16	9.08	3.94	6.63	4.05
1990–99	5.16	4.30	5.46	4.69	5.13	4.72	3.88	5.12
2000–09	6.76	4.91	6.94	5.65	8.13	3.91	4.52	4.85

Source: Author's estimations based on World Development Indicators

Figure 2.1 Growth rates of South Asia (excluding India) and India, 1970–2009

Source: Author's estimations based on World Development Indicators

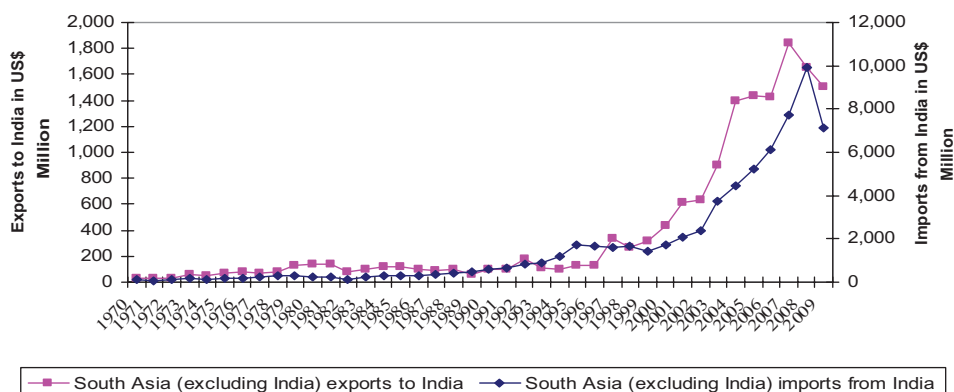
2000s. However, all countries in South Asia experienced a rise in their average annual growth rates in the 1980s compared with the 1970s, the decade in which India started growing (Table 2.1).

2.3.2 Trends in trade

South Asia's trade with India has experienced a rising trend since the 1990s (Figure 2.2). Trade with India picked up in the 2000s. The average exports to India of the countries of South Asia increased from US\$62 million in the 1970s to US\$1.1 billion in 2000–09 (Table 2.2).

India's exports to the rest of South Asia grew by 15.8 per cent and imports by 12.4 per cent. In absolute terms the region's exports to India are much lower than their imports from India (Figure 2.2).

The trend in trade between countries in South Asia reveals the growing engagement of India with the rest of the region. However, compared with India's global trade, its trade with South Asia seems to be very low. Less than 5 per cent of India's global exports in 2000–09 were to countries in South Asia.

Figure 2.2 India's trade with the rest of South Asia, 1970–2009

Source: UN Comtrade database

Table 2.2 Average annual exports and imports of the rest of South Asia and India (million US\$)

	Imports from India	Exports to India
1970–79	179	62
1980–89	304	104
1990–99	1,225	175
2000–09	5,043	1,183

Source: UN Comtrade database

2.4 Are the growth rates linked?

The trends reveal that the region of South Asia (excluding India) experienced less than 5 per cent average annual growth rates since the 1990s, while India experienced around 6 per cent average annual growth rates in the same period. The region has also experienced growing trade with India, especially since the start of the twenty-first century, though the region's share in global trade of these countries is very small. One of the important factors linking growth of different countries is trade. However, a higher volume of trade does not necessarily percolate into growth. Apart from the extent of trade, what may matter is also the composition of trade.

To estimate the extent to which growth in India is linked to growth in South Asia as a region and individual countries, the following linkages are tested:

- I. the growth rate of India with the growth rate of the rest of South Asia;
- II. the growth rate of India with the growth rates of Bangladesh, Bhutan, Nepal, Pakistan and Sri Lanka.

Further, the composition of trade between these groups is examined to show a plausible explanation for growth linkages.

2.4.1 Has India acted as a growth pole for South Asia?

India is an important trade partner for countries in South Asia. The Granger causality test is used to test the lead–lag relationship between two variables. Granger causality determines whether one series is useful in forecasting the other series; it does not imply ‘causality’ in the sense generally used, but indicates which series predicts the other and, therefore, indicates the direction of the causal relationship.

The relationship between growth rates in India and the rest of South Asia were tested. No evidence was found of any relationship between them, whether short term or long term. The results of the tests are reported in Table 2.3, the details of which are reported in Appendix Tables A2.2 and A8.8. To find a plausible explanation for this result, the top five product categories of India’s exports and imports with the region in the last ten years are examined. This provides insights into the composition of trade of these countries.

Examining India’s top five exports to the region in the period 1999–2009, it is found that India exported chemical, rubber and plastic products, petroleum and coal products, textiles, machinery and equipment, and ferrous metals to the region (Table 2.4). However, the value of this trade amounted to US\$29.5 billion, while the value of India’s imports amounted to US\$3.5 billion. The top product of India’s trade with the region is chemical, rubber and plastic products, which may not necessarily allow the region to benefit from comparative advantage.

This provides for an interesting case study as India, being a part of the region, has not been able to provide benefit to the region in terms of growth spillovers and has also not been able to benefit from the growth of the region. India’s exports to the region in the period 1999–2009 were 5 per cent of its global exports. India’s imports to the region in the same period were 0.7 per cent. Further, the percentage of Indian exports of the total global exports of the region in the period 1999–2009 was 4.2 per cent, while the percentage of India’s imports of the region’s global imports was 10 per cent.

What matters is ‘what you trade’ (or the composition of trade) and not just ‘how much you trade’. India’s exports are concentrated on chemical, rubber and plastic products and petroleum and coal products, while imports include chemical, rubber and plastic

Table 2.3 The results of tests of relationships between growth in India and individual countries in South Asia

Variable name: Growth rates	Long-term relationship	Short-term relationship	Granger causality
Bhutan (1980–2009)	Yes	Yes	– One-way: growth in India Granger-causes growth in Bhutan
Bangladesh	Yes	Yes	One-way: growth in China Granger-causes growth in Bangladesh
Nepal	No	No	Two-way
Pakistan	No	No	No evidence
Sri Lanka	No	No	

Table 2.4 India's top five exports and imports from rest of South Asia: 1999–2009

India's top five exports to the rest of South Asia (US\$ million)		The rest of South Asia's top five exports to India (US\$ million)		India's exports as percentage of total exports from rest of South Asia
Chemical, rubber, plastic products	8,771	Chemical, rubber, plastic products	1,268	11.8%
Petroleum, coal products	7,541	Metals n.e.c.	996	65.5%
Textiles	7,057	Electricity	940	99.9%
Machinery and equipment n.e.c.	3,310	Textiles	899	1.15%
Ferrous metals	2,991	Crops n.e.c.	723	8.8%

Note: n.e.c. – not elsewhere classified

Source: UN Comtrade database, GTAP product classification

products, indicating product differentiation. However, the above analysis of growth linkages at the regional level may hide some important growth linkages at the country level. Further, the composition of trade with the region may not reveal whether trade is with only one country or many and, therefore, it may not provide the relevant insights. Country-level analysis of growth linkages is undertaken in the next section.

2.5 India's growth linkages with countries in South Asia

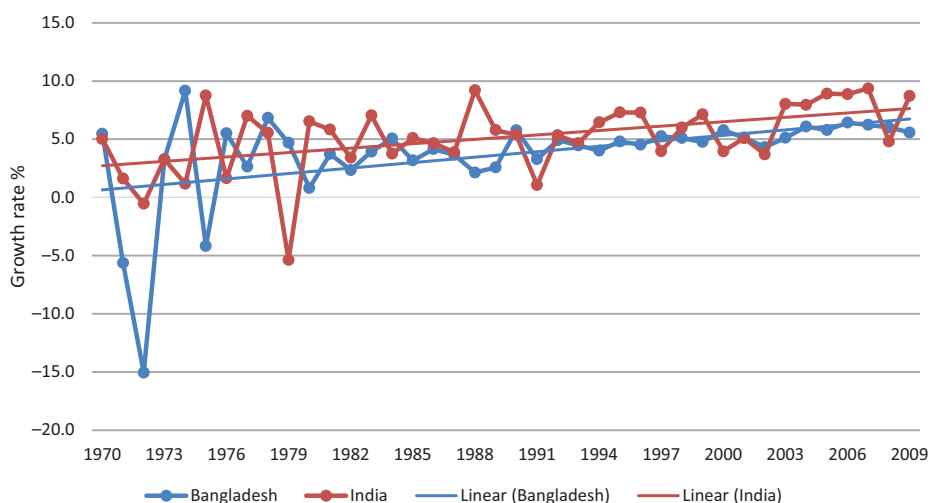
At the country level, the tests for co-integration of growth linkages are undertaken using the same methodology. The long-term relationship between the growth rates has been tested using Johansen tests for co-integration and VECM while the short-term relationship and its direction is tested by estimating the impact of lagged growth rates and conducting Granger causality tests. The analysis is undertaken for the period 1970–2009 and also for the post-structural break period, which differs for each country. Clemente et al. (1998) tests have been applied to identify two structural breaks for each country.

The results of the tests are reported in Appendix Tables A2.2 to A2.8. The broad conclusions from the tests are reported in Table 2.3. The results provide insights into the relationship of growth rates. Empirical results show long-term relationships between growth in India and growth in Bangladesh and Bhutan.

2.5.1 The relationship between growth in Bangladesh and India

Bangladesh's growth is found to have a long-term relationship with the growth of India. The short-term relationship between growth in India and Bangladesh is found to go both ways. One of the probable reasons for this could be that Bangladesh has provided an expanding market for India's exports, as they multiplied by a factor of 3.5 from 1990 to 2010, (i.e. from US\$644 million to US\$2.4 billion), while India's imports from Bangladesh were less than \$500,000 in 2009 (Reserve Bank of India 2010).

Examining the growth rates, we find that the difference in the linear trends in growth of Bangladesh and India has steadily narrowed since the 1990s (Figure 2.3).

Figure 2.3 Growth rates of India and Bangladesh, 1970–2009

Source: World Development Indicators

Rising trade between the two countries over the years could probably be a reason for the growth linkages.

The growth of Bangladesh is found to have both a long-term and short-term relationship with the growth of India and the causality is found to be in both directions for the period 1970–2009. One of the probable reasons for this is the growing market which Bangladesh is providing to India. Among the developing countries, India has become one of the principal sources of Bangladesh's imports since the 1990s. India alone supplied 30.5 per cent of Bangladesh's total imports from developing countries in 1998, though the figure was only 10.5 per cent in 1978 (Rahman 2007).

The composition of trade between the two shows that India exported US\$3 billion of cotton to Bangladesh in the period 1999–2009. This is an important input for the textiles industry of Bangladesh, but much lower than China's US\$11.4 billion of textiles in the same period. India also exported more final products to Bangladesh such as cereals, agricultural products and vehicles, and imported more input products such as textile fibres, inorganic chemicals and fertilisers (Table 2.5).

The results, therefore, show that growth in India has fuelled growth in Bangladesh, and Bangladesh's growth has further contributed to growth in India.

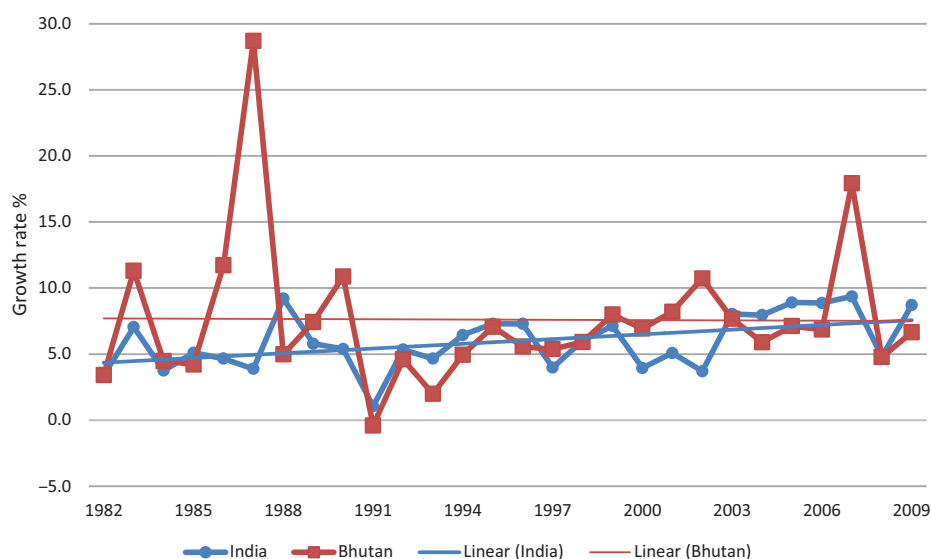
2.5.2 The relationship between growth in Bhutan and India

The empirical results indicate long-term and short-term relationships between growth in India and Bhutan. Figure 2.4 explicitly shows the convergence of the trend growth lines of India and Bhutan. India has a rising trade with Bhutan, especially after it set up the second hydroelectric project in Bhutan in 2002; thereafter 90 per cent of Bhutan's exports went to India. India's exports to Bhutan consist of electrical machinery, iron and steel, mineral fuels, machinery and appliances, and vehicles. India has been a key driver of growth for Bhutan.

Table 2.5 India's top five imports and exports to Bangladesh: 1999–2009

India's exports to Bangladesh (US\$ million)		India's imports from Bangladesh (US\$ million)	
Cotton	3,013	Other vegetable textile fibres; paper yarn and woven fabrics	337
Cereals	2,832	Inorganic chemicals; compounds of precious metal radioactive elements, etc.	279
Mineral fuels, oils and product of their distillation, etc.	1,062	Other made up textile articles; sets; worn clothing, etc.	200
Edible vegetables and certain roots and tubers	1,057	Fertilisers	148
Vehicles o/t railw/tramw roll- stock, pts and accessories	1,029	Fish and crustacean, mollusc and other aquatic invertebrate	137

Source: UN Comtrade database, GTAP product classification

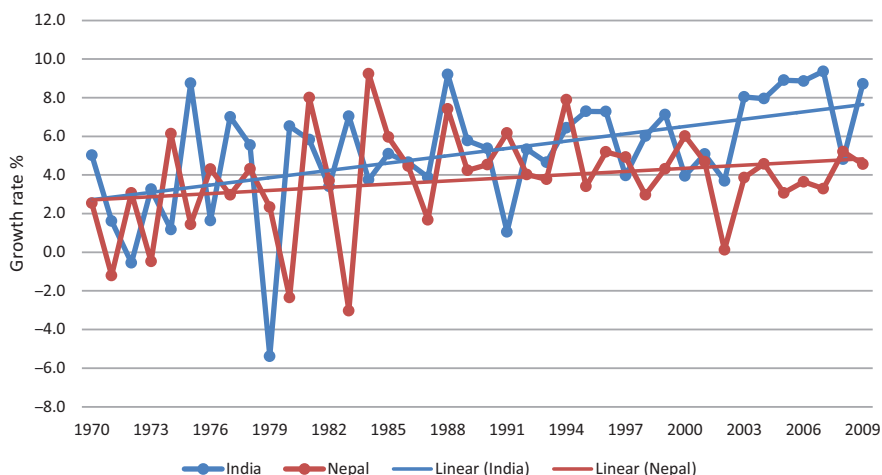
Figure 2.4 Growth rates of India and Bhutan, 1982–2009

Source: World Development Indicators

2.5.3 The relationship between growth in Nepal and India

Nepal shares borders with both China and India. India is the most important trading partner for Nepal given the geography of the region. The average value of India's exports to Nepal in the period 1999–2009 was around US\$700 million, while the average value of Nepal's imports to India was US\$355 million. However, the empirical results show that there is little long-term connection between growth rates in Nepal and India. In fact, Figure 2.5 shows a divergence in the trend growth rates of India and Nepal.

Imports to India from Nepal comprise mainly vegetable fats and oils, wood and articles of wood, essential oils, raw hides and plastic articles. Concentration of trade

Figure 2.5 Growth rates of India and Nepal, 1970–2009

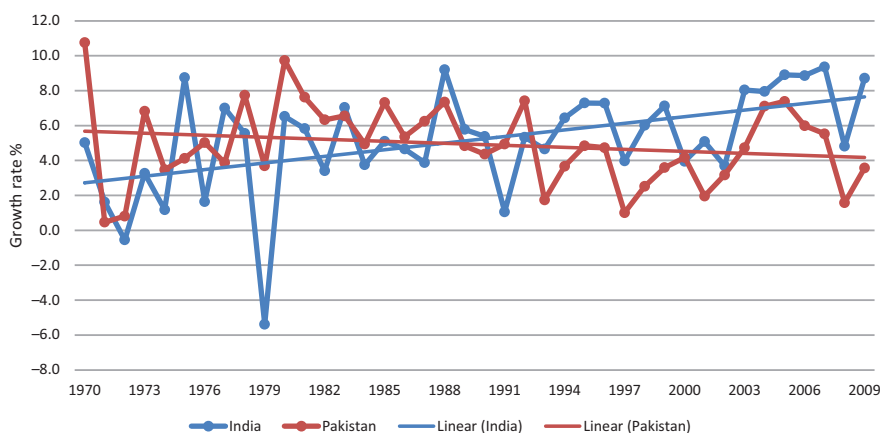
Source: World Development Indicators

in final products with Nepal may also be one of the reasons for the lack of short-term growth linkages between Nepal and India. Further, one of the main sources of export earnings for Nepal is tourism (Table 2.6).

2.5.4 The relationship between growth in Pakistan and India

Empirical results suggest no growth linkages between Pakistan and India. According to the empirical results there is no evidence of causality. The causality of growth linkages is found only in the post-1984 period, which is identified as a period of structural break for Pakistan.

Figure 2.6 depicts the growth rates of India and Pakistan. Clearly, no relationship can be seen in their growth, where the growth rate of India was lower than that of Pakistan in the pre-1988 period.

Figure 2.6 Growth rates of India and Pakistan, 1970–2009

Source: World Development Indicators

Table 2.6 India's top five imports and exports to Nepal: 1999–2009

India's exports to Nepal (US\$ million)		India's imports from Nepal (US\$ million)	
Mineral fuels, oils and product of their distillation, etc.	2,599	Animal/vegetable fats and oils and their cleavage products, etc.	438
Vehicles o/t railw/tramw roll-stock, pts and accessories	682	Iron and steel	392
Iron and steel	574	Plastics and articles thereof	331
Pharmaceutical products	481	Essential oils and resinoids; perfume, cosmetic/toilet prep	289
Synthetic staple fibres	250	Salt; sulphur; earth and stone; plastering materials; lime and cement	359

Source: UN Comtrade database, GTAP product classification

Table 2.7 India's top five imports and exports to Pakistan: 1999–2009

India's imports from Pakistan (US\$ million)		India's exports to Pakistan (US\$ million)	
Vegetables, fruit, nuts	480	Chemical, rubber, plastic products	3,158
Petroleum, coal products	354	Plant-based fibres	915
Textiles	253	Textiles	668
Chemical, rubber, plastic products	181	Sugar	578
Mineral products not elsewhere classified	122	Vegetable oils and fats	512

Note: n.e.c. – not elsewhere classified

Source: UN Comtrade database, GTAP product classification

Table 2.8 India's top five imports and exports to Sri Lanka: 1999–2009

India's exports to Sri Lanka (US\$ million)		India's imports from Sri Lanka (US\$ million)	
Petroleum, coal products	4,139	Metals n.e.c.	584
Textiles	1,883	Vegetable oils and fats	436
Chemical, rubber, plastic products	1,866	Machinery and equipment n.e.c.	323
Motor vehicles and parts	1,217	Crops n.e.c.	318
Transport equipment n.e.c.	974	Chemical, rubber, plastic products	314

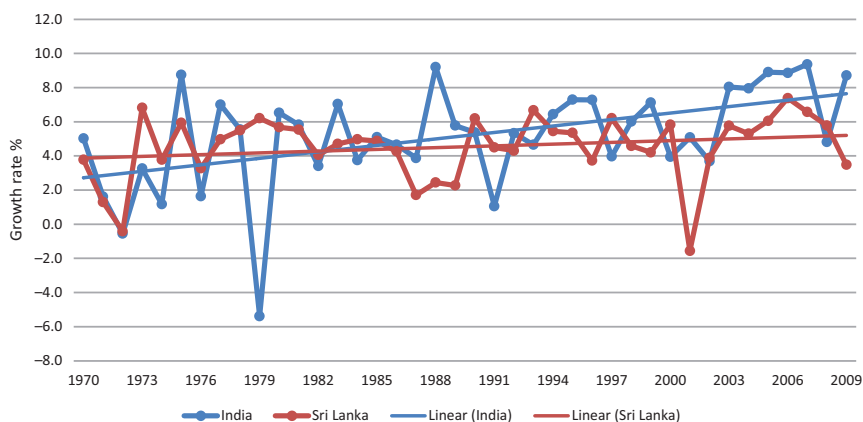
Note: n.e.c. – not elsewhere classified

Source: UN Comtrade database, GTAP product classification

India's trade with Pakistan has been low, amounting to a value of US\$7.9 billion of exports and US\$1.7 billion of imports. India's top five exports to Pakistan consist mainly of finished products such as chemicals, rubber and plastic products, sugar and vegetable oils, while its highest imports are also characteristically similar, being vegetables, fruits and nuts (Table 2.7). Even though India's trade with Pakistan is much higher than its trade with Bhutan, the growth linkages are missing, probably because of the composition of trade.

2.5.5 The relationship between growth in Sri Lanka and India

Empirical results show that growth in Sri Lanka is not co-integrated with growth in India. No long-term or short-term relationship is found between these

Figure 2.7 Growth rates of India and Sri Lanka, 1970–2009

Source: World Development Indicators

countries. Figure 2.7 also reflects the divergence of growth rates between Sri Lanka and India.

The value of India's exports to Sri Lanka in the period 1999–2009 was US\$16.1 billion while its imports were around US\$3 billion. Though India's trade has been higher with Sri Lanka than with Bhutan, the growth rates are found to be co-integrated in the case of India and Bhutan but not in the case of India and Sri Lanka. The probable reasons for this are the size of the country, its stage of development and the composition of trade.

The most important export item of India to Sri Lanka in the period 1999–2009 was petroleum and coal products, followed by textiles, chemical rubber and plastic products, motor vehicles and parts, and other transport equipment. The top five imports included mainly metals, vegetable oils and fats, machinery and equipment crops and chemical, rubber and plastic products.

2.6 Conclusions and policy implications

Economic theories on regional growth argue that growth spillovers may occur from growth poles in the region. Given the high levels of poverty in the region, where 40 per cent of the population live below the poverty line, South Asia is a region which is in need of a growth propeller. India has the potential to become the growth pole of the region. This chapter empirically examined the extent to which the South Asian region has benefitted from the growth of India.

Both long-term and short-term relationships between the growth of the region and growth in India were tested using co-integration analysis, VECM and causality tests. The analysis was undertaken at the regional level as well as at the country level. Structural breaks were identified and co-integration between growth rates was estimated in the post-structural break period as well.

Empirical evidence suggests that India's growth has limited linkages with growth in the region, in spite of its being a part of the region. Its growth is not found to be co-integrated with the growth of the region. The only relationship found between India's growth and that of other countries in the region is with Bangladesh and Bhutan.

The analysis provides some vital leads in understanding the complex issue of growth spillovers in the region. The existence of fast-growing economies within a region may not necessarily lead to regional growth. It is not the 'extent of trade' with faster-growing economies which matters, but what is being traded. The composition of trade determines the extent of growth linkages that may emerge in the short term as well as in the long term. The more integrated the economies are in each other's supply chains by exporting inputs to each other, the stronger will be the growth linkages.

It is unlikely for trade to automatically transform into being input-oriented. Conscious policies regarding the composition of trade need to be adopted which encourage trading of inputs within the region. India's top items of export and import with the region have been chemical, rubber and plastic products. India's weighted average of tariffs for many inputs originating in the region is still compared with China, for instance. The weighted average of tariffs for textiles vis-à-vis the region is around 6 per cent in China and around 10 per cent in India; for minerals it is around 1 per cent in China and around 5 per cent in India.

The South Asian Free Trade Area (SAFTA) provides a real opportunity to leverage the building of strong growth linkages. However, SAFTA has a long sensitive list, wherein tariffs cannot be brought down to zero. India is now making an effort to reduce its sensitive list under SAFTA. The new list considerably reduces the number of items for LDCs in the region. LDCs in the region have a lower number of products on the sensitive list than India's sensitive list in its duty-free, quota-free (DFQF) scheme vis-à-vis other LDCs of the world. But there still exists a quota for Bangladesh's exports in garments. Given the fact that India is exporting textiles to Bangladesh, higher exports of clothing from Bangladesh increase the demand for its imports of textiles. Therefore, there exists a potential for increasing integration which can be realised by conscious policies. Further, the new list does not offer any removal of tariff lines for Pakistan and Sri Lanka. Removal of all inputs from the SAFTA sensitive list of India can help India to integrate into the region with mutual benefits.

South-South trade can act as an important vehicle for growth of the South, as it can provide vital growth linkages, especially within the region. However, higher trade with faster-growing economies may not necessarily lead to higher growth spillovers. It is important to consciously promote input-based composition of trade which helps integrate the economies into each other's global supply chains. The faster-growing economies in the region can not only provide larger markets for finished products of other developing countries in the region, but also boost their growth by providing the necessary inputs and machinery and equipment. It is also important to note that the causality of growth linkages may run two ways and the growth poles of the region can also benefit by integrating into the regional and global supply chains.

Appendices

Appendix 1 Methodology used

To estimate the extent to which growth of a country is linked to growth of another country, co-integration analysis and causality tests are undertaken for the period 1970–2009. The data on real GDP constant US\$2000 are collected from the World Development Indicators (2009).

Unit root tests are conducted to verify the stationarity properties (absence of trend and long-run mean reversion) of the time series data to avoid spurious regressions. A series is said to be integrated of order d , denoted by $I(d)$, if it has to be differenced d times before it becomes stationary. If a series, by itself, is stationary in levels without having to be first differenced, then it is said to be $I(0)$. We use standard Augmented Dickey-Fuller (ADF) (Dickey and Fuller 1981), and MacKinnon (1991) critical values for that purpose. Second, for appropriate lag lengths, we use the VAR process in conjunction with the Akaike Information Criterion (AIC). Third, the co-integration tests are applied to detect the presence of any long-term and short-term relationship between the variables.

For two series to be co-integrated, both need to be integrated of the same order 1 or above. Lack of co-integration implies no long-run equilibrium among the variables such that they can wander from each other randomly. Their relationship is thus spurious. We use the maximum likelihood method developed by Johansen and Juselius (1990). Finally, the causality among the variables is studied by applying the statistical concept of Granger causality, which does not imply any cause-and-effect relationship in a philosophical sense. It refers strictly to the concept of predictability (Granger 1969, 1980, 1981), meaning that a variable X is said to Granger-cause a variable Y , if taking into account past values of X enables better predictions to be made for Y , *ceteris paribus*. VECM were estimated to infer the number of lag terms required (with the help of AIC) to obtain the best-fitting model and appropriate lag lengths were then used in causality tests yielding the F-statistics and respective p -values.

The time series properties of all the series were examined. The results of the unit root test are presented in Table A2.1. To verify the hypothesis that the time series follow a unit root process three different tests are used. To begin with, time series are tested for stationarity by using the ADF test. Since the lag length affects the power properties of the ADF test, we establish the correct number of the lags that should be included in our model using both the AIC and Schwarz's Bayesian Information Criterion (BIC). We fail to reject the null hypothesis of unit root for all series.

In order to test the unit root hypothesis, taking into account the possibility of structural breaks in the data, we perform the Zivot and Andrews (1992) test and the tests proposed by Clemente et al. (1998). All results are reported in Tables A.2 and A.3. When taking into account the existence of different kinds of structural breaks, we fail to reject the null hypothesis of unit root for all time series, except for Pakistan, with a break in the intercept. Two alternative events within the time series are captured: the 'additive outlier' (CLEMAO2) model that captures a sudden change in the series and the 'innovation outlier' (CLEMIO2) model that allows a gradual shift in the mean of the series. According to both the test results, we fail to reject the null hypothesis of unit root in all cases. We can conclude that unit roots are present even when instantaneous structural breaks and more gradual shifts are accounted for.

Johansen's tests for co-integration are conducted to determine whether co-integrating vectors exist between the country in question and India, which would imply non-spurious long-run relationships among the growth series. Johansen tests can determine the number of co-integrating equations. The dynamic relationship between the two growth series can be summarised by a VECM that combines the long-run co-movements

of output growth with the short-run cyclical movements (see Engle and Granger 1987). The error correction term indicates the presence of a long-term relationship, while the coefficients of lagged error correction term indicate a short-term relationship. To further test the causality of the relationships, Granger causality tests are undertaken, which test for the direction of the short-term relationship between the growth series.

Appendix 2 Econometric findings

Table A2.1 ADF unit root tests

Variable name: Growth rates	ADF	Test statistic
India	Trend (2)	-3.169**
	Difference	-5.589
South Asia excluding India	Trend (1)	-3.311*
	Difference	-5.013
Bangladesh	Trend (3)	-0.603**
	Difference	-4.792
Bhutan	Trend (1)	-1.988*
	Difference	-3.912
Pakistan	Trend (2)	-1.095*
	Difference	-2.719
Nepal	Trend (2)	-2.798**
	Difference	-3.722
Sri Lanka	Trend (1)	-3.359*
	Difference	-2.524**
	2nd Difference	-8.912

Note: * denotes the value is significant at 5 per cent. Figures in brackets are the optimum lag lengths determined by AIC and BIC for ADF and Ng-Perron modified AIC (MAIC) for Dickey-Fuller generalised least squares (DF-GLS). ** denotes the value is significant at 1%. (For ADF it denotes the test statistic being greater than the critical value at 1%).

Table A2.2 Zivot and Andrews unit root test with one unknown structural break

Variable name: Growth rates	Zivot and Andrews (break in intercept)	Year of break	Zivot and Andrews (break in trend)	Year of break	Zivot and Andrews (break in both intercept and trend)	Year of break
India	-2.430	1979	-2.465	2001	-2.469	2003
South Asia excluding India	-3.495	1997	-3.488	1991	-3.470	1997
Bangladesh	-2.216	1987	-2.379	1995	-2.203	1995
Bhutan	-2.741	1994	-2.421	1988	-2.558	1992
Pakistan	-3.641	1980	-4.663*	1989	-4.097	1993
Nepal	-3.831	1990	-2.940	2002	-2.883	2003
Sri Lanka	-4.309	1987	-3.606	2003	-4.495	1987

Note: * denotes critical values for break in trend: 1%:-4.93 5%:-4.42.

Table A2.3 Unit root test with two structural breaks

Real GDP	Additive outliers	Breaks		Innovative outliers	Breaks	
	CLEMAO2	Year of break 1	Year of break 2	CLEMIO2	Year of break 1	Year of break 2
India	−2.680	1985	2000	−1.879	1979	2002
South Asia excluding India	−2.467	1984	1997	−4.993	1976	2002
Bangladesh	−2.427	1987	1999	−3.710	1974	1994
Bhutan	−2.637	1989	2001	−2.682	1985	2000
Pakistan	−2.653	1984	1997	−5.292	1976	2002
Nepal	−2.875	1985	1997	−2.571	1972	1982
Sri Lanka	−2.402	1982	1996	−1.696	1971	2002

Note: Critical value for two breaks is −5.49

Source: Clemente et al. (1998)

Table A2.4 Johansen tests for co-integration of growth rates from 1980 to 2009

Variable name: Growth rates	Test statistics	H0: No co-integrating relation	H0: At most one co-integrating relation	H0: No co-integrating relation	H0: At most one co-integrating relation
		1970–2009		Post-structural break	
India/South Asia excluding India	Trace statistics	13.06 ^a	0.026	12.00 ^a	1.53
	Max Eigen statistics	13.04	0.026	10.47	1.53
India/Bangladesh	Trace statistics	44.39	8.71	27.71	10.13
	Max Eigen statistics	36.68	8.71	17.58	10.13
India/Bhutan (1982–2009)	Trace statistics	15.77	5.37		
	Max Eigen statistics	10.40	5.37		
India/Pakistan	Trace statistics	15.51 ^a	0.77	19.62	1.17
	Max Eigen statistics	14.74	0.77	18.45	1.17

(continued)

Table A2.4 Johansen tests for co-integration of growth rates from 1980–2009 (continued)

Variable name: Growth rates	Test statistics	H0: No co-integrating relation	H0: At most one co-integrating relation	H0: No co-integrating relation	H0: At most one co-integrating relation
		1970–2009		Post-structural break	
India/Nepal	Trace statistics	19.11 ^a	1.59	11.30 ^a	4.50
	Max Eigen statistics	17.52	1.59	6.80	4.50
India/Sri Lanka	Trace statistics	15.05 ^a	0.60	14.35 ^a	4.44
	Max Eigen statistics	14.45	0.60	9.91	4.44

Note: ^adenotes that the null hypothesis is accepted as trace statistic is lower than the critical value.

Table A2.5 Vector error correction model: India and Bangladesh

	Growth rate of India (1)	Growth rate of Bangladesh (2)
Error correction term	0.09 (1.04)	−0.53*** (−7.39)
Δ GR Bangladesh _{t-1}	0.22** (1.82)	0.20** (2.08)
Δ GR India _{t-1}	−0.09 (−0.04)	−0.01 (−0.07)
Adj R-squared	0.77	0.82
N	39	39

Note: *** denotes significant at 1%; ** denotes significant at 5%.

Table A2.6 Vector error correction model: India and Bhutan

	Growth rate of India (1)	Growth rate of Bhutan (2)
Error correction term	−0.11 (−0.73)	0.74*** (2.84)
Δ GR Bhutan _{t-1}	−0.09 (−0.72)	0.20** (2.08)
Δ GR India _{t-1}	−0.47** (−2.46)	−0.41** (−2.23)
Adj R-squared	0.31	0.35
N	26	26

Note: *** denotes significant at 1%; ** denotes significant at 5%.

Table A2.7 Vector error correction model: India and Sri Lanka

	Growth rate of India (1)	Growth rate of Sri Lanka (2)
Error Correction Term	−0.06 (−1.06)	−0.007 (−0.59)
Δ GR India_{t-1}	−0.20 (−1.28)	0.02 (0.17)
Δ GR Sri Lanka_{t-1}	−0.01 (−0.06)	0.12 (0.71)
Adj R-squared	0.83	0.85
N	39	39

Table A2.8 Results of Granger causality

Dependent variable	Full sample: 1970–2009	
	chi ²	Reject/Accept
Growth in China does not Granger-cause growth in South Asia excluding India	9.70**(0.008)	Reject
Growth in South Asia excluding India does not Granger-cause growth in India	1.32(0.24)	Accept
Growth in India does not Granger-cause growth in South Asia excluding India	0.03(0.99)	Accept
Growth in Bangladesh does not Granger-cause growth in India	12.04*** (0.002)	Reject
Growth in India does not Granger-cause growth in Bangladesh	8.09*(0.01)	Reject
Growth in Bhutan does not Granger-cause growth in India (1982–2009)	0.31(0.85)	Accept
Growth in India does not Granger-cause growth in Bhutan	5.64**(0.05)	Reject
Growth in Sri Lanka does not Granger-cause growth in India	2.50(0.28)	Accept
Growth in India does not Granger-cause growth in Sri Lanka	0.33(0.84)	Accept

Note: *p*-values are in brackets ; *** denotes significant at 1%; ** denotes significant at 5%.

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Chapter 3

Assessing Gains from SAFTA

Selim Raihan and Mohammad A Razzaque

3.1 Introduction

In recent years, there has been increased interest in regional economic integration in South Asia. The stalemate in multilateral trade talks, leading to the much prolonged Doha Round of negotiations of the World Trade Organization (WTO), has certainly contributed to intensifying efforts in regional trading arrangements with the trends likely to continue. One of the first few major regional integration initiatives in South Asia was launched in 1995 when the South Asian Association for Regional Cooperation (SAARC) Preferential Trading Arrangement (SAPTA) was signed. It took more than 10 years for SAARC member countries to establish a South Asian Free Trade Area (SAFTA), the full implementation of which will result in the abolition of customs duties on trade goods within South Asia by 2016. The transition towards deeper regional integration schemes has taken place in parallel to the establishment of unilateral trade liberalisation programmes in individual South Asian countries. Nevertheless, SAFTA is being implemented with the aim of boosting intra-regional trade in South Asia.

There are strong arguments for regional economic integration in South Asia, as it is believed to generate significant intra-regional trade and welfare gains for the countries involved. The SAFTA mechanism is expected to provide member countries with improved market access in the region, helping boost their exports and thereby augmenting the significance of intra-regional trade and the associated investment flows. SAFTA is likely to generate immediate trading opportunities triggered by tariff differentials between individual members' most favoured nation (MFN) vis-à-vis regional tariff regimes, giving rise to so-called static gains. The dynamic gains could be even greater for members owing to the possible expansion in scale of operation through access to large regional markets, further buoyed by increased investment and more efficient allocation of regional resources.

However, critics point out a number of factors which could undermine the potential benefits of SAFTA. Complementarities in the region are considered to be limited given that members specialise in similar export and trading activities. Therefore, the prospect of the expansion of intra-regional trade is argued to be not very substantial. This concern is further backed up by the fact that all South Asian countries rely heavily on the Western markets, which are the principal determinants of demand for exports from the region. It is also feared that SAFTA may lead to substantial trade diversion for some countries, as the regionalism will discriminate against the most efficient suppliers from the rest of the world. Finally, there is the general concern about the regional schemes being stumbling blocks to multilateral trade liberalisation and expansion, which is considered to be best possible option for promoting trade-led growth and development.

Notwithstanding the aforementioned arguments, there is, however, an overall favourable view of promoting intra-regional trade. Many observers are of the view that, even in the absence of any policy-induced mechanism, trade flows can be expanded within South Asia. It is argued that the current low level of intra-regional trade is due to excessive trading costs resulting from non-streamlined administrative procedures, weak infrastructural facilities, and corrupt and inefficient practices in dealing with traded goods crossing borders within the region. In this context, the barriers related to cross-border trading have, of late, become subject matters of discussions both at bilateral and regional forums in South Asia. There is some suggestion that the trade and welfare gains from reduced costs of trading in the region could be substantial.

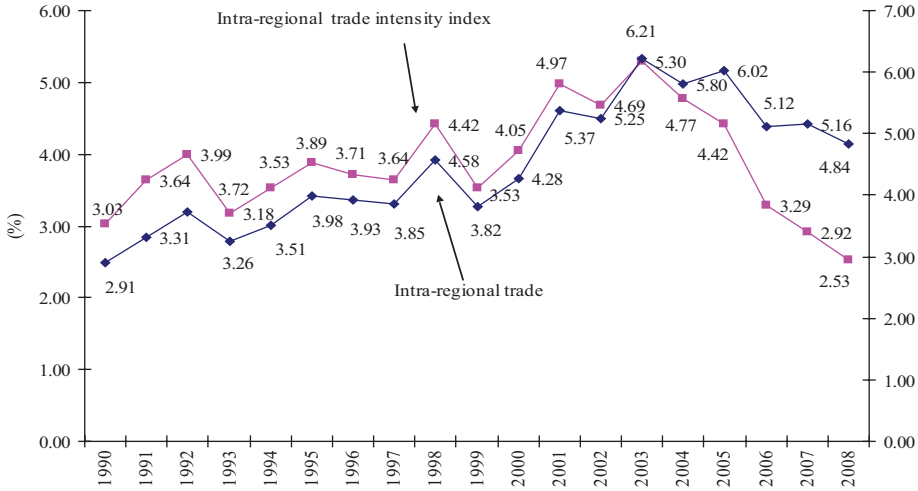
Against the above backdrop, this chapter aims to shed some light on the implications of SAFTA for South Asian countries by first reviewing the findings from the related existing studies and then undertaking some simulation exercises to gain further insights. The chapter is organised as follows: Section 3.2 provides an overview of the evolution of the pattern of intra-regional trade in South Asia; Section 3.3 gives a brief review of the findings from studies on the potential implications of SAFTA; Section 3.4 makes use of a global general equilibrium model to simulate the welfare impact of regional integration considering reduced trading costs within the region; and finally Section 3.5 makes some concluding remarks.

3.2 The pattern of South Asian intra-regional trade

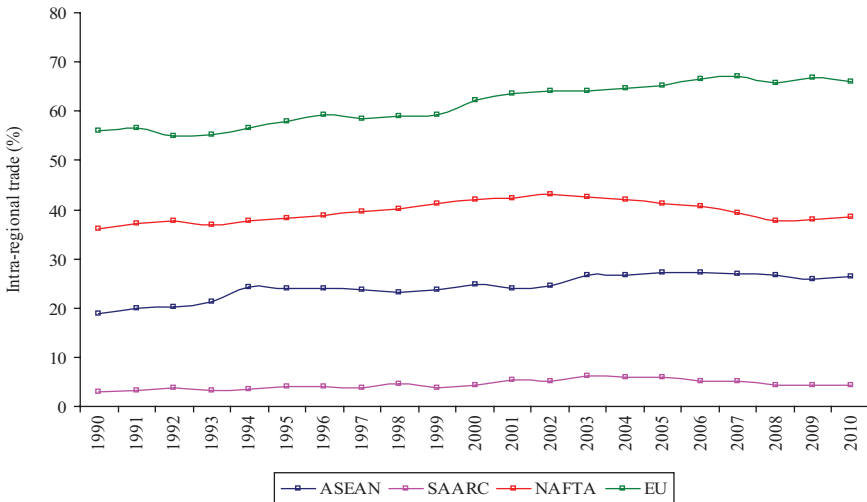
The significance of intra-regional trade among the South Asian countries is low (Figure 3.1). Throughout the 1990s the share was less than 4 per cent of the region's global trade. There were some encouraging trends in the 2000s, with the proportion of intra-regional trade rising to more than 6 per cent of the region's global trade in 2003. More recently, however, the share has hovered around 5 per cent. The intra-regional trade intensity index, defined as the ratio of the intra-regional trade share to the region's share in the world's total trade, has also followed a similar pattern showing that South Asia's trade with the rest of the world has expanded faster than its intra-regional trade. Compared with other regional arrangements such as NAFTA, ASEAN and the EU, intra-regional trade in South Asia remains very low (Figure 3.2).

The country-wise shares in regional imports and exports are presented in Figure 3.3. Bangladesh has the largest share in intra-SAARC import, 26 per cent, while its share in the intra-SAARC export is only 3 per cent. India, although accounting for only a 15 per cent share in intra-SAARC import, had a 65 per cent share in total intra-SAARC exports.

Except Nepal and Bhutan, all other South Asian countries have their major export destinations outside South Asia. Intra-regional export constitutes only about 5 per cent of total exports from Bangladesh. The corresponding figure for India is 6 per cent. Since, India is the major export destination for Nepal and Bhutan, Bhutan's exports to India comprise close to 100 per cent of its total exports and for Nepal the corresponding figure is more than 70 per cent. Trade between individual South Asian countries varies widely. Bangladesh trades very little with Bhutan, Nepal and Sri Lanka. India is the dominant

Figure 3.1 Intra-regional trade in SAARC

Source: De and Raihan (2011)

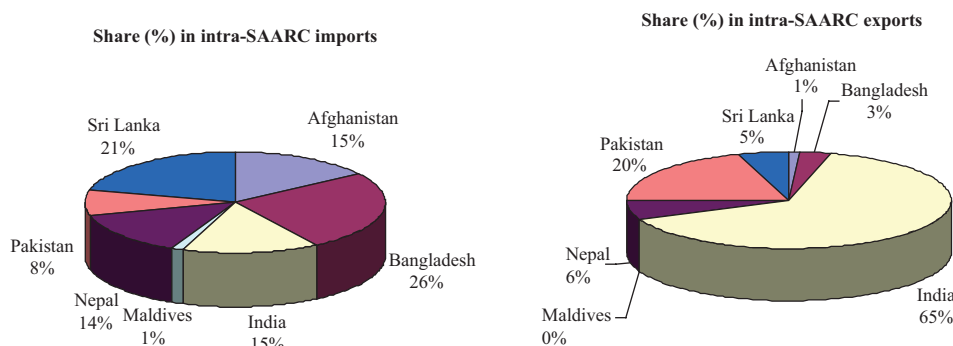
Figure 3.2 Intra-regional trade: SAARC vis-à-vis other regions

Note: Calculated based on Director of Trade Statistics Online Database, IMF

Source: De and Raihan (2011)

import source for Bhutan and Nepal, and India is also one of the major import sources for Bangladesh. However, this trade with India is largely one-sided, as the volumes of imports from India to Bangladesh and Nepal are disproportionately large.

High tariff rates among the South Asian countries have long been pointed to as one of the major reasons behind the low intra-regional trade. South Asia, as a region, has higher average tariff rates than in any other region in the world. It can thus be argued that a reduction in the tariff barriers among the South Asian countries is

Figure 3.3 Country-wise share (%) in intra-SAARC imports and exports

Source: Direction of Trade Statistics (DOTS)

likely to have important implications in terms of improved market access of these countries to their neighbouring countries. Non-tariff barriers, weak trade facilitation infrastructure and cumbersome procedures, particularly for trade through land ports, are also regarded as important constraints to regional trade.

One important aspect of South Asian intra-regional trade is the presence of informal border trade, which has always been thought to be very high. There have been some studies on informal border trade among South Asian countries and it is pointed out that informal and illegal trade between India and Bangladesh, India and Nepal, India and Sri Lanka, and India and Pakistan could be a significant proportion of trade (Pohit and Taneja 2003; Taneja et al. 2004; Das and Pohit 2006; World Bank 2006).

3.3 Potential implications of SAFTA: Review of qualitative and quantitative studies

SAFTA has been able to generate significant interest among the policy-makers, business community and researchers in South Asia. There are debates on whether South Asian countries stand to gain or lose from SAFTA. The findings of a number of qualitative and quantitative studies in this regard have been inconclusive, which has intensified this debate. The results of these studies have, however, been influenced by differences in the methodologies used.

3.3.1 Review of the qualitative assessments of the welfare effects of SAFTA

In trade theory, welfare effects of any regional trade agreement (RTA) are analysed using two concepts: trade creation and trade diversion. The overall welfare effects of economic integration are ambiguous and require case-by-case assessment. The reason is that integration is both a policy of protection and a move towards free trade. The effect of the trade liberalisation element is called *trade creation* and the effect of the protectionist element of integration is called *trade diversion*. The RTA's overall

effect on welfare for a member country is determined by comparing these two effects. If trade creation dominates, the formation of an RTA will enhance welfare. On the contrary, if the effect of trade diversion is greater than the effect of trade creation, the RTA will lead to a welfare loss for the country under consideration.¹

The fundamental arguments for regionalism rest on the evidence which suggests that RTAs are predominantly trade-creating (Rodríguez-Delgado 2007). Krugman (1991) argued that most RTAs are likely to entail relatively low welfare losses resulting from trade diversion, since the countries involved are often geographical neighbours and hence already engage in a sizeable amount of trade. It is also argued that through RTAs countries can 'lock in' reform, which is often politically not feasible under multilateralism. Whalley (1996), for example, asserted that a desire for increased credibility of domestic reforms was a central preoccupation behind the Mexican negotiating position on NAFTA. In addition, failure or stalemate of the multilateral trade talks means trade liberalisation can take place only through RTAs. It is highlighted that countries can build on the progress of regionalism and can ultimately move toward a freer trade regime on the whole.

There are, however, some critical arguments against RTAs. Regional trading blocs are often thought to undermine the spirit of multilateralism. Given the rise of mega-trading blocs, it is feared that the world might be divided into a few protectionist blocs, and they might accept RTAs to oppose further multilateral liberalisation. It is in this sense that RTAs might work as an obstacle rather than a foundation for multilateralism. Also, the 'spaghetti bowl' effect can emerge because of the many complicated overlapping RTA negotiations.² RTAs also discriminate against the non-member countries, and even the poorest countries (such as the least developed ones) could seriously be discriminated against by RTAs in developed and developing countries. It has been demonstrated that the North American Free Trade Agreement has generated adverse welfare consequences for least developed countries such as Bangladesh (Razzaque 2005). Furthermore, RTAs distort resource allocation, favouring regional producers to the potential detriment of local consumers (Rodríguez-Delgado 2007). Research on RTAs has highlighted the global consequences of multiple and overlapping RTAs in terms of the transaction costs they impose (Feridhanusetyawan 2005). It is further put forward that resources in trade ministries are limited. Therefore, too much involvement in RTA negotiations may distract attention from multilateral liberalisation.

There are concerns that through RTA (reducing tariffs for the member countries) the prices of goods imported from the member countries in the domestic market may not fall, as the member countries may see the home country's market as a 'captive market' for their exporters. For example, it is often alleged by the critics of SAFTA that, through this regional trading arrangement, Indian exporters may find a 'captive market' for their exporters in Bangladesh (World Bank 2006). As a result, even when an importing country, e.g. Bangladesh, reduces the tariffs for Indian products, the prices of those products may not fall by the full extent of regional tariff cuts, as the Indian exporters can benefit from increased margins keeping prices up to the level at which the products from the rest of the world are sold in the domestic market.

Bayson et al. (2006) argued that the economic case for SAFTA was relatively weak. The authors pointed out three important features of the South Asian economies that might make an internal free trade agreement (FTA) *economically* unattractive. First, these economies are relatively small in relation to the global economy, in terms of both GDP and trade flows. Although, in terms of population, the size of the region is substantial (20 per cent), current per-capita incomes are so low that the economic size of the region remains small: less than 5 per cent of the global economy in terms of GDP, and if India is taken out of the picture this proportion drops to 0.4 per cent. Bayson et al. (2006) further argued that the probability that the most efficient suppliers of the member countries were within the region was slim. Therefore, the probability that the FTA is likely to be largely trade diverting is quite high. The second reason relates to the relatively high levels of protection among the SAARC economies. If the country participating in a regional arrangement were itself open, it would not suffer from trade diversion even if it were small. It is, however, evident that the level of protection within the SAARC region remains high in all countries. According to Bayson et al. (2006), the third and final reason that the economic case is weak for SAFTA concerns the political economy of the selection of excluded sectors and rules of origin (RoO). When countries are allowed to choose sectors that can be excluded from tariff preferences in an FTA, domestic lobbies make sure that the sectors in which they may not be able to withstand competition from the union partner are the ones that get excluded. In addition, the RoO can also be subject to abuse by the bureaucrats administering them. In cases where imports from the partner may be threatening an inefficient domestic competitor, bureaucratic discretion may be employed to block entry of the imports.

In contrast to the arguments put forward by Bayson et al. (2006), policy-makers and many business people in South Asia, and especially in Bangladesh, are rather optimistic about SAFTA. They see SAFTA as having significant potential to expand trade among the member countries. It is also hoped that the member countries will be able to gain significantly by having greater market access in other South Asian countries, and especially in India. Those who argue for SAFTA consider that, despite the little trade volume through formal channels, substantial trade is already taking place in South Asia via informal mechanisms. Taking into account informal trade, the 'real' intra-regional trade could be anywhere between 8 and 10 per cent. Although studies have shown that there are limited complementarities in the SAARC region, it is argued that this was also the case in ASEAN during the mid-1970s, and that dormant complementarities in the region could be invigorated by intra-regional investment and foreign direct investment (FDI).³ They also argue the cost of not co-operating is quite high (CUTS 2012; RIS 2004, 1999; GEP 1998). The debate is, therefore, far from being settled. Notwithstanding, there is a general perception that regional co-operation in South Asia should not be viewed only from the trade perspective, and that there are many gains from regionalism in other areas.

3.3.2 Review of quantitative studies on the welfare effects of SAFTA

Empirical studies on the quantitative assessments on SAFTA (and on SAPTA as well) differ significantly in terms of the methodologies employed and results obtained. In

broad terms, three types of techniques have been employed to examine the potential implications of SAPTA/SAFTA. These are (i) econometric estimations techniques utilising the so-called 'gravity models'; (ii) partial equilibrium models to understand the effects of the removal of tariffs from intra-regional trade flows; and (iii) computable general equilibrium models to understand the effects of tariff reductions and resulting changes in resource allocation patterns across different sectors.

The gravity models aim, with a set of explanatory variables, to predict bilateral trade flows.⁴ These models, for the analysis of any RTA, have been used widely to predict the impact of the agreements on the bilateral trade flows (among many others, Srinivasan and Canonero 1995; Sengupta and Banik 1997; Hassan 2001; Coulibaly 2004; Hirantha 2004; Tumbarello 2006; Rahman 2003; Rahman et al. 2006; Rodríguez-Delgado 2007). The findings of these studies have been mixed. For example, studies by Srinivasan and Canonero (1995), and Sengupta and Banik (1997) predicted that the impact of a South Asian FTA on trade flows would be small for India but much larger for the smaller countries. Sengupta and Banik (1997) predicted a 30 per cent increase in the official intra-SAARC trade and as much as 60 per cent if illegal trade became a part of official trade. Coulibaly (2004) found net export creation, and Tumbarello (2006) and Hirantha (2004) found net trade creation from SAPTA. On the other hand, Hassan (2001) found a net trade diversion effect from SAPTA, while Rahman (2003) found the dummy variable for South Asia to be insignificant, indicating that regional integration is unlikely to generate significant trade expansion.

Rahman et al. (2006) used an augmented gravity model to identify trade creation and trade diversion effects originating from SAPTA. It was found that there was significant intra-bloc export creation in SAPTA; however, at the same time there was evidence of net export diversion. It also appeared that Bangladesh, India and Pakistan were expected to gain from joining the RTA, while Nepal, Maldives and Sri Lanka were negatively affected.

Rodríguez-Delgado (2007) evaluated the SAFTA within the global structure of overlapping regional trade agreements using a modified gravity equation. It examined the effects of the Trade Liberalization Programme (TLP) which started in 2006. The study predicted that SAFTA would have a minor effect on regional trade flows. The gravity model simulation suggested that SAFTA TLP would influence regional trade flows mainly by increasing exports from India and imports from Bangladesh and Nepal. It should, however, be pointed out that studies based on gravity models to estimate welfare gains are methodologically flawed. While the estimated gravity equations are for bilateral trade (and not welfare), the concepts of 'trade creation' and 'trade diversion' directly relate to welfare consequences. Being partial equilibrium analysis in nature, they also fail to take into consideration inter-sectoral and inter-regional linkage effects. Therefore, gravity models are not suitable tools for assessing welfare effects.

The major partial equilibrium studies on RTAs in South Asia are by Govindan (1994), DeRosa and Govindan (1995), Pursell (2004), World Bank (2006) and Raihan (2011). The advantage of these models is that they are generally based on disaggregated data, and are also flexible enough to facilitate sector-specific assessments. However, the

major problem is overlooking the general-equilibrium effects arising from the inter-sectoral interactions within the economy.

A partial equilibrium study, by Govindan (1994), showing the effect of preferential liberalisation within the region on intra-regional trade in food concluded that preferential liberalisation would generate welfare gains through increased trade. The analysis by DeRosa and Govindan (1995), however, showed that the welfare gains were much higher when the member countries also applied unilateral liberalisation on a non-discriminatory basis. In another partial equilibrium analysis on the cement industry, Pursell (2004), demonstrated substantial gains of preferential liberalisation between India and Bangladesh.

With a view to exploring the potentials of India–Bangladesh bilateral FTA, World Bank (2006) provided a comparative assessment between Bangladesh and India with respect to a few selected sectors. The partial equilibrium simulation results indicated that in the cases of these sectors (cement, light bulbs and sugar) the likely effects of an FTA between Bangladesh and India would lead to an expansion of the latter's exports, without any similar export effects from Bangladesh to India. This was mainly because the Indian export prices for these products were substantially lower than the ex-factory before-tax prices of the same or similar products in Bangladesh. The simulations for ready-made garments (RMG) predicted increased Bangladeshi exports to India, but also increased (RMG) exports from India to Bangladesh. The study found that an FTA would bring large welfare gain for consumers in Bangladesh provided there was adequate expansion of infrastructure and administrative capacity at customs borders. The study, however, cautioned that the benefits of such an FTA could be wiped out if it had the effect of keeping out cheaper third-country imports, e.g. from East Asia, and that such trade diversion costs could be huge. The study suggested that the only way to minimise the trade diversion costs would be through further unilateral liberalisation.

Raihan (2011) applied the popular and widely utilised World Integrated Trade Solution (WITS) partial equilibrium model to explore the trade effects of SAFTA on the member countries. Under a full implementation of SAFTA, the findings suggested some of the South Asian countries would be able to increase their exports within the region quite substantially. India turned out to be the largest gainer, securing an expansion of its exports by about US\$1 billion. For Pakistan, Bangladesh and Nepal the rises in exports were found to be US\$169 million, US\$122 million and US\$90 million, respectively. Sri Lanka's exports to the region would also rise, but because of the India–Sri Lanka bilateral FTA, additional effects to the Indian market were likely to be small. The study also showed that, except for Maldives and Sri Lanka, in all other countries the rise in their exports to India would constitute a major share of the rise in their total exports to the region. Raihan (2011), however, showed that much of the potential of the rise in exports among the South Asian countries would be restricted by the presence of a stringent sensitive list under SAFTA.

The studies based on computable general equilibrium (CGE) models predict the effects of the trading arrangement on all variables including production, consumption and trade flows, in all sectors of the economy, as well as on welfare. The studies that

apply the CGE model to SAFTA analysis are by Pigato et al. (1997), Bandara and Yu (2003) and Raihan and Razzaque (2007). Although the three studies used the Global Trade Analysis Project (GTAP) (Hertel 1997) database and the relevant model, their results differ, partly as a result of the evolution of the GTAP data itself.

Pigato et al. (1997) found that, while SAFTA would produce benefits for member nations, unilateral trade liberalisation would yield larger gains. Bandara and Yu (2003) found that, in terms of real income, SAFTA would lead to gains for India and Sri Lanka, while Bangladesh stood to lose. The authors also endorsed the view that South Asian countries would gain much more from multilateral liberalisation than from SAFTA.

Raihan and Razzaque (2007), while using the GTAP model to explain the welfare effects of SAFTA, unlike previous studies, also decomposed the welfare effects of SAFTA (as obtained from simulation results) into trade creation and trade diversion effects for individual South Asian countries.⁵ The estimates showed Bangladesh would incur a net welfare loss, despite recording a positive trade creation effect. The trade diversion effects (resulting from the replacement of competitive import supplies from the rest of the world with relatively inefficient regional sources) outweighed the positive gains, resulting in overall adverse consequences. All other South Asian countries were, however, found to gain from SAFTA, with India registering the maximum gains.

3.4 The welfare impact of SAFTA considering improved trade facilitation measures in South Asia

It appears from the above that CGE studies on SAFTA predict welfare losses for certain countries which would be primarily driven by large trade diversion effects. Costs of trading across borders in South Asia are known to be very high, as a result of which the issue of trade facilitation is considered with special importance among the concerned stakeholders.⁶ As import duties are gradually falling in most product categories, the scope for gain through tariff reductions is becoming increasingly limited. This, however, also helps minimise the scope of trade diversions. Furthermore, there can be significant additional gains to be secured through reduction in transaction costs and improved trade facilitation measures. Most observers seem to agree that improved infrastructure and connectivity, coupled with streamlined and stronger institutions yielding less administrative tangles and corrupt practices, would allow South Asia to gain and share benefits from SAFTA arrangements. Among others, De and Raihan (2011) conclude that there is strong evidence that improving the efficiency of customs and administrative procedures and the simplification of trade-related documentation could facilitate intra-regional trade.

Despite the improvements, trade facilitation indicators in South Asia remain substantially weaker than those achieved in other regions of the world. According to the World Bank's Logistics Performance Index (LPI), South Asia is just ahead of Sub-Saharan Africa and well behind all other regions (Table 3.1).

According to the Doing Business surveys of the World Bank there has been substantial progress in streamlining trading procedures in some South Asian countries over the last few years. However, the progress has not been equally spread

Table 3.1 Logistic performance index 2010: South Asia vs. other regions

International LPI rank	Region	LPI	Customs	Infrastructure	International shipments	Logistics competence	Tracking and tracing	Timeliness
1	Europe and Central Asia	2.74	2.35	2.41	2.92	2.60	2.75	3.33
2	Latin America and Caribbean	2.74	2.38	2.46	2.70	2.62	2.84	3.41
3	East Asia and Pacific	2.73	2.41	2.46	2.79	2.58	2.74	3.33
4	Middle East and North Africa	2.60	2.33	2.36	2.65	2.53	2.46	3.22
5	South Asia	2.49	2.22	2.13	2.61	2.33	2.53	3.04
6	Sub-Saharan Africa	2.42	2.18	2.05	2.51	2.28	2.49	2.94

Source: LPI 2010, World Bank

across the region. Bangladesh and India experienced the most marked reductions in import documentation, the number of documents required for imports, and the time required to process imports, from arrival at the port to their final destination. Bangladesh and India also achieved smaller but still significant improvements in export trade facilitation. Trade costs in both countries fell for both exports and imports although the cost reductions were much larger for imports. However, Nepal showed very little change in its trade facilitation parameters although there appeared to be some increase in the documentation required for exports.

Despite the improvement, trade facilitation parameters in Bangladesh remain poorer than for India (Table 3.2). According to the LPI 2010, Bangladesh was behind India but ahead of other South Asian countries. Nepal's performance was the worst. However, according to the Enabling Trade Index 2010 of the World Economic Forum, Bangladesh and Nepal were the worst-performing countries in South Asia (Table 3.3).

As part of this chapter, some global general equilibrium model simulations are undertaken to explore the effects of SAFTA under the assumptions that members employ improved trade facilitation measures.⁷ The latest version of the GTAP database covers 57 commodities, 129 regions/countries and five factors of production based on which the simulations keep the same commodity classification, shown in Table 3.4. However, in order to deal with computational challenges, the 129 regions have been aggregated into 9, as shown in Table 3.5.

One scenario is considered for the experiment: a full FTA in goods among the South Asian countries plus a reduction in trade costs for intra-SAARC goods trade by 25 per cent.⁸ The welfare effects are reported in Table 3.6. Since the shock in the GTAP model has two sub-components the welfare effects are also decomposed for these two sub-components. The welfare effects arising from 'tariff cuts only' due to SAFTA are consistent with the results of the earlier empirical studies (e.g. Raihan and Razzaque 2007). The negative welfare consequences for Bangladesh are because of a bigger trade diversion effect. All other South Asian countries, however, experience welfare improvements resulting from SAFTA tariff cuts alone. The biggest gains turn out to be for India, followed by Pakistan. From the simulated improved trade facilitation measures, gains arise for every country. The favourable impact of trade facilitation is so strong that, when considering aggregate gains, Bangladesh shows much improved and positive welfare gains. India is likely to capture the maximum gains from improved trade facilitation measures in South Asia. Nevertheless, all other countries also have sizeable gains. As a proportion of total gains, those from trade facilitation stand out as the biggest for Bangladesh (about 110 per cent). The comparable figures for other countries range between about 65 per cent and 80 per cent.

Table 3.7 presents percentage changes in exports and imports (bilateral and total) for different countries under SAFTA with improved trade facilitation, with all individual countries experiencing a rise in total exports. Given the very small base, the percentage rise in total exports turns out to be the highest for Nepal. It is interesting to find that Bangladesh posts a robust growth of 15 per cent. Given its quite significant base, the expansion is likely to be quite sizeable. Decomposition of the results seems to suggest this performance is mainly driven by increased exports to the rest of the world, unlike

Table 3.2 Logistics Performance Index 2010: South Asian countries

International LPI rank	Country	Overall LPI	Customs	Infrastructure	International shipments	Logistics competence	Tracking and tracing	Timeliness
47	India	3.12	2.7	2.91	3.13	3.16	3.14	3.61
79	Bangladesh	2.74	2.33	2.49	2.99	2.44	2.64	3.46
110	Pakistan	2.53	2.05	2.08	2.91	2.28	2.64	3.08
137	Sri Lanka	2.29	1.96	1.88	2.48	2.09	2.23	2.98
143	Afghanistan	2.24	2.22	1.87	2.24	2.09	2.37	2.61
147	Nepal	2.2	2.07	1.8	2.21	2.07	2.26	2.74

Note: Ranking is among 155 countries

Source: LPI 2010, World Bank

Table 3.3 The enabling trade index 2010

Overall index ranking	Countries	Overall index score	Sub-indices							
			Market access		Border administration		Transport and communication infrastructure		Business environment	
			Rank	Score	Rank	Score	Rank	Score	Rank	Score
84	India	3.81	115	3.42	68	3.98	81	3.34	58	4.48
99	Sri Lanka	3.59	107	3.68	79	3.71	86	3.27	100	3.68
112	Pakistan	3.39	120	3.24	73	3.85	92	3.14	117	3.31
113	Bangladesh	3.38	52	4.37	100	3.21	117	2.53	114	3.41
118	Nepal	3.27	49	4.42	118	2.71	107	2.76	121	3.19

Note: Ranking is among 125 countries

Source: World Economic Forum

Table 3.4 GTAP commodity classification in the present study

No.	Sector name	No.	Sector name
1	Paddy rice	30	Wood products
2	Wheat	31	Paper products, publishing
3	Cereal grains n.e.c.	32	Petroleum, coal products
4	Vegetables, fruit, nuts	33	Chemical, rubber, plastic prods
5	Oil seeds	34	Mineral products n.e.c.
6	Sugar cane, sugar beet	35	Ferrous metals
7	Plant-based fibres	36	Metals n.e.c.
8	Crops n.e.c.	37	Metal products
9	Cattle, sheep, goats, horses	38	Motor vehicles and parts
10	Animal products n.e.c.	39	Transport equipment n.e.c.
11	Raw milk	40	Electronic equipment
12	Wool, silk-worm cocoons	41	Machinery and equipment n.e.c.
13	Forestry	42	Manufactures n.e.c.
14	Fishing	43	Electricity
15	Coal	44	Gas manufacture, distribution
16	Oil	45	Water
17	Gas	46	Construction
18	Minerals n.e.c.	47	Trade
19	Meat: cattle, sheep, goats, horse	48	Transport n.e.c.
20	Meat products n.e.c.	49	Sea transport
21	Vegetable oils and fats	50	Air transport
22	Dairy products	51	Communication
23	Processed rice	52	Financial services n.e.c.
24	Sugar	53	Insurance
25	Food products n.e.c.	54	Business services n.e.c.
26	Beverages and tobacco products	55	Recreation and other services
27	Textiles	56	Public admin/defence/health/education
28	Wearing apparel	57	Dwellings
29	Leather products		

Note: n.e.c. – not elsewhere classified

Source: GTAP Database Version 8

Table 3.5 GTAP region aggregation in the present study

Aggregated regions	Comprising regions
Bangladesh	Bangladesh
India	India
Nepal	Nepal
Pakistan	Pakistan
Sri Lanka	Sri Lanka
Rest of South Asia	Comprising Afghanistan, Bhutan and Maldives
USA	USA
EU25	European Union
ROW	Rest of the world

Source: GTAP Database Version 8

Table 3.6 Welfare effects from tariff cuts and improved trade facilitation measures in SAFTA (US\$ million based on 2007 prices)

Countries	Tariff-cuts only	Trade facilitation	Aggregate gains	Gains from trade facilitation as % of overall gains
Bangladesh	-136.21	1567.74	1431.50	109.52
India	1,642.52	4120.01	5761.94	71.50
Nepal	463.02	1306.02	1769.04	73.83
Pakistan	1,026.66	1860.74	2887.41	64.44
Sri Lanka	35.41	2125.01	2160.42	98.36
Rest of South Asia	277.59	1047.18	1324.75	79.05

Source: GTAP simulation result

other South Asian countries. The reason for this might be that cheaper sourcing of raw materials from regional partners provides a competitiveness boost for Bangladesh's exports, particularly textile and clothing items that have a strong market presence in Europe and North America. Among others, Pakistan also registers a robust export growth rate of about 11 per cent.

3.5 Conclusion

This chapter has reviewed the implications of SAFTA for individual South Asian countries against the backdrop of the arguments both for and against regional trading arrangements. Previous studies confirm that the gains to members from preferential trading mechanisms are ambiguous and so is the distribution of gains among the partners within the regional formation. While the methodologies employed in assessing the implications can contribute to differing results, in the context of South Asia one could think of major issues *a priori* to anticipate the adverse consequences of regional integration. When members discriminate against supplies from the rest of the world by providing tariff preferences to their regional counterparts, adverse welfare consequences can arise due to trade diversion effects. This is more likely to occur if members have relatively MFN tariffs. Simulations undertaken using a popular global general equilibrium model show that while all other members in South Asia gain from SAFTA, only Bangladesh is likely to embrace overall adverse welfare implications. These results would indicate that proportionately more imports of Bangladesh would be replaced by regional sources, which is also evident in the increase in regional imports into Bangladesh under SAFTA.

While RTAs may have other dynamic gains, one serious constraint to intra-regional trade flows is the very weak trade facilitation infrastructure and measures. There have been studies that have demonstrated that South Asian countries are more protectionist when it comes to trading with neighbours. Inefficient and lengthy customs and border procedures, poor infrastructural facilities, and weak and cumbersome land port management have all affected across-the-border trading activities.

Table 3.7 Percentage changes in exports and imports under SAFTA and increased trade facilitation

To/From	Bangladesh	India	Nepal	Pakistan	Sri Lanka	Rest of South Asia		Total exports (to SAFTA plus rest of the world)
						Asia		
Bangladesh		390.01	892.86	193.37	188.14	476.32		15.06
India	270.90		192.71	262.63	94.05	209.09		4.22
Nepal	425.00	479.11		126.09	100.00	-50.00		136.44
Pakistan	400.27	1105.79	175.00		127.79	107.11		10.76
Sri Lanka	314.29	190.83	154.55	135.07		730.80		1.35
Rest of South Asia	52.60	299.45	75.00	208.51	85.86	250.00		36.42
Total imports	16.14	3.49	111.88	10.17	10.39	36.23		

Source: GTAP simulation results

Notwithstanding the significance of the trade diversion prospects at least for one country (Bangladesh), an issue of interest is to know about the potential benefits of improved trade facilitation measures in South Asia. This chapter has contributed to this discussion by undertaking some simulation exercises allowing for reduced costs in regional trade. The results are staggering in suggesting that the gains from trade facilitation in South Asia are much higher than the gains from mere tariff cuts from promoting intra-regional trade in goods. Therefore, in order to make SAFTA effective, trade liberalisation may be considered as a necessary condition, but not a sufficient one. Therefore, utmost policy priority should be given to develop trade infrastructure facilities and improve trade facilitation measures.

The review undertaken as part of this chapter and the simulation results provided offer quite an important message: as it stands the SAFTA liberalisation will benefit most South Asian countries. But trade-in-goods alone never constitutes a regional integration scheme and, in the spirit of regional co-operation, when trade facilitation is promoted gains for all countries are maximised.

Notes

- 1 Note that if member countries are the low-cost producers of the traded good, there will be no trade diversion effect and integration will unambiguously increase welfare.
- 2 See Bhagwati and Panagariya (1996).
- 3 Intra-regional trade in ASEAN was close to 6 per cent in the mid-1970s, but now has increased to around 23 per cent. ASEAN, too, was characterised by limited complementarities at the beginning but the situation changed with preferential trading, FDI and intra-regional investment (SACEPS 2002).
- 4 Typically, the exercise involves estimating a bilateral trade flow equation with bilateral trade (imports, exports or total trade at the aggregate or sector level) as the dependent variable and country characteristics, such as the GDP, population, land area, distance, the commonality of language or cultural ties, and the existence of preferential trade arrangements, as independent variables. Once estimated, the equation can then be used to predict the impact of a union between country pairs that did not have such a union during the sample period.
- 5 It should, however, be noted that the original GTAP framework does not provide any estimates of trade creation and trade diversion aspects of the total welfare effects. In order to estimate these two effects the authors made some adjustments in the GTAP model. The GTAP model provides a net welfare estimate of the SAFTA simulation that is a sum of the trade creation and trade diversion effects. With a view to isolating the trade creation effect from the total welfare effect, a separate simulation was run where necessary adjustments in the GTAP closure were made so that the imports from all other countries in the world to all the South Asian countries were held fixed. The welfare effects from this scenario only consisted of the trade creation effects for individual South Asian countries. This trade creation effect was then deducted from the total welfare effect in the original simulation to get the estimate of the trade diversion effect.
- 6 Limão and Venables (2001) found a link between the quality of infrastructure and transport costs – and thus concluded that infrastructure investments are important for export-led economic growth. However, Subramanian and Arnold (2001) argued that differences in logistics performance are driven only in part by the poor quality of physical infrastructure services such as road, rail, waterways, port services, and interfaces. The inadequacies often are caused by (non-tariff) policy and institutional constraints – such as procedural red tape, inadequate enforcement of contracts, poor definition and enforcement of rules of engagement, asymmetry in standards, delays in customs, delays at ports and border crossings, corruption and highly restrictive protocols on movement of cargo.
- 7 The detailed discussions on the GTAP model and database can be found in Hertel (1997). The information on the latest database and modification is available on the GTAP website: www.gtap.apecon.purdue.edu/databases/v8/. Some empirical applications similar to what are being done here

can be found in Razzaque et al. (2008). Version 8 of the GTAP database (which has 2007 as the base year) has been utilised to run the simulations here. Compared with previous versions, among others, GTAP 8 has added Nepal as an individual and separate country for the first time to capture its country-specific effects.

- 8 In the GTAP framework, such reduction in trade cost is introduced by shocking on the transaction cost of the bilateral trade. In this regard, the variable 'ams' – import-augmenting 'technical change' in the Armington nest, which can be used to lower the effective price of imported products, is shocked.

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Chapter 4

The Cost of Economic Non-Co-operation in South Asia¹

Bipul Chatterjee and Joseph George

4.1 Introduction

One of the major hurdles in the South Asian trade liberalisation process has been hesitancy on the part of countries from the region to subject sectors/products of high intra-regional trade potential to the Trade Liberalization Programme (TLP) under the South Asian Free Trade Area (SAFTA) agreement. This has caused a high cost to consumers in South Asia in terms of avoidable high prices on imported goods which could have been sourced from regional trading partners at considerably lower prices. Loss of consumer welfare owing to lack of depth in intra-regional trade and non-co-operative economic relations has not been hitherto subjected to thorough research. This chapter carries out a quantitative assessment of potential consumer welfare gains from deeper trade integration in South Asia and presents the results of a perception survey analysis on the views of key stakeholders on the relevance of consumer welfare in trade discourse. The results of the quantitative assessment show that minimum static annual consumer welfare gains of US\$1.9 billion could be realised from enhanced regional trade. The general perception of stakeholders is that bringing in consumer welfare aspects of trade will help to rebalance the SAFTA negotiations and, towards this goal, initiatives for awareness generation and networking among various stakeholder groups is of utmost importance.

The volume and impact of international trade in the world economy has grown phenomenally over the past few decades. Its share of world trade in world GDP has gone up from 39 per cent in 1985 to 50 per cent in 2010.² To a large extent, this growth was made possible by an upsurge in participation by developing countries in global trade, as they underwent a paradigm shift in their national economic policy outlook, embracing the hitherto familiar concept of 'trade – an engine of growth'. This is highlighted by the fact that lower-middle-income countries experienced a sharper rise in trade to GDP ratio, from 32 to 56 per cent, during the 1985–10 period.³ Today, trade liberalisation has become a standard norm throughout the developing world as can be seen from the unprecedented growth in number of free trade agreements (FTAs), albeit with varying levels and degrees of success.

The South Asian regional initiative for regional economic co-operation is spearheaded by SAFTA. Despite this and other bilateral trade agreements currently in operation in the region, South Asia remains one of the least integrated regions in the world. Trade negotiations under SAFTA have so far failed to influence growth in intra-regional trade in a significant way. Between 1995 and 2005, intra-regional

trade in South Asia hovered around 5 per cent of the total trade of these countries. On the other hand, such intra-regional trade ranged between 20 and 60 per cent in the case of many other regional economic blocs. SAFTA member states are also yet to initiate an institutional framework to move toward deeper economic integration beyond trade relations.

It is generally recognised that SAFTA failed to achieve its intended objective of enhancing intra-regional trade as a result of limited product coverage.⁴ Though South Asian countries shifted to more outward-looking policies in the 1990s, reducing restrictions on private sector involvement in business and trade, remnants from their previous economic policy approaches still remain. Export promotion has replaced import substitution as the central theme for most governments in the region, but there are echoes of a mercantilist attitude – increasing exports, while still attempting to restrict imports (World Bank 2011). The protective tendency of the SAFTA member states is evident from the large sensitive lists containing products kept out of bounds of the agreement's TLP.⁵

The net result of economic non-co-operation among the South Asian countries is a high cost to consumers. Enhanced regional trade would bring down the prices of many key commodities significantly by avoiding the additional costs of importing from outside the region. For instance, certain previous estimates show that Pakistan stands to save between US\$400 million and US\$900 million on its import bill if it allows imports from India on several items to replace its present imports from other countries at a higher cost (Qamar 2005).⁶

This chapter addresses the issue of the impact on consumer welfare of regional trade liberalisation in South Asia. In the following section, a quantitative assessment of potential consumer welfare gains from full trade liberalisation under SAFTA is presented. The chapter also includes the main observations gathered from a perception survey analysis, examining the opinion of key stakeholders in the region on the role and relative importance of consumer welfare aspects in trade negotiations under SAFTA.

4.2 Potential impacts of SAFTA on consumer welfare: A quantitative assessment

Benefit from trade has two streams – gains to producers and gains to consumers – which are essentially inseparable. When it is said that the best producers in each trade sector will capture the market by outcompeting inefficient competitors and earning their right to sell, it necessarily also means that buyers get to choose from the best quality products at the lowest possible prices. But the consumer welfare effects of trade are often neglected, as consumers' savings due to imports are not as visible as producers' export earnings. Moreover, imports are often viewed with discontent owing to the uncertainty they pose on the survival of domestic industries.

Irrespective of the expectations and goals of participating countries and of the level at which it operates (multilateral, preferential/regional or bilateral), a trade agreement cannot operate without reciprocal exchange of an import concession for an export opportunity. Trade agreements, by design, cannot serve a unilateral agenda

of export promotion along with import substitution. When signatories undermine the importance of imports and view them only as a threat, trade negotiations most commonly face an impasse. This may be observed from the way many preferential trade agreements across the globe function.

A survey of existing literature reveals that assessment of consumer welfare gains from trade liberalisation has hardly been subjected to thorough research in the context of SAFTA. Neither have such considerations influenced the course of SAFTA negotiations in any significant manner (Ghani and Din 2006; Dayal et al. 2008). A change in this attitude is imperative to push the tariff liberalisation agenda forward, without which deeper economic integration will remain unattainable.

The first step towards this is to realise the importance of granting import concessions, not only as a policy tool to gain export markets but also as a significant source of economic benefits in its own right. In this chapter, an empirical exercise is undertaken to assess potential welfare gains to South Asian consumers arising out of enhanced intra-regional imports. Towards this end, an elementary method is used to measure the impact on consumer welfare of an increase in imports as currently reserved product categories are brought under the ambit of the tariff liberalisation scheme agreed under SAFTA. The basis for this analysis is drawn from the notion that when countries are allowed to choose sectors that can be excluded from tariff preferences under a preferential trading arrangement (PTA), domestic lobbies work to ensure the exclusion of products in which they may not withstand competition from the partner countries, as is observed from the India–Sri Lanka FTA (Baysan et al. 2006).⁷ Thus, sensitive lists of excluded products often give a good starting point for finding sectors of importance for intra-regional trade.

4.2.1 Assessment of consumer welfare gains: Methodology and product selection

One of the primary objectives sought through SAFTA, given the limitations of its predecessor SAPTA, was to generate sufficient tariff preferences by increasing product coverage under the agreement's TLP. Though member countries adopted reduced sensitive lists containing items which are not subject to tariff reduction, the lists are still large and include many items in which SAFTA trading partners exhibit comparative advantage.

With the exception of Bhutan, all the other seven members elected to exclude more than 10 per cent of total product lines (Harmonized System (HS) six-digit level) from the ambit of the TLP. At the time of commencement of preferential tariff reductions under SAFTA in 2006, all five major member countries (Bangladesh, Nepal, India, Pakistan and Sri Lanka) kept 15–25 per cent of total product lines out of bounds under their sensitive lists. Since then only a marginal reduction in the lists has been achieved. While India lowered the number of product lines in its lists for least developed countries (LDCs) from 744 to 484, the list for non-LDCs has remained at the same number, at around 860 product lines. Bangladesh, Nepal, Pakistan and Sri Lanka still retain more than 1000 product categories in their lists, with a hitherto unfulfilled commitment to a 20 per cent reduction.

The method adopted in this study for arriving at consumer welfare gains has two stages. In the first stage, an algorithmic process is followed to select products included in the sensitive lists of the five major SAFTA member nations for calculating figures of minimum gains for product categories with maximum potential effects on consumer welfare.

Sectioning of products was carried out by sequentially applying two criteria: products in sensitive lists (i) of a SAFTA member country (m) with high shares in the total exports of SAFTA partner countries (p) to the rest of the world (RoW), reflecting the export potential of partner countries in such products; and the list thus selected was further filtered by selecting products in which exports of partner countries to the member country were minimal and imports of the member country were high, reflecting high intra-regional trade potential in the future.

In the second stage, the potential consumer welfare gains for each SAFTA member are calculated as the difference between current import expenditure incurred by the member country on the selected products and likely import expenditure if that country were to import the same products from SAFTA trading partners at the lower price currently offered by them.⁸

$$\sum CW^{mi} = \sum (P^{mi}Q^{mi} - P^{pi}Q^{mi}), \text{ where:}$$

CW^{mi} – consumer welfare due to change in import price of country m in product i ;

P^{mi} – import price of member country m in product i from RoW;

P^{pi} – export price of SAFTA partner country (p) in product (i) to RoW;

Q^{mi} – import quantity of member country (m) in product (i) from RoW.

In the second stage calculation process, those product categories will automatically get eliminated in which the current export price of the SAFTA trading partner to RoW exceeds the current import price of a member country from RoW. Only those products with the potential for savings on imports leading to a reduction in consumer expenditure are considered and, thus, the estimation method helps to identify products with maximum potential consumer welfare gains for each country and qualifies those products for removal from their sensitive lists.

One of the important features of this methodology is that it minimises the risk of displacement of domestic industries owing to imports – the single most important concern of an importing country – because it ensures the selection of product categories which already rank high in the import baskets of SAFTA members. Another objection often raised against the reduction of import tariffs is the loss of revenue from the same. However, because of the increase in intra-regional trade owing to tariff reductions on selected products in their respective sensitive lists, each SAFTA member stands to gain in terms of an increase in export earnings, which could be taxed to offset for the loss of customs revenue. Dependence on customs revenue is to be forgone in any case in the course of multilateral trade liberalisation to which the selected SAFTA members are committed as World Trade Organization (WTO) signatories.

The estimates arrived at using this method form the basis for more detailed studies on the effects of reduction in transportation costs and other trade facilitation measures, which would further reduce the import costs and subsequently prices facing consumers. Thus, the stated methodology used for the study and selection of products based on the mentioned criteria will facilitate a comparison of import costs with other trade costs and allow the relative merits of tariff liberalisation in each product category to be assessed in detail.

4.2.2 Results on consumer welfare gains

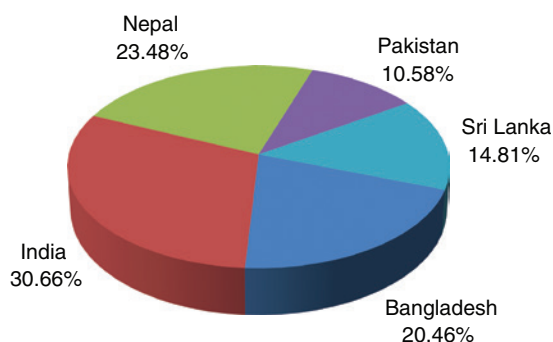
After identification of products which satisfied the aforementioned criteria from the sensitive lists of each of the five major SAFTA members (Bangladesh, India, Nepal, Pakistan and Sri Lanka), consumer welfare gains, represented by reduced import bills, arising for each country in each product category were calculated. Table 4.1 gives the summary of aggregate results. A combined total of 355 product categories were identified from the sensitive lists of the five countries which had high regional trade potential and promised high welfare gains. The current aggregate import bills paid to RoW by the SAFTA members under consideration on these product categories amounted to US\$6212.83 million. Intra-regional trade at reduced prices would generate a 31.36 per cent saving on this import expenditure, leading to annual savings of about US\$1948.15 million for buyers in the region.

Figure 4.1 shows the share of each SAFTA member in aggregate welfare gains. India tops the list in terms of share in aggregate regional gains, accounting for about 30 per cent of the total. It is commensurate with the high number of product lines that qualified for removal from India's sensitive list. Despite the slight variation in share of total gains, all countries stand to gain substantially in terms of gains per capita, in proportion with their economic size and population. Though Pakistan receives only 10.5 per cent of total gains, the lowest, it stands to save 59.04 per cent on its current import expenditure on selected products.

Fifty product lines qualify for removal from Bangladesh's sensitive list, bringing about US\$398.5 million worth of savings on imports which is about 14 per cent of current expenditure (Table 4.2). Imports from SAFTA trading partners are almost evenly distributed in terms of product lines, but most of the gains accrue from imports from

Table 4.1 Summary of aggregate results on consumer welfare gains

Country	Product lines qualifying for removal from sensitive lists	Consumer welfare gains (US\$ million)	Current value imports of country from RoW (US\$ million)	Percentage of consumer welfare gains in imports
Bangladesh	50	398.56	2781.33	14.33
India	161	597.29	1095.45	54.52
Nepal	73	457.50	1068.27	42.83
Pakistan	44	206.18	349.24	59.04
Sri Lanka	27	288.61	918.54	31.42
Total	355	1948.15	6212.83	31.36

Figure 4.1 Country-wise share in aggregate regional consumer welfare gains

Pakistan (57 per cent) and India (36 per cent). Bangladesh stands to gain mostly through imports of mineral fuels and oil by-products. Other major items which would reduce its import bill are electrical equipment and pharmaceutical products. The contributions of imports at reduced prices from Sri Lanka and Nepal amounts to less than 7 per cent of the total gains for Bangladesh. However, in absolute terms, Bangladesh would save about 30 per cent each on its current aggregate spending on imports from Sri Lanka and Nepal on selected product categories.

Results for India show total gains of US\$597.29 million (Table 4.2). Even though this figure is much higher in absolute terms than for other countries, relative gains for India may be lower than for its SAFTA trading partners, given its large economic and demographic size. An interesting feature is that more than 90 per cent of the gains accrue by way of imports from Pakistan of plastic-based articles. Though only 5 products (chiefly iron and steel-based articles) are eligible for welfare gains in India for imports from Nepal, India stands to gain 70 per cent on its import bill. Forty-one product lines eligible for imports from Bangladesh chiefly consist of articles of apparel. However, because of the comparatively low price differential between the two countries, the saving on these items together contributes to only 2.15 per cent of India's total welfare gains.

Nepal accounts for about 23.5 per cent of aggregate regional welfare gains. Through import displacement in 73 selected product categories, the landlocked state would save US\$457.5 million, which is almost 50 per cent of its current import expenditure on these categories (Table 4.2). Imports from India and Pakistan account for the bulk of the country's welfare gains. The main items which would help Nepal save on spending are mineral fuels and minerals including salt, sulphur and limestone. Nepal's trade prospects with Sri Lanka seem to be weak as the latter's export opportunities lie in rubber-based products and apparels. However, with all other countries, there exists import opportunities for the country with a high prospect of welfare gains.

In the case of Pakistan, the results show a selection of 44 product lines from its sensitive list with an aggregate saving of US\$206.18 million, which is close to 60 per cent of its current import bills on the selected product categories (Table 4.2). As a reciprocal case of India, Pakistan stands to gain predominantly through imports from India, accounting for almost all of its total welfare gains. Pharmaceuticals and electrical items would constitute most of its new import basket from South Asian trading partners.

Table 4.2 Consumer welfare gains (country-wise results)

SAFTA trading partner	Applicable product lines from current sensitive lists	Percentage of product lines in total product lines	Potential consumer welfare (US\$)	Percentage of consumer welfare in total consumer welfare	Current value imports by Bangladesh from RoW (US\$)	Percentage of consumer welfare in imports
Bangladesh						
Pakistan	14	28.00	227012665.18	56.96	1317564000	17.23
India	9	18.00	143469447.53	36.00	1388535000	10.33
Sri Lanka	13	26.00	1210361.70	0.30	4142000	29.22
Nepal	14	28.00	26870146.30	6.74	71085000	37.80
Total	50	100.00	398562620.71	100.00	2781326000	14.33
India						
Pakistan	63	39.13	545005991.91	91.25	939533208	58.01
Sri Lanka	52	32.30	32005052.94	5.36	90735000	35.27
Bangladesh	41	25.47	12822800.40	2.15	54663000	23.46
Nepal	5	3.11	7459603.10	1.25	10519000	70.92
Total	161	100.00	597293448.35	100.00	1095450208	54.52
Nepal						
Bangladesh	45	61.64	11233014.82	2.46	25555000	43.96
Pakistan	20	27.40	255041185.55	55.75	586586000	43.48
Sri Lanka	4	5.48	107012.52	0.02	852000	12.56
India	4	5.48	191121724.49	41.77	455279000	41.98
Total	73	100.00	457502937.38	100.00	1068272000	42.83
Pakistan						
India	6	13.64	203878774.21	98.89	339251000	60.10
Sri Lanka	13	29.55	356850.25	0.17	1676000	21.29
Nepal	5	11.36	301170.78	0.15	1362000	22.11
Bangladesh	20	45.45	1639500.07	0.80	6949000	23.59
Total	44	100.00	206176295.31	100.00	349238000	59.04

(continued)

Table 4.2 Consumer welfare gains (country-wise results) (continued)

SAFTA trading partner	Applicable product lines from current sensitive lists	Percentage of product lines in total product lines	Potential consumer welfare (US\$)	Percentage of consumer welfare in total consumer welfare	Current value imports by Bangladesh from RoW (US\$)	Percentage of consumer welfare in imports
Sri Lanka						
India	12	44.44	286459853.66	99.25	914684000	31.32
Pakistan	5	18.52	277969.54	0.10	689000	40.34
Nepal	10	37.04	1876641.65	0.65	3168000	59.24
Total	27	100.00	288614464.84	100.00	918541000	31.42

Though aggregate welfare gains of Sri Lanka amount to the comparatively lower figure of US\$288.61 million, per capita gains would be the highest, it being the least populated among the selected South Asian countries. On 27 product categories included in its sensitive lists, diverted imports from within the region would help Sri Lanka to save 31.42 per cent of its current import expenditure. Almost all of its expected gains come through imports from India in mineral fuels and oil by-products. Sri Lanka would not gain by imports from Bangladesh, as its own export basket consists of articles of apparel that are price competitive and capable of capturing part of the South Asian textiles market with Bangladesh. Though welfare gains accruing to Sri Lanka by way of imports from Nepal are only US\$1.88 million, the island nation is set to save close to 60 per cent on imports from RoW by choosing alternatives from Nepal on certain items.

4.2.3 Export opportunities in selected products and trade potential

Increase in intra-regional trade also implies enhanced export opportunities for each of the SAFTA members. As we have only considered the replacement of imports to the region with cheaper imports from within the region, the difference between current total import expenditure on the selected products and the aggregate savings on import bills by all countries should amount to the total exports that would be internalised by the South Asian region. This figure stands at around US\$4 billion.

Though it may be argued that only internalisation of exports could occur in this scenario, without a real increase in export volume we must consider the dynamic effects on regional exports. The key issue that confronts intra-regional trade potential is the supply capacity of trading partners from the region. If the supply capacity remains static, the mere diversion of exports to RoW with exports to SAFTA partners is the probable result, which may lower the aggregate nominal export earnings for a country but in all likelihood raise profitability in real terms, since lower preferential tariffs within the SAFTA region allow producers/exporters to lower their price while raising profit margins.

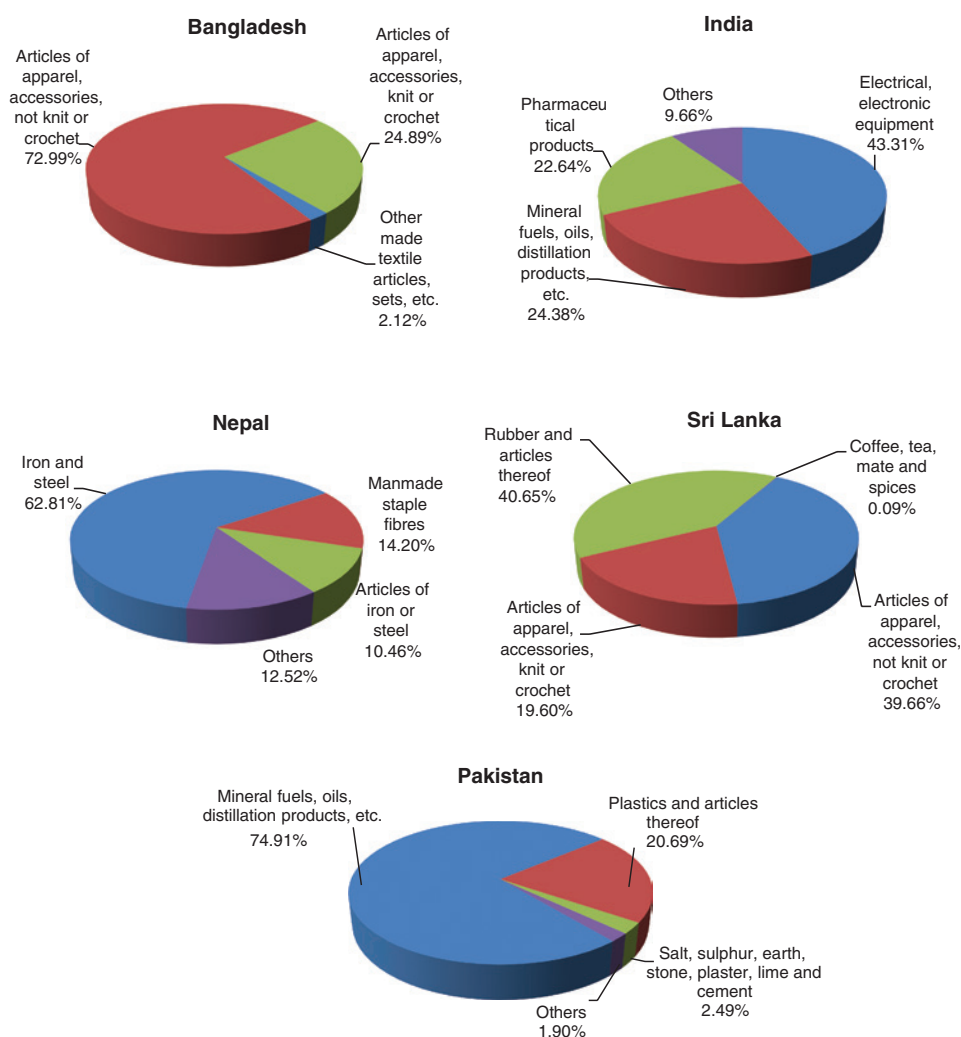
Trade potential in a particular product category with a static supply capacity scenario can be assessed as the difference between the minimum of the set (importing country's total world imports, exporting South Asian partner's total world exports) and existing imports of the importing country from that particular partner country, where exports and imports are in quantity terms. This simplistic measure shows whether South Asian trading partners could meet each other's import requirements with their current export quantity. Though required data on all the selected product categories is not available, intra-regional trade potential assessed using this measure stands between 80 and 90 per cent of current imports from RoW.

There are two key elements to be considered here with respect to potential export market expansion. First, assuming that global market conditions remain the same, there is no particular reason why existing export markets in RoW cannot be retained by South Asian countries while new export opportunities emerge within the region. Second, depending on the magnitude of the import price elasticity of the products in the importing countries, a lower price would increase import demand and thereby

expand the intra-regional export markets further. Therefore, huge opportunities for substantial export expansion in many product lines are available to SAFTA members, which may be tapped by addressing supply constraints.

Figure 4.2 shows main product categories in which export opportunities emerge for each SAFTA member country under consideration. Bangladesh's export basket is heavily skewed with textile products. For India, the export basket is fairly balanced with pharmaceuticals, electrical items and mineral fuels. While for Nepal articles of iron and steel, as well as industrial inputs based on iron, feature prominently in its potential export profile, for Pakistan, mineral fuels dominate, accounting for two-thirds of its total export prospects. Sri Lanka's prospects are spread between textile items and cash crops, including rubber, tea and spices. The potential export baskets give a clear indication for the targeting of export promotion policies in the context of regional trade in South Asia.

Figure 4.2 Product category-wise export opportunities



4.2.4 From minimum to maximum gains

As stated earlier, the method used in this study gives the minimum consumer welfare gains accruing to South Asian consumers directly arising out of preferential tariff reduction under SAFTA. Even though we have only selected product categories which assure the figures given in the preceding sections, certain counter arguments are often raised in popular discourse for which further clarification may be needed. More importantly, it needs to be noted that the assessment of consumer welfare gains herewith omits certain crucial aspects because of data limitations, implying that the actual welfare gains could be much higher.

One of the first questions raised is whether the South Asian export price will hold for regional trading partners once preferential trading within the region comes into operation. While there could be no straightforward answer to this, at closer examination it could be seen that export price offered to RoW is likely to go down for regional trading partners. This is mainly for two reasons: first, export price to RoW covers mostly the most favoured nation (MFN) tariffs rates, as South Asian exporters hardly enjoy preferential rates in their main export destinations. Even in the case of Bangladesh and Nepal, who benefit from duty-free, quota-free (DFQF) rates applicable to LDCs in certain developed country markets, preferential market access is limited to a fixed number of product lines. Since a preferential rate below MFN is on offer under SAFTA, there is no particular reason for the export price to rise. Second, if it is safe to assume that transportation costs would be less because of a proximity to each other within the region, export prices (South Asia to RoW) may actually fall when it comes to intra-regional trade.

Another major concern raised is the possibility of trade diversion. In case of the selected products mentioned in the preceding sections, the fact that at least one South Asian partner country has revealed a comparative advantage in terms of its current export performance in global markets lessens the probability of negative trade diversion effects. Since South Asian exporters are already price competitive compared with RoW, even before liberalisation, removal of these products from the sensitive lists is unlikely to result in them being replaced by more efficient producers from outside the preferential region.

Further, the figures for consumer welfare gains generated under this study only show the effects of change in import price with fixed quantities of imports. But the initial changes in import prices owing to preferential trade are only a starting point which triggers other factors into action, with a combined effect of increasing consumer welfare gains to several times the initial figures. Specifically, the following three main effects should be considered:

- effects of domestic price reduction due to enhanced import competition;
- effects of trade creation due to increase in import demand; and
- effects of reduction in trade costs and subsequently import prices within the South Asian Association for Regional Cooperation (SAARC) region following development of trade infrastructure.

The first effect here implies savings in consumer expenditure not only on imported products but also on domestically manufactured items facing import competition. A fall in import prices from within the South Asian region will have a competitive effect on domestic manufacturing in the selected sectors as well as on exports from RoW, leading to overall control effects on the prices of the commodities under consideration. The second effect, trade creation, is closely linked with this. Here, as the affordability of consumers rises because of a fall in prices, more of the imported product will be in demand, implying possible trade creation. In general, irrespective of whether trade creation actually occurs or not, consumption baskets of buyers expand as their real income increases.

The third effect refers to an often hidden positive impact on consumption. The fact that South Asian countries are importing the selected products from RoW although regional trading partners are relatively more price competitive, suggests that non-tariff barriers (NTBs) could be impeding trade in such products to a greater extent than tariffs and that these NTBs hurt South Asian exporters more than RoW exporters. Intra-regional trade costs, because of poor connectivity, transport infrastructure, costly customs procedures and the absence of adequate trade finance, are very high in South Asia.

There is a dire need for trade policy reforms at the regional level to improve this situation, which could not be initiated without an actual increase in trade volume between South Asian countries. As trade volume increases, it would naturally fuel growth of trade relationships, resulting in better trade facilitation measures, procedural ease and economies of scale in the transport sector, better returns and rents from investments in trade infrastructure and additional incentives for private enterprises to explore regional markets. Substantial cuts in trade costs can surely be expected from such a virtuous cycle of trade to more trade.

4.3 Perceptions and expectations about regional economic co-operation in South Asia

The popular discourse on South Asian economic relations has undergone many transformations since the idea of SAARC was proposed and realised in the early 1980s, with one of its main goals as the 'promotion and strengthening of collective self-reliance among the countries of South Asia'.⁹ It has been heavily influenced by the ever tilting kaleidoscope of bilateral political relations between SAARC member states. As a result, objective analysis of the economic costs and benefits of open trade in South Asia without considering political implications has always remained inconsequential (Weerakoon 2010).

In the wake of the formation of the WTO in 1995, closely following policy reorientation in all the leading states in the region towards export-based growth strategies, participation by the South Asian countries in the multilateral negotiations to expand trade liberalisation was the immediate focus. Though SAPTA also came into force in 1995, regionalism took a back seat during this period, as an exploration of export markets in the neighbourhood was not considered worth the enormous negotiating capital required for keeping non-trade issues at bay. Proliferation of PTAs

among WTO member nations and success stories elsewhere rekindled interest in SAPTA, leading to its subsequent graduation into SAFTA in 2004.

During this period, mercurial bilateral relations between India and Pakistan, the largest member states, have played a big role in shaping the expectations of various stakeholders from all over South Asia about the regional trade agreement. Consequently, around the turn of the century, it was widely believed that bilateral trade pacts would have better prospects and were pursued with greater emphasis. India–Sri Lanka (1998), Pakistan–Sri Lanka (2002), India–Bangladesh (amended Agreement, 2006), Bhutan–India (2006), etc. were the major developments in this direction.

Because of this multifaceted approach towards trade policy, as well as a frequent change in the focus of dialogues on trade-related issues, opinions about regional trade vary widely between and within different stakeholder groups directly associated with trade in various capacities in all South Asian countries. The diversity in viewpoints has naturally fed into the policy formulation process at the national level and has had a very deep bearing on the course of regional trade negotiations thus far. Analysing the perceptions of relevant stakeholder groups, thus, is highly rewarding for understanding the nuances of SAFTA negotiations.

The perception survey of key informants and stakeholders on regional trade integration in South Asia was carried out based on the premise that political economic aspects rooted in conflicting interests of diverse stakeholder groups eclipse pure economic reasoning when it comes to trade policy decision-making in the region. The different stakeholder groups selected for the survey were: (i) producers/traders/exporters, (ii) government officials, (iii) trade-related service professionals,¹⁰ (iv) political persons, (v) academic/researchers, (vi) civil society organisations, (vii) business/industry organisations and (viii) media.¹¹

4.3.1 How SAFTA is compared to alternatives

One of the common elements in perception is the way regionalism is compared to other alternative modes of trade liberalisation. Very few identify it with the maximisation of efficiency gains from multilateral liberalisation. Those who admit that self-selection of best producers at the global level results in best possible prices and quality discredit the participation of South Asian countries in the WTO process as uncertain and time consuming. Likewise, in a comparison between SAFTA and bilateral agreements, bilateral are preferred on the same grounds. For the beneficiaries, actual and speedy results matter more than what theorists say about the pros and cons of an international trade agreement at all levels.

There are two particular aspects noticeable from comparative viewpoints. First, complexity of negotiations as reflected by reports in the popular media has an impact on opinions of stakeholders belonging to all categories. Second, those who find merit in trade agreements in the reverse order – from bilateral to multilateral – think so primarily because they see bilateral as a building block to regional, and subsequently multilateral, negotiations. Thus, complexity owing to intrusion of non-trade issues into trade talks could be resolved in a stage-by-stage process.

An overwhelming 96 per cent of the interviewees suggested that political priorities are far more influential than economic logic in trade talks at all levels. Variability of comparative perspectives with reasons for failure of SAFTA returns a high correlation between the two (0.86), showing that SAFTA is considered to be the second-best choice because there are more non-trade issues to be sorted out before negotiations can progress than with bilateral agreements. Following this reasoning, it may be generalised that:

There is hardly any resistance to SAFTA on the grounds that the agreement lacks economic merits; rather popular support for it, which would determine its success in the future, critically depends on the extent to which non-trade issues are disentangled from trade negotiations.

4.3.2 On the economics and politics of South Asian regionalism

As most of the stakeholders believe that trade talks could not be devoid of political tension, the overwhelming response is that better returns from SAFTA negotiations should contribute to lessen the intensity of international disputes in the region rather than to affect trade negotiations within. Through diverse expressions a common theme emerges; economics and politics of trade negotiations are necessarily complementary not competing ends. Political establishments establish strongholds in their domestic constituencies by proving themselves harvesters of commercial opportunities wherever available so as to improve the standard of living for the masses.

From the options present before the interviewees, lack of complementarity in production consumption patterns in South Asia and lack of economic potential were outcompeted by a huge margin by distrust among South Asian countries as the predominant reason why regional economic co-operation agenda stagnates. More than 75 of the respondents who held this view also raised doubts about the effectiveness of SAFTA in bringing about a change in the scenario. In conjunction with the earlier observation, it clearly shows that regional trade negotiations have always been seen through the political prism and that leadership in the region failed to connect economic benefits with SAFTA negotiations. This fact is also evident from the fact that, while trade liberalisation has been aggressively pursued during the reform period, numerous agreements except SAFTA entered into by South Asian countries turned out to be progressive for whichever political leadership delivered on economic promises.

A substantial transformation in course of SAFTA is highly probable if political leadership realises and uses potential of the agreement for the fulfilment of its non-economic objectives.

4.3.3 The place of consumer welfare in perceptions on trade impacts

Another striking observation is that consumer welfare gain is hardly recognised as a positive result of competitive trade. Across all stakeholder groups, including researchers on regional economic issues in South Asia, either ignorance or neglect

of trade issues on the consumption side is widely prevalent. More than 60 per cent of the stakeholders interviewed were hardly aware of consumer welfare impacts of trade, far less the potential for such benefits out of SAFTA. Any estimation on reduction in import bills due to cheaper goods in the context of regional trade could not be recalled.

One of the most interesting results from the survey is that of the respondents who expressed ignorance about the topic, almost all agreed that consumer welfare aspects should also be considered in future analysis to get a clearer and balanced picture about the potential of the agreement. Though the conviction behind such opinion in the context of the survey may be questioned, it goes undisputed that a phenomenal avenue for change lies on this point. The mere spread of awareness about this often forgotten topic has a powerful potential to sway the perceptions on trade objectives in general and regionalism in particular, from one way to another. Augmenting the highlighted result in Section 4.2, it may be stated that:

A hitherto ignored catalyst for change in the political utilisation of SAFTA is awareness generation on consumer welfare gains from the agreement, given the fact that consumers as a group constitute the entire electorate.

4.3.4 Stakeholder's view on future steps

Apart from lack of inclusivity in trade, policy-making has been one of the main concerns raised by stakeholders. Omissions have been made in the past because of the partial or trivial levels of involvement of directly affected stakeholder groups due to a lack of an institutional mechanism to facilitate policy formation in South Asian countries. While it is recognised that a change in the policy formulation process by way of institutional and procedural restructuring is not possible in the short term, it has been suggested that a proactive move on the part of stakeholder groups can make a difference by way of voluntary contribution of inputs to make the process at the governmental level better informed.

While business community, administrative and political representatives as stakeholders have direct access to the policy-making process at the national level, and the academic community has a relatively better chance of exerting influence, consumer organisations lack both awareness of trade issues concerning them and channels of influence. Given this scenario, it should be noted that ideas on steps for the future differed across groups. For the former categories, objective and in-depth studies on the effects of the agreement featured as the priority, while for consumer organisations the urgency was on awareness generation and usage of collective bargaining power to gain access to policy-making processes.

On the question of principal deterrents of regional trade negotiations, lack of adequate representation of all categories of beneficiaries was ranked as the second most important factor after political distrust. The majority reported that an attitudinal change is warranted. Protectionism still obscures the right approach to trade negotiations and comes with the heavy cost of lagging traditional sectors ridden with productive inefficiencies.

4.3.5 Overcoming hurdles: Networking is the key

In a priority-based ordering of future steps, all stakeholder categories unequivocally agreed that national dialogues on a wider scale deserve the first consideration. Particularly, three aspects should be highlighted in such dialogues: (1) the prospects of peace dividends from economic co-operation, (2) the benefits of increase in imports and (3) the other benefits of regional integration, considering growing regionalism at the global level which increasingly threatens to restrict the market expansion plans of South Asian countries to outside the region.

As far as the promotion of such dialogues across countries is concerned, networking and discussion with the objective of awareness generation at the national level should strengthen international initiatives of composite dialogues. The order of priority is: (1) networking among consumer organisations at the national and regional levels, (2) media campaigns at national and regional level (3) networking among policy-makers, industry and consumer organisations at the national level.

4.4 Conclusions

From conceptual as well as practical viewpoints, consumer welfare and producer welfare are two inseparable results of open international trade, since efficiency gains in production would in turn benefit consumers by way of cheaper and better quality products. Increases in imports will also expand the choice sets of consumers. Moreover, trade agreements – the vehicles of liberalisation – can only function on the basis of reciprocal exchange of export opportunities for import concessions.

It is widely recognised that SAFTA members maintain large sensitive lists with high intra-regional trade potential. Protectionist tendencies continue at the regional level and benefits from increases in imports are disregarded in policy circles, despite the fact that denying such benefits is detrimental to the expansion of production and exports as well. The end result is stagnating regional trade and recognition of the agreement as an ineffective tool.

Though literature is divided on the economic effects of South Asian regional trade, evidence exists to show positive net gains on many counts, which are often not considered under traditional analysis done for predictive purposes because of methodological and practical limitations. Moreover, many arguments raised in the literature, such as potential harmful trade diversion effects, are also shown as standing on unsure grounds by subsequent works.

As regards the consumer welfare impact of SAFTA, this aspect is almost completely ignored in earlier works. This study therefore attempted an empirical exercise for the assessment of consumer welfare gains from SAFTA arising out of subjecting currently excluded products to preferential rates under the agreement. Using an algorithmic process of selection, those products with high intra-regional trade potential in the sensitive lists of the five largest economies out of the eight member states of SAFTA (Bangladesh, India, Nepal, Pakistan and Sri Lanka) were chosen. Potential consumer

welfare accruing to each country was then derived by taking the difference between the total import expenditure in the selected products incurred by the country under consideration and likely import expenditure if that country were to import the same products from SAFTA trading partners at a lower price currently offered by them.

Results show an aggregate minimum consumer welfare gain of more than US\$1.9 billion per annum to the South Asian region by way of savings on aggregate consumer expenditure. This figure (savings on consumer expenditure) is about 31 per cent of the total current import expenditure on these categories. The exercise helped to identify which products had the maximum potential to have consumer welfare gains for each country and, therefore, qualify for removal from their sensitive list. The estimated figures are only starting points or minimal assured gains and they will facilitate comparisons with other trade costs and relative merits of tariff liberalisation in each product category. More detailed studies on the effects of reduction in transportation costs and other trade facilitation measures would inflate these figures and thereby would present a stronger case for application of preferential tariff rates at the regional level at the earliest.

The study also carried out a survey on the perceptions of key informants associated with trade issues in the region. It was found that opinions about regional trade vary widely between and within the different stakeholder groups in all South Asian countries and such perceptions had an important role in shaping the course of regional trade negotiations. Most notably, it came to the fore that most of the stakeholders believe that the lack of success from SAFTA to date is owing to political rather than economic reasons, for which there are solutions.

Primary focus should be on separating non-trade issues from trade negotiations as much as possible. Building widespread awareness about the untapped and forgotten aspects of consumer welfare gains will help to refocus on economic issues. It would also better inform the ongoing negotiations and help to check protectionist tendencies in the region. The most important complementary feature of this approach will be to shift the focus of the political aspirations of the regional leadership without actually having to eliminate them from SAFTA proceedings. Consumers as a group form a strong constituency; prospects of political dividends from catering to their needs will surface and, thus, political intervention could be constructive rather than damaging as was often experienced in the past. Initiatives for networking among consumer organisations at the national and international levels in South Asia, with this objective in mind, offer the prospect of bringing about a long-awaited change in the history of regionalism in South Asia.

Notes

- 1 This chapter is an output of a research project carried out by CUTS International with the support of The Asia Foundation. The methodology used in this chapter for calculation of consumer welfare gains is adopted from Chatterjee and George (2012).
- 2 World Development Indicators (WDI Database), World Bank (2011).
- 3 Ibid. Middle-income countries also registered a sharper growth in trade–GDP ratio and developing countries together now account for about 35 per cent of world trade.
- 4 See Moinuddin (2008) and Moktan (2008).

- 5 SAFTA TLP stipulates reduction of tariff rates to upper limits of 20 and 30 per cent for developing and least developed countries, respectively, within 2 years from the date of enforcement of the Agreement (1 January 2006). It also requires an annual reduction of 10 per cent for developing countries and 5 per cent for least developed countries during this period for products with tariff rates less than the prescribed upper limits on the date of enforcement.
- 6 Based on 2003–04 data, Qamar (2005) shows that after excluding the items that are on the positive list for India, 45 per cent of the items could be imported by Pakistan from India at less than the current import cost from the rest of the world.
- 7 Baysan et al. (2006: para 2, page 11) have noted that, in the context of India–Sri Lanka FTA, domestic industrial lobbies have put pressure on their respective governments to put barriers on imports of products in which the threat of import surges is high. In other words, the sectors in which a country has high export capacity, and hence high propensity for trade, are the ones that are highly likely to get selected in the sensitive/negative lists of its partners under an FTA.
- 8 Country-wise trade data for the analysis is accessed from the UN commodity trade (Comtrade) database and data on import and export prices and quantity for the year 2009 is accessed from Trade Maps, International Trade Centre. The analysis is carried out at HS07 six-digit level.
- 9 Article 1, Charter of SAARC.
- 10 Transport sector, insurance sector, banking sector, etc.
- 11 The survey was conducted in twelve cities across five South Asian countries that had a significant place in the political economy of regional trade integration in South Asia. In each city, about 25 questionnaires were executed. In all, about 300 stakeholders were targeted for this survey.

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Chapter 5

Building Regional Supply Chains in South Asia: The Case of the Textiles and Clothing Sector

Rashmi Banga and Mohammad A Razzaque

5.1 Introduction

A long time has passed since the South Asian countries initiated a process of preferential trade liberalisation with the establishment of the South Asian Association for Regional Cooperation (SAARC) in 1985. The next concrete step for promoting regional trade was the operationalisation of the SAARC Preferential Trading Arrangement (SAPTA) in 1996 with an expectation of moving towards a South Asian Free Trade Area (SAFTA) agreement, the implementation of which eventually began in 2006 and is scheduled to be completed by 2016. Nevertheless, South Asia remains one of the least integrated regions with intra-regional trade accounting for about 5 per cent of the region's global trade, in contrast to the most recent estimates of a global average intra-regional trade of 35 per cent (WTO 2011) and region-specific comparable figures of 70 per cent for the EU; 49 per cent for NAFTA; 25 per cent for ASEAN; 16 per cent for CARICOM; and 10 per cent for COMESA. Since the 1990s, individual South Asian economies have opened up at a rapid pace. Their overall exports and trade have risen enormously. However, the relative significance of intra-regional trade remains appallingly low.

Despite the growing regionalism and increasing significance of intra-regional trade in many different regional trading blocs, it is important to recognise that not all trade taking place among countries belonging to regional arrangements of some type is actually preferential in nature. Indeed, only a very small proportion of such trade can be attributed to preferences exchanged under their regional integration initiatives. It is estimated that only 16 per cent of regional trade is preferential in nature, i.e. more than four-fifths of the trade among preferential trading agreement (PTA) partner countries tends to take place not because of preferences but on the basis of the most favoured nation (MFN) principle, even when they belong to a particular trading bloc. In other words, the growth of intra-regional trade has been dominated by exports and imports of goods under partner countries' MFN regimes.

The fact that regional trade is overwhelmingly dominated by non-policy-induced policy mechanisms has an interesting relevance for SAFTA. Against the backdrop of not very encouraging growth of regional trade volumes, many analysts strongly advocate abolishing all tariffs on regional partners and expanding regional integration beyond trade in goods. While extended co-operation involving services, infrastructure development, transshipment, etc. is under consideration, less attention has been given to understanding the scope for building supply chains based on

industrial units located in different countries within the region. This could potentially be an area where regional trade can naturally flourish without any preferential trade and tariff regimes.

A recent project jointly undertaken by UNCTAD, the Commonwealth Secretariat and the Centre for WTO Studies at the Indian Institute of Foreign Trade has carried out such an assessment of trade-related production linkages among South Asian countries with a case study on the textiles and clothing (T&C) sector (UNCTAD et al. 2011). In the context of South Asian countries, particularly for Bangladesh, India, Pakistan and Sri Lanka, the significance of the sector cannot be overestimated. It is the source of the leading manufacturing activities in the region in terms of its contribution to output, employment and trade. The sector collectively employs close to 60 million people directly and more than 90 million indirectly in the region.¹ The region's share in global exports of the sector (including both textiles and apparel items) increased from about 2 per cent in 2002 to more than 10 per cent in 2012, with exports reaching a value of over US\$75 billion. Its critical importance is also reflected in the contribution of the sector to individual countries' export earnings. Textiles and apparel products constitute 75 per cent of the total merchandise exports of Bangladesh; 45 per cent of Sri Lanka; 55 per cent of Pakistan and around 12 per cent of India.

Consideration of the T&C sector as a case study to assess the potential for building supply chains is also of interest from another perspective. Since the four above-mentioned individual countries are important exporters and they compete among themselves in the global market, it is often argued that South Asian nations cannot complement one another in developing and further strengthening supplying chains, and thereby in promoting their overall competitiveness. However, because of product variety and relative specialisation in different disaggregated items within the broad sector, it is necessary to map production and export structures in individual countries and their sourcing of inputs before making an informed assessment feasible. The scope for establishing and expanding export-led regional production networks looks promising *a priori*, given that India and Pakistan both have a strong textiles base and are sources of important raw materials, while Bangladesh and Sri Lanka are mainly apparel manufacturers.

This chapter draws on the joint project by UNCTAD et al. to provide a summary of the work undertaken and findings obtained. As can be inferred, the main aim of the project has been to understand the production patterns and sources of raw materials used by different countries in South Asia, utilising the information on highly disaggregated product classifications (i.e. at the Harmonized System (HS) six-digit trade classification level). Based on this, attempts have been made to identify the potential supply chains that either can be formed or strengthened further based on the existing comparative advantages of the countries vis-à-vis their partners in South Asia as well as global suppliers. The analysis undertaken is policy neutral in the sense that it does not call for considering region-wide trade protection and/or exchange of preferences to make the supply chains work for enhancing competitiveness. Being export products, the underlying argument is that if the raw materials cannot be procured from most competitive sources, a country's competitiveness would be

undermined. As this chapter will reveal, South Asian countries seem to have strong complementarity in promoting regional supply chains that are likely to augment their mutual competitiveness.

This chapter is organised as follows: Section 5.2 provides a brief review of the relevant literature; Section 5.3 provides an outline of the methodology used in the technical analysis; Section 5.4 summarises the key results with implications for individual countries' participation in supply chains; and Section 5.5 provides some concluding remarks, highlighting a few key policy issues.

5.2 A brief review of the literature

Despite a vast literature on regional integration, there has not been much discussion on supply chains in the context of the South Asian region. A number of studies have, however, pointed out the benefits of regional co-operation arising from the regional T&C sector. ADB and UNCTAD (2008) point out the growing intra-industry trade (IIT) in T&C within South Asia and the potential to increase it further. The study estimated bilateral indices to show that IIT increased in some product lines within the sector. The study also estimated gains to all countries in South Asia by the lowering of tariffs in the South Asian T&C sector.

Robbani (2004) underlines the importance of enhancing collective export competitiveness of South Asian countries through co-operation rather than competition. According to the study, the hourly compensation rate in all the four countries in South Asia is among the lowest in the world. According to USITC (2004) apart from the low-cost labour, the region as a whole has other competitive advantages over others, with the availability of raw materials being one of its main strengths.

The textiles and clothing sub-sectors in Bangladesh, India, Pakistan and Sri Lanka exhibit somewhat different degrees of specialisation. Given this heterogeneity, there can be scope for regional co-operation. While firms in Pakistan specialise in cotton textiles intermediate goods (yarn and grey fabrics), firms in Bangladesh and Sri Lanka remain export-oriented apparel producers, dependent on imported inputs such as yarn and fabric. India has developed a highly complex sector, covering the entire value and production chain from fibre production to garment manufacture and packaging. India has certain unique advantages, such as having a wide range of fibres, both natural and synthetic, production capacities from spinning thread right up to apparel manufacture and cheap skilled labour.

Tewari (2008) discusses the need for regional integration through production networks in South Asia in the T&C sector. On the basis of analysis of trade data at the aggregate level and structured interviews, the study brings out the complementarities between countries in the region and the possibility of forming a production network in the region. RIS (2004) argues that the region as a whole could meet the challenge collectively if it pursued horizontal integration, i.e. co-operation in the same or similar lines of production and exports. Such a South Asian strategy envisages a particular South Asian country that has gained export specialisation in certain textiles or clothing

product lines acting as a host for relocated plants from other South Asian countries. In this way, the textiles and clothing sector can become a regionally integrated sector as countries vacate certain lines of production and gain in other lines of production according to their relative competitive advantage in the global market. Such restructuring would promote intra-regional investment flows that would be trade-creating vis-à-vis the global and regional markets. Vertical integration from one stage of processing to another according to comparative advantage can be considered in the subsequent phase. South Asia would, thus, not lose in the value-added chain, concludes the study.

Knappe (2005) suggests that firms and countries should accelerate South–South co-operation to tap markets in other developing countries. Increased intra-regional trade of intermediate products is thought to improve competitiveness, to exploit traditional markets in the North and to participate in global production chains. The argument is that intermediary products are available on world markets, but sourcing them from nearby countries can provide shorter delivery times. As it is unrealistic to assume that individual least developed countries (LDCs) will become vertically integrated at the national level, they can look at developing regional and even inter-regional value chains to exploit complementarities. The study concludes that trade in intermediate products provides a lot of scope for co-operation between developing countries. Magder (2004), however, highlights that while exporting through international supply chains was a successful way for East Asian countries to develop their textiles and apparel industries in the 1970s and 1980s, it is a less clear route for countries trying to replicate the same strategy today. He argues that by exploring to what extent geography, trade preferences, and local production factors may help, countries should carve out a role for themselves in global supply chains, and provide an engine to drive industrial upgrading throughout the country.

Gereffi (2002) uses the global commodity chains framework to explain the transformations in production and trade networks, as well as corporate strategies, which have altered the global apparel industry over the past decades and improved the prospects for developing countries to enter and move up these chains. The apparel industry is identified as a buyer-driven product chain that contains three types of lead firms: retailers, marketers, and branded manufacturers. As apparel production became globally dispersed and competition between these firms intensified, each type of lead firm developed extensive global sourcing capabilities. In the outward-processing or production-sharing ‘assembly’ pattern, the production networks are anchored in low-cost countries and they do not foster the kinds of local linkages and knowledge transfers that are needed for successful upgrading strategies.

Apart from the above studies, country-specific studies have also been undertaken which have extensively discussed this issue. For example, Kelegama (2005) emphasises that the challenge for Sri Lanka’s textiles industry lies in improving its competitiveness. One strategy is to reposition the Sri Lankan garment industry in a South Asian context and increase competitiveness by increasing vertical integration, capturing economies of scale, focusing on horizontal specialisation, incorporating innovative designs and building a stake in global marketing networks.

5.3 Methodology for identifying potential supply chains

The broad trends in T&C trade are indicative of the existing demand and supply of inputs used within the region. Identification of the potential chains would involve disaggregating input flows to compare sourcing options. The methodology adopted in the UNCTAD et al. project is based on a simple logic that identifies those products that have both demand and supply available in the region. For this purpose, those inputs of T&C are identified which a country imports from outside the region although there exists a South Asian country which exports these globally. For such inputs, which may be from within or outside the T&C sector, both demand and supply exists in the region. Using this simple idea, the following steps were undertaken to conceive the potential supply chains:

Step I: Identify T&C products for global exports in four major economies in South Asia – Bangladesh, India, Pakistan and Sri Lanka. These products fall in HS Chapters 50–63. This is done by examining the global exports of each of the four countries in each of the tariff lines at the HS six-digit level. When exports of an item exceed US\$0.1 million, it is selected as a final product for global exports in the potential supply chain of the country concerned. The final product can be any product of the sector.

Step II: For the identified final products for global exports in each country, the inputs used both from within the T&C sector and from other sectors are identified. This is done by using an input–output database constructed for the T&C sector. The database identifies the inputs at the HS six-digit level with the corresponding tariff lines. These inputs are labelled as stage I inputs.

Step III: After identifying the stage I inputs, which may be from the T&C or other sectors, a trade matrix is constructed for each of the inputs used. For the potential exports of a country, if global imports of stage I inputs in a country are greater than US\$0.1 million, and there exists a South Asian country which exports more than US\$0.1 million of the input, the stage I input is identified as a potential input in the supply chain. This indicates that the country exporting the final product has an import demand for the identified input and South Asia has the capacity to supply this input. Two countries in South Asia which export more than US\$0.1 million of the stage I input are identified. To illustrate, if a final product is identified as a potential export product by India, then potential stage I inputs of the final product are identified where India is globally importing more than US\$0.1 million and two other countries in South Asia are identified which are globally exporting more than US\$0.1 million each and ‘therefore’ have the capacity to export the stage I input to India.

Step IV: Once the countries which can export the stage I inputs have been identified, we identify the primary inputs used in the production of the stage I input. These primary inputs could be, for example, the chemicals used in the dyes which are used as stage I inputs in fabrics. A similar exercise (as undertaken in *Step III*) is then undertaken for identifying the countries which can export the primary inputs. A trade matrix (indicating global exports and imports of the primary

inputs) is constructed. For the country, which can export the stage I inputs, its global imports of the primary inputs are reported. In addition, the global exports of primary inputs of the other three countries are reported. If the global imports of a primary input are greater than US\$0.1 million the country is identified as a potential importer of the primary input. Two countries which export more than US\$0.1 million of the primary input are identified. To illustrate, if Bangladesh is exporting the final product, it may import the stage I inputs from India or Pakistan. India in turn may import the primary inputs used in stage I inputs from Sri Lanka or Pakistan; and Pakistan may import the primary inputs from Sri Lanka or Bangladesh.

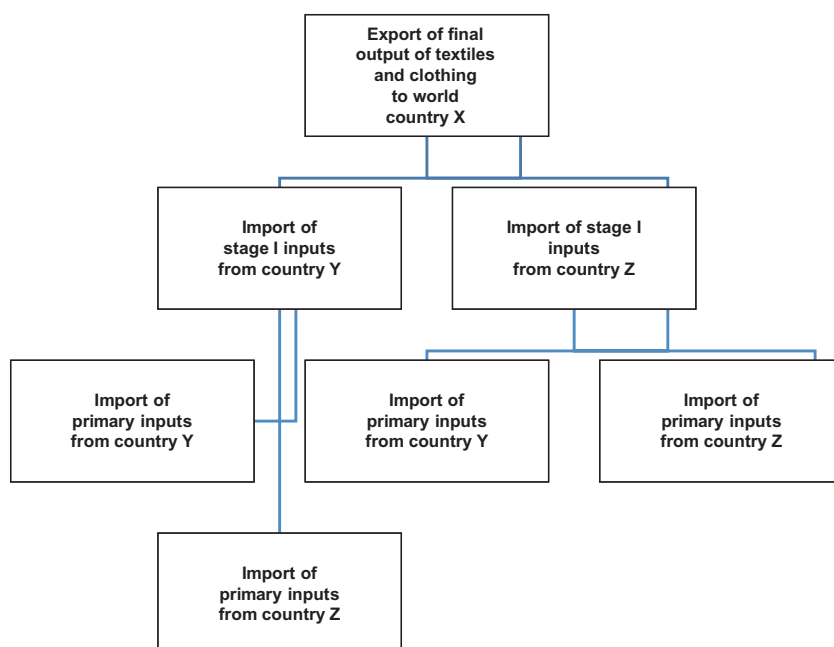
Step V: The final supply chain consists of:

- a) a final output which is exported by a country, say, X;
- b) stage I inputs which are imported by country X from two other identified countries (e.g. Y and Z); and
- c) primary inputs which are imported by Y and Z from any two South Asian countries.

The supply chain constructed for the T&C sector, based on the trade data, can be illustrated as shown in Figure 5.1.

Using the above methodology, supply chains have been identified for four major economies of the region, which are Bangladesh, India, Pakistan and Sri Lanka, at HS six-digit codes. The trade matrix used for identifying the potential exports and

Figure 5.1 Constructed potential supply chain in textiles and clothing sector



imports is constructed using three-year averages (2005–07). The data source used for the study is UN Comtrade database using World Integrated Trade Solutions. In order to avoid the selection of products due to data-reporting errors and/or otherwise inconsistent trends over a very short period of time, resulting in high average values, export and import figures were compared against their long-term trends over the 2000–07 period. Therefore, only those products were selected in the supply chain either as final products or potential stage I or primary imports that show consistent export earnings.

Thus, the supply chain identifies the final outputs to be globally exported by a country or two countries that can provide the stage I inputs which are used in the production of the final output, and two other countries which can provide primary inputs, which are used in the production of stage I inputs. It should be noted that the final output to be exported may not necessarily be clothing. It could include yarn, fabrics or other upstream products. The stage I and primary inputs into these upstream products are then identified.

There is a possibility that despite the existence of the capacity to supply inputs within South Asia, the import may be cheaper from other countries. To consider this, the export unit values of all South Asian countries have been compared with those of the major global exporters of the same products.

Further, for some products, only two-stage supply chains could be formed. These supply chains have been identified for all the four countries along with the final outputs to be exported to the world and stage I inputs to be imported. For these supply chains two possible countries were identified from where stage I inputs can be imported. The export unit values of all South Asian countries, which have global exports of more than US\$0.1 million indicating some supply capacity, were considered.

5.4 Implications on potential supply chains

There are at least three different ways of analysing potential supply chains. First, these can be analysed from the perspective of the number of times a country participates in different stages of the supply chain, as an exporter of final product, exporter/importer of stage I input or exporter/importer of primary inputs in the supply chains formed. The number of stages in all supply chains in which each of the four major countries in South Asia participates is reported in column 1 of Table 5.1.

Second, supply chains can be examined by tracking the flow of inputs leading to the final exported products. For example, if a country X exports the final product (which can be apparel, made-up, fabrics, etc.), it will import stage I inputs which are used in the production of the final products from country Y and country Y, in turn, will import primary inputs used in the production of stage I inputs from country Z. To elaborate further, two unique supply chains are formed if, for exports of a particular product, country X imports one stage I input from country Y, and country Y in turn imports two primary inputs from country Z for producing the stage I input. However,

Table 5.1 Number of potential three-stage and two-stage supply chains and number of potential products of import and export

	Number of stages a country participates in three-stage and two-stage supply chains (1)	Number of potential three-stage supply chains formed by export of final product (2)	Total number of unique HS six-digit tariff lines of imports in the potential three-stage and two-stage supply chains (3)	Number of unique HS six-digit tariff lines identified as potential product for exports in three-stage and two-stage supply chains (4)	Number of unique HS six-digit tariff lines identified as potential imports of stage I inputs in three-stage and two-stage supply chains (5)	Number of unique HS six-digit tariff lines identified as potential imports of primary inputs in three-stage supply chains (6)
Bangladesh	245	109	65	15	19	47
India	1,032	212	38	37	25	19
Pakistan	795	67	117	29	27	103
Sri Lanka	418	363	36	8	34	2

there would be four unique supply chains if country Y imports four different primary inputs for producing the stage I input.

In other words, under this perspective, supply chains can be analysed by taking an export product and tracking the imports of its stage I inputs, and thereafter tracing the imports of primary inputs used in the production of stage I inputs. It may be noted that under this perspective each supply chain represents a unique product–country combination for export of the final product, import of stage I inputs relevant to production of the final product and import of primary inputs relevant to the production of that stage I input. Column 2 of Table 5.1 reports the number of supply chains that can be formed in the region from exports of final product from each country. The number of supply chains based on exports of the final products of a country that are formed should not be taken as an indicator of that country's potential to integrate in regional supply chains. A better indicator of this potential could be the number of times a country participates in different stages of all supply chains.

The third perspective examines the number of unique HS six-digit tariff lines involved a particular country's participation as an importer in different stages of all the unique supply chains, that is, (i) as an importer of stage I inputs linked to the final product; and (ii) as an importer of primary inputs linked to those stage I inputs which can be exported by that country. Column 3 of Table 5.1 reports the number of unique tariff lines each country can import from the region in the potential supply chains.

Table 5.1 presents the three described different ways of analysing the potential supply chains formed using the stated methodology. In addition, it also reports the number of unique final products which a country can export (column 4); inputs that may be imported as stage I inputs from the region (column 5); and number of unique primary inputs that a country may import for production of stage I inputs (column 6).

From the first perspective of the number of stages of a country's participation in all supply chains, India participates in the maximum number of stages in the identified supply chains (1032), followed by Pakistan (795), Sri Lanka (418) and Bangladesh (245). From this perspective, the more diverse the range of inputs of T&C exported/imported by a country, the higher its participation in different stages of the potential supply chains.

From the second perspective, the final product identified for global exports forms 109 supply chains in Bangladesh, 212 in India, 67 in Pakistan and 363 in Sri Lanka. A plausible reason for the lower number of potential supply chains formed for Pakistan is that the final products exported by Pakistan are more textiles than clothing. Textiles, compared with clothing, may have lower backward linkages in terms of inputs used for the production of the final product.

From the third perspective of the number of unique tariff lines that can be imported by a country in the identified potential supply chains, Bangladesh can import 65 stage I and primary inputs, India can import 38 inputs, and Sri Lanka 36 inputs and Pakistan 117 inputs. Most of the inputs identified for Pakistan are non-textiles inputs which are used in the textiles and clothing sector. The greater the number of inputs globally imported by a country, the greater the number of importable inputs that are identified in the potential supply chains to be formed in South Asia.

There were 15 unique textiles and clothing tariff lines identified as final product for global exports that can form supply chains within the region for Bangladesh. For India, 37 unique tariff lines have been identified, 29 for Pakistan and 8 for Sri Lanka. The unique first stage inputs identified, which can be imported from within the region are highest for Sri Lanka (34), closely followed by Pakistan (27), India (25) and Bangladesh (19). The number of potential primary inputs that are used in the first stage that can be imported are highest for Pakistan (103), followed by Bangladesh (47), India (19) and Sri Lanka (2).

Having examined the number of unique tariff lines involved in each stage of the unique supply chains in which a country participates, it is relevant to assess whether existing trade flows point towards the possibility of establishing regional supply chains in the T&C sector in South Asia. Three aspects are relevant in this assessment. First, whether the country has import demand for stage I and primary inputs; second, the extent to which the import demand is met from countries within and outside the region; and third, whether other countries in the region have the export capacity to meet the import demand. Table 5.2 presents the country-wise global and regional imports of the tariff lines identified as stage I inputs or primary inputs in the potential supply chains. It is interesting to note that in respect of all the four

countries, the imports of inputs are mainly from sources outside the region, although supply capacity exists within the region.

Estimating the percentage share of a country's global imports of the identified inputs to the region's global exports of these inputs, we find that Bangladesh's global imports comprise only around 18 per cent of the region's global exports. For Pakistan and Sri Lanka, these are around 7.5 per cent and 9 per cent respectively. This indicates that supply capacity exists within the region to cater to the demand for the identified inputs by the region.

However, India's global imports of the identified inputs is around 350 per cent of the region's global exports, indicating that India's demand for the identified inputs is much more than the region's capacity to export. This may be a result of the diverse production structure of India in the T&C sector, which ranges across the entire value chain. It also indicates the role that India can play in generating demand for the inputs within the region.

The existing regional imports of the inputs compared to total import demand are found to be very low (Table 5.2). In the case of Bangladesh and Sri Lanka, regional imports are around 30 per cent. India's regional imports are the lowest at less than 5 per cent, indicating the potential of intra-regional trade for India. However, India's demand for exports is significantly higher than the export capacity within the region.

To analyse the reasons for low regional imports we examined at the country level the identified inputs in the supply chain along with the export unit values of the countries in the region. Country-wise participation in supply chains is presented in the following sections. The existing tariffs on these identified products for imports in each country are reported along with the indication of whether the product appears in the sensitive list of the countries.

It should be noted that the exercise undertaken to identify supply chains is not exhaustive but is demonstrative in nature. At the country level, only those products where the country ranks either highest or second highest in terms of global exports have been selected as final products for exports.

Table 5.2 Global and regional imports of identified inputs in potential supply chains: Average for 2005–07

	Global imports (US\$'000)	Imports from other three countries of the region (US\$'000)	Global exports of other three countries in the region (US\$'000)	Imports from the region as % of country's global imports	Global imports of a country as a % of global exports of the region
Bangladesh	493,150	146,628	2,690,257	29.7	18.3
India	4,834,969	221,657	1,380,133	4.5	350.3
Pakistan	1,166,083	202,466	15,543,371	17.3	7.5
Sri Lanka	327,176	94,808	3,623,488	28.9	9.0

5.4.1 Participation by countries in potential three-stage and two-stage supply chains

Bangladesh

By adopting the discussed methodology, three-stage and two-stage supply chains (where only first-stage inputs are present) have been identified for the individual South Asian countries under consideration. The unique tariff lines identified as final products for exports and inputs for imports in supply chains are available in the main report (UNCTAD et al. 2011) along with the individual countries' demand and the region's supply-side capacity. For Bangladesh, most of the inputs identified in the potential supply chains had much higher global imports than imports from within the region. It was, however, found that the supply capacity of the region in most of the products was much more than that globally imported by Bangladesh, indicating that the region can fulfil Bangladesh's demand for the inputs.

Fifteen products were identified as final products that may be exported by Bangladesh, which was found to be either the largest or second largest exporter from the region. These products mainly belong to HS Chapters 61 (articles of apparel and clothing accessories, knitted or crocheted) and 62 (articles of apparel and clothing accessories, not knitted or crocheted) and include products such as women's and girl's suits, ensembles, jackets, blazers, men's or boy's shirts, T-shirts, jerseys, pullovers, cardigans, women's overcoats, capes, cloaks, men's or boys' suits, jackets, etc. It should be noted that there are many more products that Bangladesh exports to global markets, but the identified ones are those which have the potential to form supply chains in the region. That is, there exists a genuine possibility of regionally importing the stage I and other primary inputs.

The final products for exports also include a few woven fabrics of silk and synthetic filament. These products have a low share for Bangladesh in South Asia's exports, as the country that ranks highest (in this case India) has around a 98–99 per cent share in the region's exports. However, exports of these products do show a rising trend and thus can be considered as potential exports of Bangladesh.

The stage I inputs that are used in production of the final products for global exports are from both the T&C sector as well as from other (i.e. non-textiles) sectors. Thirteen such categories from the T&C sector have been identified that can be regionally imported by Bangladesh. In most of these products, Bangladesh is importing less than 20 per cent of its global imports from the region, while the global exports from the region are much higher than that of Bangladesh's global imports. These products include raw silk, yarn spun from silk waste, yarn of other vegetable textile fibres, synthetic filament yarn, synthetic staple fibres, wadding of textile materials, and quilted textile products. Only in two products, namely raw silk and wadding of textile materials, are Bangladesh's global imports higher than the region's supply.

There are six non-T&C products that are used as stage I inputs in the final products identified for global exports for Bangladesh. These are mainly synthetic organic colouring matters, lubricating preparations, finishing agents and laboratory reagents.

Except for lubricating preparations, Bangladesh imports from the region are less than 25 per cent of its total global imports, while the region's global exports are much higher than Bangladesh's global imports, except for finishing agents. Bangladesh's regional imports of lubricating preparations are around 26 per cent and of synthetic organic colouring matter (3204.15) are 36 per cent from the region. This shows the potential that exists in terms of global demand for the inputs of Bangladesh, which can be met within the region, leading to effective supply chains.

There are 47 products that have been identified as primary inputs of stage I inputs. Except for yarn spun from silk waste, all the products are from non-T&C sectors. Out of these, regional imports of 35 products are less than 20 per cent in Bangladesh, while regional supply is insufficient in only 5 products compared with Bangladesh's global demand. In all other products there exists a global exporter of the product in the region.

As part of the exercise, the export unit values of global top exporters have been compared with those of regional suppliers for the products identified in the supply chains. While the details can be found in UNCTAD et al. (2011), the comparisons do reveal that regional suppliers are cost competitive in most of the cases. Although the export unit values can be taken only as indicative of the export prices of the product and may not be comparable across countries as the quality of the product may vary, the findings are in line with the fact that South Asian countries are among the most competitive global suppliers.

India

Using the same methodology, three-stage and two-stage supply chains for India have been identified for products for global exports, and for imports as stage I inputs and primary inputs. The analysis finds 37 products for global exports from T&C, including silk yarn, cotton yarn, woven fabrics of cotton, synthetic filament yarn, woven fabrics of synthetic filament yarn, carpets, knitted and crocheted fabrics, women's suits, etc. In all but one item, India has more than a 10 per cent share in global exports from the region. In ten products, India's share in the region's global exports is more than 90 per cent. In 13 products, the South Asia region contributes more than 10 per cent of global exports.

Twenty-four products were identified for imports from the region by India. These are the products which are globally imported by India, but also have regional suppliers who are globally exporting (more than the threshold value of US\$0.1 million). Of these, three-quarters are related to T&C, while the rest are from non-textiles sectors. Products under T&C include woven fabrics of silk or silk waste, wool and yarn of wool, cotton, cotton yarn, woven fabrics of cotton, synthetic filament yarn, synthetic staple fibres, yarn of synthetic staple fibres, wadding of textile materials, etc. Some of these products are produced and exported as well, but several differentiated categories under the same tariff lines are being globally imported by India. From the non-T&C sector, the products which may be imported by India from the region are synthetic organic colouring matter; some starches and finishing agents (from HS Chapter 32.04, 32.06, 35.05 and 38.09). However, only in 7 out of 25 stage I inputs,

are India's global imports lower than the region's global exports, which indicates the insufficient supply capacity of the region to fulfil India's demand. But, in 21 out of 25 products, India's regional imports are less than 10 per cent of its total global imports. This indicates the potential of forming regional supply chains by India.

In the list of identified primary inputs of stage I inputs, which India could import regionally, there are 19 products, of which 14 belong to the non-T&C sector. In 16 out of 19 products, India imports less than 10 per cent regionally, while in only 4 products, India's global imports are lower than region's global exports. This indicates that although the region's supply capacity is limited in terms of fulfilling India's global demand for the inputs, whatever the given supply capacity, only a small part of it is being utilised by India.

To assess the feasibility of regional imports, the export unit value of the top exporter of these products to India was compared along with those of three other countries in the region. Of the whole sample of potential supply chain items, the export unit value of the exporter was found to be lower in only eight categories (i.e. global suppliers being more competitive). Therefore, in most of the cases the regional sources appeared to be least-cost suppliers.

Pakistan

A total of 29 products are in the potential supply chain as products for final export by Pakistan. These include, among others, cotton, cotton yarn, woven fabrics of cotton, synthetic filament yarn, woven fabrics of synthetic filament yarn, other knitted or crocheted fabrics, men's or boys' knitted or crocheted shirts, etc. In 22 of these products Pakistan's share in the region's exports is above 10 per cent, while in the remaining categories it exports around 50 per cent or more of the region's total exports.

There are 27 stage I inputs identified, of which 16 are from the T&C sector. These are mainly from HS Chapter 55 (synthetic staple fibres). There are three tariff lines of HS Chapter 52 (5201.00, 5203.00 and 5205.11) of which Pakistan globally imports more than US\$100,000. One of these products, cotton yarn (other than sewing thread) containing 85 per cent or more by weight of cotton, not put up for retail sale (5205.11), is imported mainly from the region, while 23 stage I inputs have less than 10 per cent imports from the region. In most of the products the region's global exports are higher than Pakistan's global imports suggesting that there exists supply capacity within the region to cater to Pakistan's global demand for the stage I inputs.

There are 103 primary inputs identified in the potential supply chains. These primary inputs are used in stage I inputs. An overwhelming majority (97) of these primary inputs are from non-T&C sectors. The large number of these inputs indicates diversity in Pakistan's basket of global imports. In 72 out of 103 products, Pakistan's regional imports are less than 10 per cent, while in only 14 cases Pakistan's global imports are greater than the region's global exports indicating insufficient capacity. These include products such as finishing agents, prepared binders for foundry moulds or cores, and artificial staple fibres, not carded, combed or otherwise processed for spinning.

Sri Lanka

The three- and two-stage potential supply chains identified eight products of Sri Lanka for final export, which have the potential of forming regional supply chains. These are the products where Sri Lanka is the largest or second largest global exporter in the region. These products are mainly from HS Chapters 61 (articles of apparel and clothing accessories, knitted or crocheted) and 62 (articles of apparel and clothing accessories, not knitted or crocheted).

There are 34 inputs identified as stage I inputs that may be imported from the region, of which 28 are from the T&C sector. These are mainly cotton (not carded or combed), cotton yarn, woven fabrics of cotton, and synthetic filament yarn. However, unlike other countries in the region, Sri Lanka is importing to a large extent from the region. Regional sourcing in 24 out of 34 products was greater than 10 per cent. Nevertheless, Sri Lanka's regional imports of cotton (HS 5201.00) are less than 3 per cent, while the region has high global exports of the same. For some tariff lines in woven fabrics, the regional supply capacity is limited as Sri Lanka's global imports are much higher than the region's global exports.

There are 36 unique products that Sri Lanka can import regionally in either two-stage or three-stage identified supply chains. Except for one item, synthetic filament yarn (HS 5402.20), which Sri Lanka is importing from the Republic of Korea, in all other products the export unit values of one of the three suppliers in the region is lower than those of the top exporters to Sri Lanka. None of the identified inputs are in Sri Lanka's sensitive list under SAFTA. This is indicative of the existing potential for regional imports for Sri Lanka.

5.5 Policy implications

The findings presented and discussed above therefore suggest the significant scope of developing supply chains using production networks across the borders of South Asian countries. Many of the products identified as inputs in the potential supply chains can be sourced from within the region without undermining competitiveness, as South Asian countries were also found to be global suppliers in the same categories. Comparisons of export unit values of regional suppliers with those of global suppliers also indicate a similar conclusion. It is quite interesting to find that despite the availability from the least-cost suppliers within the region, the global imports by individual South Asian countries of many of the identified inputs are higher than imports sourced from their neighbours.

The above, thus, brings to the forefront an important conclusion: despite the high potential, market forces on their own have not been successful in developing regional supply chains. Intra-regional trade still remains very low, while complementarities in the region have largely been ignored. Regional supply chains, if put in place, offer not only a reduction in costs of production but also the advantages of economies of scale, as well as lowering the lead time in global deliveries, which has become particularly critical for apparel exports.

The issue of developing supply chains, however, might give rise to certain unwarranted concerns. One popular argument in South Asia is that regional sourcing will undermine the efforts of the countries in developing their own domestic backward linkage industries. On the contrary, the methodology employed and discussed in this chapter rules out such a possibility. The basic premise of the analysis is whether the countries are already importing the required raw materials from the rest of the world and, if so, whether regional sourcing can replace those supplies. Therefore, if a country, for instance, is sourcing all its import requirements internally (from domestic backward linkage industries), there is no scope for developing regional supply chains. In other words, since global imports exist, there is no reason to believe that regional imports would hurt domestic industries.

It is also important to point out that the analysis has only considered regional imports for use in the export-oriented sector and not for domestic consumption. As a result, regional supply chains – at least the way they have been presented in the study – are not any threat to domestic industry.

Following from the above, it is worth mentioning that the sensitive list under SAFTA may not be a constraint for regional supply chains. The export-oriented sectors, in most cases, procure their raw materials from the cheapest possible global sources. Even when the relevant domestic import-competing sectors operate under the shield of tariffs and other support measures, exporters are allowed duty-free import of raw materials or to make use of such facilities as duty-drawback and bonded warehouse to protect their competitiveness by getting inputs from globally efficient suppliers. From this perspective, the sensitive list maintained by different countries in the region should not be a problem for allowing their exporters to source raw materials regionally.

There might be some apprehension about compromising the export sector's competitiveness by using raw materials and primary inputs manufactured in the region. Another related concern is whether the regional supply chains could lead to trade diversions triggering welfare costs. However, as already pointed out above, South Asian countries are exporting many of these items to the world market and they compete well with other major global suppliers, and as such the concern about undermining competitiveness in the export sector may not be true in a range of product lines. It is important to note that this chapter does not advocate trade policy-induced measures (such as tariff concessions for regional partners) for promoting regional trade or supply chains. The South Asian textiles and clothing industry is overwhelmingly global market-oriented and exporters will have to have access to raw material supplies at world prices. Therefore, any suggestion of discriminatory tariffs on input supplies by sources is not considered, thereby eliminating the possibility of trade diversion. Nevertheless, it does not rule out the scope of policy interventions by South Asian countries, as they can be more ambitious in integrating their textiles and clothing industry across the region. But this is not something that has been considered as part of the current study.

There are, however, other factors associated with competitiveness where regional supply chains can actually exert beneficial effects. Unlike the traditional trade

theories, there is now robust evidence that transport costs reduce tradeable volumes. Under ideal circumstance, supplies procured within the region will involve lower transport costs improving the competitiveness of individual South Asian countries. With regard to the exports of textiles and apparels, most South Asian countries suffer from high 'lead time' (i.e. the time spent between the receipt of the export order and delivery of the order at the importer's designated port). Regional sourcing of raw materials, particularly for apparels, can greatly help mitigate the problem.

The distribution of regional export gains could also attract the attention of some observers. As within the region some countries have a larger supply capacity than others, concerns may be raised about unequal distribution of gains from regional supply chains. However, this argument is misconceived. According to the methodology adopted, countries are importing intermediate inputs in order to increase their exports. If countries could not experience increased export earnings, regional imports would also not rise. In addition, one should not merely focus on the distribution of regional exports; what is more important is the growth of overall exports to the global markets.

One important caveat about the supply chain assessment, however, must be acknowledged. Despite the use of highly disaggregated data, it has not been possible to take into account the quality variations across various suppliers. There is no denying that the quality of inputs would determine a supplier's catering to a particular market. In the case of apparels in particular, many importers often provide strict specifications with regard to the inputs to be used and their preferred sources. This can somewhat reduce the scope of regional sourcing. Nevertheless, the study has provided detailed and disaggregated product-level information where potential for developing regional supply chains exists. Based on this, the industry stakeholders can more precisely assess any likely effects of product heterogeneity on regional sourcing and exports.

It goes without saying that much of the existing scope for exploiting supply chains would largely depend on the progress made on overall co-operative efforts among the South Asian nations. The existence of bilateral political differences has affected the advancement of regional economic co-operation. It has been found that when it comes to regional partners, South Asian countries have more restrictive regimes for their regional partners than for the rest of the world. Along with tariff barriers, a plethora of non-tariff measures seriously constrain intra-regional trade and investment flows. As a result of lack of political will, the region also suffers from a relatively poor state of trade facilitation and high transaction costs associated with cross-border exchange. All this will naturally have serious implications for promoting regional supply chains. Indeed, many business leaders and informed observers attending the consultation meetings that were undertaken as part of the aforementioned UNCTAD et al. project identified, among others, weak trade facilitation infrastructures, inconsistent policy regimes in cross-border trade using land-ports, and port-management and related inefficiencies as major obstacles to building regional supply chains.

Note

- 1 According to the currently available information, the sector provides direct employment to 3.5 million people in Bangladesh, 38 million in India, and 15 million in Pakistan.

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PART II. KEY AREAS FOR CO-OPERATION

Chapter 6

Non-tariff Barriers in South Asia: Nature and Modalities to Address the Attendant Issues

Mustafizur Rahman and Mohammad A Razzaque

6.1 Introduction

With tariffs coming down worldwide, attention has been increasingly diverted to issues related to barriers to trade other than the tariffs, non-tariff barriers (NTBs). It is true that, often, NTBs are put in place for protectionist purposes; on the other hand, NTB-imposing countries tend to argue in favour of these barriers for a variety of reasons. The border line between *defensive* and *offensive* interests with regard to the NTBs thus tends to be blurred. The fact also remains that in many regional trading agreements (RTAs), which were set up in the first place to enhance intra-regional trade flow, NTBs have emerged as the *spoiler* that defeats the very purpose and objective of the RTAs. In this context South Asia has emerged as an epitome of this dichotomy.

The issue of enhancing intra-regional trade in South Asia is high on the agenda of policy-makers in all the member countries of the South Asian Association for Regional Cooperation (SAARC). Though the SAARC regional grouping was established in 1980, the first institutional arrangement for stimulating intra-regional trade could be put in place only in 1993 when the SAARC Preferential Trading Arrangement (SAPTA) got off the ground. Four rounds of SAPTA negotiations were held between 1993 and 2005, with each successive round having an increasingly large number of goods which were accorded preferential tariff treatment by the member countries. The margin of preferences was also gradually raised.¹

The SAPTA, as is known, was followed by the agreement to establish the South Asian Free Trade Area (SAFTA). The SAFTA Agreement (2006) envisaged bringing down existing tariff barriers in accordance with the Trade Liberalization Programme (TLP) agreed by the member countries. The programme included three schedules – (i) a positive list, (ii) a negative list and (iii) a residual list. A two-track approach was taken – one for developing members, the other for the least developed countries (LDCs). Duties on tariff lines belonging to the *positive list* were set at zero from the date of implementation of the SAFTA accord. However, a large number of tariff lines belonging to the *negative list* continue to be traded at existing most favoured nation (MFN) tariff rates. These lists were to be reviewed periodically (every three years).² Duties on items belonging to the *residual list* were to be reduced to between 0 and 5 per cent by 2013 by developing SAARC members and by 2016 by the LDC members.³

It should, however, be noted here that both developing countries and the LDCs in the SAARC have reduced their tariffs, primarily through trade liberalisation reforms.

MFN tariff rates, which used to be on average in the range of 50–60 per cent during the early-1990s had, in fact, come down to 15–20 per cent by mid-2000s. Thus, the preferential margins enjoyed by members under the envisaged TLP of the SAFTA is set to provide declining dividends. The fact is that a large number of items continue to remain in the negative (sensitive) lists of SAARC countries undermining both the spirit and the efficacy of the SAFTA.⁴ Less than 5 per cent of the global trade of SAARC member countries is with each other.⁵

It is often argued that one of the major reasons for this low level of intra-regional trade lies in the presence of the plethora of NTBs that limit the potential benefits and opportunities emerging from the free trade accord. Not only are NTBs perceived to be limiting the scope of realising the benefits of duty-free access, they also severely constrain the promotion of intra-regional trade in general. It is true that the SAFTA accord envisages initiatives to reduce NTBs, facilitate customs co-operation and enable trade facilitation. However, until now not much progress could be made in this context. Sobhan (2006) points out that tariff reduction is only a part of the narrative and in order to deepen regional co-operation a more comprehensive approach would be needed. Both trade and investment remain critical to the economic development of the South-Asia and Asia-Pacific region. However, both these important drivers are constrained by NTBs and lack of trade facilitation (UNESCAP 2013). The problems faced particularly by the weaker economies of the SAARC have received prominence in a number of studies (Razzaque 2010, De et al. 2012). Some authors have also specifically pointed out how NTBs are constraining the possibilities of Indo-Bangladesh bilateral trade (De and Bhattacharya 2007, Rahman et al. 2011).

There is, thus, a need to conduct an in-depth investigation into what the various NTBs are, how they affect intra-regional trade, how they can be addressed and what institutional mechanisms can be put in place to resolve the attendant disputes.

The purpose of this chapter is to (a) examine the various concepts and typology of NTBs (Section 6.2);⁶ (b) identify the nature of the NTBs in place in South Asia (Section 6.3); (c) examine cross-country experiences in addressing the NTBs (Section 6.4); (d) document how the NTBs are being addressed within the SAFTA architecture and what lessons can be learnt from other regions (Section 6.5); and (e) provide policy recommendations to address NTB-related issues in the context of South Asia (Section 6.6).

6.2 Non-tariff barriers: Concept and typology

6.2.1 Definition of NTBs and their classification

As is broadly defined, a tariff is a tax imposed on foreign goods and services as they enter a country through customs points, whilst non-tariff barriers are non-tax measures which act as barriers to the entry of goods and services exported by foreign suppliers. Such measures could provide certain advantages to domestic suppliers or suppliers from other countries for which the measures are not applicable. Some of the NTBs may have relatively unimportant trade effects, e.g. packaging and labelling

requirements can impede trade, but perhaps only marginally. Non-tariff measures, such as quotas, voluntary export restraints, and other non-automatic import authorisations and variable import levies would have much more significant effects on market entry as well as price-competitiveness.

The broadest definition of a NTB is any measure other than a tariff that distorts trade (Linkins 2002). Tariff barriers to trade are easy to measure, as these are quantifiable. In contrast, NTBs are often grey; they come in various shapes, sizes and forms. NTBs tend to lack concrete features and are often devoid of precise data and information and involve a lot of grey areas that are subject to interpretative ambiguities.

The trade analysis and information systems of the United Nations Conference on Trade and Development (UNCTAD) provide a comprehensive list of NTBs classified according to trade control measures. These, according to UNCTAD, fall under five broad categories:

- a. *Price control measures*: administrative pricing (minimum import prices, administrative pricing); voluntary export price restraint (variable levies, variable components, compensatory elements, flexible import fees, variable charges); anti-dumping measures (anti-dumping investigations, duties, price undertakings).
- b. *Finance measures*: advance payment requirements (advance import deposit, cash margin requirement, advance payment of customs duties, refundable deposits for sensitive product categories); multiple exchange rates; restrictive official foreign exchange allocation (prohibition of foreign exchange allocation, bank authorisation, transfer delays, queuing).
- c. *Quantity control measures*:
 - i. Non-automatic licensing (licence with no specific ex-ante criteria, licence for selected purchasers;
 - ii. Licence for specified use, licence linked with local production (purchase of local goods, local content requirement, barter or counter trade); licence combined with or replaced by special import authorisation;
 - iii. Authorisation for sensitive product categories, licence for political reasons;
 - iv. Quotas: global quotas (unallocated, allocated to exporting countries), bilateral, seasonal, linked with export performance, linked with purchase of local goods, quotas for sensitive product categories, for political reasons; prohibitions: total, seasonal, temporary prohibition, suspension of issuance of licences, import diversification, prohibition for political reasons (embargo);
 - v. Export restraint arrangements: voluntary export restraint arrangements, Multifibre Arrangement (MFA): quota agreement, consultation agreement, administrative co-operation agreement, export restraint, etc.; and
 - vi. Enterprise-specific restrictions: selective approval of importers, enterprise-specific quota.

- d. *Monopolistic measures*: single channel for import (state trading administration, sole importing agency), compulsory national services (compulsory national insurance, transport).
- e. *Technical regulations*: requirements for product characteristics, marking, labelling, packaging, testing, inspection and quarantine, information, requirement to pass through specified customs, etc., pre-shipment inspection, special customs formalities, return obligation.

This list would indicate that (a) NTBs are fairly diverse in nature; and (b) many NTBs are subject to interpretative ambiguities and it is difficult to separate which are protectionist in nature and which originate from genuine concern. This would also imply that resolving any NTB-related dispute would involve a complex negotiation and arbitration process.

6.2.2 Use of NTBs in international trade

As was mentioned earlier, from the early 1990s, as tariff rates started to come down at a fairly accelerated pace, many countries tended to make use of regulations in a more aggressive manner to govern trade flows. The use of NTBs in international trade has been on the rise. Before dwelling on the issues of NTBs in South Asia and identifying modalities to address the relevant disputes, it is pertinent to keep in mind that NTBs have become a common phenomenon in international trade and so have NTB-related disputes. Examples of NTBs include regulations referring to technical requirements, either directly or by referring to or incorporating the content of a (mandatory or voluntary) standard, technical specification or code of practice, with a view to protecting human life or health or animal life or health (sanitary regulation), protecting plant health (phytosanitary regulation), protecting the environment and wildlife, ensuring human safety, ensuring national security, and preventing deceptive and unfair practices. In the European Union, the focus of regulation was primarily on the environment, health and safety (EHS). However, there have been tendencies by governments to regulate IT and telecommunications products in terms of certain features, such as privacy and security.

Control measures, such as those in the area of sanitary and phytosanitary (SPS) regulations, meant to protect humans, animals and plants, have often exceeded multilaterally accepted norms. Often what is accepted by one country has not been accepted by others. Technical barriers to trade (TBT) have often constrained trade flows, when standards, regulations and assessment systems intended to ensure safety were not applied uniformly. Experience has shown that duplication of testing procedures that do not add value to a product adds to the cost of compliance and undermines competitiveness.

Regulations in developed countries apply stringent rules on food quality, packaging and labelling. For example, exports of poultry products have been particularly affected by such sanitary regulations, which encompass rules pertaining to equipment and methods used in the processing and packaging of the product. Obtaining approval is a lengthy process that involves substantial documentation and tedious bureaucratic

procedures. It has taken exporters of meat products from developing countries more than two years to get approval.

When perceived as protectionist measures, these have also been challenged on appropriate platforms. When developed countries are members of RTAs, the dispute settlement mechanism of the RTAs have been put in to effect when an aggrieved party has lodged a complaint. On some occasions the dispute settlement mechanism of the World Trade Organization (WTO) has been put into effect when it was perceived to be a better route to resolve an NTB-related conflict.

Indeed, according to UNCTAD, in the last ten years there has been a seven-fold increase in government-mandated testing and certification requirements with increasing costs that had to be borne by the exporters in order to comply with the various technical regulations and standards related requirements. According to an International Trade Centre (ITC) study (2005), 42 per cent of LDCs were subject to some NTBs. The issue has been debated to such an extent that a special working group has been created in the WTO to deal with NTBs. This working group has identified a wide variety of NTBs based on the discussion and submissions from WTO member countries.

Rahman and Razzaque (2009) provide information on the prevalence of NTBs, including where countries have been members of RTAs for periods that far outrun the existence of SAFTA as an RTA. They found that NTBs came in various shapes. Interestingly, in the Association of South East Asian Nations (ASEAN), the overwhelming majority of NTBs are related to customs surcharges (70%). These could be perceived as protectionist measures on the part of trading partners to provide safeguards to domestic producers. One would have thought that with the deepening of trade liberalisation these would come down in both numbers and degree of incidence. However, it is worth noting that NTBs in the form of SPS and TBT do not figure in any significant way. This was the case mainly because SPS-TBT-related NTBs were largely resolved through agreements pertaining to mutual recognition of standards and certification. This is something which, as will be seen later, is very significant for the SAARC members. One could infer that a mechanism such as the one in ASEAN could play an important role in reducing the number of NTBs in South Asia.

The upshot of the aforesaid brief discussion is that when the issue of NTBs in the context of South Asia is considered, it is well-advised to keep in mind that NTBs are a widely prevalent phenomenon in the global trading regime and there is hardly any scope to wish these away. Cross-country experiences indicate that the best way go about it is to (a) build up capacities to ensure compliance and (b) put in place appropriate institutions to resolve attendant conflicts.

6.3 Non-tariff barriers in South Asia

6.3.1 NTBs constraining intra-SAARC trade

If the UNCTAD definition of NTBs is considered, the menu of NTBs that inform intra-SAARC trade would be quite an extensive one. All the four major trading partners in SAARC (India, Pakistan, Bangladesh and Sri Lanka) have a large number

of NTBs in place. Whilst individual members tend to consider their own NTBs to be genuine and WTO-compliant, they are, as a rule, opposed to NTBs imposed by partners, arguing that such NTBs are protectionist in nature.

Though the SAFTA Agreement requires members to notify the committee of experts (CoE) of any NTBs and para-tariff measures, the CoE can only recommend their removal as these recommendations do not entail a *binding commitment*.

A survey of NTBs reported by SAARC member countries to the CoE shows the NTBs that are most frequently imposed in trade among the SAARC countries related to SPS measures and TBT, quotas, anti-dumping measures, licence requirements and countervailing measures. Documentation procedures and SAPTA certification for rules of origin are also considered to be NTBs by exporters. Computerisation of trade transactions (cargo declaration, licensing and duty payments) have opened up the need for new standards (e.g. Automated System for Customs Data (ASYCUDA)) and compatibility across regional systems.

A wide range of NTBs, albeit WTO-consistent, are in place in India. These include tariff rate quotas (TRQs) on 14 tariff lines (Harmonized System (HS) eight-digit level), import restrictions and licensing, and restrictions in the form of entry through particular ports. Under the India–Sri Lanka Free Trade Agreement, for example, tea and garment exports from Sri Lanka to India can only be cleared through specified ports. In Bangladesh, there is a significant application of para-tariffs (e.g. surcharges and supplementary duties) – estimates are that 38 per cent of the average protection is due to para-tariffs. Bangladesh continues to maintain quantitative restrictions on eggs, poultry and salt, for which the government has obtained waivers from the WTO. Sri Lanka bans the import of tea and spices on the grounds that low quality imports, if mixed with Sri Lankan products, would reduce the quality of exports and thus affect their marketability.

As can be seen from Table 6.1, information which has been collated by the Asian Development Bank (ADB) (2008) shows 86.3 per cent of NTBs in the region relate to SPS, TBT and other related measures. Thus, the overwhelming majority of NTBs are indeed in areas where compliance with SPS and TBT are major requirements. If such measures are on an MFN basis, non-discriminatory and equally applicable for all imports, and if these relate to compliance with relevant national laws, one would be hesitant to call them protectionist measures. It is when these are applied on a discretionary basis and when the required standards are more stringent than national laws would be that these could perhaps be considered ‘NTBs’ in the strictest sense of the term.

6.3.2 Connectivity barriers as NTBs

Lack of physical, industrial, and communication infrastructure in the region has also contributed to restricted trade among countries. This could also be termed a NTB in the context of its broad definition. Kabir (2007) provides a summary of the key barriers to trade in this context. Air and maritime port facilities in South Asia are ranked as less competitive compared to East Asia. While it takes two hours to clear a vessel in

Table 6.1 Percentage share of NTBs to all NTBs by SAARC countries

Non-tariff measures	Share
SPS, TBT and other related measures	86.3
Tariff quota	9.8
Anti-dumping measures	7.4
Licence requirement	5.3
Countervailing measures	1.2

Source: ADB (2008)

Singapore and Laem Chabang, Thailand, it takes two to three days in Chittagong, Bangladesh, and at Delhi airport India, the average cargo dwell time is two and a half days. Some estimates have been made with regard to the magnitude of NTBs in the form of lack of connectivity and infrastructure. For example, the World Bank (2003) estimate savings in terms of transport costs from road to rail along the Kolkata–Kathmandu corridor at 22–33 per cent of road cost. UNESCAP (2003) estimates transit charges at 0.45 per cent of cost, insurance and freight (CIF) value for private cargo.

The United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) Nataraj (2007) also found that inter-South Asia disparity in infrastructure facilities has been on the rise in recent years. Additionally, progress on information technology is also considered to be as important as the development of physical infrastructure and is crucial for customs and standards harmonisation among countries of the region. This is lacking in South Asia.

Lack of border infrastructure and traffic planning is a major constraint to deepening trade relations in SAARC (Rahmatullah 2008). Most border crossings between South Asian countries are not designed to handle the volume of traffic that currently passes through them. This results in severe traffic congestion and delays in handling the shipments.

Land ports at the border have emerged as a major stumbling block for seamless movement across borders. As goods are required to be transshipped, precious time is wasted at the borders. About 90 per cent of the trade between India and Bangladesh is carried out through 17 land ports. These land ports do not have adequate storage facilities and godowns and warehouses for proper storage of goods. This leads to waste and pilferage. Often goods have to be offloaded at the border and are not allowed to be brought to warehouses inside the importing country. Because of increased trade volumes, storage dwell times have been on the rise at the ports where storage capacity tends to be highly inadequate. At the Petrapole–Benapole border, it takes more time to unload vehicles at the land ports than physical clearance time. All these factors undermine competitiveness and add to cost.

In some land ports there is also a lack of adequate human resources to deal with customs clearance work. Often, the officer is not appropriately trained and has to send documents to head office, which causes inordinate delay. Often, when goods are exported under preferential treatment, delays also occur because the customs

official at the border point does not have enough knowledge about tariff classification and is not adequately equipped to certify the authenticity of the certificates of origin. Many of the land customs offices lack testing and laboratory facilities at the border ports and have to send samples to relevant institutions that are situated far away. This is a common phenomenon in the case of Bangladesh's export of cement and fruit juice to the north east Indian markets. The absence of appropriate banking facilities (honouring letters of credit opened for trade) also delays trade transaction and discourages trade. At times NTBs are imposed as purely protectionist measures, as has been the case for the anti-dumping duty (ADD) imposed by India on imports of dry-cell batteries from Bangladesh. Whist the ADD was subsequently withdrawn (Box 6.1), the exporters had already incurred significant damage.

Trader practices also often create bottlenecks. Importers often do not submit the required clearance documents to customs on time. As a significant amount of time is required to collect the formidable array of supporting documents, importers use godowns at storage facilities while they deal with the required financial and documentation work involved. This is often the case because storage charges are relatively low. Hence, storage facilities are being used for purposes they were not designed for in the first place.

Lack of cross-border transport agreements also creates problems for the movement of goods. As a result of lack of through-transport movement, there are transport inefficiencies at the interface. As some of the recent reports (Rahmatullah 2008; FICCI 2010) point out, the SAARC countries have about 3.8 million km of road network, which accounts for about 10 per cent of the world's road networks; the railway networks spread over 77 thousand km (FICCI 2010). However, because of a lack of bilateral and multilateral road and rail transport agreements, the seamless movement of goods, road/rail vehicles and wages across borders is not possible – this is true for movement

Box 6.1 The ADD on Bangladesh's dry-cell battery

India started to impose ADD on the import of dry-cell batteries from Bangladesh from the mid-1990s. India's argument was that Bangladeshi exporters were exporting the items at prices that were below the cost of production in Bangladesh. Bangladesh argued that the ADD was an NTB to protect India's domestic producers. Several meetings took place between the two countries to resolve the dispute, which created a lot of resentment in Bangladesh, without any positive result. The issue was also raised several times in meetings of the CoE; however, the case could not be resolved and the ADD continued to be imposed for several years. In 2005 Bangladesh decided to go to the dispute settlement mechanism of the WTO, the first time any LDC had done so. Following due process, a panel was constituted to hear the case. Bangladesh built its case on the ground that the ADD was not in compliance with relevant WTO provisions. In the end, India decided not to contest the case and the ADD was withdrawn.

between Bangladesh and India and between India and Pakistan. Major obstacles here are the absence of protocols, lack of standardisation of technologies, operation and maintenance practices, incompatibility of rolling stock, load restrictions on bridges, and differences in rail gauges, braking systems and couplings. At present, there are also restrictions on the movement of goods from Nepal and Bhutan through India to Bangladesh that are destined for third-party countries. Although South Asia has 25 major ports and one of the largest water systems in the world, lack of capacities, and the absence of comprehensive protocols hinder the cross-border movement of goods. This lack of trade facilitation is a major non-tariff barrier (in the broad sense of the definition) that (a) limits scope of intra-regional trade and (b) results in costly transshipment. Discussions have been initiated, at bilateral levels, to address some of the attendant issues. Existing protocols are being reviewed to explore the possibility of expansion.⁷ In this regard, the positive role that information technology could play has been highlighted by some authors (Alburo 2010).

Some experts have argued that establishing SAARC regional rail. Networks will be the best way to move forward at this point of time. Addressing the attendant issues related to transport facilitation to stimulate trade among SAARC countries will require comprehensive negotiations between the member countries to identify the win-win options, which alone could lead to successful resolution of these NTBs. The recent visit of Bangladesh's Prime Minister to India and the communiqué resulting from the visit indicate some positive movement in this regard.

A careful review of the various NTBs faced by exporters in South Asia shows that the manifold and diversified NTBs that inform trade between SAARC countries could be categorised in the following broad areas *at the border* and *behind the border*. Broadly, these may be grouped into seven clusters: (a) NTBs related to SPS measures; (b) NTBs related to customs regulations; (c) NTBs related to TBT and environmental measures; (d) quantitative restrictions including bans; (e) border-crossing barriers; (e) labelling requirements; (f) rules of origin; and (g) visa requirements.

6.3.3 Current state of NTBs in Bangladesh and India

Information collated from UNCTAD Trade Analysis and Information System (TRAINS) Database gives an idea of the various types of NTBs that are in place in Bangladesh and India in the context of trade in particular items within the region.

NTBs in Bangladesh

Apart from the MFN duties, Bangladesh maintains a number of other duties on particular goods in the form of para-tariffs.⁸

Customs surcharges Supplementary taxes ranging from 15 per cent to 75 per cent are levied on the duty-paid value of goods, such as liquor, tobacco products, certain cosmetics, ceramic tiles, large engine automobiles, air conditioners, refrigerators and televisions.

Tax on transport facilities An infrastructure development surcharge of 3 per cent is levied on the assessable value of most imported goods. This has since been withdrawn.

Additional charges Import duty on gold in different forms is subject to specific duty at the rate of 'taka' (Tk) 300 per 'tola' (11.644 grams).

- A 1 per cent insurance fee and a 1 per cent landing charge are levied on the cost and freight (CFR) value of imported goods.
- An Import Registration Certificate assessed between Tk 500 and 5,000 is required from importers.
- Internal taxes and charges levied on imports.

General sales taxes A value-added tax (VAT) at the rate of 15 per cent is levied on all imports and domestically produced goods with the exception of selected items, including feed and medicines for poultry, dairy machinery, aircraft and spare parts, textile machinery, raw cotton, certain types of medical equipment, and items from small and cottage industries.

Internal taxes and charges levied on imports A fee of 1 per cent is levied on the value of imports to finance the pre-shipment inspections. In addition to the VAT levy, applicable supplementary duties ranging from 5 per cent to 270 per cent are levied on certain luxury products that include liquor, tobacco products, petroleum products, make-up materials, perfume, ceramic tiles, air-conditioners, refrigerators, televisions and motor vehicles.

Financial measures

- An advance payment for importation of specialised or capital goods requires the approval of the Bangladesh Bank.
- Only commercial banks and specialised financial institutions authorised by the Bangladesh Bank are allowed to trade in the foreign exchange market.
- Payment for imported goods to Bangladesh are financed either by the country's own resources, or from foreign aid, loans or by means of barter trade.
- Registered importers are allowed to import against Letter of Credit Authorisation Forms (LCAF) issued by authorised dealer banks.
- In general, payment against imports is permissible under irrevocable letters of credit.

Quality control measures Non-automatic licensing: as there is no import requirement for most goods, there is a registration requirement for importers by the Ministry of Commerce, the issuance of a prior permission for the importation of goods on the restricted list (controlled for religious, health or trade reasons, e.g. textiles and shrimps, raw sugar, milk foods, pork sausages), as the existence of authorised users to import certain restricted goods. For the importation of goods on the restricted list, a LCAF is needed. A clearance permit is required for the importation of the following goods: books, magazines, journals and periodicals; scientific and laboratory equipment against surrender of UNESCO coupons; plant and machinery of permissible specifications, new or not exceeding 12 years old; motor cars, new or not exceeding 5 years old; cargo or passenger vessels of steel or wooden body; plant or machinery for export-oriented industries, trawlers and other fishing vessels; imports of free samples,

advertising materials and gift items; imports of drugs and medicines (allopathic); and imports of capital machinery as a share of capital of the foreign shareholder.

Licence for specified use: a permission from the Director General, Narcotics Control Department, or others with permission from the same and the Ministry of Commerce allows foreign exchange earning hotels to import narcotics.

To ensure national security: a prior approval from the Chief Inspector of Explosives of the Ministry of Energy and Mineral Resources is required for the importation of explosives; and armaments are importable only by the government or by dealers approved by the government.

Prohibitions To control drug abuse: poppy seeds and dried 'posto dana', marijuana, opium and 'tendu' leaves are prohibited for importation.

To ensure human safety: there is an import prohibition on vessels more than 15 years old, motorbikes more than 3 years old, and single-phase electricity meters.

To ensure national security: importation of the following items is prohibited: maps, charts and globes indicating the territory of Bangladesh and not in conformity with government printed maps.

Prohibitions for purposes: an import ban is set on horror comics and obscene or subversive literature or materials, and used goods, including reconditioned office equipment, live pigs, pig and poultry fat, eggs, except hatching eggs, lard, lard and tallow oil, solid or semi-solid palm oil, raw sugar, un-denatured ethyl alcohol, denatured spirits of any strength, wine, artificial mustard oil, selected petroleum products, woven fabrics of silk or silk waste, pig hair, certain kinds of cloth, certain insecticides, nylon and polyethylene ropes, fishing nets, used or new rags.

Prohibitions with particular political objectives (embargo): import prohibition of goods originating from Israel and Serbia/Montenegro.

Monopolistic measures Compulsory national insurance: insurance for imports must be taken with the *Shadharan Bima Corporation* or any Bangladeshi insurance company.

Compulsory national transport: the Bangladesh Flag Vessels (Protection) Ordinance, 1982, ensures that at least 40 per cent of sea-borne cargo of imported goods is transported by national flag vessels.

NTBs in India

India maintains a large number of NTBs which impose additional burdens on importers. These constrain both intra-regional and extra-regional trade.⁹

Customs surcharges

- A special additional duty (SAD) introduced in the fiscal budget of 1998–99 is levied at the rate of 4 per cent on most imports, except duty-free ones.

- The 2004–05 Budget announced on 8 July 2004 a levy on imported goods of a 2 per cent education surcharge based on the CIF value with customs and excises taxes.

General sales taxes Levies of sales taxes ranging from 2 per cent to 20 per cent with permitted assessment of up to 4 per cent are set on textiles, sugar and tobacco products. In addition, as of 1 April 2005, a VAT levy at state level will be in effect, and the rate defined.

Internal taxes and charges levied on imports Domestic taxes, known as the central VATs, are assessed at the rates of 8 per cent, 16 per cent and 24 per cent on goods with some exceptions.

Price control measures Anti-dumping measures: imports of goods into India, valued at prices less than in the country of origin, are subject to anti-dumping measures laid in the Customs Tariff Act with a view to protecting domestic production.¹⁰

Finance measures Restrictive official foreign exchange allocation: the Indian currency, the rupee, is convertible on current account transactions as capital account transactions are carried out by foreign investors; however, Indian firms and individuals remain subject to capital account restrictions.

Regulations concerning terms of payment for imports: when imported machinery and capital goods require down payments exceeding US\$15,000, a bank guarantee from an international bank covering the advance remittance amount is required from importers.

6.3.4 NTBs in South Asia identified by nationally appropriate mitigation action (NAMA) working group

As was mentioned earlier in section 6.2.2, a special working group was constituted in the WTO to look into the NTB issues. The following NTBs were notified for Bangladesh, India, Pakistan and Sri Lanka.

Bangladesh:

- health, religious, environmental and balance of payment purposes;
- quantitative restriction;
- import through state-trading enterprises (salt);
- restricted port of entry;
- custom surcharges in the form of supplementary taxes.

India:

- tariff rate quotas;
- import through state trading enterprises;
- health and sanitary regulations (quarantine fees);

- restricted port of entry and inland customs port;
- anti-dumping and countervailing duties;
- customs valuation.

Pakistan:

- ban on imports from India of products not on the positive list of 771 items (corresponding to about 1,500 HS eight-digit lines);
- local content required in the auto industries.

Sri Lanka:

- import ban (tea and certain spices);
- import monopoly (wheat);
- health and sanitary regulations.

The general criterion of SAFTA rules of origin is change in tariff heading (CTH) +40 per cent value addition for non-LDCs and CTH +30 per cent value addition for LDCs. There is also a product-specific rule for 191 items where the general criteria does not apply. Under regional cumulation rules of the SAFTA, applicable rules relate to the provision of value addition criteria only. In this case, the regional value addition is 50 per cent, of which 20 per cent has to be in the final exporting country.

Two cases are presented here in Boxes 6.1 and 6.2 to provide an understanding about how NTBs were addressed in the context of bilateral trade between Bangladesh and India. In one case (that of dry cell batteries) the case was taken to the WTO dispute settlement mechanism, whilst in the other case (that of apparels) the NTBs could be resolved through discussion and negotiation.

The case of conflicts that arose with regard to Bangladesh's export of apparels to India under the special market access initiative may be mentioned in this connection. The case demonstrates how NTBs might creep in, even when there are good intentions, and could undermine the spirit of decisions taken at the political level.¹¹

Possible non-tariff barriers in service trade

Despite services not having been included in the SAFTA framework as yet, it is to be noted that at present SAARC members are moving forward in negotiating the SAARC Framework Agreement on Trade in Services (SAFAS), which will bring the services sector within the ambit of SAFTA. If and when the agreement is signed, exporters could face the following NTBs: limits on the total value of service transactions; limits on the number of service operations; limits on the number of natural persons to be employed necessary for the supply of a particular service; measures which force a service supplier to supply a service through a particular legal means; limits on the percentage share of a foreign investment, which may be accounted for by foreign shareholders into a telecommunication firm. Furthermore,

Box 6.2 India's offer of market access of apparel and NTBs

As was mentioned, India has kept apparel items in its sensitive list for LDCs, under the SAFTA. Later, in a welcome move in 2007, India offered to put in place a TRQ on apparel and decided to provide zero-tariff access to Bangladesh for 6 million (which subsequently was raised to 8 million) pieces of items of apparel. The preferential treatment was given exclusively to Bangladesh, on a bilateral basis. This was an extremely important and welcome initiative for Bangladesh, as apparel constitutes about 75 per cent of Bangladesh's global exports and it was felt that duty-free access would significantly enhance Bangladesh's export competitiveness of this item in the Indian market. Initially, the offer was subjected to a number of conditions: (a) 50 per cent of the fabrics had to be sourced from India; (b) the exports would be permitted through only certain land ports; and (c) Bangladesh will need to declare upfront, at HS six-digit level, the volume of export under specific tariff lines. In the end, following protracted discussions, India agreed to withdraw all pre-conditions and Bangladesh has been making good use of the duty-free market access offered by India. This case study serves as a good example of how the spirit of duty-free initiatives can be undermined by bureaucratic interventions.

in compliance with the scheduled specific commitments, there could be barriers in terms, limitations and conditions of market access; conditions and qualifications of national treatment; undertakings relating to additional commitments; the time frame for implementation of such commitments; and the date of entry into force of such commitments. Any future framework of dispute settlement will need to keep such possibilities in perspective. It will be advisable that these are kept in mind when SAFAS is negotiated.

6.4 Cross-country experience in resolving non-tariff barriers

A majority of RTAs have developed mechanisms to deal with the NTBs. Most RTAs have signed mutual recognition agreements whereby certification and laboratory tests, the standards of one country, are accepted at border points by other member countries. Such mutually beneficial arrangements were found to be a good modality to address concerns of RTA member countries with regard to compliance with measures against SPS and TBT.

ASEAN, for example, has signed an agreement on the general framework of a process by which NTBs would be addressed, and subsequently eliminated. The process involves (a) verification of information on NTBs, (b) prioritisation of products/NTBs, (c) developing specific work programmes and (d) obtaining a mandate from the ASEAN economic ministers to implement the work programme.

Member countries are now in the process of verifying the list of NTBs and products covered by these measures compiled by the ASEAN Secretariat. Several criteria have

been considered by the Interim Technical Working Group (ITWG) on Common Effective Preferential Tariff (CEPT) for the ASEAN Free Trade Agreement, with a view to identifying which products/measures have to be dealt with first. These criteria would be used individually or in combination with each other in order to set priorities. These criteria are, in order of importance: (a) number of private sector complaints, (b) difference between domestic and world prices and (c) trade value. The *first criterion* would rely on the private sector's or exporters' complaints, as they are in a better position to tell how different measures existing in the country of destination act as a trade barrier. The *second criterion* relates to the price divergence between domestic and global prices. The price gap provides an indication of how much trade is hindered, for if there are no trade barriers, imports tend to narrow down and eliminate the price differences. However, finding appropriate price data to make this type of comparison has not been easy. The *trade value criterion* prioritises those NTBs/products which are traded most widely (both within and outside the region). The fact that the ASEAN Secretariat has this information certainly helps. However, it is not easy to prove whether or not NTBs present in the sector hamper trade. If there is an extensive trade in a particular item, this may indicate that the NTB is not an important hindrance to trade; on the other hand, if that is not the case, the NTB could be identified as a major constraint. The criteria may not be mutually exclusive and could also be used jointly. Indeed, where all three criteria converge, they should give a robust indicator of the degree to which NTBs exist in that product or sector and appropriate actions may be initiated depending on this. That is what ASEAN is doing.

6.4.1 NAFTA dispute settlement (NTB) mechanism

The North American Free Trade Agreement (NAFTA) Secretariat deals with complaints regarding NTBs under Chapter 19 and Chapter 20 of the NAFTA. Chapter 19 provides for a system of binational panel review of decisions by a party authority on anti-dumping and countervailing duty matters. Article 1903 provides that a party may request that amendments to the other party's anti-dumping or countervailing duties statutes be referred to a bi-national panel for a declaratory opinion on whether the amendment is consistent with the General Agreement on Tariffs and Trade and the NAFTA. Bi-national panels comprise of five independent experts.

In Chapter 20, process is 'applicable to all disputes regarding the interpretation of application of the NAFTA' and 'intended to resolve disputes by agreement, if at all possible' (NAFTA n.d.). The process begins with government-to-government consultations, can proceed to a meeting of the ministerial level Free Trade Commission, and then finally move to the creation of a five-member arbitral panel. Panel rules are designed to result in final panel decisions within 315 days of the date on which a request for a panel is made. Within the 315-day period, strict deadlines have been established relating to the selection of panel members, filing of briefs and reply briefs, and the setting of the date for Oral Argument. In the event of failure to comply with decisions of a bi-national panel on statutory amendments, the complaining state is free to adopt comparable legislation or equivalent executive action to the violating amendments, or even withdraw from NAFTA (NAFTA n.d.).

Chapter 20 also provides for scientific review boards, which may be selected by a panel in consultation with the disputing party, to provide a written report on any factual issue concerning environmental, health, safety or other scientific matters to assist panels in rendering their decisions. Moreover, a third party that believes it has a substantial interest in a disputed matter is entitled to join consultations or a proceeding as a complaining party on written notice.

6.4.2 NAMA dispute settlement proposal (NAMA 11)

NAMA Dispute Settlement Proposal (NAMA 11) stipulates that the aim of the dispute settlement mechanism is to secure a positive solution to a dispute. A solution mutually acceptable to the concerned parties and which is consistent with the covered agreements is to be preferred. In the absence of a mutually agreed solution, the first objective of the dispute settlement mechanism is usually to secure withdrawal of the measures concerned if these are found to be inconsistent with the provisions of any of the covered agreements (Article 3.7). It is understood that requests for conciliation and the use of the dispute settlement procedures should not be intended or considered as contentious acts and that, if a dispute arises, all members will engage in these procedures in good faith in an effort to resolve the dispute (Article 3.10). The proposal also mentions that during consultations members should give special attention to the particular problems and interests of developing country members (Article 4.10).

6.4.3 European Commission dispute settlement proposal

The EU currently follows the WTO dispute settlement mechanism to deal with NTBs. According to the EU Trade Commission, the following recommendations have been made to strengthen the process:

- a. The introduction of a system of more permanent panellists.
- b. The clarification of the dispute settlement understanding provisions on implementation, covering notably:
 - i. the sequencing issue (that is, the steps which need to be taken, and their order, before determining that the losing party has not complied correctly with the dispute settlement body recommendations and reacting accordingly);
 - ii. the arbitration procedure on the level of suspension of concessions;
 - iii. the establishment of a procedure to lift suspension of concessions once a losing party has implemented changes.
- c. The improvement of the provisions on trade compensation to make it a more attractive option before moving on to suspension of concessions and for speeding up the process whenever this is feasible and justified.
- d. Greater transparency to secure continued public support and confidence in the WTO system, while preserving its inter-governmental character.

A number of RTAs have developed mechanisms for the assessment of equivalence of qualification, licensing and other requirement-related regulations with a view to improving the market. The EU, North American Free Trade Agreement (NAFTA) and Trans-Tasman Mutual Recognition Arrangement (TTMRA) between Australia and New Zealand are some of the RTAs that have done so.

Approaches to mutual recognition and coverage of mutual recognition agreements (MRAs) could vary significantly. Two basic approaches have been suggested as the basis for mutual recognition. The so-called *vertical approach* argues recognition to be provided on a profession-by-profession basis, and as a result of the harmonisation or co-ordination among the parties to an MRA with regard to education and training being required by each profession (harmonisation-based approach) (Zarrilli 2005). The horizontal approach, on the other hand, allows for mutual recognition to be provided without prior harmonisation of curricula and training requirements, on the basis of a broad equivalence of qualifications (equivalence-based approach). While the vertical approach normally leads to unconditional market access, Zarrilli argues that the process is a long and laborious one and usually requires significant time and effort. On the other hand, compared with the vertical approach, the horizontal approach leads to much faster and concrete results. Thanks to this, more and more countries are relying on it as the basis for their MRAs. Since the establishment of equivalence with respect to qualification, licensing and standard requirements vary from country to country. South Asian countries would be well advised to follow the horizontal approach. A proposal in this vein has been submitted by India and is under consideration by the CoE.

6.5 Dispute settlement mechanisms in SAFTA and its efficacy: SAFTA committee of experts

As noted, the CoE, with government officials of the SAARC countries as its members, is the body that has been entrusted to deal with non-tariff-related issues and complaints.¹² The SAFTA CoE deals with notifications and responses with regard to NTBs. To begin with, the contracting state notifies the SAARC Secretariat about all its non-tariff and para-tariff measures to trade on an annual basis. The measures are then reviewed by the CoE, established under Article 10, in its regular meetings to examine their compatibility with relevant WTO provisions. The CoE then recommends elimination or implementation of the measure in the least trade-restrictive manner in order to facilitate intra-SAARC trade.

In view of the importance of the attendant issue, successive high-level meetings, both at ministerial and summit levels, have put emphasis on a co-ordinated and structured response to address non-tariff and para-tariff measures that impede and discourage intra-SAARC trade. The sub-group on non-trade measures, which was constituted at the first meeting of the SAFTA-CoE in April 2006, asked all member countries to notify the CoE about the NTMs they were facing whilst exporting to SAARC partner countries. Member countries, in response, notified of NTMs/para-tariff measures (PTMs) faced by their exporters in their intra-regional trade. The sub-group in its

fourth meeting identified the notifications under six broad headings: (a) sanitary and phytosanitary measures, (b) technical barriers to trade, (c) para-tariff measures, (d) trade facilitation measures relating to infrastructure, procedures, transparency, standards and testing, (e) customs rules and procedures and (f) others. It was decided that individual SAARC member countries would examine all notifications addressed to it by their partner countries to decide whether those NTBs met the basic principles of the WTO relating to non-discrimination and national treatment and whether their application had been made in a trade-friendly manner. It was decided that the fifth meeting of the SAFTA-CoE would review the responses to the notifications and identify the way forward.

A careful examination of the detailed list of notifications and responses of partner countries indicates that all member countries have tried to justify themselves on the grounds that measures taken by them did not violate national treatment and non-discrimination principles of the WTO and that these measures originated from health-hygiene and other admissible concerns.

Each of the three countries, Bangladesh, Pakistan and India had submitted detailed lists of NTBs that they perceived in the other two partner countries, at and beyond the border. A close examination of the submissions and responses indicates that NTBs have been interpreted by member countries from the perspective of a very broad definition of barriers to trade. Relevant documents reveal some interesting patterns.

The complaints regarding the submissions mainly relate to (a) market access difficulties faced on account of requirements relating to SPS-TBT, certification, labelling, registration, laboratory testing and standardisation in place in partner countries; (b) difficulties faced in partner countries due to infrastructural constraints that impede cross-border movement of goods from the exporting countries (lack of infrastructure, low handling capacity, lack of warehouse facilities, etc.); (c) imposition of para-tariffs, surcharges, cess, VAT, sales tax and other duties beyond MFN tariffs; (d) requirements of licences and permits from importing countries; (e) anti-dumping and countervailing measures; (f) interpretation of rules of origin; and (g) lack of availability of adequate letters of credit facilities and necessary financial intermediation.

What is perhaps not surprising is that, as a reporting country, (exporting) members have given generous interpretations of the NTB-related difficulties faced in trading with (importing) partners, but in submitting their own responses the same partners have attempted to justify similar types of NTB/NTM in place in their own countries. The responses have tended to argue that their own NTB/NTMs should not be interpreted as such because: (a) SPS-TBT and other related complaints actually should not be perceived as NTBs/NTMs, as these have been put in place to ensure compliance with national relevant standards, rules and regulations; (b) measures perceived as NTBs/NTMs are of MFN nature and are not directed at specific countries; (c) these measures are WTO-compatible; (d) some of the measures relate to security concerns; (e) partner countries have also imposed similar barriers; and (f) lack of domestic capacity to develop necessary infrastructure has led to infrastructure-related constraints in importing countries. In only a few cases did the

partner country, in response, mention that they are taking steps to address particular complaints (building of infrastructure) or that relevant authorities (often central banks) have been asked to provide clarification as to the complaint. Thus, in spite of the best efforts of the CoE to resolve the existing NTB-related issues, much remains to be done in actually resolving the outstanding issues.

Indeed, it is understood that at the meeting of the CoE it was pointed out that submission of responses and counter-responses may not be very helpful in terms of leading to resolution of issues related to NTMs/PTMs. Rather, efforts should be made to list NTMs/PTMs which are trade restrictive as per relevant WTO provisions. The sub-group of the CoE was asked to clarify whether notified NTMs/PTMs fall into any of the following categories: (a) SPS; (b) TBT; (c) para-tariff measures; (d) trade facilitation measures relating to infrastructure, procedures, transparency standards and testing; (e) customs rules and procedures; and (f) others. The idea is to take it from there, by identifying WTO-compatible barriers and WTO-incompatible barriers, and then proposing measures to address the attendant concerns.

Whilst member countries could go on arguing whether what they were facing were NTBs or not and whether those were WTO-inconsistent or not, the fact of the matter is that intra-regional trade flow continues to be significantly constrained because of the 'real' or 'perceived' NTBs. The task is to take concrete initiatives to address the attendant concerns, in a positive manner, through constructive engagements at various levels. As would appear from the above discussion, initiatives will need to be taken in three broad areas: harmonisation of customs policies and procedures, capacity building in compliance-related areas and improving trade facilitation at border points.

Developing MRAs is also critical in the area of trade in services, which is envisaged to be the next phase of SAFTA. Of particular relevance in this context will be trade in services with regard to Mode 4 (Movement of Natural Persons) under the General Agreement on Trade in Services (GATS). Lack of recognition of qualifications, skills or experience is one of the most common barriers affecting Mode 4 (Chanda 2005). It either denies market access altogether to foreign service providers or induces such suppliers to perform at a capacity that is below their level of qualification (academic or otherwise). These problems will need to be dealt with in the course of SAFAS negotiation.

6.6 Policy initiative to address the NTBs

NTBs have not only severely restrained the potential opportunities of trade expansion among SAARC countries, the related issues have often been politicised in a manner that has severely undermined the overall spirit of co-operation among the member countries. As the discussion above would indicate, in spite of efforts at various levels to deal with the related issues, much more needs to be done by way of concrete measures. This is not to deny the fact that some positive movements have taken place in terms of addressing the attendant problem within the SAARC institutional framework. However, the need of the hour is to build on the progress made thus far,

and move forward at a faster pace. The following sections focus on a number of steps and initiatives that are required to address the concerns that were identified in the preceding sections, based on the experience of addressing the NTB-related issues in other, more advanced, regional trading arrangements.

General principles: SAARC members should work towards some general principles with regard to NTMs/PTMs. In general, the principle should be that NTMs/PTMs that have not been notified to the WTO, and hence are unlikely to be admissible if contested in the WTO dispute settlement body, should not be imposed in the case of intra-regional trade. If a new NTM/PTM is to be introduced, member countries should be given prior notification for examination and preparation. The principle of MFN and national treatment should be guaranteed in all intra-SAARC trade transactions. An agreement may be made to the effect that value of all imported products would be ascertained on the basis of a customs valuation assessment (CVA) of the WTO.

Strengthening SPS-TBT related capacities: As is evident from the aforesaid discussion, a majority of the NTBs relate to such areas as certification, testing and SPS-TBT compliance. A practical way of resolving this, which also has been floated during SAARC meetings at various levels, is to (a) strengthen national capacities in relevant areas through capacity building of standardisation institutions and (b) putting in place mutual recognition agreements (MRAs) whereby certificates issued by standardisation/accreditation institutions of one country will be accepted by those of another country. Indeed India made an offer in the fourth meeting of SAFTA sub-group on NTMs to assist LDCs to develop the required capacities in the areas of standards, technical and human resources. The need to address NTBs inhibiting Indo-Bangladesh bilateral trade was also highlighted at the highest policy level (Indo-Bangladesh Communiqué 2010). These are to be provided on the basis of specific requests from member states. India has started to provide some technical assistance towards the strengthening of the Bangladesh Standards and Testing Institution (BSTI). The decision to establish the South Asian Regional Standards Organisation (SARSO) in Dhaka is also a step in the right direction. SARSO is expected to provide assistance in areas of national capacity building in standardisation related areas. SARSO could also play a critical role in ensuring the evolution of common standards in various SPS-TBT, certification, testing-related areas and could also play an important role in facilitating the MRAs.

Dispute settlement mechanism: A workable dispute settlement mechanism is important to resolve conflicts relating to NTBs in trade among SAARC members. As was mentioned earlier, until now the CoE has served as the dispute settlement authority in the SAARC. Whilst the CoE has been trying to address the NTB-related disputes and issues as best it can, the fact remains that it is an ad hoc body, which is able to sit only periodically and does not have enough power to follow-up with the decisions. In view of this there is a need for a more institutionalised approach to deal with the NTB issues in SAARC. Experience of other RTAs, such as ASEAN, NAFTA and the EU, may be studied thoroughly to come up with an acceptable structure for SAARC in this context. The SAARC Secretariat could take the lead in this respect by (a) introducing a system

of permanent panellists; (b) putting in place a transparent system of arbitration; and (c) introducing transparent procedures for lodging complaints and getting remedies.

Establishment of accreditation agencies: In order to ensure that certificates issued by relevant agencies in one country are accepted by another country, appropriate accreditation institutions will need to be developed. These agencies will be required to have the necessary competence in relevant areas. These could play an important role in resolving many of the compliance-related concerns. Governments should provide incentives so that such accreditation institutions are set up in the private sector. In a good move, an SAARC Arbitration Council has been set up for which nominations have been submitted by member countries for the governing board. Some of the administrative and financial matters have been addressed and the progress was reported in the first meeting of the Council held in January 2009. What will be required now is to ensure that the Council has the required capacity and logistical support to deal with disputes as and when these appear. It is perceived that the Council could serve as a clearing house of disputes and that it could help stimulate trade by guaranteeing that trade is not disrupted until the Council gives a verdict with regard to the dispute being arbitrated by the Council. An effective arbitration Council could play an important role in resolving NTBs, such as ADDs and CVDs. If the Council is vested with appropriate authority and capacity, it could rule whether the specific NTB is WTO-compatible or not. The Council could also suggest ways so that damage to the aggrieved parties is kept at the minimum.

SAARC standards co-ordination body: As varying standards in the SAARC countries are one of the major reasons disputes arise in the first place, it is a welcome initiative that the SAARC has constituted a *Standards Coordination Board*. The board has already met several times. The board has finalised the statutes and bylaws of SARSO to be headquartered in Dhaka. The board has also identified an initial list of products for which work has commenced with regard to harmonisation of standards among countries of the region.¹³ The important task at hand now is to build the infrastructure of SARSO as speedily as possible and to organise the appropriate human resources for SARSO, which then can take on the task of harmonisation of standards encompassing all tradeable goods in SAARC.

Customs co-operation: A frequent reason for disputes during cross-border movement of goods is bottlenecks at customs points. Often disputes arise because of interpretations of tariff lines and whether particular products belong to a particular tariff line. Often exporting country officials are keen to put the item under a tariff line that enjoys preferential treatment, whilst importing country officials would try to put it under a line with MFN duties, particularly when there is an interpretation ambiguity with regard to the item. In recent times, some initiatives have been taken towards customs co-operation among SAARC countries. An SAARC *Agreement on Mutual Administrative Assistance in Customs Matters* was finalised by the sub-group on customs co-operation.¹⁴ The focus of attention here should be on capacity building, harmonisation of HS eight-digit tariff lines at among member countries, customs clearing procedures and facilitation for movement of consignments traded under SAFTA. The task now is to expedite this entire spectrum of exercise. In this context, speedy completion of the harmonisation

and computerisation of the customs clearance process at border points and ports should be given priority so that disputes, particularly at land customs stations, can be reduced. It is to be noted here that four of the seventeen land customs stations in Bangladesh have been placed under private sector management contract. There is a need for public–private partnership initiatives in this context.

Dealing with para-tariffs: Indeed, the practice of some countries in various RTAs to determine assessable values of imported items by fixing a certain percentage of abatement on retail sales or on the basis of pre-fixed tariff value, often give rise to disputes among member countries. In countries with a federal structure, such as India, disputes often arise because exports which enter the border at zero-tariff are subjected to state-level taxes.¹⁵ Whilst, such ‘para-tariffs’ can hardly be contested,¹⁶ per se, member countries could think about coming to an agreement in terms of not imposing any para-tariffs/surcharges in intra-regional trade.

Reducing sensitive lists: As the sensitive lists of individual SAARC countries tend to be long, and often disputes arise as to whether or not an item (at the disaggregated HS eight-digit tariff line) should be accorded preferential treatment under SAFTA (the positive or residual list) or whether it belongs to the sensitive list, one way of resolving such disputes is to have an agreement towards an accelerated reduction of the sensitive list. Already, India has taken some positive steps in this regard and other members could also think of fixing definitive timelines.¹⁷

Mutual recognition agreements: One key factor to resolve disputes with regard to SPS-TBT standards is to go for (a) signing MRAs with regards to certification, technical regulations, testing, etc.,¹⁸ and (b) putting in place the required capacities in this respect. Indeed, India has offered to provide technical assistance in building and strengthening the capacity of SAARC LDCs in compliance-related areas.¹⁹ However, given the importance of the issue and the need to take urgent initiative in this area, member countries (particularly LDCs) should also seek support from other potential donors including the EU, which has extensive trade-related capacity-building support programmes in place for LDCs.

Addressing infrastructure-related trade-facilitation bottlenecks: The most often-mentioned NTBs relate to the lack of trade facilitation at border points. The bottlenecks come in various shapes. The issue of addressing the ‘soft ones’ (customs valuation, tariff harmonisation, computerisation, etc.) has already been mentioned. However, what hinders cross-border movement of goods, to a large extent, is the absence of physical infrastructure at border points. Some of these relate to conscious policy choices (e.g. when a country would not allow unloading of imports at its ware houses, which then has to be done at the border) or by default (when appropriate facilities, such as testing laboratories, warehouses, etc., are not there). Whilst ensuring seamless movement through regional connectivity and multi-modal transport facility is the long-term solution, from a short- to medium-term perspective there is an urgent need to build the necessary border infrastructure to facilitate cross-border movement of goods. Co-ordination among partner countries in terms of the development of infrastructure facilities is also critical in addressing these issues.²⁰

Services trade and NTBs: The World Bank (1977) provides a number of guidelines for MRAs in selected services which could serve as guiding principles for similar initiatives in the SAARC. With regard to services trade, Chanda suggests that any progress on the issue of recognition requires initiatives to be taken simultaneously at three levels (Chanda 2005). The first is to improve the framework for MRAs. The second is to address more broadly the entire concept of recognition, such as the assessment of competence and determination of equivalence. The third is to address the operational difficulties facing the South Asian countries in negotiating recognition agreements, given institutional, technical, and financial constraints, and Mode 4 GATS interests that tend to fall outside the purview of most MRAs. However, the most common way to achieve recognition has been through bilateral agreements. Article VII of the GATS recognises this as permissible. There are differences in education and examination standards, experience requirements, regulatory influence and various other matters, all of which make implementing recognition on a multilateral basis extremely difficult. In this regard, it has been suggested that bilateral negotiations will enable those involved to focus on the key issues related to their two environments (WTO 1997). WTO further suggests, once bilateral agreements have been achieved, this can lead to other bilateral agreements, which will ultimately extend mutual recognition more broadly (WTO 1997). Zerrilli (2005), for example, cites the case of Mercosur (Mercado Común del Sur or Southern Common Market), an RTA that includes several South American countries, where accredited degrees are recognised by member countries which makes it possible for professionals to move around the region.

6.7 Concluding remarks

NTBs are often cited as stumbling blocs to deepening regional integration among the countries of the SAARC. In the preceding sections an attempt has been made to situate the discussion on NTBs in South Asia in the context of cross-country experiences, and to put forward recommendations based on best practices available with various RTAs. There is now a growing recognition among SAARC member countries that NTBs not only constrain trade expansion within the region, but also add tensions to bilateral relations that go beyond trade and commercial aspects of the relationships. It is, thus, critically important that SAARC members start to apply their collective wisdom to address the attendant issues, taking a long-term view.

As the study has pointed out, this will need policy initiatives on a number of fronts. First, as the discussion shows, in many RTAs some categories of NTBs, particularly those related to SPS and TBT and health and hygiene concerns, were successfully dealt with by putting in place appropriate capacities and institutional mechanisms. SAARC should deal with these NTBs in a similar fashion by strengthening the domestic capacities of member countries to ensure compliance in the aforesaid areas and by signing MRAs. Second, there is a need for putting in place a mechanism in the SAARC Secretariat for the arbitration of NTB-related disputes which would have transparent procedures for selection of panellists, submission of complaints, appeal, remedy and sanctions. Third, as discussed, many NTBs arise from ambiguities with regard to customs procedures, lack of customs harmonisation and also because of

various para-tariffs and surcharges in place. The best solution, as has been found with many RTAs, is a move towards graduation to customs unions. Whilst this can be seen as a medium-term solution, individual SAARC member countries in the meantime could address such 'perceived NTBs' by gradually moving towards a unified customs code that does away with most para-tariffs and surcharges. Fourth, investment in trade facilitation has come out to be a key factor in addressing NTBs in South Asia. Indeed, initiatives in the form of development of infrastructure both at and behind the border, better connectivity and putting in place the required protocols have emerged as one of the most effective means of removing NTBs in the South Asian context.

If the SAARC member countries are to succeed in enhancing intra-regional trade, they will need to get on with the attendant tasks on an urgent basis.

Notes

- 1 This was mainly done through a *positive list approach* where particular sectors/items were identified for preferential treatment, with the preference margin ranging from 10–100 per cent of the MFN applicable duties.
- 2 Member countries were to have two negative lists: one for LDCs (shorter) and another for the developing country members. However, not all countries have come up with two lists.
- 3 The three developing SAARC members are India, Pakistan and Sri Lanka and the LDC members are Bangladesh, Nepal, Bhutan and Maldives, which were joined recently by Afghanistan.
- 4 It may be noted here that in a welcome move India, the dominant trading partner in the SAARC, has offered to accelerate the reduction of its negative list through periodic reviews. India has taken out 264 items from its negative list, which now stands at 480 items. In addition India has also allowed TRQs for 164 items (8 million pieces of apparel) to Bangladesh on an autonomous basis. It is also to be noted that India has agreed to take out an additional 47 items from the negative list. However, items on this list are yet to be made known.
- 5 It is to be reckoned that a significant volume of trade in SAARC is conducted through informal channels. Whilst recent data on informal trade is not available, studies conducted in the mid-1990s put the ratio between formal and informal trade to be 1:1.2.
- 6 It may be noted here that trade flows among India, Pakistan, Bangladesh and Sri Lanka account for about 95 per cent of intra-South Asia trade for the SAARC members.
- 7 For example, under a bilateral water protocol signed between Bangladesh and India, Bangladesh allows India to transport goods by waterways to certain ports in Bangladesh. There have been talks between these countries with regard to access of Nepal and Bhutan to global markets through India and allowing India limited connectivity to the north east by extending the remit of the current protocol.
- 8 The items tend to vary from budget to budget.
- 9 Here also the type of items falling under NTBs and the depth of incidence has varied from one budget to another.
- 10 The following anti-dumping measures are in force against the following products: acrylic fibres on 18 July 2000, analgin on 8 October 2001, potassium permanganate on 1 November 2001, paracetamol on 27 March 2002, sodium nitrite on 29 November 2002, caustic soda on 14 November 2003 and green veneer tape on 9 February 2004.
- 11 It is to be noted that the EU also expressed its intention to join the case as an interested party.
- 12 The CoE was constituted as per Article 10 of the SAFTA Agreement. The CoE is mandated to review all NTBs and NTMs and to recommend elimination or implementation of measures in the least trade restrictive manner to facilitate intra-SAARC trade.
- 13 These include cement, sugar, biscuits, skimmed milk powder, vegetable, textile fabrics, jute, etc.
- 14 This was done during the Thirteenth SAARC Summit in Dhaka in November 2005. The Agreement has been ratified by all countries.

- 15 For example, in India there are state taxes, cess (at 4%), etc.
- 16 Member countries (in this case, for example, India) argue that items coming from other states, when they enter the particular state, have to pay similar duties.
- 17 India carried out a review of its negative list in April 2008 (after two years of SAFTA, although the agreement stipulates a review in at least every three years. The number of items in India's negative list was reduced from 744 to 480 (as a result of exclusion of 264 items from the negative list). Moreover, through a bilateral memorandum of understanding India has given a TRQ to 164 items of apparels export from Bangladesh.
- 18 Indeed, India has offered, and Bangladesh has accepted, the signing of a framework agreement on mutual recognition.
- 19 India is providing assistance in strengthening the capacity of the BSTI in certain areas.
- 20 This is important in view of the fact that, in the past, it has been seen that countries have developed border facilities, particularly land ports, in such a manner that port infrastructure and trade facilitation measures have been developed on one side of the border, whilst the developments have taken place on the other side of the border in another land port. Such disjointed developments have tended to restrict the potential benefits to be accrued from improvements at border crossing points.

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Chapter 7

Dealing with Non-tariff Barriers in South Asia

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7.1 Introduction

There is considerable heterogeneity across South Asian countries in terms of the extent to which they trade and the relative importance of trade in goods and services. Information on trade in services is simply not available for countries such as Afghanistan and Bhutan. Among others, Pakistan has the lowest level of trade as a share of GDP in the region: exports of goods and services comprise just 13 per cent of GDP. Bangladesh, Sri Lanka and India each have a share of trade in goods and services of around 20 per cent of GDP, with trade in services accounting for 13 per cent of GDP in India compared with just 6 per cent in Bangladesh and 11 per cent in Sri Lanka. The smallest economies of the South Asian region – Afghanistan, Bhutan and Nepal – which are also landlocked, in general have higher shares of trade as a percentage of GDP. This is also the case for the island states of Maldives and Sri Lanka.

Non-tariff barriers (NTBs) constrain intra-regional trade in South Asia. Table 7.1 summarises some of the main regional trade agreements (RTAs) and preferential trade agreements (PTAs) in the region and their definitions of non-tariff measures (NTMs), NTBs and related commitments. Not all agreements explicitly define NTBs or provide for the institutional arrangements to assist members in the harmonisation of NTMs and mutual recognition of standards. In some cases, the distinction between the two is not clear, as in the South Asian Free Trade Area (SAFTA). In other cases, NTBs are not defined but a number of commitments are made to address them, as in the Association of South East Asian Nations (ASEAN)–India Free Trade Agreement (AIFTA). Ambiguity in some of the agreements should be a cause for concern because it obscures the fact that some NTMs may be used for legitimate public policy objectives. Making the distinction between the intent and the impact of an NTM is crucial to determining the extent to which legitimate measures may serve as unnecessarily restrictive barriers to trade. That is, when an NTM serves as an NTB.

In some cases, progress on the reduction and harmonisation of tariff and non-tariff measures appears to have stalled (e.g. the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation, BIMSTEC). In other cases, deeper PTAs have been signed with countries outside the South Asian Association for Regional Cooperation (SAARC) rather than within it, such as the India–Singapore Comprehensive Economic Partnership Arrangement (CEPA), which specifies detailed procedural arrangements related to the mutual recognition of standards, the designation of conformity assessors and apex chambers. There are no binding commitments on the removal of NTBs in SAFTA and much remains to be done to harmonise NTMs

Table 7.1 Definitions of NTB and NTMs used in RTAs and PTAs in the South Asia region

Agreement	Definitions of NTMs and NTBs	Commitments on NTMs and NTBs
SAFTA	NTMs include any measure, regulation or practice other than 'tariffs' and 'para-tariffs'. Para-tariffs mean border charges and fees, other than tariffs, on foreign trade transactions of a tariff-like effect which are levied solely on imports, but not indirect taxes and charges, which are levied in the same manner on like domestic products.	Requires the elimination of tariffs, para-tariffs and non-tariff restrictions on the movement of goods, and any other equivalent measures, in addition to the adoption of trade facilitation and other measures and the progressive harmonisation of legislations by the Contracting States in the relevant areas.
Pakistan–Sri Lanka Free Trade Agreement (PSFTA)	NTM means any measures, regulation, or practice, other than 'tariffs' and 'para-tariffs'; the effect of which is to restrict imports, or to significantly distort trade within the Contracting Parties. 'Para-tariffs' mean border charges and fees, other than 'tariffs', on foreign trade transactions of a tariff-like effect which are levied solely on imports, but not those indirect taxes and charges, which are levied in the same manner on like domestic products.	Article III is on the elimination of para-tariffs and NTBs. The Contracting Parties further agree to eliminate from the date the Agreement enters into force, all NTBs, and any other equivalent measures on the movement of goods and services, other than those imposed in accordance with Article IV of the Agreement. The Contracting Parties also agree not to make any increase in the existing para-tariffs, if any, or introduce new or additional para-tariffs without mutual consent.
India–Sri Lanka Free Trade Agreement (ISFTA)	In this Agreement there is no specific reference to NTBs beyond general agreement to remove barriers that inhibit trade. Only tariffs are defined – there is no mention of para-tariffs.	The objectives of the Agreement include the removal of barriers to trade, harmonious development and expansion of world trade.

(continued)

Table 7.1 Definitions of NTB and NTMs used in RTAs and PTAs in the South Asia region (continued)

Agreement	Definitions of NTMs and NTBs	Commitments on NTMs and NTBs
AIFTA	Not defined	Article 8 on non-tariff measures states that Parties shall not institute or maintain any NTM on the importation of goods from the other parties or on the exportation or sale for export of goods destined for the territory of the other Parties, except in accordance with its WTO rights and obligations or other provisions in this Agreement. Each party will ensure the transparency of its NTMs allowed under subparagraph (a) and their full compliance with its obligations under the WTO Agreement with a view to minimising possible distortions to trade to the maximum extent possible.
BIMSTEC	Not defined	Under Article 2, Measures for a Comprehensive Free Trade Agreement, the parties agree to the progressive elimination of tariffs and NTBs substantially in all trade in goods, as well as to the establishing of facilitative measures including, but not limited to, the simplification of customs procedures and the development of mutual recognition arrangements.
India–Singapore Comprehensive Economic Partnership Agreement (ISCEPA)	Not defined	Article 2.5 on non-tariff measures states that neither party shall adopt or maintain any non-tariff measure on the importation of any goods of the other party or on the exportation of any goods destined for the territory of the other party, except in accordance with its WTO rights and obligations or in accordance with other provisions of the Agreement. Moreover, that each party shall ensure that such measures are not prepared, adopted or applied with a view to, or with the effect of, creating unnecessary obstacles to trade between Parties.

in the region so as to ensure that legitimate measures are implemented in the least trade-restrictive manner, as well as to supervise the removal of para-tariffs.

By drawing on the experiences in other regions, this chapter discusses how South Asia can alleviate NTBs in the region. Section 7.2 provides an overview of these barriers to trade in the region. Section 7.3 presents the models for monitoring and surveillance of NTBs. Section 7.4 discusses issues relating to conforming to regulations and standards. Section 7.5 draws on examples to discuss measures to upgrade producers to meet standards. Section 7.6 discusses the interrelationship between monitoring NTBs and dispute settlement mechanisms. Section 7.7 concludes the chapter by highlighting the key issues.

7.2 Significant barriers to trade

Analysis of reported NTBs to the United Nations Conference on Trade and Development (UNCTAD) Trade Analysis and Information System (TRAINS) database across countries within South Asia suggests that most measures fall into the category of price and quantity control measures, which would include such practices as non-automatic licensing, as well as price setting and interventions in food and commodity markets. These main categories are followed by monopolistic measures and technical measures, more broadly.² The difference in exposure to product specific NTBs will depend on the export basket of each trading partner. However, there may also be differences in the ability of producers in each country to adapt to the measure imposed.

Qualitative analysis of NTB peaks and troughs across the Harmonized System (HS) six-digit level for India's imports suggest that many more South Asian countries are subject to a low rather than a high number of NTBs when importing into India. Nepal is the only South Asian import partner to feature as a top import partner across those products most susceptible to NTBs (up to 12) for the following product lines: wheat and meslin products (HS 1001.90) and soya beans (HS 1201.00). Analysis of all imports, from other South Asian partners, that fall within a HS six-digit category subject to between 8 and 12 NTBs shows that Pakistan is the largest source of imports, in terms of value, followed by Afghanistan, Bhutan and Nepal. The products most susceptible to NTB peaks appear to fall within HS Chapters 70, 80 and 90. In the case of Sri Lanka, only India features as a top five import partner for those products most susceptible to NTBs at the HS six-digit level (up to ten). The results from this type of qualitative analysis suggest that, the higher the number of NTBs, the more challenging it is to enter the Indian and Sri Lankan market for exporters from South Asia.

7.2.1 Choosing priorities

There is a clear need for improvements in monitoring, reporting and notifying mechanisms of NTBs. Knowledge of, and the ability to conform to, mandatory standards on trade in goods by producers within the region are important barriers; these include agricultural goods as well as industrial products such as cement.³ There appear to be fewer reported difficulties within the region regarding adherence to private voluntary standards.⁴ Mandatory standards seem to be particularly

Table 7.2 Most restrictive NTBs and challenging NTMs

Barrier or measure	Type			Govern- ment control	Resolution	
	Regulatory	Admini- strative	Procedural		Short term	Long term
Mandatory market access requirements Sanitary and phytosanitary measures (SPS)/Technical barriers to trade (TBT) Lack of harmonisation of customs classifications Infrastructure	No MRAs in place	Checking at borders, systematic and random	No testing facilities available at borders, which mean procedural delays.	✓	Invest in testing facilities at borders	Agree MRAs across products of interest
	No memorandums of understanding between customs authorities		Revaluation common at the border	✓	Invest in updated harmonised and electronic systems	
				✓	Invest in storage and loading facilities at borders	Invest in transportation corridors
				✓	Addressing procedural and administrative barriers (Pakistan–India)	Reach agreement on services
Visa requirements	No agreement on free movement of labour	Length of time taken to obtain visa	Detailed procedures to be followed for Pakistani nationals into India	✓		
Ad hoc export and import restrictions	Yes	Yes		✓	Improved notification systems	Enhanced enforcement and dispute settlement mechanisms

challenging because there are currently no mutual recognition agreements (MRAs) in operation within the region, which means 100 per cent testing at borders. Testing facilities are not always located close to borders, which results in procedural delays for traders within the region. Table 7.2 summarises some of the most restrictive NTBs and challenging NTMs in the region identified through key informant interviews.

Poor customs procedures and other logistical constraints are formidable barriers to intra-regional trade. These barriers include, for example, lack of cold storage facilities at borders and limited space for loading bays. Tariff harmonisation is ongoing within the region, which means that revaluation at borders is reported to be common. This suggests a need for better and more co-ordinated information systems across customs authorities.

In addition to regulatory barriers, such as those related to the lack of MRAs within the region, there are other types of NTBs that are in widespread use within the region and remain undisciplined at the regional level. This includes the use of export restrictions to deal with seasonal shortages of goods, such as onions, cotton and rice.

There are mixed views on the potential role of dispute settlement mechanisms at the regional level. It is fair to say that at the current time, negotiations on barriers to trade mainly take place on a bilateral basis, even where these are in direct contradiction to the rules agreed under SAFTA (as well as other bilateral agreements).

There are similarly concerns that, however implemented, enhanced trade surveillance of the reduction of reported NTBs and harmonisation of other NTMs needs to be depoliticised politicised; the process of monitoring NTBs needs to remain outside government control, but to feed into policy processes, which suggests the need for an enhanced role of national and regional chambers of commerce in order to perform this function. The following section introduces the other components of the feasibility study and, where applicable, discusses what the results of the fieldwork suggest for their future development.

7.3 Models of non-trade barrier monitoring and trade surveillance

Only one of the approaches adopted by different regional economic communities (RECs) towards NTB monitoring and trade surveillance intends to have a fully functioning online and publicly available NTB monitoring mechanism, tracking complaints in real-time. That is, the tripartite region which comprises the East African Community (EAC), the Southern African Development Community (SADC) and the Common Market for Eastern and Southern Africa (COMESA). The EAC and SADC were planning to develop an online mechanism, but these plans have been superseded to some extent by the establishment of the tripartite NTB monitoring mechanism between EAC, COMESA and SADC (which are yet to sign a free trade agreement (FTA)).

However, in the case of the EAC, even though the tripartite monitoring mechanism is in place there remain concerns that this is not sufficient and that a regional

mechanism between EAC members may still be required. This is an important point to note since an NTB monitoring mechanism between members of a planned, but not yet implemented, FTA cannot substitute for one within a customs union (CU), where many more barriers are supposed to have been removed. No CU exists in South East Asia at present (although ASEAN has one planned), nor in South Asia.

The EU, which has moved beyond the formation of a CU towards a monetary union, provides different websites on which traders can register a trade-related complaint regarding intra- or extra-regional markets. In contrast, ASEAN has no publicly available information source on which to register: for either an NTB- or a trade-related complaint. Efforts to address NTBs remain primarily driven by economic objectives and the demands of regional priority products. This section identifies three different models of NTB monitoring and trade surveillance. Within these three models there are potentially replicable elements for South Asia.

7.3.1 EU approach

This approach can be summarised as being two-pronged in the sense that separate mechanisms exist for different types of trade barriers experienced in the internal market compared with external markets. And within these there are different mechanisms to respond to reported barriers. Clearly this type of mechanism is well advanced and designed for a deep form of integration, over and above that which exists in other RECs, but what it serves to highlight is how monitoring mechanisms have evolved in two ways, depending on the market and rules in place for each, as well as whether or not the reported barrier is perceived to be legal or illegal.

In relation to barriers that continue to exist within the European market, there are alternative channels that may be pursued in order to address these and there is a formidable legal structure in place to enforce common rules and standards. A regional legal structure and regional court exist with the jurisdiction to enforce rules, regulations and to resolve disputes.

The approach to addressing unnecessarily trade restrictive NTMs within the internal market was, and remains, based on the principle of minimum harmonisation, whereby existing national standards are expected to adhere by general principles, as opposed to the creation of product-specific standards and a regional catalogue to this effect. However, where regional standards have been created (for technical or other reasons), member states have to prove to the European Commission why they have decided not to implement the rule. A clear distinction continues to be made between harmonised and non-harmonised sectors; in the latter the principle of mutual recognition applies.

Efforts to maintain momentum for the further deepening of the EU's single market remain very much ongoing; an online complaints mechanism to report NTBs is just one tool that is used in this process. Reporting mechanisms at an institutional level between the Commission and the Council also continue to develop, as trade barrier reports have been updated to also include barriers related to investment trade and investment.⁵

For external markets, it is possible to submit a complaint directly to the Directorate-General for Trade for investigation using the trade barriers reporting (TBR) mechanism. Alternatively, complaints about barriers to trade in external markets which relate to existing NTMs perceived to be unnecessarily trade restrictive may be raised during market access partnership meetings. Over time these services have been combined to some extent in the form of the market access database (MADB), which includes relevant information on tariffs, product requirements, relevant documentation as well as other reported trade barriers in external markets.

7.3.2 ASEAN approach

The ASEAN approach is similar to that of the EU in a number of respects – the crucial difference, however, is in terms of the stage and level of economic integration (e.g. ASEAN is not yet a CU), which means that enforcement and automatic implementation mechanisms differ. The approach towards the reduction of NTBs and harmonisation of other NTMs was initially based on the principle of self-assessment by members and dialogue with the private sector beginning in the 1990s. The implementation of the common effective preferential tariff (CEPT) meant that each member was expected to get its own house in order, with longer time periods in which to do so granted for the least developed members of the ASEAN (the CLMV countries – Cambodia, Laos, Myanmar and Vietnam). A working definition of NTBs was adopted and technical working groups established at the ASEAN Secretariat level were charged with overseeing the process of their reduction, in addition to the reduction of tariffs between members more generally.

As the regional integration process gathered pace, a more strategic approach was adopted at the regional level, through the identification of specific products of economic interest and their related trade barriers. That is, the approach adopted has been driven by a reactive approach, on the one hand, towards addressing those barriers most frequently reported and assessed as being trade restrictive, and, on the other hand, by a more proactive approach towards the facilitation of trade in priority products, mapping regional production networks and their related trade constraints.

This approach subsequently provided the impetus for the harmonisation of standards first for priority products and then for others considered important, though not necessarily for economic reasons. This has meant that the development of regional standards remains a work in progress for priority agricultural products, which range from livestock to onions (and this process has resulted in the creation of other technical working groups). More general trade facilitation measures have also been implemented, such as the single window for customs procedures.

Only in the late 2000s have efforts to reduce NTBs between members been underpinned by a dispute settlement mechanism. The legal architecture of ASEAN has only very recently proceeded to strengthen, not least in the light of the recent wave of ASEAN+1 agreements signed with such partners as China, Japan and India. And it is only very recently that the ASEAN Free Trade Agreement (AFTA) council has endorsed the modality and plan for NTB elimination across all members, which remains an ongoing process. There are no online reporting mechanisms on which

to log complaints about NTBs; instead all communication remains by traditional means, such as dialogue between member states and business associations within each country. Information on the process of elimination of identified NTBs and the extent to which non-compliance is actually enforced is limited. This means it is not possible really to assess the extent to which objectives to remove NTBs have actually been met.

However, the general approach of ASEAN does exhibit some similar tendencies to the EU in that a sector- and product-specific approach was first adopted in order to address NTBs, harmonise NTMs and, therefore, facilitate trade, with a strong emphasis on internal market development within a broader context of open regionalism, so as to facilitate the development of regional production networks and achieve economic objectives. The regional architecture surrounding this process is still in the development phase, remaining focused on internal market development with no mechanism available, to the best of our knowledge, on reporting trade barriers in external markets as is available in the EU.

7.3.3 Potential models of trade surveillance and NTB monitoring mechanisms in South Asia

Based on the current level of economic integration within South Asia, there remain a number of outstanding questions as to who could undertake trade surveillance and NTB monitoring mechanisms within the region, for example, the SAARC Secretariat (based in Nepal) or the SAARC Chamber of Commerce and Industry (based in Pakistan). At the time of writing, there is no dedicated technical working group within SAARC to address NTBs, or an executive body which could be charged to oversee reductions in reported barriers (or robust dispute settlement mechanisms to enforce decisions).

The approach towards identifying specific sectors and products of interest at the regional level and their related trade barriers has not yet begun at the regional level. This is reflective of the relatively loose organisational structure of SAARC: its existing commitments on goods are not enforced, which suggests that the potential for the further deepening of commitments at the regional level may be limited. Members have so far found it more effective to seek bilateral channels and negotiations in order to achieve their objectives on enhanced market access, in addition to addressing NTBs (e.g. recent dialogue between India and Pakistan). This means that the approach towards addressing NTBs and trade surveillance more generally remains rather un-co-ordinated, being undertaken primarily through bilateral channels.

What does this suggest in terms of the potentially replicable elements of other models of trade surveillance and NTB monitoring mechanisms for South Asia? It suggests that if internal market development through the removal of NTBs and harmonisation of other NTMs is desirable, particularly for the least developed and landlocked members (and the small and medium enterprises (SMEs) within them), there is a need for better information systems so as to identify priorities. The adoption of a working definition of NTBs, as in other regions, such as ASEAN, might help to get this process started, as could the formalisation of an approach towards NTMs, as adopted within the EU.

Could the platforms and investments already made by India for the provision of market access information be further built on in terms of trade surveillance and NTB monitoring? Potentially, but there remain strong concerns within the region in relation to the need to depoliticise the process of NTB reduction and NTM harmonisation, in order to achieve buy-in from the private sector. National and Regional Chambers of Commerce are already performing the role of NTB monitoring of a sort by responding to private sector concerns, as and when they arise. However, this process is not yet systematic and consistent, in terms of disentangling what has already been agreed at the regional level and not yet implemented and what has not yet been agreed but which needs to be.

This suggests that a more systematic approach towards documenting the barriers reported by businesses at the national and regional levels could be adopted. Governments within the region could undertake their own assessments as to where barriers exist that are not in line with regional commitments, so as to provide the foundations for further dialogue at the regional level, with a view to designing interventions to overcome these, as in the case of ASEAN.

India is already acting as the regional standard setter with regards to the harmonisation of mandatory market access requirements, such as sanitary and phytosanitary measures (SPS). Moreover, as well as other South Asian members, it has invested in making information on its market access requirements publicly available. However, the links between these systems with others in neighbouring countries have not yet been formalised in terms of being updated regularly. Knowledge of these systems by business generally seems to be limited.

Related technical assistance provided by India on standards seems to be focused on those products where it has direct interest and where its constituent business community has voiced its concerns. It is not known to what extent the support provided actually matches the demands of, for example, the least developed members of SAARC. A more objective approach towards identifying capacity constraints and targeting support may be necessary, which requires the current lack of information on real and perceived barriers to intra-regional trade, definitions of NTBs and NTMs, and understanding and adherence of regional commitments to be addressed within the region.

7.4 Conforming to regulations and standards

Not all NTMs are NTBs: many are important regulations designed to protect human health and safety and to ensure that buyers are accurately informed about the goods on offer. These are often referred to generically as ‘standards’ or, more explicitly, technical barriers to trade (TBT) or SPS measures. This terminology (which is mirrored, for example, in the WTO) underlines how these measures can restrict trade even if this is not their primary (or even an intended) objective.

However successful the countries of South Asia are in reducing undesired NTBs, there will always remain a host of NTMs which – if not well understood by traders – could act as unintended NTBs to regional trade. There is evidence reported in the scoping and diagnostics report, which includes information obtained from key informant

interviews, that traders within the region are generally poorly informed about regional NTMs. This being the case, in some instances, it is also highly probable that they are also not as well informed about NTMs in extra-regional markets as is desirable.

NTMs are constantly changing. For example, the International Organization for Standardization (ISO) sets new standards through a system that brings together experts, and every working day of the year an average of eight ISO meetings are taking place somewhere in the world. Moreover, between meetings, the experts continue the standards development work by correspondence and through electronic communication, with some ISO technical bodies having already gone over entirely to working electronically, which speeds up the development of standards.

To cope with this, firms and standards bureaux in South Asia need to keep abreast of the developments of standards in their field and to understand where and how new standards are formulated. It is especially important for SMEs to be kept informed and for domestic standards bureaux to be aware of their needs both when setting domestic standards and (if they are different) when participating in international standards setting exercises. Several of the regional groupings to which South Asian states belong are aiming to harmonise their domestic standards around international norms. These include those produced by the ISO, the International Electrotechnical Commission (IEC), and the Codex Alimentarius hosted by the Food and Agriculture Organization (FAO). Since the standards set through these bodies are also widely used in extra-regional trade, they form an obvious first place for South Asian firms to start (and on which training and information resources made available to South Asian SMEs should initially focus).

In the concept note drafted for this feasibility study we said that we would focus on the potential for regulation in SAFTA related to the harmonisation and mutual recognition of public mandatory standards. The results of the scoping and diagnostics exercise, in addition to key informant interviews during fieldwork, has revealed that this potential is currently extremely limited. The development of the regional regulatory architecture is progressing slowly, cautiously and in a rather piecemeal fashion (for example, with the Council of Europe intervening regarding specific cases on an 'as and when' basis rather than in any systematic way). There are no mutual recognition arrangements currently in place within the South Asian region. Negotiations continue on unregulated areas such as services.

This suggests that training needs actually relate more to sensitising the private sector, national governments, chambers of commerce and regional chambers of commerce to the economic objectives of regional integration and how these might be better met within the region.

7.5 Upgrading producers in meeting standards: Lessons from regional economic communities

Many richer and some middle-income states provide significant support to their producers (often focused on SMEs) to help them understand and meet standards

in their domestic market and, sometimes, in foreign markets as well. It appears that there are few explicitly *regional* initiatives in this specific direction.

For the fast-growing economies of South Asia, the middle-income states of Latin America may offer relevant lessons. Here, though, despite strong regional organisations, such as Mercosur, the Andean Community and the Central America Common Market, most action is taken at a national level. Despite the fact that international recognition is critical for access to markets, it is fair to say that Latin American states, whilst they have been making progress, have much more to do to support the aggressive export strategies that most regions embrace. The lesson is that South Asia is not alone in being at a relatively early stage in removing unnecessary intra-regional NTMs by helping producers to upgrade to meet standards in neighbouring (and international) markets.

7.5.1 The experience of Latin America

Analysis undertaken by the World Bank suggests that investing in accreditation bodies leads to increased private sector representation as well as autonomy, enabling them to quickly respond to sectoral needs and firms' demands (Guasch et al. 2007). However, it still takes 50 per cent to 150 per cent longer to accredit a laboratory in most of Latin America than it does in the United Kingdom. With mutual recognition being an important element in assisting national producers in meeting standards in foreign (and regional) markets, some Latin American accreditation bodies are fully co-operating with regional and international organisations to establish MRAs. Argentina, Brazil and Mexico, for example, are extremely well connected and internationally recognised, having secured intra-regional, extra-regional, and international MRAs covering most of their trade partners. But others remain isolated (Guasch et al. 2007: Table 9.6). For example, Colombia's accreditation body, the Superintendency of Industry and Commerce (SIC), is not a member of a single international or regional accreditation organisation. As a member of the Inter American Accreditation Cooperation (IAAC), Peru's National Institute for the Defense of Competition and the Protection of Intellectual Property (INDECOPI) remains slightly less isolated than the SIC, but it is not a member of either the International Accreditation Forum or the International Laboratory Accreditation Co-operation. Colombia, Peru and Ecuador are only parties to the Andean Community's incipient MRA, which itself is limited to product certifications.

7.5.2 The EU

The EU is one of the most fully developed RECs and for several years the European Commission and the European Parliament have recognised the need to get SMEs more involved in standardisation (as well as helping them in many other ways such as providing practical information on market opportunities and European legislation; helping to find suitable business partners using its business and technology co-operation database; providing information on tender opportunities and international networking; developing research and innovation capacities by helping to create synergies with other research actors; and helping SMEs to share research results and participate in research programmes). Among the specific

standards-focused activities undertaken by the Commission in this area, one activity has been to support the creation of the European Office of Crafts, Trades and Small and Medium sized Enterprises for Standardisation (NORMAPME). It was created to improve the participation of SMEs in European standardisation, to increase the influence of small enterprises in standards writing and to help SMEs understand and implement standards.

Where REC-wide action may be helpful is in establishing visibility. One of the important results of the NORMAPME operation is the establishment of greater visibility of small- and medium-sized enterprises in the standardisation process. The Euro Info Centres (EICs) Network also plays a role in standardisation and as a more general provider of international information to enterprises. There are now nearly 300 EICs, which have developed information products and seminars to raise awareness of, and the level of knowledge on, standardisation with enterprises.

7.5.3 Donor-funded efforts

Regional support for producer upgrading is often linked to aid-funded assistance. The USA, for example, has a range of programmes aimed at making producers more competitive, partly by helping them upgrade and meet the standards imposed in export markets. The African Global Competitiveness Initiative (AGCI) is aimed at promoting the export competitiveness of enterprises in Sub-Saharan Africa in order to expand African trade with the United States, other international trading partners and regionally within Africa. The overall objective of promoting export competitiveness of enterprises in Sub-Saharan Africa is to be achieved through two main strategies: the provision of technical assistance that advances export competitiveness and support for complementary activities.

A central element of the strategy has been the creation of three African Global Competitiveness (or Trade) Hubs for West Africa, Southern Africa, and East and Central Africa. They provide information and technical assistance to African organisations, USA government agencies, donor and civil society organisations, and the private sector on trade, investment and business activities in the region, including training opportunities. They also play a key role in the knowledge sharing and analysis elements of the programme. This strategy identifies and disseminates evidence on best practice for trade-led economic growth through knowledge sharing and analysis briefs, summaries of applied best practices, conferences, trainings and presentations.

Many SMEs lack the technical skills to comply with international market requirements and this hurts their competitiveness when they evaluate and enter new markets (AGCI 2009). Poor capacity and skills in product development, business planning, fund management procurement of products and services, formulation of export plans and bankable projects (access to credit) impede success in the export market. Many SMEs do not consider critical items, such as laboratory analysis, quality certifications for organic products, knowledge of consumer tastes and preferences, and other marketing and international trade practices, when evaluating new markets and planning entry into those markets.

The Southern Africa Trade Hub, for example, aims to increase international competitiveness, intra-regional trade and food security in the Southern African Development Community (SADC) region, including SMEs. It delivers targeted technical assistance to governments, the private sector and civil society organisations in support of advancing regional integration and increasing the trade capacity of selected value chains within Southern Africa. A particular focus is to promote increased private sector competitiveness along specific value chains within the region by harmonising standards with international standards and helping private firms to understand and comply with regional and international market standards. It concentrates in particular on textiles and clothing, legumes and staple crops.

The ASEAN Competitiveness Enhancement (ACE) project is also funded from the US-supported ASEAN Development Vision to Advance National Co-operation for Economic Integration (Nathan Associates 2008). The project provides technical assistance in fostering the competitiveness of ASEAN value chains and supply chains. The expectation is that by focusing on the growth and productivity of regional value chains and supply chains (those that organise production and value-adding activities across ASEAN borders before selling to markets inside or outside the region) this will help increase intra-ASEAN trade and reinforce regional economic integration among ASEAN member states.

7.5.4 Upgrading conformity infrastructure in South Asia

There is considerable scope for upgrading existing conformity infrastructure in South Asia. Contrary to expectations, the major barriers relate to mandatory market access requirements in other South Asian partners and not other standards, such as private voluntary ones in extra-regional markets. Countries such as India have already begun to compile information sources on the mandatory market access requirements of South Asian countries. However, there is a general lack of awareness among national chambers of commerce of this information source.⁶

There are also other concerns related to the reliability of this information source, given that a full and comprehensive stocktake of existing rules and procedures related to mandatory market access requirements (such as SPS) has yet to be undertaken. The demand expressed for technical assistance in the area of SPS standards so as to fortify trade capacity in Sri Lanka currently remains unmet, although efforts had begun to address it beginning in 2005.⁷ This suggests that there are considerable knowledge and information gaps related to existing regulations, let alone any new ones that might be adopted at the regional level in the future. Organisational constraints within countries play some role in contributing to this deficit.⁸

This suggests that a stock take of existing mandatory market access requirements, which are related on a national level to SPS-TBT and health and hygiene standards, and how these are currently communicated to private sector actors, revised and updated, etc., is urgently required prior to development of harmonised regional standards, so as to ascertain in what ways existing standards conform to international requirements, where they go beyond these requirements and how standards within the region should be harmonised. For example, at the current time is not known to what extent India's

mandatory market access requirements actually go beyond what is required at the international level, although there are anecdotal reports that the standards that it applies are more stringent compared with extra-regional markets, which constitutes a barrier because of the additional investments necessary to meet India-specific standards.

Regional priorities related to upgrading producers to mandatory standards should therefore include investments in conformity infrastructure, such as building the capacity of accrediting bodies within the region, serving to reduce the need for testing at borders over time. The provision of technical assistance to particular types of producers, such as SMEs, is likely to be more a national priority, at least in the short term and until regional priority products have been identified.

7.6 Linking non-trade barrier monitoring and surveillance mechanisms to dispute resolution mechanisms: Lessons from regional economic communities

Countries do not enter into regional trade agreements with a view to launching disputes. They enter them in the expectation that the commitments made will be mutually beneficial and lead to increased regional economic activity and that any joint institutions will offer an additional channel of communication. Nonetheless, it is important to remember that the dispute settlement provisions underpin the enforceability of any agreement. If they are weak or lacking, the agreement is no more than the expression of good intentions. Even if never activated, the combination of measurable obligations and a system for imposing penalties for non-compliance is likely to have an impact at least on the extent of commitments made in the agreement.

Whilst an expression of good intentions may have an intrinsic value, it also has its limitations. An agreement with weak dispute settlement may reflect an absence not only of commitment but also of trust. Rigorous dispute settlement is as much an expression of the mutual trust between the partners as it is of a commitment to a particular theory of trade. For two or more governments to pass to a body that is at least partially independent of them the final judgement over whether or not their national policies are consistent with their regional commitments – and to impose penalties for a failure to remove inconsistencies – demonstrates not only a substantial commitment to the terms of the agreement but also considerable trust in the other parties. The absence of binding dispute settlement may well reflect not so much an oversight as the absence of this high level of trust.

This is particularly important in relation to NTBs, since these are often more deeply rooted in a country's 'way of doing things' than tariffs. Reducing the tax on imports from, say, 25 per cent to 10 per cent through tariff reduction merely makes an import cheaper than it otherwise would be. Agreeing mutual recognition of standards may remove an absolute barrier to the import of a good from a neighbour, even if it fails to meet domestic standards. The crucial case that opened the way for the Single European Market, on *Cassis de Dijon*, demonstrates how the effective removal of the most deep-seated NTBs may require there to be an adjudication body that is outside the direct control of any of the participating governments. Binding supranational dispute settlement has

played a central role in the removal of NTBs on goods in the EU, and plays a continuing role in limiting the spread of new measures. The combination of public and private action to curb trade restrictions has also been important. The fact that private actors can seek a judicial review of the actions of governments and public bodies means that stakeholders are not reliant upon the support of their national government when taking cases forward. At the same time, the existence of a supranational executive to monitor the actions of member governments means that action has been less haphazard than it might have been had only the private sector been involved.

Two questions arise for South Asia:

1. How do the dispute settlement provisions in the RTAs signed by the countries of the region measure up to this (pretty demanding) standard?
2. If they fall short, is there still a positive role that effective monitoring and surveillance can play in reducing if not eliminating intra-regional NTBs?

7.6.1 The rigour of regional dispute settlement

The short answer to question 1 is: not very well. All of the agreements provide a forum to which evidence can be brought on the existence of NTBs and their effect on intra-regional trade – but none has binding commitments that go beyond those to which all of the states that are WTO members have already committed multilaterally. This does not mean that the agreements add nothing to the WTO, but the extent to which they add value needs to be carefully explained. As is often the case, dispute settlement in the WTO tends to favour large, powerful countries over small, poor ones, though supporters would argue with justification that the imbalance is less marked than in many other fora. Bringing a dispute is always costly (in terms of time and expertise if not hard cash). And the remedies available following a successful case are asymmetrical, since the suspension of benefits is likely to have a much bigger economic impact if undertaken by a rich plaintiff against a poor defendant than vice versa. Usually, however, remedies are not needed: the losing party voluntarily changes its practice because of a desire not to be seen to be flouting WTO rules. It is moral authority or what might be called ‘pragmatic authority’, a desire not to weaken an institution that is regarded as valuable, that underpins WTO dispute settlement as much as the remedies available.

The question for the dispute settlement provisions of the South Asia regional agreements, then, is whether they can score over the WTO in terms of:

1. the ease with which countries can bring cases (and in this respect, the ease with which the smaller countries can bring cases is primarily of interest); and
2. the availability of appropriate means for resolution either through the existence of remedies that are useful for the smaller countries or the greater moral or pragmatic authority of the regional institutions.

It might be argued that some of the regional agreements score on point 1, simply because they are smaller. Under the AIFTA Agreement on Dispute Settlement, for example, arbitration panel rulings are binding and, if they are not implemented, there are provisions in Article 16 for the compensation and the suspension of concessions

or benefits. Similarly, the India-Singapore Comprehensive Economic Partnership Agreement (ISCEPA) contains positive support for the removal of NTBs and detailed arrangements for dealing with disagreements. It sets out possible compensation and suspension of benefits if tribunal rulings are not applied.

However, until disputes are brought within one of these forums rather than through consultation and mediation in the WTO it is hard to know whether they are actually perceived as superior means to pursue alleged infractions to a country's WTO commitments. Also, neither of these agreements covers any country from South Asia apart from India which is an active participant in the WTO. Only SAFTA and the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) include all the smaller states. The latter currently contains no disciplines on NTBs (though these might be added in future) and critics of SAFTA argue that it has left open ended the enforcement of decisions and procedures for withdrawing and reinstating concessions, and also that it contains a catch-all provision allowing contracting states to opt out of the SAFTA agreement at any time, without due cause or penalty.

7.6.2 Surveillance and monitoring without enforcement

This leads onto question 2: is there a useful role for surveillance and monitoring in a system where an NTB will only be curbed by the consent and active engagement of the country that has imposed it? The answer from the experience of other RECs seems to be that it can be useful. Just as the full range of rules affecting trade can be sub-divided into legitimate NTMs and NTBs, so the latter can be also be divided. One group is of the rules, regulations and procedures that governments wish explicitly or implicitly to retain in order to control trade. The hard core of these are unlikely to be removed short of a fundamental change of heart by the imposing government or by much more muscular dispute settlement than is currently found in the South Asian agreements. But the second group comprises measures of which governments may not be (fully) aware, and to which they may not be firmly committed. By publicising this second group, monitoring and surveillance mechanisms may help to keep them in check. And by offering a negotiating forum the regional agreements may help disciplines to be agreed once the measures have been publicised. The experience of other RECs, though, suggests that one should not be too optimistic.

ASEAN

The experience of ASEAN needs to be watched closely. Because of the range of different reported NTBs in ASEAN, it was recognised that efforts were needed to develop the mutual recognition of standards across members, and that their elimination might require co-ordinated action. The agreed general approach was to:

- verify the available information on NTBs;
- prioritise products and NTBs;
- develop specific work programmes to address identified, verified and prioritised NTBs; and
- mandate interventions to address the highest priorities.

A working group was established to prioritise identified barriers and established the following criteria, in order of importance:

- (a) number of private sector complaints;
- (b) the difference between domestic and world prices; and
- (c) the trade value affected.

However, publicly available information on the total number of complaints raised by the private sector on NTBs is scarce and it is not known how far these have actually been assessed. In October 1997, the ASEAN economic ministers requested that the ASEAN Chamber of Commerce and Industry compile a list of barriers to trade, and, in the same year, the ASEAN Secretariat commissioned a survey on NTBs and customs procedures but no results seem to have been published.

In any event, the ASEAN members have identified 11 priority sectors which include electronics, information technology, health care, wood-based products, automotives, rubber-based products, textiles and apparel, agro-based products, fisheries, air travel and tourism. The ASEAN Secretariat has categorised barriers inhibiting growth of these sectors according to:

- **trade impact:** indicated by the number of private sector complaints, the difference between domestic and world prices, trade values/volumes affected;
- **regulatory objective:** protection of consumers or generation of revenue; and
- **WTO consistency:** in accordance with WTO principles, NTMs must be transparent and non-discriminatory and, in the case of SPS measures, have a scientific basis and have no better alternative.

Measures were subsequently classified by the technical working group charged with implementing the FTA as:

- **red:** to be removed immediately;
- **amber:** not clearly identified as a barrier, continued monitoring required; and
- **green:** can be maintained as justified.

The AFTA Council endorsed the modality for NTB elimination in 2007. This consists of self-assessments by member states, as well as cross-verifications by the technical working group. The effort is ongoing.

EAC

In East Africa, recognition of the constraints imposed by NTBs on businesses within the region has resulted in the East African Business Council undertaking its own surveys across members in order to highlight the issues to policy-makers. In addition to these efforts, a series of detailed studies has identified specific measures based on surveys undertaken by private sector advocacy organisations in the region. This has resulted in the creation of national-level focal points, which include business associations, and the publicising of specific NTBs to draw them to the attention of

policy-makers, as well as citizens in general, and therefore garner support for their removal.

A more targeted approach was adopted in 2008 following the compilation of an NTB inventory by the EAC in 2005/2006. This identified the following barriers:

- **customs and administrative documentation procedures:** varying systems for imports declaration and payment of applicable duty rates, limited customs working hours, varying interpretations of the rules of origin, application of discriminatory taxes and other charges on EAC-originating imports, cumbersome procedures for verifying containerised imports, unfair competition from counterfeit products, and diversion of transit goods into the region;
- **immigration procedures:** varying application of visa fees and work permits, cumbersome and duplicated immigration procedures, lack of regional East African passport;
- **cumbersome inspection requirements:** including, procedures on gross vehicle mass (GVM) and axle load regulations, costly quality inspection procedures, cases of lack of recognition of inspection certificates issued by accredited laboratories, and lack of mutual recognition of quality certification marks and test certificates issued by EAC standardisation bureaux, as well as ad hoc testing procedures introduced without prior discussions and consensus;
- **police road blocks:** police officers stopping commercial vehicles at various inter-country road blocks and at border crossings;
- **varying trade regulations among the three EAC countries:** different axle loads and specified maximum GVM for commercial vehicles, varying parameters on weights, labelling, and quality tolerance in measurements;
- **varying, cumbersome and costly transiting procedures in the EAC countries:** varying requirements on commercial trucks used in transit traffic, bottlenecks in offloading imports, unrealistic grace period on imports before application of demurrage charges, application of insurance bonds on regional goods;
- **limited conformity infrastructure and duplicated functions of agencies:** numerous agencies are involved in import and export inspection and the certification of compliance, in some cases inspection bodies have not established laboratories at major entry and exit points; and
- **business registration and licensing:** varying business registration procedures, lack of preferential treatment to EAC-originating businesses vs. foreign-originating businesses, multiplicity of licences used in production, distribution and sale of goods.

As part of this process, member states established National Monitoring Committees (NMCs) and adopted a time-bound programme for the elimination of identified NTBs. The NMCs established in 2008 were intended to serve as focal points for the complaints of national and regional business associations regarding NTBs and other problematic NTMs. However, they are not the only focal point – complaints may also

be received by line ministries or other government agencies, with the expectation that information will still be relayed back to the NMCs. All complaints received by the NMCs are then expected to be channelled to the EAC Secretariat, headed by the Secretary General, to be subsequently passed to the EAC Trade Remedies Committee to be handled. This committee essentially serves as a supranational executive body. Finally, approval must be sought by the EAC Council on the proposed remedy and solution. However, it is important to point out that the extent to which any of this actually happens in practice is not known.

It is the responsibility of the NMC to classify identified NTBs into one of four categories based on the level of political and economic complexity and the magnitude of the impact on EAC trade. Those measures perceived as easiest to reduce are placed in Category A, which require immediate action. These are the 'quick win' measures. Things get a bit more difficult, however, as the political and economic complexity of the measure increases, as well as the trade impact. Category B includes high-impact measures on trade for which the EAC council has reached a consensus on the need for action, but agreement on how to implement these actions has not yet been achieved. This is to some extent illogical, since those measures with the least complexity and highest trade impact should be considered most urgent. However, this may reflect capacity and resource constraints related to implementation. Measures included in Category C may be related to food or product safety for which there may be a consensus that an existing NTB should be abolished, but this does not mean that there is agreement on how to meet legitimate regulatory objectives in a less trade-restrictive manner.

This approach has its limitations. It relies heavily on the discretion of the NMCs, which do not have legal standing. The categorisation of measures according to their trade impact is not always backed up by analysis. However, since the EAC Secretariat lacks a legal mandate to enforce trade facilitation and the region lacks a dispute settlement body, the whole process of reducing NTBs remains voluntary. So far this approach has failed to make significant progress. This has led to concerns that the NMCs risk becoming an ineffective talking shop as the same issues are repeatedly referred back to the EAC Council of Ministers for resolution.

SADC

In SADC, too, the day-to-day monitoring and reporting of NTBs depends essentially on member state self-assessment, which has not been effective in all circumstances. But a new NTB monitoring mechanism has been established by TradeMark for COMESA, EAC and SADC, in anticipation of the FTA to be created between them. This includes a reporting mechanism whereby complaints that originate from the private sector are submitted online and are subsequently dealt with by the SADC executive secretary and finally the SADC dispute settlement mechanism, if appropriate. The mechanism has had some teething problems, which include limited capacity and availability of focal points on NTBs in member states. According to a recent tripartite meeting held in November 2010, it was observed that the SADC Secretariat was yet to commission an NTB impact study for the region. Only one member of SADC had established an NMC for NTBs, agreed as part of the tripartite process.

7.7 Conclusions

Regional integration always involves a sequence: legal initiatives leading to trade responses, identification of border or regulatory or standards problems as traders seek to exploit the new opportunities, legal initiatives to remove the newly identified barriers, and then the sequence repeats. The SAFTA countries are just beginning this process. This chapter attempts to analyse what they can learn from other regions about the likely problems and about possible ways to smooth the process. What is clear, however, from both regional and multilateral experience is that the sequence will continue to repeat as integration increases, so it is important to develop robust and sustained mechanisms, not one-off initiatives.

Although the report has focused on barriers among South Asian countries, and these may seem unimportant because intra-regional trade is relatively low (except for Bhutan and Nepal), many of the problems identified as NTMs or NTBs apply to all trade. As other regions, notably the EU, have discovered, removing barriers within the region makes the region more competitive in all its markets.

The most important 'barrier' seems to be lack of information: about standards, about official procedures and requirements, and about the way in which regional arrangements, including SAFTA, are implemented. Transparent regulations and consistent application of rules are clear requirements for efficient trade, whether regional or global. There has been so little progress on harmonisation and mutual recognition, that there are few rules on these to implement. Hence, the immediate focus must be on sensitising officials (and policy-makers) to transparency and, in particular, to the ways in which national policies and procedures are perceived in partner countries.

However, there are also examples of the next stage of problems, in applying regional rules. There are concerns about the ways in which the application of national standards at the border obstructs even goods which meet the required standards through costly or burdensome testing procedures or inconsistent application of standards. Such problems may require not only sensitisation but assistance on building the capacity of testing and standard-setting bodies. Building institutional capacity to set standards can, and probably should, occur in parallel with deepening political commitment to regional integration.

At the official level, South Asian countries have shown concern about NTMs in a variety of regional and bilateral negotiations, but there is still no systematic approach to dealing with them in a SAFTA context and, apparently, also no consensus that an official response, rather than an industry-based one, is required. There is certainly an important role for private sector initiatives. The possibility of more regular contacts and discussions among businesses within a region may provide a good alerting mechanism to new or newly important barriers. All the other regions discussed provide various examples of how to use private sector actors to identify and report on obstacles to trade. Private reporting and discussion alone may not be enough, but strong private sector groups may be able to provide some of the information function, and the serious problems identified here suggest that any initiatives

would be valuable. Simply compiling a list of problems which individual exporters have faced, but without further action, will not be complete or sustainable because exporters will have little incentive to participate.

Notes

- 1 The authors would like to acknowledge an earlier Asian Development Bank project (implemented during 2011), which resulted in much of the analytical work forming the basis of this chapter.
- 2 This information is obtained from sources which include WTO TPRs undertaken periodically, but which have not yet been undertaken for Afghanistan, Bhutan or Nepal.
- 3 The Memorandum of Co-operation, India, reportedly receives around four or five complaints from traders every six months or so. Out of these the majority relate to procedural or administrative difficulties and are addressed as appropriate on an 'as and when' basis. In other cases, however, the difficulties arise because of testing procedures.
- 4 In fact, mandatory market access requirements, such as plant quarantine certificates, were reported by some interviewees to be more difficult to obtain than those demanded by private retailers in European markets.
- 5 It has not been possible to discuss the role of the European Council or European Parliament in much more detail at this stage; this includes in relation to other trade defence matters such as anti-dumping.
- 6 FICCI is also a member of the Indian Ocean Rim Network (IORNET), supported by the Ministry of External Affairs India, which includes as its objective the promotion of business linkages and co-operation among members. This web-based system provides links on investment opportunities among members and is already supported by national chambers of commerce (who may submit, modify or remove specific business enquiries, such as export, import, technology, consultancy, investment and joint venture, marketing tie-up offers and requests).
- 7 This information was obtained from discussions with Subhashini Abeysinghe, Economist, Ceylon Chamber of Commerce, May 2011.
- 8 Examples were given during key informant interviews of cases whereby new national legislation would create a direct barrier to trade given limited testing and conformity infrastructure, as well as adding additional burdens to manufacturers (e.g. requiring retail prices to be printed on confectionery).

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Chapter 8

Regional Investment Co-operation in South Asia

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8.1 Background

Although theoretically foreign direct investment (FDI) and trade are considered to be substitutes for each other, evidence suggests that FDI could exploit those markets better by using its intangible assets that cannot be substituted by trade (Bloström and Kokko 1997; Caves 1996). These intangible assets of foreign companies include technological and marketing expertise, which could be used for exploiting knowledge of local markets, consumer preferences and business practices, etc. Under an integrated regional market, FDI from member countries could target each other's market with a view to operating with low-tariff barriers. Such kinds of operation would be effective when production networks within the region function in a vertically integrated manner. In those markets, extra-regional FDI would take advantage of tariff barriers and large regional markets, etc. Despite the advantages of an integrated market, all locations within the region may not attract intra- and extra-regional investments at the same level; countries which have strong locational advantage could attract most of the FDI (Bloström and Kokko 1997). In other words, investment between member countries in an integrated region may be differentiated by differences in size of economy, variation in economic policies, poor physical and non-physical infrastructure facilities, lack of cross-border facilities and political factors (Sobhan 2004). Overall, an integrated regional market could facilitate 'investment creation' at a large scale both by intra-regional and extra-regional FDI. Promotion of FDI in South Asia should take that perspective into account in its initiative for regional co-operation for investment.²

Despite liberalising investment policies, undertaking various support measures under national policies and signing investment treaties with major investment sources by countries in South Asia, FDI in the region has remained at a low level. During 2011, FDI flow in South Asia was US\$35 billion, which was a mere 1.6 per cent of the global flow of FDI; similarly, the stock of FDI in South Asia was only 2.3 per cent of total global FDI stock at the end of 2011. Except India, none of the South Asian countries has received a considerable amount of FDI, which indicates a lack of diversity in terms of location of FDI within the region. Needless to say, intra-regional FDI flow has accounted for a small share of total FDI flow. This poor state of FDI flow in South Asia raises doubt about the efficacy of various policy measures undertaken by South Asian countries since the late 1980s despite the fact that national, bilateral and regional policies undertaken by developing countries, in general, have had a positive impact on the FDI flow (Banga 2003).

Promotion of regional FDI through application of specific policy instruments did not get due attention in the South Asian Association for Regional Cooperation (SAARC) framework. SAARC declarations in the late 1980s, 1990s and early 2000s put little focus on this issue; it has only been addressed in recent SAARC summits. Moreover, SAARC initiatives for the promotion of FDI appear to be undertaken within the framework of regional trade integration. Given the limited level of intra-regional trade in South Asia and weak interlinkage between trade and investment, there is doubt about the efficacy of existing trade-based initiatives to promote investment in South Asia. Intra-regional investment in South Asia also faces a number of other constraints, which include structural barriers, institutional bottlenecks, political tensions, narrow nationalism and mutual distrust (Aggarwal 2008; Jayasuriya and Weerakoon 2002). The existing initiatives address those challenges very little and therefore are not able to cater for more FDI in the region.

The present chapter focuses on two issues: (a) understanding the current state of national and regional policies and institutional arrangements for enhancing regional co-operation for investment and (b) putting forward suggestions for the development of an effective policy framework for enhancing intra-regional investment in South Asia. The chapter comprises seven sections. Sections 8.2 and 8.3 provide a brief overview on the structure and composition of FDI in South Asia and the FDI-related policies practised in South Asian countries. Section 8.4 analyses the existing institutional approach for enhancing intra-regional FDI, particularly under the SAARC framework. Section 8.5 discusses the institutional framework in the Association of Southeast Asian Nations (ASEAN) for enhancing FDI in South East Asia with a view to appreciating the possible lessons for strengthening institutional initiatives under the SAARC framework. Section 8.6 provides a set of recommendations for strengthening institutional measures to enhance intra-regional investment in South Asia. Finally, Section 8.7 summarises the major findings of the chapter.

8.2 Foreign direct investment in South Asia: A brief overview

South Asia is the lowest recipient region of FDI in the world; of the US\$1.5 trillion global flow of FDI in 2011, only US\$35 billion was directed to this region (Table 8.1). In contrast, FDI flow to other regions was quite high; for example, US\$452 billion in the European Union (EU), US\$267.8 billion in North America, US\$116.6 billion in South East Asia, US\$42.7 billion in Africa and US\$217 billion in Latin America. Other than India, none of the locations in South Asia is considered to be locationally advantageous for investment by foreign companies, including transnational corporations (TNCs), and, more importantly, these corporations perceive India to be the investment destination with the third most potential (Bartels et al. 2009; UNCTAD 2012). Except India, most of the locations in South Asia suffer from various constraints and weaknesses. India's liberal economic policy, large domestic market, skilled workforce, infrastructural facilities, natural resources, and technological and productive capacity have made it an attractive investment destination. As a result, FDI is increasingly concentrated in India – from 35 per cent of total regional stock of FDI in 1990 to 85 per cent in 2011. Consequently, the share of other South Asian countries (Pakistan, Bangladesh and Sri Lanka) has decreased over time. Both

Table 8.1 FDI in South Asia

Region/Economy	2006	2007	2008	2009	2010	2011
South Asia (US\$ million)	26,271	32,689	50,958	39,323	28,098	34,791
<i>Share of FDI flow in South Asia (%)</i>						
Afghanistan	0.9	0.6	0.2	0.2	0.8	0.2
Bangladesh	3.0	2.0	2.1	1.8	3.2	3.3
Bhutan	0.3	0.0	0.0	0.0	0.1	0.0
India	77.4	78.0	85.2	90.5	86.0	90.7
Maldives	0.4	0.4	0.3	0.4	0.8	0.8
Nepal	0.0	0.0	0.0	0.1	0.3	0.3
Pakistan	16.3	17.1	10.7	5.9	7.2	3.8
Sri Lanka	1.8	1.8	1.5	1.0	1.7	0.9
<i>Share of global flow of FDI (%)</i>						
South Asia	2.0	2.0	3.0	4.0	2.0	3.0
South East Asia	4.0	4.0	3.0	4.0	7.0	8.0
East Asia	9.0	8.0	10.0	13.0	15.0	14.0
Africa	3.0	3.0	3.0	4.0	3.0	3.0

Source: Prepared by the author based on UNCTAD (2012)

developed and developing countries outside the region are the major sources of FDI for most of the South Asian countries: the top five sources account for about two-thirds of the total FDI flow in South Asia (Table 8.2). Such kinds of concentration of FDI flow reflect the locational disadvantage of other South Asian countries in terms of building horizontal and vertical linkages within the region. Weak intra-regional trade can partly explain this poor situation of regional investment.

Intra-regional FDI accounted for a miniscule share of FDI in most of the South Asian countries. None of the countries except India made a significant outward investment. Although India's outward investment is over US\$15 billion, only a small amount was directed to South Asia (Table 8.3). These investments are mainly targeted at important strategic sectors such as infrastructure building, resource extraction, information technology (IT) and the high-tech sectors of developing and developed countries, where South Asian countries have limited opportunities and potential. India's FDI to Sri Lanka is mainly directed at steel, cement, rubber products, tourism, computer software, IT training and other professional services (Aggarwal 2008) and its FDI in Nepal is mainly in textiles, chemicals, food and beverages, and fabricated metals, etc. Bilateral investment between India and Sri Lanka after the Indo-Sri Lanka Free Trade Agreement (FTA) shows different categories of capital flow, including market-seeking (Sri Lankan Company Brandix's investment in India), resource-seeking (Indian company Ceat's investment in Sri Lanka) and tariff-arbitrage (export of Vanspati).

Most of the countries in the region have not yet fully opened their capital accounts concerning possible adverse effect on the balance of payment. Because of the restriction or partial openness of the capital account, outward FDI flow by local companies has been significantly restrained. A major constraint for outward investment of South Asian countries is to put restrictions over outward flow of capital (Habib et al. 2004).

Table 8.2 Sources of FDI

Country	Year	Top sources of FDI	Share of top five territories (%)	Share of traditional OECD countries (%)*	No. of identified source countries*
India	2010–11	Mauritius, Singapore, USA, Japan and the Netherlands	65.4	27.0	100
Bangladesh	2010–11	UK, USA, Hong Kong, South Korea and Egypt	61.3	51.0	44
Pakistan	2010–11	USA, UAE, UK, Hong Kong and China	57.6	61.0	33
Nepal	2010–11	India, China, South Korea, Japan and Canada	67.0	22.0	25
Sri Lanka	2010	USA, Malaysia and UAE	62.0	NA	NA

Note: *Data for 2006.

Source: Author's estimation based on Aggarwal (2008), Bangladesh Bank (2011), State Bank of Pakistan (2011), Central Bank of Sri Lanka (2010), Kamaladevi (2011)

Table 8.3 Outward flow of FDI from South Asia (US\$ million)

Country	2006	2007	2008	2009	2010	2011
Afghanistan	—	—	—	—	—	—
Bangladesh	4	21	9	29	15	9
Bhutan	—	—	—	—	—	—
India	14,285	19,594	19,257	15,927	13,151	14,752
Maldives	—	—	—	—	—	—
Nepal	—	—	—	—	—	—
Pakistan	109	98	49	71	47	62
Sri Lanka	29	55	62	20	46	50
South Asia	14,427	19,768	19,377	16,047	13,259	14,873

Source: UNCTAD (2012)

8.2.1 Intra- and extra-regional trade in South Asia

Strong interlinkage between trade and investment is considered to be highly important for enhancing regional investment. Since the 1980s, South Asian countries have gradually liberalised their trade regimes and have also signed a number of bilateral, subregional and regional trade agreements both within and outside the region,

which have contributed to the overall increase in trade of South Asian countries – from US\$320 billion in 2005 to US\$938 billion in 2011 (Table 8.4). However, no significant change took place in the direction of trade – the overwhelming share of South Asia's total trade is still directed outside the region. Intra-regional trade has increased at a much slower rate; while extra-regional trade of South Asian countries registered a rise of 20 per cent per year between 2006 and 2010, intra-regional trade increased only at 8.5 per cent per year during the same period.³ A number of factors have contributed to the low level of intra-regional trade, including long sensitive lists, Pakistan's positive list approach to India, non-tariff barriers and similarities in export baskets (Rahman 2010). The rise in bilateral trade of South Asian countries with neighbouring regions (e.g. South East Asia and East Asia) has yet to make a considerable impact in enhancing regional trade in South Asia. However, South Asia's increasing link with broader production networks with East and South East Asian countries could be an important aspect in future co-operation for trade and investment. Thus, the regional trade integration under the South Asian Free Trade Area (SAFTA) should be broadened through effective operation of other subregional integration initiatives, such as the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) and Bangladesh China India Myanmar (BCIM) Economic Corridor etc. (Table 8.4).

Trade in services in South Asia has registered a considerable rise since the early 2000s. Its share in gross domestic product (GDP) almost doubled between 2001 and 2010, particularly because of the significant rise in India's trade during that period (Table 8.5). Although most countries in the region have experienced a consistent rise in trade in services as a share in GDP, a few of them have experienced deceleration of growth in their service trade, including Nepal and Sri Lanka. South Asia's service trade is contributed to by a large endowment of professionals, skilled workers and unskilled workers, mainly through inward flow of remittances by migrant workers of the region. Despite such positive changes, South Asia's service sector with its large size is still weak in generating large-scale employment. However, the rise in the service sector since the early 2000s has been contributed to by the liberalisation of most of the services sector including telecommunications, energy and financial services, where a significant amount of FDI flow has been directed (Raihan 2008). There was no regional agreement in trade in services until 2010, when South Asian countries signed the SAARC Agreement on Trade in Services (SATIS), taking a positive list approach for further liberalisation and deeper coverage.

8.3 An overview on Foreign Direct Investment-related policies of South Asian countries

South Asian countries have provided various kinds of incentives and supports for attracting FDI under national FDI policies (Table 8.6). In the case of the pre-entry treatment phase, measures include few sectoral bans, limited use of caps on foreign ownership, requirement of screening in specified projects, almost no minimum capital requirement and no locational clause, etc. There is no sectoral ban in Nepal, Sri Lanka and Maldives, while limited levels of ban are practised in Bhutan, India and

Table 8.4 Export and import of SAARC countries

South Asia's trade with	Export			Import				
	2002	2005	2010	2011	2002	2005	2010	2011
World	60,328.9	132,306.8	272,272.3	365,323.8	73,099.0	188,027.7	438,421.1	572,179.9
SAARC	19.4	47.0	137.1	149.7	20.4	45.1	98.6	143.0
% of total trade of SAARC								
India	83.0	75.9	80.9	82.5	78.6	74.9	79.8	80.8
Pakistan		12.1	7.9	6.9		13.3	8.6	7.6
Sri Lanka	7.8	4.7	3.1	2.7	8.3	4.4	2.8	3.4
Bangladesh	3.9	2.7	1.8	1.8	12.6	6.7	6.0	5.5
Nepal			0.3	0.3			1.2	1.0
Maldives	0.2	0.1	0.03	0.02	0.5	0.4	0.2	0.2
Bhutan		0.2	0.2	0.1	0.0	0.2	0.2	0.2

Source: Trade Map Database (2012)

Table 8.5 Trade in services (% of GDP)

	2001	2005	2010	2011
South Asia	7.5	11.5	13.3	
Bangladesh	4.8	5.7	6.8	7.0
India	7.6	12.0	14.3	
Maldives	57.8	54.0	108.9	123.0
Nepal	10.5	10.0	9.6	8.7
Pakistan	5.2	10.2	7.8	6.2
Sri Lanka	19.7	14.9	11.3	12.0

Source: World Development Indicators database 2013

Note: No data are available for Bhutan and Afghanistan

Bangladesh. Most of the South Asian countries impose different levels of caps over FDI taking into account the capacity of domestic investors. Most countries keep the screening provision for new FDIs in order to appreciate the quality on various aspects such as nature of production, nature of employment, its environment friendliness and impact of FDI in the locality, etc. Out of the seven countries reported in Table 8.6, five countries do not follow minimum capital requirement, while the other two countries have such requirements but on a sectoral basis.

In the case of post-entry treatment FDI, measures include, among others, no employment requirement, limited performance requirement, allowing import of technologies, no restriction on repatriation of capital and profits, and provision of different tax incentives (Aggarwal 2008). Despite a general demand for more FDI in labour-intensive industries, no country has imposed any employment requirement as a clause for investment. The same is true for performance requirement although most countries expect better use of local resources by foreign-owned companies. Countries are liberal in cases of technology transfer by the foreign-owned companies, although it is considered to be a major device for the development of technological capacity of developing countries. Evidence suggests that technology transfer by multinational corporations (MNCs) in developing countries is not induced by market-related factors and often transfer is limited due to various factors (Moran et al. 2005). Repatriation of profit and dividend is allowed for foreign companies despite the fact that net inflow of foreign exchanges may be either too low or even negative (Bhattacharya 2004). All countries provide tax incentives to foreign investment in order to encourage them to invest in their country, although its consequences are not always positive in many countries (Moran et al. 2005). Overall, South Asian countries are following liberal FDI policy with conditions at the pre-establishment phase but few at the post-investment phase. However, homogenous policy environments across the region alone cannot ensure similar advantage to all locations, rather, a number of other factors are responsible for ensuring that advantage to different locations.

Most of the South Asian countries have signed bilateral investment treaties with a number of developed and developing countries outside the region (Table 8.7). Within South Asia, such treaties are not so common. These treaties have specific provisions for safeguarding foreign investment in the destination country. Various analyses

Table 8.6 FDI policies of South Asian countries

Criteria	Bangladesh	India	Nepal	Pakistan	Sri Lanka	Bhutan	Maldives
<i>Pre-entry treatment</i>							
Sectoral ban on FDI	Private ownership restricted in four sectors	Nine broad sectors		Alcohol		Positive list of sectors	
Caps of foreign ownership	None	Ownership cap on 16 sectors	FDI prohibited in 23 sectors	100 per cent in all sectors	A negative list of sectors	Maximum 70 per cent equity allowed	Investment >US\$5 million can be wholly owned
Screening	No screening except in telecom, power and mineral	Screening for FDI in specified sectors	Approval from department of industries	No screening except in five manufacturing sectors	Strict screening by Board of Investment	Screening by FDI committee which meets once in three months	Mandatory screening if foreign equity is >51 per cent; Conditional screening if it is <51 per cent
Minimum capital requirement	None	None	None	Agriculture: US\$0.3 million; Infrastructure: US\$0.3 million; IT and Telecom: US\$0.15 million	None	Manufacturing: US\$1 million; Services: US\$0.5 million	None
Location	None	None	None	None	None	None	None

(continued)

Table 8.6 FDI policies of South Asian countries (continued)

Criteria	Bangladesh	India	Nepal	Pakistan	Sri Lanka	Bhutan	Maldives
<i>Post-entry treatment</i>							
Employment performance requirement	None	In the small-scale sectors	None	None	None	Restricted	None Use of local content encouraged
Technology imports	None	None	Subject to approval	Limits in agriculture and services	None	Subject to approvals	None
Restrictions on repatriation of capital and profits	None	None	Subject to approval	None	None	Subject to restrictions	None
Tax incentives	Tax incentives on expatriate incomes	Non-discriminatory	Non-discriminatory	50 per cent on plant and machinery and depreciation	Non-discriminatory	Non-discriminatory incentives	Foreign investors have to pay royalty to the government

Source: Aggarwal (2008)

Table 8.7 Bilateral investment treaties signed by South Asian countries

Country	1980	1985	1990	1995	2000	2011
Bangladesh	1	1	8	8	12	19 (0, 3)
India	0	0	0	1	13	33 (1, 4)
Nepal	0	1	2	3	3	4 (0, 3)
Pakistan	2	4	7	10	15	23 (1, 4)
Sri Lanka	4	13	16	17	20	23 (2, 4)
Afghanistan						3
Total	7	19	33	39	63	105

Note: Figures in the parentheses indicate number of bilateral investment treaties and avoidance of double taxation treaties signed within South Asia.

Source: Banga (2003) and author's calculation

show that bilateral investment treaties signed by South Asian countries have limited impact in attracting FDI to the region (in the case of Bangladesh, see Bhattacharya 2004; Bhattacharya and Moazzem 2006).

Imposing different kinds of restrictions over bilateral investment is a major factor for low level of investment in South Asia. India has put restrictions on the investment of Pakistan and Bangladesh. However, a number of developments took place in the political arena, under which India has recently withdrawn restrictions over Bangladesh's investment at limited scale. The development of an India–Pakistan relationship would make way to withdraw restrictions over Pakistan's investment in India.

It is clear from the above discussion that South Asian countries are yet to give adequate attention to enhancing regional investment. Policies and measures for regional investment co-operation in South Asia have experienced marginal development compared with those related to trade integration. More importantly, promotion of intra-regional investment seems to be considered mainly through promotion of trade between South Asian countries. Regional co-operation for investment has yet to be considered as a major policy instrument for strengthening regional integration.

8.4 Institutional approach for enhancing regional investment: An analysis of SAARC initiatives

SAARC was the main body to take initiatives towards enhancing intra-regional investment in South Asia. However, SAARC initiatives were often found to be little and sporadic. During the 1980s and early 1990s, SAARC initiatives for promotion of FDI were largely absent, perhaps because of the low level of global flow of FDI at that time (Table 8.8). With the rise in the global flow of FDI in the 1990s, SAARC put emphasis on encouraging extra-regional FDI. Malé SAARC

Table 8.8 SAARC declarations on promotion of regional investment

Summit	Venue and year	Status of mention	Major highlights
First	Dhaka, 1985	No mention	
Second	Bangalore, 1986	No mention	
Third	Kathmandu, 1987	No mention	
Fourth	Islamabad, 1988	No mention	
Fifth	Malé, 1990	No mention	
Sixth	Colombo, 1991	No mention	
Seventh	Dhaka, 1993	- The Heads of States or Governments noted the importance of adequate investment in the health and education sectors for the success of their population programmes - They observed that the economies of developing countries continued to suffer as a result of limited market access for their exports, dwindling resource flows, absence of adequate foreign investment, mounting external indebtedness, inadequate transfer of technology and inequities in the global monetary, financial and trading systems - Referring to the competing demands for capital investment resources, the Heads of States or Governments underscored the need to ensure the adequate flow of investment resources to the developing countries through increasing global savings and a more equitable utilisation of the peace dividends	Extra-regional FDI stressed
Eighth	New Delhi, 1995	No mention	

(continued)

Table 8.8 SAARC declarations on promotion of regional investment (continued)

Summit	Venue and year	Status of mention	Major highlights
Ninth	Malé, 1997	- The Heads of States or Governments agreed that the efforts to enhance trade and economic co-operation in the region would be further strengthened by initiating specific steps to promote and protect investment, increase complementarities in economic activities of member states and other measures supportive of promotion of SAARC joint ventures - They also welcomed the offer of India to host a meeting on promotion and protection of investment and the offer of Pakistan to host a meeting on avoidance of double taxation - They also welcomed measures of co-operation in the areas of customs standardisation, arbitration and enhancing industrial economy and management - The Heads of States or Governments reaffirmed their determination to encourage the private sector in the region to contribute increasingly to the strengthening of intra-SAARC links in key areas of trade, investment and finance - They welcomed the decision by the SAARC Chamber of Commerce and Industry (SCCI) to convene annually an Economic Cooperation Conference in conjunction with the annual meeting of SAARC Commerce Ministers and SAARC Trade Fairs - The Heads of States or Governments called on the developed countries to assist the developing countries through the creation of a favourable and supportive global economic environment, in particular, through domestic action in their countries for purposes of accelerated investment flows to developing countries, thereby generating a positive impact on the developmental efforts of developing countries as well as assisting their integration into the multilateral trading system	- Promotion and protection of intra-regional investment stressed - Domestic measures of developed countries to enhance investment in developing countries

(continued)

Table 8.8 SAARC declarations on promotion of regional investment (continued)

Summit	Venue and year	Status of mention	Major highlights
Tenth	Colombo, 1998	- Increased opportunities in trade and investment have bypassed many developing countries. The least developed countries (LDCs) have in particular been marginalised through a series of developments including the shrinking of official development assistance (ODA), concessional and other financial flows to these countries - The Heads of States or Governments cautioned that potential efforts to formulate a new multilateral investment agreement should not overlook the need to ensure the continued independence of developing countries and LDCs to formulate specific investment policies appropriate to their stage of development - They acknowledged the need to enhance the collective capacity of SAARC in respect of policy analysis, with a specific emphasis on international financial, monetary, trade and investment issues and their domestic ramifications - The Heads of States or Governments agreed that the benefits of economic liberalisation would be more extensive and better balanced through the promotion of trade-creating joint ventures, investment and trade in services such as tourism	- Multilateral investment agreement should provide scope to LDCs and developing countries to formulate specific investment policy - Building analytical capacity at regional level
Eleventh	Kathmandu, 2002	- The Heads of States of Governments agreed to accelerate co-operation in the core areas of trade, finance and investment to realise the goal of an integrated South Asian economy in a step-by-step manner - The Heads of States of Government also decided to instruct the Secretary General to facilitate the early finalisation of a regionally agreed investment framework to meet investment needs of the SAARC member states - The Heads of States of Government acknowledged that investment in poverty alleviation programmes contributes to social stability, economic progress and overall prosperity	Finalisation of regional investment framework stressed

(continued)

Table 8.8 SAARC declarations on promotion of regional investment (continued)

Summit	Venue and year	Status of mention	Major highlights
Twelfth	Islamabad, 2004	Investment in human resources is critical for future development of South Asia. It is, therefore, essential to establish a network of centres of higher learning, training and skill development institutes across South Asia	Investment in human resources
Thirteenth	Dhaka, 2005	The Heads of States of Government recognised the need to take the process of regional economic integration further by expanding the scope of SAFTA to include trade in services, enhanced investment and harmonised standards	Acceleration of trade in services and investment under SAFTA framework
Fourteenth	New Delhi, 2007	Heads of States of Government stressed that to realise its full potential, SAFTA should integrate trade in services. They called for finalisation of an agreement in the services sector at the earliest. They also directed that the Agreement on Investment Promotion and Protection be finalised	Finalisation of Agreement on Investment Promotion and Protection stressed
Fifteenth	Colombo, 2008	Towards achieving further economic integration, they directed that the Draft Agreement on Investment Promotion and Protection be finalised early and the SAARC Arbitration Council be operationalised	- Finalisation of Agreement on Investment Promotion and Protection stressed - Operationalisation of SAARC Arbitration Council

(continued)

Table 8.8 SAARC declarations on promotion of regional investment (continued)

Summit	Venue and year	Status of mention	Major highlights
Sixteenth	Thimphu, 2010	- The leaders emphasised the need to strengthen the role of the private sector in regional initiatives through appropriate mechanisms including through public-private partnership (PPP) as well as the need for greater intra-SAARC investment promotion efforts - The leaders underlined the important role of the SAARC Development Fund (SDF) for financing regional and subregional programmes and projects. They welcomed the ratification of the SDF Charter. The leaders also welcomed the inauguration and operationalisation of the Permanent Secretariat of the SDF including the appointment of its first Chief Executive Officer (CEO). The leaders also urged the importance that projects funded through SDF be demand-driven, time-bound and aligned with the developmental priorities of the region. The leaders also emphasised the need for the member states to take full advantage of the mechanism of the SDF through expeditious clearance and implementation of the projects and programmes to promote the welfare of the people of the SAARC region, to improve their quality of life and to accelerate economic growth, social progress and poverty alleviation in the region	- Strengthening of the role of private sector through greater intra-regional investment promotion efforts - Ratification of the SAARC Development Fund for financing regional and subregional programmes and projects
Seventeenth	Addu City, 2011	- To direct the SAARC finance ministers to chart a proposal that would allow for greater flow of financial capital and intra-regional long-term investment - To make available an appropriate percentage of national income towards the respective countries' renewable energy investments, subject to the approval of national arrangements	- Proposal for greater flow of financial capital and inter-regional long-term investment - Investment in renewable energy

Source: Prepared by the author based on the SAARC Declarations, see: www.saarc-sec.org/SAARC-Summit/7/ (accessed 21 May 2014).

declarations in 1997 urged developed countries to take domestic measures for encouraging investment in South Asia. During the 1980s and 1990s, most of the SAARC countries had not opened their capital accounts and not allowed the outward transfer of capital on a large scale. As a result, initiatives for promotion of investment in South Asia were largely confined to attracting extra-regional investment in South Asian countries.

A major policy focus of SAARC initiatives was the promotion of trade-led intra-regional FDI. As a result, a major part of the SAARC initiatives for economic co-operation in the 1990s and early 2000s was largely confined to promotion of regional trade co-operation – at first by establishing the SAARC Preferential Trading Arrangement (SAPTA) in 1995, and then by establishing the South Asian Free Trade Area (SAFTA) in 2006. There was no broad discussion on the promotion of investment during this period outside the purview of trade co-operation within the region. Discussion on regional co-operation for investment was confined to the preparation of draft acts for promotion and protection of intra-regional investment. This was implemented perhaps with the assumption that with the enactment of SAFTA, intra-regional investment would automatically be increased.

The most concrete initiative so far made under the aegis of SAARC is to draft an agreement on the promotion and protection of investment from regional countries. The major objective of the agreement is to ensure equal treatment for investments of SAARC countries without restriction, quota and marketing. Products of such investments will not be listed under the sensitive list, in order to promote cross-border trade and investment. However, the draft agreement has been pending approval since 2007. During the Seventeenth SAARC Summit, held in Maldives, a fast-tracking of the regional investment treaty was called for, along with the creation of regional production chains, in order to deepen linkages in the SAARC region.

SAARC initiatives for the promotion of investment need to take into account a number of characteristic features of the region, particularly with regard to the domestic production base, production network, and intra-regional and extra-regional investment. First, FDI in South Asia is mainly targeted toward local markets, particularly domestic market-oriented manufacturing and services-related industries. Thus, intra-regional trade would have few implications on the promotion of regional flow of FDI. Second, South Asia is part of global production networks linked with countries outside the region. Thus, promotion of an exclusive regional production network would not be attractive to the foreign investors, including those from the region. Third, since foreign investors outside South Asia predominate in FDI in most of the South Asian countries, promotion of extra-regional investment should be equally considered or at least should not be adversely affected through other measures. Fourth, with the rise of the global flow of financial capital, South Asian countries need to consider further relaxation of the capital account in order to enhance regional flow of capital. In the SAARC Summit, held in Addu City, Maldives, in 2011, regional flow of financial capital was stressed, along with the promotion and protection of investment. Thus there is scope for taking initiatives beyond the

traditional framework of regional investment co-operation in South Asia. Future institutional frameworks for investment should cater to multidimensional aspects of investment co-operation both within and outside South Asia.

The SAARC Development Fund (SDF), which started its operation in 2010 with an initial capital of US\$300 million, is mandated to finance development projects in social, economic and infrastructure-related projects. Initially, it provided finance to social sector projects, such as strengthening the livelihood initiative for home-based workers in the SAARC region; strengthening maternal and child health including immunisation; scaling up of zero energy cold storage (ZECS) technology for the horticultural commodities in the high hills of SAARC countries; empowering rural communities 'reaching the unreached'; conducting a study on teacher development as the key to enhancing the quality of basic education in selected SAARC countries; and strengthening the livelihood initiative for home-based workers in SAARC region (Phase-II) and the South Asia Initiative to End Violence Against Children (SAIEVAC).⁴ The other two components of the Fund, such as economic and infrastructure-related projects, have not yet been initiated. The overall objective of the Fund is to improve quality of life, promote welfare and accelerate economic growth, social progress and poverty alleviation in the SAARC region. In these regards, the Fund promotes cross-country initiatives. The Fund is mandated to promote social and economic projects instead of commercially viable investment projects. Hence, despite its prospect in terms of facilitating cross-border flow of funds, it would contribute little towards enhancing large-scale intra-regional FDI.

In 'effective' terms, there is no independent separate body in the institutional structure of SAARC to deal with investment-related issues. The inter-ministerial committee for trade discusses and takes decisions on investment-related issues apart from its core activities related to trade. As the committee has to spend a substantial amount of time discussing trade-related issues, investment issues have been discussed very sporadically and particularly on a need basis. Such an approach to investment co-operation makes the issue dependent on the progress made in trade integration within the region. Given the gravity of the issue of investment co-operation both within and outside the trade-investment nexus, a separate body in the SAARC needs to be formed to deal the relevant issues.

8.5 Experience of ASEAN towards enhancing regional investment: Learning for SAARC

SAARC can take lessons from ASEAN with regard to the initiatives undertaken for the promotion of investment in South East Asia. Although there is huge difference between the two regions in terms of size of the economy, level of economic development and level of integration, the success of ASEAN would be a good learning experience for the SAARC region. A major characteristic of ASEAN initiatives is to promote investment along with trade, both within and outside the region.

Under the institutional framework of ASEAN, investment co-operation between South East Asian countries has evolved over the years with a view to promote

both intra- and extra-regional investment. In 1987, ASEAN countries signed an agreement on the promotion and protection of investment.⁵ In a continuation of this process, a framework agreement on the ASEAN Investment Area (AIA) was signed in 1998 with a view to promote ASEAN as an investment area, to strengthen and increase the competitiveness of ASEAN economic sectors, and to work on the reduction of investment barriers in order to enhance investment.⁶ Over time ASEAN members have joined in the Agreement on the AIA. The major focus under the AIA is to implement co-ordinated ASEAN investment co-operation and facilitation programmes, to implement a co-ordinated promotion programme and investment awareness activities, to grant national treatment facilities, to ensure active involvement of the private sector in the AIA development process, to provide a more streamlined and simplified investment process, and to eliminate investment barriers and liberalise investment rules and policies. To oversee the implementation of the AIA framework agreement, a ministerial-level ASEAN Investment Area Council was established which was assisted by the ASEAN Coordinating Committee on Investment. In 2009, ASEAN further widened investment co-operation by signing the Comprehensive Investment Agreement.

Despite the progress made in the institutional arrangement of AIA, its impact on FDI flow in South East Asia is mixed. The key instrument of the AIA is to liberalise investment provisions for most of the industries for the investors of the ASEAN region except for four categories of industries. According to Jarvis, Shaofeng and Boon (2009), most countries have restricted investment to a number of key strategic sectors under the AIA with a view to protecting domestic investment. These sectors include telecommunication, financial services, infrastructure, transport and print, electronic and broadcast media, etc. Moreover, member countries impose various conditionality clauses which make investment access difficult in the sectors liberalised under the AIA including ceiling in equity participation, joint-venture clause, forced government business co-operation contracts, directed sourcing contracts, domestic market access restrictions, export-only clause, etc. (Jarvis et al. 2009). Thus a wide discrepancy is found in terms of provisions as per the AIA and that is followed at national level by member countries. In that context, ASEAN member countries have to undertake various liberalisation initiatives in order to make the AIA more effective for regional investors.

Besides various initiatives undertaken at government to government levels, a number of private sector initiatives have been carried out among regional investors including the ASEAN Industrial Joint Venture (AIJV) and the Brand-to-Brand Complementation (BBC) schemes and ASEAN Industrial Cooperation (AICO) scheme, etc. Given the limitations of the first two approaches, the third initiative is that AICO is currently particularly focusing on investment schemes to be promoted through tariff and non-tariff incentives (e.g. preferential tariff of 0–5 per cent for products manufactured by participating companies).⁷ Under the AICO, ASEAN companies could undertake joint-venture initiatives in the manufacturing sectors. Such arrangements facilitate physical movement of products between participating companies, as well as encouraging resource sharing/pooling and/or industrial complementation.

ASEAN investment co-operation both at inter-governmental level as well as in the private sector is being pursued for greater integration in the regional production network. In order to integrate trade, investment and production-related activities within the region, it has put emphasis on three core integration schemes including AIA, AFTA and the AICO scheme. Such integration of investment-related schemes under strong trade integration between countries could facilitate greater regional integration and make the regional production networks more competitive.

Investment in the ASEAN region has been enhanced by Japanese FDI, as it takes a lead role in promoting intra-regional investment. Japanese TNCs have developed vertical and horizontal production networks in the region which facilitate investment. South Asia needs this kind of investment in the region which takes a lead role for the development of a production network targeting the regional and global markets.

The institutional mechanism followed in the ASEAN region is definitely a learning model for SAARC. However, its replication in SAARC region is not so easy, particularly because of the lack of preparedness of SAARC to address core challenges such as low trade integration, limited market size, the weak intra-regional production network, lack of infrastructural facilities and insufficient human resources. However, ASEAN initiatives could provide directives to SAARC for the promotion of regional investment.

8.6 Suggestions for accelerating SAARC's institutional initiatives for enhancing intra-regional investment in South Asia

SAARC Secretariat is the official body that pursues investment-related initiatives through a Trade and Investment Sub-committee. Given the importance of regional investment co-operation in South Asia's economic growth and its growing link with trade and non-trade issues, SAARC should consider forming a separate sub-committee with specific terms of reference to deal with investment-related issues. This committee should identify a possible mechanism for enhancing regional investment and should set a work plan with a specific timeline for implementing various activities. One of the major activities of the proposed sub-committee would be to work out an effective mechanism to ensure regional capital flow in order to enhance investment in potential sectors in different South Asian countries.

A major constraint for prospective regional investment is very limited knowledge about investment potential in different SAARC countries, particularly lack of information – for example on regional markets, sectors, investors and facilities. Various studies have identified potential sectors at regional level where a regional value chain could be developed (Aggarwal 2008; Moazzem 2005) (Table 8.9). In this context, each country should make information accessible to the investors through national-level investment-promoting agencies.

Given the importance of extra-regional FDI for the development of South Asia, SAARC initiatives should continue to provide necessary incentives and support

Table 8.9 Priority industries for investment in South Asian countries

Pakistan	Value-added export industries: manufacturing categories such as garments, bed linens, surgical instruments, and sporting goods High-tech and IT industries: chip manufacturing, software development and precision equipment manufacturing Others: tourism, housing, engineering, chemicals and construction
Bangladesh	Textiles, electronics, IT, natural gas-based industries, frozen foods, leather, ceramics, light engineering and agro-based production
Nepal	Medicinal and aromatic plants, agro-based (mushroom, spices, vegetables, fruits), dairy, tea, sericulture, hydropower, leather, poultry and textiles
Sri Lanka	Electronics, light engineering, textiles, rubber, mineral and processing, tourism, IT, gems and jewellery, healthcare and pharmaceuticals, ceramics and services
Bhutan	Hydropower, agro-processing, tourism and medicinal plants
Maldives	Marine-based industries, tourism, infrastructure, and air and sea transport

Source: Aggarwal (2008)

for that. ASEAN experience shows that both intra-regional and extra-regional investments should be treated equally, and should be promoted with equal emphasis. Thus SAARC should work on regional investment promotion taking broader and long-term issues into consideration.

A number of initiatives are currently under discussion and at the phase of implementation at the SAARC, which if completed successfully, could facilitate intra-regional investment in South Asia. These include, among others, establishment of an SAARC Arbitration Council, SAARC limited multilateral agreement on avoidance of double taxation and mutual administrative assistance in tax matters. Operationalisation of these agreements and institutions would help to increase trade and investment in South Asia. SAARC should put emphasis on timely completion of these agreements.

SAARC Chamber of Commerce and Industry (SCCI) has been formed to enhance trade and investment, to safeguard economic and business interests of SAARC, and to promote the exchange of commercial and industrial management, and scientific information, education and know-how among the member countries. This private sector trade body is pursuing broader investment co-operation in South Asia through the creation of awareness-building activities in the business communities. A major area of interest of the SAARC Chamber is to develop an institutional framework for supporting economic co-operation. SCCI should facilitate regional investment by facilitating investors at the pre-establishment phase by providing important market-related information.

Awareness building for enhancing intra-regional investment should be expedited through the initiative of the private sector trade bodies both at local and regional levels. SAARC Chamber has to play a proactive role in this direction. According to the Asian Development Bank and Federation of Indian Chambers of Commerce and Industry (2010), intra-regional investment has been constrained by restrictive policies, such as excluded sectors, equity restrictions, lack of sufficient protection

for investors, under utilisation of bilateral investment treaties and lack of strategic promotion of intra-regional investment. In this context, the Chamber has suggested the following proposals: opening up the excluded sectors on a limited basis; allowing FDI for those sectors in specific cities; expansion of the use of bilateral investment treaties and harmonisation of investment provisions in FTAs; promoting more intra-regional investment through boards of investment; establishing dedicated country offices; expanding the marketing strategies and targeting the priority sectors; and conducting a feasibility study on creating an umbrella investment body for South Asia. In this context a separate institutional structure is needed in order to enhance regional investment.

Trade-led FDI will play a major role in the coming decade, particularly India's ongoing endeavour for building economic co-operation both within and outside the region. In this context further tariff liberalisation under the SAFTA accord, particularly reduction of member country's sensitive lists, would contribute to the enhancement of regional trade. Such tariff liberalisation would have direct implications on intra-regional investment in South Asia. Besides, ongoing discussions on a number of bilateral trade agreements between South Asian countries might facilitate investment in the future. Moreover, a number of subregional initiatives (e.g. BIMSTEC) are ongoing. Extra-regional initiatives such as the India-ASEAN, India-EU and India-Mercusur trade agreements would have direct implications on extra-regional investment in South Asia, particularly in India. Analysis shows that such agreements will have an adverse impact on small countries (CARIS 2008). Moreover, financial capital would also be invested within the region which needs to be accommodated in the framework for investment co-operation in South Asia.

8.7 Conclusion

South Asia is one of the lowest FDI recipient regions in the world despite the fact that its FDI regime is one of the most liberalised regimes in the world. Except India, none of the countries of the region could attract a considerable amount of FDI every year. More importantly, intra-regional FDI is not the major source of FDI in most of these countries. Extra-regional sources predominate in regional trade and investment. In other words, weak regional integration is one of the major stumbling blocks for strengthening regional investment co-operation in South Asia.

Regional co-operation for investment is not yet becoming a priority agenda in the SAARC initiative. Various activities related to investment co-operation are miniscule and sporadic in nature with little impact on the promotion of regional investment. Most importantly, initiatives for investment co-operation are considered 'supplementary' to those of trade-related initiatives. Given the importance of co-operation for regional investment, there is scope for undertaking investment-focused initiatives in SAARC's institutional structure, particularly when trade integration is yet to be strengthened at the regional level.

It is understandable that South Asia is quite backward compared with other regions in terms of undertaking institutional measures targeting investment co-operation.

A good learning model for SAARC could be ASEAN. Various measures have been undertaken at government level over the years, of which the latest are the AIA and the Comprehensive Investment Agreement. Moreover, a number of private sector initiatives are in operation for the promotion of intra-regional investment of which the most recent is the ASEAN Industrial Cooperation (AICO) scheme. In order to strengthen the regional production networks and make them globally competitive, ASEAN has recently begun to integrate a number of government-level and private-level initiatives. South Asia could take lessons from those ASEAN initiatives for regional investment co-operation. Similar to Japan in the case of promoting intra-regional investment in South East Asia, one or two major FDI sourcing countries with an interest to investment in South Asia could take the lead role to enhance bilateral and regional investment with a view develop production networks within the region.

South Asian countries should work toward building production networks in different sectors using intra- and extra-regional trade and investment. This could be done under the aegis of the institutional structure of the SAARC. In this context, a separate independent body is to be formed focusing on the promotion of intra-regional and extra-regional investments. The Committee will work with the government of the member countries as well as with the private sector trade bodies to introduce new policies and to undertake measures and action plans for increasing regional FDI. The Committee should take initiatives to identify barriers to investment within the region, support private sector with market-related information and set the agenda for discussion in the SAARC Summit with a view to strengthening regional investment co-operation in South Asia in a sustained manner.

Notes

- 1 The author would like to thank the participants of the International Conference on 'Regional Trade and Economic Cooperation in South Asia: Trends, Challenges and Prospects' held in New Delhi on 2–3 May 2013 for their valuable comments on this chapter. The Conference was organised by the Research and Information System for Developing Countries (RIS), India and the Commonwealth Secretariat, London. Some of the issues discussed in the chapter are also reflected in another paper of the author (Moazzem 2012).
- 2 An investment creation in an integrated regional market could be a good substitute of possible 'trade diversion' in the region (Bloström and Kokko 1997).
- 3 India is the major trading partner for most of the South Asian countries.
- 4 A number of projects are in the pipeline which include access to water in SAARC countries; regional inter-professional master's programme in rehabilitation science; establishment of toll-free helplines for women and children; and post-harvest management and value addition of fruits in production catchments in SAARC countries.
- 5 This act was amended in 1996.
- 6 In 2001, a protocol was signed to amend the framework agreement.
- 7 The AICO scheme allows joint-venture of participating companies which operate at different stages of the production value chain including raw materials, intermediate products and final products. Produced products of the participating companies will enjoy different levels of market access in the respective companies' market depending on at what stage the products are produced – from 0–5 per cent in the case of raw materials and intermediate products to unlimited access in the case of final products. (For details see: www.asean.org/communities/asean-economic-community/item/asean-industrial-cooperation-scheme).

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Chapter 9

Regional Trade in Services in South Asia

Selim Raihan

9.1 Introduction

Even though the services sector is the major contributor to gross domestic product (GDP) in most South Asian countries, trade in services in South Asia is low. However, even at the global level, compared to the trade in goods, trade in services has a much lower share in total world trade. The ‘intangibility’ and ‘unstorability’ factors were considered the main impediments to trade in services. The services sector was not included in the multilateral trading system until the inception of the Uruguay Round of General Agreement on Tariffs and Trade. Following the conclusion of the Uruguay Round, the General Agreement on Trade in Services (GATS) was the first initiative that aimed at the progressive liberalisation of trade in services. Since January 1995, the World Trade Organization (WTO) has been administering this agreement and finally, services trade is getting the necessary importance in the multilateral trading system.

Since the late-1980s, the services sector has boomed in the South Asian countries. Alongside the growth, liberalisation of the services trade too has become a critical economic agenda for these economies. Some of their services sectors have been liberalised as part of their commitment under GATS. Under the request–offer process of GATS, there have been requests from other developing and developed countries to open up services sectors of the South Asian countries. Additionally, they have also taken steps for the unilateral liberalisation of the sector. South Asian countries have also taken initiatives to liberalise trade in services among themselves. The latest development of these initiatives is the South Asian Association for Regional Cooperation (SAARC) Agreement on Trade in Services (SATIS) in 2010.

Against this backdrop, the chapter explores the issues and concerns related to liberalisation of trade in services in South Asia. The chapter is divided into the following sections: Section 9.2 provides an overview of the services sector in South Asian countries, highlighting the growth of the sector and its contribution to the economy in terms of output, employment, trade and investment flows. Section 9.3 deals with the experiences of South Asian countries in terms of multilateral commitments and offers made and in this regard, the issues and concerns of domestic preparedness for further opening up of the services sector. Section 9.4 presents the scenarios of services trade liberalisation negotiations in South Asia. Section 9.5 analyses the current state of domestic preparedness in different services sub-sectors in terms of their competitiveness and the likely outcomes of liberalisation in South Asia. Finally, section 9.6 concludes.

9.2 Overview of the services sector in South Asia

9.2.1 Growth in the services sector value added

Table 9.1 compares the growth rates in the services sector of South Asian countries for different time periods. Bangladesh, India and Nepal have experienced a persistent rise in the growth of the services sector. In contrast, Bhutan, Pakistan and Sri Lanka have experienced a rather fluctuating trend in the growth of their services sectors. During the 2000s, the average growth rate in the services sectors increased by 78 per cent in Nepal compared with that of the 1980s. The corresponding rates for Bangladesh, India and Sri Lanka are 64 per cent, 41 per cent and 23 per cent, respectively. However, growth rates decelerated for Bhutan and Pakistan during the same period – by 13 and 23 per cent, respectively.

9.2.2 Contribution to GDP

South Asian countries have witnessed a significant shift in the structure of their economies towards the dominance of the services sector in national production. Table 9.2 suggests that during the 2000s, with the exception of Afghanistan, the share of the services sector in the GDP had been more than 50 per cent in these countries. The most significant services sub-sectors in terms of output are distribution (wholesale, retail trade, restaurants and hotels), transport-storage and communication, construction, and community-social and personal services within other activities. These sub-sectoral trends in service output reflect the importance of a variety of factors in shaping services sector performance in the South Asian countries. These factors include deregulation and policy reforms in areas such as telecommunications, and the role of rising incomes and domestic demand in driving growth in segments such as trade and distribution services or community, personal and social services.

9.2.3 Contribution to trade

Bangladesh, India, Maldives and Sri Lanka experienced consistent rises in the growth rates of services exports and imports (Table 9.3). In contrast, Nepal and Pakistan

Table 9.1 Average annual growth rates in service sector value added in South Asian countries

Country	1981–1990	1991–2000	2001–2010
Afghanistan	n/a	n/a	12.86
Bangladesh	3.71	4.48	6.10
Bhutan	10.59	6.96	9.24
India	6.47	7.42	9.11
Maldives	n/a	15.28	7.16
Nepal	3.70	6.44	6.59
Pakistan	6.62	4.50	5.12
Sri Lanka	4.74	6.04	5.81

Note: n/a=data not available.

Source: Author's calculation based on WDI data

Table 9.2 Sectoral composition of GDP: South Asian perspective

Country	Sub-sector	1981–1990	1991–2000	2001–2010
Afghanistan	Total	100.00	100.00	100.00
	1 Agriculture, hunting, forestry, fishing (ISIC A–B)	66.04	60.37	37.67
	2 Mining, manufacturing, utilities (ISIC C–E)	15.20	11.68	16.29
	3 Construction (ISIC F)	2.21	4.53	8.98
	4 Wholesale, retail trade, restaurants and hotels (ISIC G–H)	7.20	9.36	8.74
	5 Transport, storage and communication (ISIC I)	4.10	6.29	14.60
	6 Other activities (ISIC J–P)	5.25	7.77	13.72
	Total services (ISIC F–P)	18.76	27.95	46.04
Bangladesh	Total	100.00	100.00	100.00
	1 Agriculture, hunting, forestry, fishing (ISIC A–B)	29.60	24.19	20.14
	2 Mining, manufacturing, utilities (ISIC C–E)	14.13	16.95	19.32
	3 Construction (ISIC F)	4.88	6.14	8.02
	4 Wholesale, retail trade, restaurants and hotels (ISIC G–H)	13.67	13.48	14.79
	5 Transport, storage and communication (ISIC I)	9.68	9.82	10.87
	6 Other activities (ISIC J–P)	28.04	29.42	26.86
	Total services (ISIC F–P)	56.27	58.86	60.54
Bhutan	Total	100.00	100.00	100.00
	1 Agriculture, hunting, forestry, fishing (ISIC A–B)	54.32	36.23	22.17
	2 Mining, manufacturing, utilities (ISIC C–E)	14.96	23.25	24.58
	3 Construction (ISIC F)	3.63	7.63	16.09
	4 Wholesale, retail trade, restaurants and hotels (ISIC G–H)	5.29	3.90	5.79
	5 Transport, storage and communication (ISIC I)	6.62	10.22	10.56
	6 Other activities (ISIC J–P)	15.17	18.77	20.80
	Total services (ISIC F–P)	30.71	40.52	53.24
India	Total	100.00	100.00	100.00
	1 Agriculture, hunting, forestry, fishing (ISIC A–B)	34.38	27.12	18.39
	2 Mining, manufacturing, utilities (ISIC C–E)	19.14	21.09	20.62
3	Construction (ISIC F)	6.92	6.58	7.53

(continued)

Table 9.2 Sectoral composition of GDP: South Asian perspective (continued)

Country	Sub-sector	1981–1990	1991–2000	2001–2010
4	Wholesale, retail trade, restaurants and hotels (ISIC G–H)	12.24	13.75	16.41
5	Transport, storage and communication (ISIC I)	4.62	5.42	8.27
6	Other activities (ISIC J–P)	22.70	26.04	28.78
	Total services (ISIC F–P)	46.48	51.79	60.99
Maldives	Total	100.00	100.00	100.00
1	Agriculture, hunting, forestry, fishing (ISIC A–B)	12.43	7.52	6.11
2	Mining, manufacturing, utilities (ISIC C–E)	5.05	5.27	7.40
3	Construction (ISIC F)	2.61	3.04	5.17
4	Wholesale, retail trade, restaurants and hotels (ISIC G–H)	27.88	32.21	30.42
5	Transport, storage and communication (ISIC I)	6.39	11.22	15.23
6	Other activities (ISIC J–P)	45.65	40.73	35.66
	Total services (ISIC F–P)	82.53	87.20	86.48
Nepal	Total	100.00	100.00	100.00
1	Agriculture, hunting, forestry, fishing (ISIC A–B)	45.22	37.02	34.18
2	Mining, manufacturing, utilities (ISIC C–E)	6.69	10.34	10.44
3	Construction (ISIC F)	5.42	6.37	6.59
4	Wholesale, retail trade, restaurants and hotels (ISIC G–H)	18.41	19.04	15.76
5	Transport, storage and communication (ISIC I)	5.89	7.22	9.27
6	Other activities (ISIC J–P)	18.37	20.01	23.76
	Total services (ISIC F–P)	48.09	52.64	55.38
Pakistan	Total	100.00	100.00	100.00
1	Agriculture, hunting, forestry, fishing (ISIC A–B)	26.44	24.36	21.79
2	Mining, manufacturing, utilities (ISIC C–E)	19.53	21.51	23.38
3	Construction (ISIC F)	3.54	3.22	2.68
4	Wholesale, retail trade, restaurants and hotels (ISIC G–H)	17.87	17.84	16.83
5	Transport, storage and communication (ISIC I)	12.98	13.14	12.69
6	Other activities (ISIC J–P)	19.64	19.94	22.64
	Total services (ISIC F–P)	54.03	54.14	54.84

(continued)

Table 9.2 Sectoral composition of GDP: South Asian perspective (continued)

Country	Sub-sector	1981–1990	1991–2000	2001–2010
Sri Lanka	Total	100.00	100.00	100.00
1	Agriculture, hunting, forestry, fishing (ISIC A–B)	21.32	16.05	12.16
2	Mining, manufacturing, utilities (ISIC C–E)	17.72	21.93	23.30
3	Construction (ISIC F)	6.68	6.45	7.00
4	Wholesale, retail trade, restaurants and hotels (ISIC G–H)	21.14	22.99	23.18
5	Transport, storage and communication (ISIC I)	10.85	10.16	11.98
6	Other activities (ISIC J–P)	22.28	22.43	22.38
	Total services (ISIC F–P)	60.95	62.03	64.54

Source: Author's calculation based on UNSTAT data (<http://unstats.un.org/unsd/snaama/dnllist.asp>, accessed on 4 March 2013)

Table 9.3 Annual average growth rate of services exports and imports (%)

Country	Services exports (balance of payments, current US\$)			Services imports (balance of payments, current US\$)		
	1981–1990	1991–2000	2001–2010	1981–1990	1991–2000	2001–2010
Bangladesh	6.81	7.94	11.95	4.38	10.17	11.36
India	4.73	14.07	23.69	7.54	12.57	20.90
Maldives	7.01	13.80	25.69	0.23	11.33	16.33
Nepal	3.17	12.85	5.21	7.03	2.73	16.78
Pakistan	9.13	0.11	19.57	9.14	1.74	15.23
Sri Lanka	7.33	8.27	11.11	6.36	9.94	7.37

Source: Author's calculation based on WDI data

encountered some fluctuating growth rates. The impressive growth of services exports helped India achieve healthy surpluses in the services trade during the 2000s, whereas, during the 1980s and the 1990s, India encountered a deficit in services trade (Table 9.4). High growth in services exports during the 2000s also helped Maldives to widen trade surpluses. In contrast, Bangladesh, Nepal, Pakistan and Sri Lanka experienced deterioration in balance in trade in services during the same period.

In terms of the contribution of the services trade to total trade, South Asian countries had mixed experiences (Table 9.5). During the 2000s, Bangladesh, Nepal and Pakistan observed a decline in the share of services exports in their total exports compared with the 1980s. For Bangladesh and Pakistan this has been mainly because of much better export performances of the manufacturing sectors. For Nepal, however, the

Table 9.4 Trade balance in services (US\$ million)

Country	1981–1990	1991–2000	2001–2010
Bangladesh	–274.43	–533.56	–1,117.30
India	–904.50	–2,524.36	6,742.96
Maldives	35.31	168.99	608.41
Nepal	63.57	310.79	–38.81
Pakistan	–376.31	–980.78	–2,592.19
Sri Lanka	–163.55	–377.93	–577.97

Source: Author's calculation based on WDI data

Table 9.5 Significance of services in total trade (% of country's total trade)

Country	Services exports (balance of payments, current US\$) as % of total exports			Services imports (balance of payments, current US\$) as % of total imports		
	1981–1990	1991–2000	2001–2010	1981–1990	1991–2000	2001–2010
Bangladesh	21.87	15.96	12.16	17.56	18.54	15.79
India	23.45	21.39	31.67	22.38	25.68	25.83
Maldives	67.71	66.58	78.21	33.78	23.31	23.42
Nepal	56.60	57.76	36.59	19.90	17.82	17.02
Pakistan	22.13	17.29	20.00	17.03	23.52	26.02
Sri Lanka	19.11	17.59	20.74	20.13	20.25	21.35

Source: Author's calculation based on WDI data

growth rate in services exports fell during the 2000s. India and Maldives managed to register remarkable growth in their share of services exports in total exports thanks to their impressive growth performance of services exports during that period. In the case of share of services imports in total imports, Bangladesh, Maldives and Nepal experienced falls whereas, India, Pakistan and Sri Lanka experienced rises.

According to Chanda (2011a), the sub-sector composition of services exports for Bangladesh, India, Pakistan and Sri Lanka reveals that there has generally been a trend away from traditional services exports, such as travel and transport, towards other services. However, within the 'other services' segment, only India and Sri Lanka reveal a commercial services orientation to their services export basket, with commercial services accounting for the bulk of other services exports and also for more than 90 per cent of total services exports. In the case of Bangladesh and Pakistan, the shift towards other services exports has been dominated by government services and, overall, commercial services exports constitute only about half of total services exports. A common feature, however, is that computer and information services show the most significant increase in share across all four countries. This suggests that, notwithstanding differences in trade orientation and competitiveness across the four countries, the software services sub-sector has been an important driver of services exports in all four countries. This reflects their common source

Table 9.6 Importance of workers' remittances (% of GDP)

Country	1981–1990	1991–2000	2001–2010
Bangladesh	2.77	3.36	8.21
India	0.99	1.86	3.11
Nepal	n/a	1.39	14.45
Pakistan	7.16	2.53	4.30
Sri Lanka	5.24	6.10	7.67

Note: n/a = data not available.

Source: Author's calculation based on WDI data

of comparative advantage in this sub-sector, i.e. the availability of low-cost skilled labour and government policies that boost software services exports.

Workers' remittances are gaining importance for the region, especially for these low-income countries, reflecting the significance of labour-based services exports (Table 9.6). For, Nepal, during the 2000s, the share of remittances in GDP increased to more than 14 per cent. South Asia's large labour endowment, including low-skilled, semi-skilled, high-skilled categories, results in a regional comparative advantage in exporting labour-based services under the Mode 4 of GATS – that is, the temporary movement of workers.

9.2.4 Contribution to employment

In all South Asian countries service sector employment has shown a rising trend (Table 9.7). During the 2000s, countries like Bangladesh, Maldives and Nepal experienced large rises in this share thanks to the liberalisation in some key services sectors, such as telecommunications and financial services. Studies have indicated that services sector liberalisation has helped employment growth with the most dynamic sub-sectors exhibiting the highest rates of employment growth (Raihan 2008). However, the employment elasticity of services is lower than that of manufacturing and agriculture in most of the South Asian countries. Therefore, though the share of the services sector in total employment had increased substantially during the 2000s,

Table 9.7 Share of services sector in total employment (%)

Country	1981–1990	1991–2000	2001–2010
Bangladesh	22.88	21.57	36.94
Bhutan	n/a	n/a	28.68
India	n/a	23.25	25.85
Maldives	48.50	50.30	58.35
Nepal	n/a	14.40	20.70
Pakistan	28.04	34.14	35.92
Sri Lanka	29.07	34.53	38.28

Note: n/a = data not available. For other years the averages have been calculated based on the available data.

Source: Author's calculation based on WDI data

its contribution to total employment has been much lower than its contribution to the GDP in all South Asian countries.

Chanda (2008), however, observes that official statistics on services sector employment in the developing countries when juxtaposed with the dynamic nature of sub-sectors such as trade and distribution services or construction services, may also suggest that part of the employment growth in services has been informal in nature. Therefore, the official estimates of the services sector's contribution to overall employment may, to some extent, understate the actual contribution of this sector to total employment due to their failure to capture informal employment.

9.2.5 Services sector and FDI

In South Asia, during the years 2005 and 2010, India saw a huge inflow of FDI in the services sectors, while Bangladesh experienced a slight rise and Afghanistan and Pakistan encountered a significant fall (Table 9.8). In several South Asian countries, increased FDI in the services sector has been associated with increased liberalisation (Raihan 2008). In the case of Bangladesh, since 2003–04 the services sector has been able to attract a large inflow of FDI and, as a result, by 2005–06 the FDI inflow in the services sector accounted for 81 per cent of total FDI inflows in the country. The services sub-sectors, which received the highest share of FDI in recent years, are telecommunication, energy and financial sectors. The experience of India suggests that among the services sub-sectors, financial, IT and telecommunication services appear to be the most important recipients of FDI. The majority contribution of FDI to Pakistan appears to be in telecommunication and financial services. In Sri Lanka a large amount of FDI went to the telecommunication sector.

9.2.6 Revealed comparative advantage (RCA)

The identification of readiness of key services sectors to face international competition after liberalisation is a difficult task due to the unavailability of data. Whether a sector is prepared for international competition or not, we need to explore the competitiveness of that sector in terms of price competition, technical standard, capacity of the existing firms, etc. Given the fact that there is a lack of these types of data in almost all South Asian countries, this study takes into consideration the best available data to construct the Balassa Index of Revealed Comparative Advantage (RCA) for the services sectors in South Asian countries (Balassa 1965). Table 9.9

Table 9.8 FDI inflows in the services sectors (US\$ millions)

Country	2005	2010
Afghanistan	166	67.7
Bangladesh	623.8	660.9
India	2,630	1,0904
Pakistan	1,682.7	633.8
Sri Lanka	n/a	405.3

Source: Author's calculation based on investment map data (www.investmentmap.org/prioritySector.aspx, accessed on 4 March 2013)

Table 9.9 Revealed comparative advantage of services sub-sectors in South Asia

Description	Bangladesh			Bhutan			India		
	2000	2005	2010	2000	2005	2010	2000	2005	2010
1 Transportation	0.50	0.41	0.39	0.78	0.92	1.63	0.99	0.65	0.54
2 Travel	0.19	0.21	0.17	1.28	1.82	2.46	1.22	0.70	0.51
3 Communications services	0.00	0.80	5.47	0.28	0.75	0.38	6.05	1.65	0.50
4 Construction services	0.00	0.52	0.00	0.00	0.00	0.00	3.32	0.39	0.20
5 Insurance services	0.00	0.20	0.15	1.28	4.55	0.82	1.63	1.26	0.58
6 Financial services	0.25	0.20	0.27	0.17	0.16	0.19	0.62	0.40	0.68
7 Computer and information services	0.16	0.34	0.31	0.00	0.00	0.00	14.01	12.18	8.18
8 Royalties and licence fees	0.00	0.00	0.00	0.01	0.06	0.00	0.11	0.09	0.02
9 Other business services	0.60	0.70	1.14	0.00	0.00	0.00	0.18	0.89	0.74
10 Personal, cultural and recreational services	0.13	0.08	0.07	0.00	0.00	0.00	0.43	0.30	0.41
11 Government services, n.i.e.	32.51	29.47	22.35	17.52	8.88	1.58	3.53	0.39	0.22

Description	Maldives			Pakistan			Sri Lanka		
	2000	2005	2010	2000	2005	2010	2000	2005	2010
1 Transportation	0.25	0.30	0.25	2.61	1.31	1.03	1.83	1.95	2.23
2 Travel	2.85	3.30	3.92	0.18	0.18	0.20	0.82	1.04	0.98
3 Communications services	0.00	0.00	0.00	6.50	3.24	1.50	2.29	1.19	1.38
4 Construction services	0.00	0.00	0.00	0.00	0.22	0.13	0.00	0.86	0.75
5 Insurance services	0.12	0.09	0.06	0.19	0.46	0.25	2.32	2.52	1.22
6 Financial services	0.00	0.00	0.00	0.11	0.18	0.10	0.00	0.00	0.00
7 Computer and information services	0.00	0.00	0.00	0.68	0.36	0.49	0.00	1.19	1.79
8 Royalties and licence fees	0.18	0.42	0.16	0.00	0.07	0.01	0.00	0.00	0.00
9 Other business services	0.00	0.00	0.00	0.47	0.37	0.40	0.93	0.51	0.39
10 Personal, cultural and recreational services	0.00	0.00	0.00	0.00	0.06	0.09	0.00	0.00	0.00
11 Government services, n.i.e.	0.42	0.90	0.40	3.35	21.11	29.73	1.21	0.66	0.46

Note: n.i.e. = not included elsewhere.**Source:** Author's calculation based on UNSTAT data (<http://unstats.un.org/unsd/servicetrade/>, accessed on 4 March 2013)

reports the results of such an exercise for Bangladesh, Bhutan, India, Maldives, Pakistan and Sri Lanka. The exercise suggests that in 2010, RCAs greater than 1 were observed in communication services, other business services and government services for Bangladesh, in transportation, travel and insurance services for Bhutan, in computer and information services for India, in travel services for Maldives, in transportation, communication and government services for Pakistan and in transportation, communications services, insurance services and computer and information services for Sri Lanka. The striking feature is that in 2000, India had RCAs greater than 1 in sectors like travel, communications services, construction services, insurance services and government services which by 2010 declined to less than 1, indicating India's deterioration in comparative advantage in these sectors.

9.2.7 Backward and forward linkages of the services sectors

Using the Social Accounting Matrix (SAM) and associated multiplier model it is possible to calculate the backward and forward linkages of the services sectors in the South Asian countries. The basic idea of backward linkages is to trace the output increases which occur in supplying sectors or accounts when there is a change in the sector or account using their outputs as inputs. Similarly, with forward linkages the output increases could be traced which occur or might occur in using industries or accounts when there is a change in the sector or account supplying inputs (Bulmer-Thomas 1982). The South Asian countries have different magnitudes of backward and forward linkages in different services sectors (Table 9.10). For example, in the case of energy, the largest backward linkage is found in Bangladesh and the lowest one is observed in Pakistan; and the largest forward linkage is observed in India and the lowest one is in Nepal. Bangladesh has also the largest backward linkages in transport, housing, private service and public service. Nepal has the largest backward linkages in construction and trade. In the case of forward linkages, India has the largest ones in energy, construction and trade, Pakistan has the largest ones in

Table 9.10 Backward and forward linkages in the services sectors in South Asian countries

	Bangladesh		India		Pakistan		Nepal		Sri Lanka	
	BL	FL	BL	FL	BL	FL	BL	FL	BL	FL
Energy	9.55	4.40	9.03	13.15	3.97	6.34	9.52	3.30	7.08	5.80
Construction	10.27	2.17	8.62	16.08	6.33	3.48	10.61	3.00	6.88	3.25
Trade	10.18	31.99	7.96	65.20	7.95	32.18	10.72	22.74	7.40	33.71
Transport	10.49	9.06	8.34	12.63	6.24	25.27	10.09	7.83	7.10	16.99
Housing	10.60	30.88	8.42	2.68	8.63	7.15	10.18	12.89	7.58	6.50
Private Service	10.59	9.59	8.27	8.80	7.47	22.40	9.67	10.78	7.31	5.06
Public Service	10.69	3.13	7.68	2.00	7.90	6.22	10.09	9.90	8.05	3.77

Note: BL=backward linkage, FL=forward linkage.

Source: Author's calculation from the social accounting matrices of Bangladesh, India, Pakistan, Nepal and Sri Lanka for the year 2007 from Raihan and Khondker (2010).

transport and private services, Bangladesh has the largest one in housing and Nepal has the largest one in public services.

9.3 Experiences of South Asian countries in General Agreement on Trade in Services negotiations

Article IV of GATS stresses that, in order to increase the participation of developing countries in global services trade, there is a need to strengthen the domestic service capacity of these countries and its efficiency and competitiveness, *inter alia*, through access to technology on a commercial basis; to improve these countries' access to distribution channels and information networks; and to liberalise market access in sectors and modes of supply of export interest to them. Such calls were re-emphasised by the WTO in the Doha Ministerial Declaration of 2001 as well as in the July 2004 Framework of the Doha Round of negotiations. In the Hong Kong Ministerial Declaration of 2005, particular attention to sectors and modes of supply of export interest to developing countries was highlighted again.

It is, however, important to note that a large number of developing countries have been facing difficulties in identifying sectors of their specific interest. Moreover, registering any meaningful liberalisation commitment in the negotiations has achieved little progress. There is serious concern about developing countries' lack of capacity to evaluate the requests received from other member countries and the development of their own requests. A major challenge has been the determination of their national policy objectives and the competitiveness of each sector or sub-sector. In the case of liberalisation of Mode 4 services, in the categories and skill levels of interest to developing countries, no real progress has been achieved. Further to this, no progress has been achieved with respect to streamlining or increasing the efficiency of processing mechanisms for visas and work permits.

Negotiations under GATS are important for the South Asian countries, as they are facing constraints in economic development due to poor infrastructure, institutional settings and governance deficits. Hence, the services sector is the dominant segment in these economies. In addition, there is huge growth potential of the domestic services market in these economies. Among the major supply constraints that prevent the building of a competitive services sector in the South Asian countries are the lack of human resources and technology to ensure that professional and quality standards are met, the lack of a national strategy for export of services, the lack of government support to help service firms, especially SMEs, and the lack of financial capacity of firms.

The outcomes of ongoing GATS negotiations will have significant implications for the national development initiative. The South Asian countries should have clearly defined negotiation strategies, based on a clear conceptual framework and understanding in order to make GATS negotiations conducive for the economic development of a country. Every strategy should have a fallback position if it becomes necessary. Most of the relevant literature emphasises Mode 4, as these countries have comparative advantage on the movement of temporary workers. But there are other areas in the services sector that also have huge growth potentials.

Bangladesh has made certain specific horizontal commitments on market access and national treatment with some limitations relating to commercial presence (Mode 3) and movement of natural persons (Mode 4) in the cases of the communications and tourism sectors. GATS classified the tourism sector into four sub-sectors and Bangladesh made commitments in one sub-sector, namely luxury hotels. In the ongoing services trade negotiations, India is very much on the offensive in seeking market access in developed countries, particularly under Mode 1 (cross-border trade) covering business process outsourcing and Mode 4, which deals with the movement of temporary workers. India has been receiving requests from all major developed countries as well as several developing countries on a wide range of services. Most of the requests are to enter the Indian market through commercial presence (Mode 3) with importance being given to financial and telecommunication services, though offers in the field of education and environmental services have also been made. Nepal became the 147th member of the WTO in April 2003. Under the WTO, Nepal has committed to liberalise 11 services sectors. Pakistan has received collective requests from several WTO members on services in the areas of energy, environment, financial services, architectural and engineering services, integrated engineering, maritime transport, construction, telecommunication services, air transport services and logistic services. Sri Lanka's initial commitment in GATS was limited to tourism and travel services. This was expanded in 1997 to include financial services and telecommunications.

9.4 Services trade liberalisation negotiations in South Asia

Ratna (2010) presented a summary of the negotiations for services trade liberalisation in South Asia. The importance of services, especially tourism, was recognised in the Tenth SAARC Summit, in Colombo in July 1998. The Thirteenth SAARC Summit, in Dhaka in November 2005, recognised the potential of trade in services, especially informal trade, and decided on a study to see how services could be integrated into the SAFTA process. The First Meeting of the SAFTA Ministerial Council, in Dhaka in April 2006, approved the course of action including the completion of a study on services in a time-bound manner. The Second Meeting of the SAFTA Ministerial Council, in Kathmandu in February 2007, approved the recommendations made by the SAFTA committee of experts (CoE) and directed the Secretariat to ensure that the Study on Trade in Services should be WTO plus and WTO compliant. The Fourteenth SAARC Summit, in New Delhi in April 2007, stressed that to realise its full potential, SAFTA should integrate trade in services. They called for a finalisation of an agreement in the services sector at the earliest time possible. The Third Meeting of the SAFTA CoE, in New Delhi in March 2008, took note of the Revised Regional Study done by the co-ordinator of the study 'Research and Information System for Developing Countries' (RIS), New Delhi. The Third Meeting of the SAFTA Ministerial Council, in New Delhi in March 2008, considered the Study on Potential of Trade in Services under SAFTA including the recommendations of the Third Meeting of the SAFTA CoE thereon. The Meeting endorsed the recommendations of the Third Meeting of SAFTA CoE and decided that RIS be requested to draft the text of the Draft SAARC Framework Agreement on Trade in Services (SAFAS)

by 30 June 2008. It also decided to constitute an Expert Group by 30 June 2008 to commence negotiation on the Framework Agreement on Trade in Services. The Fifteenth SAARC Summit, in Colombo in August 2008, expressed satisfaction at the conclusion of the Study on Trade in Services and welcomed the decision of SAFTA Ministerial Council to commence negotiation on the Framework Agreement on Trade in Services. At the Sixteenth SAARC Summit, in Thimpu in April 2010, SATIS was signed with the aim of the liberalisation of intra-regional trade in services. The objectives of the Agreement are to promote and enhance trade in services among the contracting states in a mutually beneficial and equitable manner by establishing a framework for liberalising and promoting trade in services within the region in accordance with Article V of GATS.

Member states are yet to schedule their specific liberalisation commitments under SATIS. Negotiations for a schedule of specific commitments will take place keeping in view the national policy objectives, the level of development, and the size of the economies of contracting states and individual sectors. The Agreement will progressively cover the liberalisation of trade in services with broad-based and deeper coverage of the majority of services sectors/sub-sectors with a view to fulfilling the objectives of Article V of GATS, for example, that a positive approach be followed. Negotiations for specific commitments for progressive liberalisation would be based on a 'request and offer' approach.

Chanda (2011b) called for four necessary steps for services trade integration in South Asia. The first step is to improve information about services, not only in individual member countries but also generally with regard to bilateral trade and investment flows with other South Asian countries. A second step would be to undertake more regional discussions on regulatory and institutional issues so as to facilitate cross-country learning in the development of regulatory frameworks and enable an eventual move towards greater harmonisation of standards in the region. A third step, which would need to underpin much of the regional efforts in services (and also in goods), would be the development of regional transport services infrastructure and trade facilitation measures in the region. A final critical step would be to engage in capacity-building efforts regionally. This would take the form of joint research and development (R&D) activities, joint projects in selected services such as health care, environment, education, renewable energy and tourism, regional training and development of human resources, sharing and exchange of ideas and information and sharing of best practices.

Raihan and Angkur (2012) argued that, greatly endowed with low- and semi-skilled labour and reliance on human resources exports, the South Asian countries would need greater co-operation on Mode 4. Deeper regional integration in services trade would provide huge welfare gains for the South Asian countries, as almost all South Asian countries were net importers of services. Services would continue to play a key role in the eradication of poverty because of their social, cultural and welfare-enhancing functions, so further studies on these issues would be needed. Negotiations among nations should focus on important sectors such as education, health, communication, tourism and IT. South Asian countries should also co-operate in

the formulation of uniform regulatory measures to enhance trade in services. Lack of data, regulatory capacity and maturity of the services sector are some key issues that need to be addressed. Finally the agreement made for regional co-operation should provide special treatment and technical assistance for least developed countries (LDCs).

9.5 Domestic preparedness of services trade liberalisation in South Asia¹

Bangladesh adopted a cautious approach in making commitments on trade in services on market access, national treatment and MFN treatment. It was guided by a number of considerations. Like many LDCs, it found that GATS allows the developed countries greater market access in developing countries through Mode 3, while market access to unskilled or semi-skilled labour of developing countries through Mode 4 is restricted. The services sector in Bangladesh, like in other LDCs and developing countries, is far less developed, and hence, under free trade in services, the country is likely to be in a disadvantageous position. Moreover, the existing legal and regulatory infrastructure should undergo minimum structural changes.

A number of concerns have been raised with regard to liberalisation in different services sub-sectors in Bangladesh. For example, in the case of the *construction* sector low capacity and capability of local contractors and consultants, due to a weak resource base and inadequate skills and experience, were considered the major concerns. Poor working environments, including low standards of safety and occupational hazards at construction sites, weak and non-facilitative policies and regulatory framework, low productivity and quality of domestic firms due to a low technology base and limited skills and experience, are the major constraints in construction services that contribute to its disadvantageous position. Moreover, there is a lack of supporting institutional mechanisms to facilitate easier access to key inputs including access to finance and equipment. Lack of a regulatory framework, intense competition among well-funded and equipped foreign operators and a lack of access to finance and equipment as well as inexperienced management are issues that should be addressed to reverse this situation. Analysts in this sector have been arguing that economic opening will lead to the introduction of new financing instruments that can increase the local firm's access to critical assets and will expose the labour force to skills and management experience critical for the growth and consolidation of the domestic operators.

In the *banking* sector in Bangladesh, competition has been enhanced due to the announcement of the opening of markets to new entrants, and, as a result, interest rates have been lowered and loan quality (i.e. the share of non-performing loans in the banks' balance sheets) has improved. It appears that the activities in the banking sector, dominated by inefficient nationalised commercial banks, are being replaced by relatively more efficient and competitive private commercial banks and foreign commercial banks. However, absence of prudential regulation may result in an economic crisis with serious social impact, as the Asian financial crisis of 1997 indicates. Hence, stakeholders consider that Bangladesh should exercise caution and

slow down the process of liberalisation in the banking sector. The regulatory agency of the *insurance* sector in Bangladesh is not equipped with adequate staff and resources to supervise this growing industry, which limits the agency's role in the development of the sector. Insurance analysts consider that while opening this sector, apart from introducing efficiency and better regulation, the insurance companies also need to be innovative in expanding their business activities in order to reach the general public. In the *travel and transport* sector, major weaknesses in the regulatory framework include poor co-ordination between authorities and poor governance (corruption and poor enforcement). According to analysts, Bangladesh can liberalise this sector under Mode 4 only after setting up a proper regulatory body. Because of its unique geographical location, Bangladesh has the potential to become a 'transport hub' to serve the entire hinterland comprising Nepal, Bhutan and North East India.

In India, there is a strong sentiment in *legal* services that permitting foreign law firms entry to the market, even in a limited manner, would lead to the shrinking of the opportunities available to domestic lawyers (Kumar and Jatkar 2008). It has been highlighted that there is a need for a strategy for this sector as there is scope for Indian law firms to take advantage of the expanding global business and there is also a danger that if the process is not judiciously planned and necessary structural changes are not undertaken, the opening up of this sector may result in a fiasco for the domestic sector. India did not schedule *education* services either in the Uruguay Round or in its revised commitments under the ongoing Doha Round. Although India, in its revised offer, included higher education, many sections, such as civil societies, have opposed such a move. Whatever liberalisation has occurred in this area, such as allowing 100 per cent FDI on an 'automatic route' and permitting foreign participation through twinning, collaboration, franchising and subsidiaries, has been autonomously driven. In the Doha Round of negotiations, India had both an offensive and defensive interest in the *accountancy* sector. In the Uruguay Round, India did not make any commitments on accounting. However, in its revised offer for accountancy services, India offered full commitments on accounting and book-keeping services under Mode 1 and Mode 2 while keeping Mode 4 subject to horizontal commitments. Supply of services under Mode 3 has been 'unbound'. Many considered India's revised offer defensive because it was very little. It appears that although there are some significant potential gains from further trade liberalisation, India has adopted a cautious approach. Also, the strengthening of the domestic regulatory rules in some of the services sectors, and capacity building in a few of them, seem to be necessary to face global competition.

In Nepal, as the *insurance* sector already has a few foreign companies with 100 per cent equity and a few joint venture companies, liberalisation under the WTO does not expose the country to a completely new scenario. However, the need for a sound regulatory system is still necessary to maintain an efficient, safe, fair and stable insurance market and to promote growth and competition in the sector, as insurance markets have developed at a much faster pace than the process of insurance supervision. Over the years, the *banking* sector of Nepal has slowly transformed from a heavily state-owned sector to a vibrant one dominated by private companies. Under the Financial Sector Reform Programme, Nepal has undertaken various institutional reforms. However, Nepal Rastra Bank (the Central Bank of Nepal) needs to address gaps in its supervisory

framework and enhance cross-border supervision mechanisms. In addition, before any further liberalisation of the financial sector, Nepal needs to resolve a few issues, such as loan recovery from large, wilful defaulters, and improve the financial condition of the two government-owned commercial banks. Nepal's commitments under the WTO remove all limitations on the number of suppliers in various *telecommunication* services. In addition, Nepal has committed to allow foreign participation of up to 80 per cent in the sector. These changes seek to make telecommunication services reliable and accessible throughout the country at a reasonable cost. However, the liberalisation process has to be accompanied by the setting up of regulators to ensure that competition is fair and consumers are not exploited. In addition, as Nepal is moving from a government-owned monopolistic market into a liberalised competitive market, a major challenge is to establish an independent regulator with adequate expertise, information, authority and accountability.

The *communication* sector in Pakistan, particularly telecommunication, has witnessed comprehensive reforms and robust growth, contributing to a large share of the country's total GDP. As a result, it is often considered one of the most successful services sectors to have gained substantial benefits from liberalisation. Regarding communications, primarily the telecommunication and IT industries, Pakistan has negotiated extensively at the WTO and formulated a comprehensive schedule of commitments, further shaping Pakistan's policy framework concerning trade liberalisation in these sectors. The legislation dealing with licensing in this sector does not distinguish between domestic and foreign service providers, since Pakistan provides national treatment to all telecommunication service providers. Another sector that has witnessed strong growth and subsequent liberalisation is the *financial* sector, particularly banking services. Pakistan's central bank, the State Bank of Pakistan, has pursued reforms aimed at liberalisation and privatisation since the beginning of the 1990s, and has achieved considerable progress. There are no restrictions on the establishment or operation of foreign banks in Pakistan. In order to further strengthen and synchronise the domestic legislative framework in relation to multilateral trade negotiations and commitments, the Government of Pakistan has established a commission to review the country's financial sector. There are various regulatory bodies governing *engineering, construction and architectural* services in Pakistan. The regulations governing construction services aim to encourage joint ventures and collaboration with local service providers. Licences are granted for projects where local firms do not have the requisite technical capacity. In effect, this works as a safeguard to local construction and engineering firms, who do not face undue competitive pressures.

Despite the fact that Sri Lanka has made commitments in GATS and scheduled conditional offers at the Doha Round of negotiations, its *telecommunications* sector is far from perfect in terms of regulatory rigour. This is unfortunate as Sri Lanka stands to gain by locking in reforms and providing investors with security for the much-needed investment in this sector. While Sri Lanka has made additional commitments to implement the Telecom Reference Paper, in practice, most of the commitments have not been met. This, in fact, could make Sri Lanka liable to international arbitration. The level of implementation of the Reference Paper commitments is a good indication of

domestic preparedness for further liberalisation. Weak implementation has resulted in many of Sri Lanka's scheduled commitments (for instance the liberalisation of the external gateway) being made redundant. The implication is that Sri Lanka should focus on tightening its domestic regulatory framework and improving the capacity of the regulatory bodies through increased financial independence. Only then would further commitments in the telecommunications sector be realistic and useful.

There is much work to be done in other sectors to improve domestic preparedness for the liberalisation of services. Many professional service associations lack regulatory and legislative capacity to effectively regulate even local service providers. This is unfortunate given the fact that Sri Lanka stands to gain if there is increased foreign participation in many services sectors. This would provide greater access to foreign expertise and technology whilst triggering competition and investment that would be beneficial to consumers in Sri Lanka. In order to enjoy these potential benefits, the regulatory environment needs to be improved.

9.6 Concluding remarks

This chapter highlighted the importance of services trade liberalisation in South Asia. Since the 1980s, South Asian countries have witnessed a significant shift in the structure of their economies towards the dominance of the services sector in national production. Despite this, services trade constitutes a low share of total trade for most of the South Asian countries. It is also important to highlight the fact that workers' remittances, as a per cent of GDP, are increasing in most of the countries of this region, especially for low-income countries, reflecting the significance of labour-based services exports. This study has also indicated the fact that in all South Asian countries services sector employment has shown a rising trend.

The chapter highlighted that, based on the calculated RCAs, in 2010 RCAs were greater than 1 in communication services, other business services and government services for Bangladesh, in transportation, travel and insurance services for Bhutan, in computer and information services for India, in travel services for Maldives, in transportation, communication and government services for Pakistan, and in transportation, communications services, insurance services and computer and information services for Sri Lanka. However, the striking feature is that, though in 2000 India had RCAs greater than 1 in such sectors as travel, communications services, construction services, insurance services and government services, by 2010, RCAs in those sectors declined to less than 1, indicating India's deterioration in comparative advantage in those sectors.

The chapter also calculated the magnitudes of backward and forward linkages in different services sectors in the South Asian countries. Among the South Asian countries, Bangladesh has the largest backward linkages in energy, transport, housing, private service and public service; Nepal has the largest backward linkages in construction and trade. In the case of forward linkages, India has the largest ones in energy, construction and trade; Pakistan has the largest ones in transport and private services; Bangladesh has the largest one in housing and Nepal has the largest one in public services.

It is evident that competitiveness of the services sectors and a well-functioning regulatory system are essential for ensuring gains from services trade liberalisation in South Asia. It can be argued that development of skills and technologies in the services sub-sectors can improve the competitiveness of these South Asian countries.

There is no denying that in most instances, these countries lack established and well-functioning regulatory and institutional frameworks when it comes to services trade liberalisation. As for policy stance, a common position of these countries is the need for adequate time to frame appropriate domestic regulation policies considering the specific economic requirements and, at the same time, to ensure necessary technical assistance for capacity building. There should also be considerations on ensuring adequate regulatory flexibility for these countries to promote liberalisation. According to Article XIX of the GATS Agreement, the developing countries are allowed appropriate flexibility on an individual country basis. This implies that the South Asian countries should consider country-specific interests to take an appropriate policy stance.

Complications relating to services negotiations call for the South Asian countries to identify ways to deal with intricate matters associated with specific details of various provisions. It is also important for policy-makers to be able to assess the potential implications arising out of certain provisions. Furthermore, effective participation in services trade requires enacting and implementing the necessary domestic regulations. All these will require technical assistance and effective utilisation of domestic regulation.

Note

- 1 Benefitted from Raihan (2008).

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Chapter 10

Connectivity and Regional Co-operation in South Asia

Prabir De

10.1 Introduction

One of the major challenges facing South Asia in deepening regional integration and increasing competitiveness is poor quality and inefficient national and international infrastructure services, both hardware and software, which raise costs of transportation and production and constrain the capacity of the South Asian economies to gain from a liberal trading environment, regional or otherwise. The South Asian region, with its geographical contiguity, has great potential for co-operation in the area of connectivity.

The importance of tariffs as barriers to trade has gradually reduced; however, high-tariffs still exist for certain sensitive products, and there is a strong presence of non-tariff barriers (NTBs) including high border transaction costs in the region. High transportation costs, poor institutions, inadequate cross-border infrastructure, and the absence of a regional transit trade are some major barriers penalising the region's trade and integration.¹ A wide range of current trade barriers are purely policy-induced barriers, such as high sensitive lists, complicated NTMs, etc.

From a trade perspective, and in order to forge greater regional integration in South Asia, there is a need to reduce the elements of trade costs. Despite falling tariffs, geographical proximity, and economic and cultural similarities, higher trade costs have meant trade in South Asia has not grown. The cost of trade transportation increases if the country is landlocked (e.g. Afghanistan). The land border in South Asia is overcrowded and needs special attention in order to reduce time delays and transaction costs. Therefore, the estimated 138 per cent intra-regional trade costs (tariff equivalent) for South Asia appear to be very high (Duval and Uthoktham 2010). Higher trade costs not only restrict trade but also downplay the political will to form greater regional co-operation.

It is against this backdrop that this chapter attempts to identify the prospects and challenges for regional connectivity and trade facilitation in South Asia. It identifies the contours of the potentials for regional co-operation in regional connectivity and trade facilitation and provides some policy perspectives.

10.2 An overview of regional connectivity in South Asia

In South Asia, the maritime and aviation sectors are relatively well connected to their respective global networks. There is also a higher degree of private sector involvement in developing and managing infrastructures. Tremendous efficiency gains could be

realised by removing physical and non-physical barriers to transport and improving intermodal connectivity. Both of these steps would improve the efficiency of transport services and raise the utilisation rates of existing infrastructure.

10.2.1 Maritime transport

Since the 1990s, the container terminals in South Asia have been handling increasing volume of cargoes, dominated by Indian container terminals. However, none of the world's top ten busiest container ports is from South Asia. Asia's most important liner routes, by volume, still run from Asia to Europe and North America. There has been a substantial increase in intra-Asian shipping, particularly between India and South East and East Asian countries. Driven by trade between India and China, containerised trade in South Asia has also been growing rapidly.

Almost none of the coastal countries in South Asia is now linked by direct shipping services. Transshipment through hub ports (e.g. Colombo or Singapore) is the only option for linking with South Asian markets. Shipping connectivity is still poor in South Asia. On top of this, the three landlocked countries and one island country in South Asia depend on transit ports in neighbouring countries for their trade. The United Nations Conference on Trade and Development (UNCTAD) Liner Shipping Connectivity Index shows that between 2006 and 2011 shipping connectivity increased markedly in a number of the South Asian economies, such as Sri Lanka, Pakistan and India, while it deteriorated for Maldives. A UNESCAP study which analysed differences in trade costs found that liner shipping connectivity accounts for about 25 per cent of the changes in trade costs that are unrelated to non-tariff policies.² Thus, those countries which have witnessed a decline in liner shipping connectivity are likely to have faced higher trade costs.

South Asian countries can achieve economies of scale through collective shipping arrangements. To start with, liner shipping services can be routed between the ports of Sri Lanka, Pakistan, Bangladesh and India, and also the ports in neighbouring countries in South East Asia and the Middle East. A regional commission in South Asia may be set up for exchanging information on regulations and encouraging competition of shipping services. There is further scope to improve connectivity, particularly for landlocked countries, through reduction of trade processes and procedures at transit ports. A faster port not only increases the productivity of the home country but also improves the competitiveness of traded goods, more importantly the goods in transit for landlocked countries.

10.2.2 Air transport

Air freight in South Asia reached 2,452.99 million ton-km in 2010, this was an increase of about 10 per cent per annum since 2000.³ Aircraft departures in South Asia have increased by about 8 per cent per annum in the 2000s. However, changes in air transportation performance remain uneven across South Asian countries.

Capital cities in South Asia are unconnected by direct airlines. For example, Delhi and Islamabad or Dhaka and Islamabad are yet to have direct flights between them. Even though bigger nations have direct air links for passengers and freight in South

Asia, smaller nations, more importantly landlocked and island countries, heavily depend on neighbouring countries for air transportation.

Increasing connectivity boosts traffic. One study suggests that improvements in air connectivity have resulted in a 22 per cent increase in global traffic.⁴ Air traffic in South Asia is poised to continue to grow strongly. For the period 2010–20, the International Civil Aviation Organization (ICAO) estimates that passenger aircraft movement will increase annually by about 5 per cent, while between 2010 and 2014, passenger traffic on many intra-South Asia routes is projected to increase annually by about 10 per cent.⁵ The increasing demand for air transportation is not adequately met by the existing infrastructure in the region. This will require the region to mobilise investments, and will need to be supported by appropriate regional policies to air transportation and connectivity.

10.2.3 Land transport

Inter-country land transport linkages are particularly underdeveloped in South Asia. There is high potential for improving road conditions since many South Asian countries still have a substantial length of unpaved roads. Governments have invested in major national roads as well as rural road networks. Some major rural road development initiatives have been implemented in, for example, Bangladesh, India and Sri Lanka. The Intergovernmental Agreement on the Asian Highway Network, adopted under the auspices of UNESCAP on 18 November 2003, established technical specifications for the regional road network. The Asian Highway Network now extends through 32 member states and comprises 142,000 km of highways. Currently, about 32 per cent of the network is classified as meeting Primary and Class I standards, the two highest categories of road class.

There are still 11,500 km of Asian highway routes that need to be upgraded to meet the minimum standards. The poor quality of some road segments is a deterrent for international transport because it increases transport time and operating costs for vehicles. Countries are also struggling to maintain their Asian highway routes due to limited finances and institutional capacity. Furthermore, as in the case of other infrastructure networks, it is often difficult to fund cross-border projects unless such projects are part of a broader integration strategy, such as the Almaty–Bishkek Regional Road Rehabilitation project funded by the Asian Development Bank (ADB) under the Central Asia Regional Economic Cooperation (CAREC) programme, or more recently the Northern Economic Corridor of the Greater Mekong Subregion (GMS). This underlines the critical role played by regional co-operative frameworks, such as the Intergovernmental Agreement on the Asian Highway Network, as well as the many subregional initiatives promoted by subregional organisations and multilateral financing institutions.

Railways face the challenge of missing links, which prevent the network from functioning as a continuous system. According to UNESCAP estimates, member countries constitute about 10,500 km of rail track, mostly located in the Association of Southeast Asian Nations (ASEAN) subregion. While these links can be filled by transshipments to carriages, shippers are discouraged from using rail because of

the longer transit time and higher costs. In addition, interoperability across borders remains a problem. In South Asia, there are some successful bilateral arrangements for passenger and freight trains between countries. There are two good examples of passenger trains operating in the region: (i) Maitree Express between Kolkata and Dhaka, and (ii) Samjhauta Express between Delhi and Lahore. More passenger and freight trains could be made operational with investment from Bangladesh, India and Pakistan.

Given the expected growth in intra-regional trade, as well as the heightened awareness about the transport sector's contribution to climate change, the railways could capture a greater proportion of intra-regional transport, particularly for freight. But there is a need to show this potential, for example, through demonstration runs of container trains.⁶ Countries in South Asia can also increase rail connectivity by developing more inland container depots and dry ports with rail connections. Afghanistan, Nepal and Bhutan and inland parts of India and Pakistan should set up more container depots and dry ports. Nepal has been successfully running a container depot at Birgunj (mainly for Nepal's international traffic) and another one is coming to Kakarvitta (to facilitate Nepal's trade with the eastern South Asia subregion). The same model can be extended to other parts of South Asia such as in Bhutan and Afghanistan.

10.2.4 Cross-border infrastructure services

A cross-border transport network enlarges market size and helps economies to grow further through increased trade and production. Some examples are the GMS corridors, India–Bhutan hydropower projects, Lao PDR–Thailand hydropower projects, among others. Cross-border infrastructure projects are a popular and well-accepted model to encourage regional economic integration.

Table 10.1 presents selected cross-border connectivity services in operation in the South Asia region. The development of international infrastructure in South Asia

Table 10.1 Cross-border connectivity in operation in South Asia

Sector	Particular
Road transportation (passenger bus services)	Delhi–Lahore, Amritsar–Nankana Sahib, Amritsar–Lahore, Poonch–Rawalakot, Srinagar–Muzaffarabad, Kolkata–Phuentsholing, Agartala–Dhaka, etc.
Rail transportation (passenger train services)	Delhi–Lahore, Kolkata–Dhaka, etc.
Shipping links	Mumbai–Karachi, Colombo–Kolkata, Colombo–Chittagong, etc.
Air links	Delhi–Lahore, Mumbai–Karachi, Dhaka–Karachi, Delhi–Katmandu, Colombo–Mumbai, Colombo–Delhi, etc.
Gas pipeline	TAPI ^a , Amritsar–Lahore ^a
Electricity links	Amritsar–Lahore, ^a Bhutan–India

Note: ^aTo be operational

Source: Compiled by author

has been so far limited to land and ocean transportation and hydropower. While there has been a relative upsurge in cross-border overland infrastructure services in South Asia, the cross-border infrastructure investment is rather limited to only a few hydropower projects that exist between India and Bhutan. The power trading arrangement between India and Bhutan is one of the oldest cross-border infrastructure investments in Asia, which is an outcome of a successful partnership between the two countries (Box 10.1).

Box 10.1 Example of cross-border co-operation: India–Bhutan power projects

The India–Bhutan partnership in hydropower was effectively started in 1978, when India extended US\$200 million for construction of 336 MW hydroelectric plant at Chukha in Bhutan. The Chukha hydroelectric project was entirely funded by the Government of India with a 60:40 ratio of grant and loan. It was successfully commissioned in 1988, and the project was handed over to the Bhutanese government in 1991. About 70 per cent of power generated by this project is exported to India, which helped Bhutan to reduce the trade gap with India.

Table 10.B1 Cross-border infrastructure projects in South Asia

Location	Financial closure (year)	Investment (US\$ million)
Chukha (3,336 MW)	1988	200
Kurichhu (60 MW)	2002	119
Tala (1,020 MW)	2003	750

Source: Ministry of Power, Government of India

India has implemented three hydroelectric projects, namely Chukha, Kurichhu and Tala, in Bhutan, of which Tala is the largest one (Table 10.B1). The Tala hydroelectric project is the biggest cross-border power project in South Asia, and also the largest hydro project in Bhutan. This 1,020 MW project is constructed with an investment of around US\$750 million, which is entirely funded by the Government of India by way of grants and loans (with a ratio of 60:40). India is also helping Bhutan not only in setting-up the hydroelectric plants but also by providing training and human resource development in the power sector. In 2008, India laid the foundation stone of another 1,095 MW hydropower project at Punatsangchhu. The benefit of cross-border energy trade encouraged Bhutan to seek Indian investments in setting up hydroelectric power plants, which have over 30,000 MW hydroelectric potential.

10.3 Challenges to regional connectivity

The present level of connectivity reflects a restrictive policy regime. South Asia suffers from excessive direct costs and time taken to cross borders and from inefficiency in cross-border transactions, all of which ultimately affect trade negatively. The state of air connectivity among the countries of South Asia is characterised by restrictive aviation policies, resulting in a limited number of economically viable routes. Differences in rail connections, i.e. broad gauge and meter gauge, remain a major stumbling block to realising physical connectivity among SAARC member countries. Trade in the region is constrained by the poor condition of infrastructure, congestion, high costs and lengthy delays. These problems are particularly severe at border crossings many of which pose significant barriers to trade. The rent-seeking informal economy is very deep-rooted and makes trade transactions expensive at the border. Removing such inefficiencies in trade transactions would increase welfare in the region. However, it is worthwhile to note that the gains accruing to some smaller countries in the region are much larger when they occur as a result of the removal of transaction inefficiencies than those resulting from trade liberalisation. Therefore, the results underscore the importance of implementing reforms in border infrastructure and logistics in tandem with other policy reforms, such as transit, to enhance regional integration.

10.3.1 High non-tariff trade costs

Non-tariff trade costs are a significant determinant of a region's competitiveness, wherein an integrated and efficient transport network along with a regional transit mechanism for cross-border movement of goods and services play the pivotal role in integrating a region and would significantly improve the region's trade competitiveness. One of the outcomes of the lack of connectivity in South Asia is higher non-tariff trade costs. In *ad valorem* terms, bilateral non-tariff trade costs between India, Bangladesh, Pakistan and Sri Lanka have been above 90 per cent between 2007 and 2009 (Table 10.2). The cost would be higher if trade in agriculture were considered. The South Asian countries have a higher incidence of indirect cost of trade procedures, currency fluctuation and business (regulatory) environment, compared with tariffs. The variation in *ad valorem* policy-related non-tariff trade costs across countries and commodities presumably lies in obstacles in trade policy, cumbersome trade procedures and infrastructure facilities (UNESCAP 2010).

While countries have succeeded in reducing the number of documents required for export and import, it still takes considerable time for export and import, more particularly in landlocked countries like Afghanistan (Tables 10.3(a) and 10.3(b)). However, the variation in export and import time across South Asian countries is very high.⁷ While time for export in Afghanistan takes 74 days, in Sri Lanka it takes only 6 days. Preparation of export documents and inland transport times are the major components of delay in export in the region (Figure 10.1), whereas inland transportation costs make exporting from Afghanistan, Nepal and Bhutan very expensive, and port handling charges in Bangladesh and Maldives are critical to overall export costs (Figure 10.2). In general, import takes more time than export

Table 10.2 Bilateral non-tariff trade costs in manufacturing (%), 2007–09

	IND	BGD	PAK	LKA	THA	CHN	DEU	USA
India (IND)		89 (6)	116 (–24)	76 (9)	90 (–4)	86 (–8)	70 (–17)	74 (–5)
Bangladesh (BGD)	89 (6)		142 (–9)	127 (11)	130 (33)	133 (6)	101 (7)	104 (12)
Pakistan (PAK)	116 (–24)	142 (–9)		127 (14)	118 (–2)	105 (–7)	94 (–15)	94 (–10)
Sri Lanka (LKA)	76 (9)	127 (11)	127 (14)		114 (9)	140 (–1)	98 (2)	103 (23)
Thailand (THA)	90 (–4)	130 (33)	118 (–2)	114 (9)		66 (–14)	79 (–13)	72 (–3)
China (CHN)	86 (–8)	133 (6)	105 (–7)	140 (–1)	66 (–14)		49 (–28)	51 (–15)
Germany (DEU)	70 (–17)	101 (7)	94 (–15)	98 (2)	79 (–13)	49 (–28)		46 (–19)
United States (USA)	74 (–5)	104 (12)	94 (–10)	103 (23)	72 (–3)	51 (–15)	46 (–19)	

Note: Change vis-à-vis 2001–03 in brackets.

Source: UNESCAP Trade Cost Database (version 2)

in the South Asian region. Some of the South Asian countries, such as Bangladesh in number of export documents or India in export time, perform better than China, but South Asian countries cannot compete with China in export or import costs (Figure 10.3). Therefore, the region can achieve substantial productivity gains and cost reductions by reducing policy-related non-tariff trade costs.

10.3.2 Cumbersome cross-border and transit transport facilitation

With the increase in intra-regional trade since the 1990s, countries have opened more border crossings and domestic routes for international transport, and are

Table 10.3(a) Documents, time and cost to export in South Asia, 2012

Country	Documents to export (number)	Time to export (days)	Cost to export (US\$ per container)
Afghanistan	10	74	3,545
Bangladesh	6	25	965
Bhutan	8	38	2,230
India	8	16	1,095
Maldives	8	21	1,550
Nepal	9	9	1,960
Pakistan	7	7	660
Sri Lanka	6	6	715
Coefficient of variation (%)	16	82	56

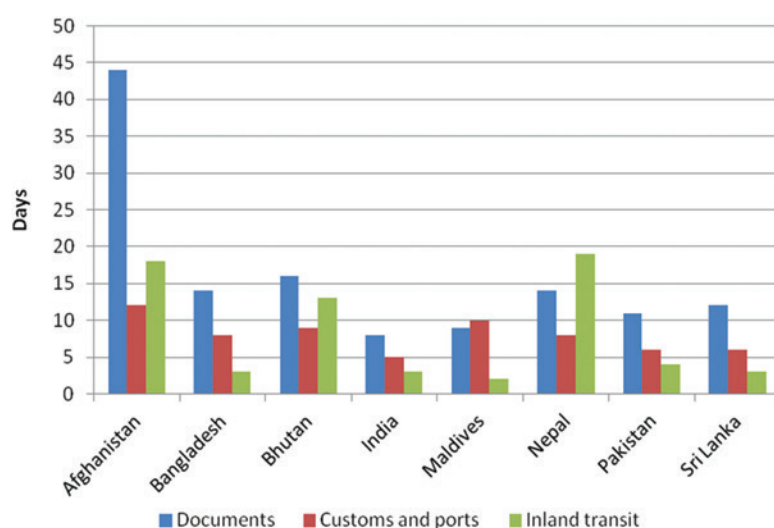
Source: Doing Business Database, World Bank (2012)

Table 10.3(b) Documents, time and cost to import, 2012

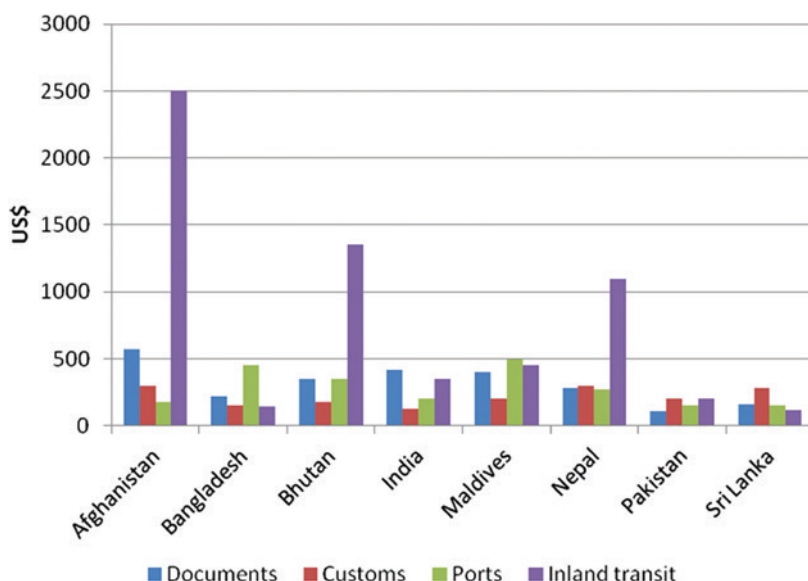
Country	Documents to import (number)	Time to import (days)	Cost to import (US\$ per container)
Afghanistan	10	77	3,830
Bangladesh	8	31	1,370
Bhutan	12	38	2,805
India	9	20	1,070
Maldives	9	22	1,526
Nepal	9	35	2,095
Pakistan	8	18	705
Sri Lanka	6	19	745
Coefficient of variation (%)	18	53	54

Source: Doing Business Database, World Bank

using bilateral and multilateral agreements on transport facilitation to improve the conditions for international land transport. Ambitious initiatives include the customs union among Belarus, Kazakhstan and the Russian Federation, joint customs controls between Georgia and Turkey, and the modernisation of border gates in India, to mention a few. To deal with challenges of co-ordination among different agencies dealing with transport facilitation, many countries have set up national co-ordination mechanisms. India and Pakistan provide transit transport facility to landlocked countries such as Bhutan and Nepal, and Afghanistan, respectively. In many cases, these agreements need revisions in light of new changes in transportation, handling and storage mechanisms and procedures.

Figure 10.1 Time to export (days), 2010

Source: Doing Business Database, World Bank

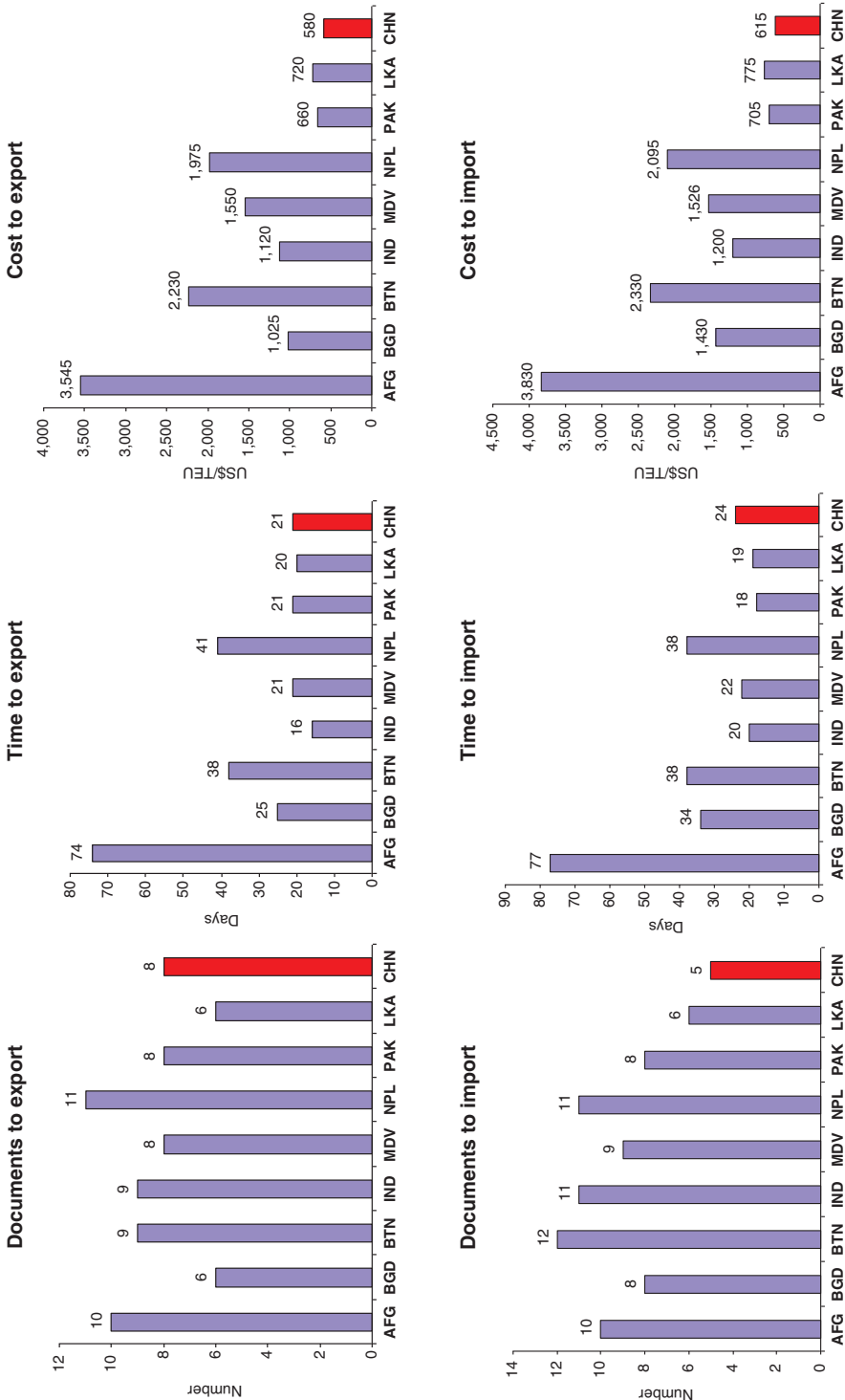
Figure 10.2 Costs of export (US\$ per container), 2010

Source: Doing Business Database, World Bank

Nevertheless, cross-border and transit transport are still hampered by many non-physical barriers that lead to excessive delays, high costs and uncertainties. These include multiple technical standards, inconsistent and complex border-crossing procedures and excessive documentation. In addition, goods are often inspected on both sides of the borders by different authorities, and sometimes even while in transit, rather than being inspected either at loading or unloading points. Experience has shown that unilateral measures have had a limited impact on transport facilitation, since gains on one side of the border may be lost on the other – thus, co-operation is essential.

Landlocked countries, which depend on inter-country land transport for much of their external trade, could benefit the most from multilateral facilitation; despite being connected to regional networks, they still depend on transit across neighbouring countries for their goods to reach sea ports and beyond. Many organisations have been bringing stakeholders together to remove these barriers. UNESCAP, for example, through resolution 48/11 adopted in 1992, has been urging member countries to accede to seven international conventions related to land transport facilitation (Table 10.4). To ensure that these efforts converge in the long term, the secretariat has prepared a Regional Strategic Framework for Facilitation of International Road Transport (see Box 10.2). The framework was recently adopted by the Ministerial Conference on Transport held in Bangkok in March 2012. Its adoption by the member states will pave the way for dealing with non-physical barriers comprehensively, which is of critical importance to enhance trade and boost regional integration.

Figure 10.3 Trading across borders in 2013: South Asian countries and China



Note: TEU 20 foot equivalent units
Source: Doing Business Database, World Bank

Table 10.4 Status of accession of UNESCAP regional members in South Asia to the seven international conventions related to land transport facilitation listed in Commission Resolution 48/11, as of 14 February 2012

Country or area	Convention on road traffic (1968)	Convention on road signs and signals (1968)	Customs convention on international transport of goods under cover of TIR carnets (1975)	Customs convention on the temporary importation of commercial road vehicles (1956)	Customs convention on containers (1972)	International convention on the harmonization of frontier controls of goods (1982)	Convention on the contract for the international carriage of goods by road (CMR) (1956)
Afghanistan			X				
Bangladesh				X			
Bhutan							
India		X					
Maldives							
Nepal							
Pakistan	X	X					
Sri Lanka							

Note: X=acceded before adoption of resolution 48/11.**Source:** UNESCAP (2012)

Box 10.2 Regional strategic framework for facilitation of international road transport

The UNESCAP Ministerial Conference on Transport, held in Bangkok in March 2012, adopted the Regional Strategic Framework on Facilitation of International Road Transport. It consists of long-term, common targets as well as desirable strategies for fundamental elements of international road transport and essential facilitation approaches. This could help ensure convergence of efforts by countries to facilitate transport by avoiding inconsistencies and possible conflicts between different facilitation agreements and measures. The framework identifies major challenges to international road transport and provides possible solutions for them. It covers road transport permits and traffic rights, visas for professional drivers and crew, temporary importation of road vehicles, third-party liability insurance, vehicle weights and dimensions, and vehicle registration/inspection certificates. It also includes measures to mitigate transport delay by promoting international conventions, co-ordinating legal instruments, applying new technologies, developing professional training, strengthening national co-ordination mechanisms, and promoting joint border controls and economic zones at borders. One of the important proposals in the framework is the establishment of a regional network of legal and technical experts to help countries upgrade the capabilities of their officials and experts, and provide professional support to the development of transport facilitation agreements, measures and projects.

Source: UNESCAP (2012)

10.3.3 Procedural complexity, multiple handling and inefficient border corridors

The efficiency of border corridors and land customs stations (LCSs) is an important factor for South Asia's competitiveness and its trade prospects. The present trade flow in South Asia is very uneven across the border corridors. Regional connectivity in South Asia would be likely to redistribute regional trade and traffic among the existing corridors. An efficient corridor is, thus, very important in order to maximise the benefits of regional connectivity. Thus, the objectives of the trade and transport facilitation measures in the South Asian region would be to (i) constantly improve the performance of border corridors and LCSs, (ii) eliminate the asymmetry between LCSs pairs, and (iii) remove multiple handling of goods at borders. There is mismatch in the timing of operations of customs and immigration among the LCSs, and the days of operation differ between India and Bangladesh. Apart from immigration, customs and security, which are an essential part of all LCSs, the other facilities in both the physical and non-physical categories vary across the LCSs. For example, except for Birganj in Nepal, none of the major LCSs in South Asia has an exclusive container-handling yard at the border. Similarly, except for Petrapole in India, none has effectively adopted the fast-track cargo clearance system. In the case of

e-governance in customs, most of the LCSs in South Asia now use electronic data exchange platforms. For example, Petrapole and Raxaul use ICEGATE while Benapole and Birganj use ASYCUDA+. The existing electronic data interchange (EDI) system also suffers from certain shortcomings that add to the transaction costs. For example, although the filing of declarations has been made possible online, a hard copy of the declaration is generated by the system – albeit at a later stage – and signed for a variety of legal and other reasons, both for the importer and for customs. Other supporting documents are also submitted for verification by government authorities and their agents. An electronic signature on cross-border movement of goods is not acceptable by customs. A through bill of lading is also not started. Therefore, many shortcomings are associated with documentation, and continue to exist under the present EDI system. Interoperability of electronic interfaces is needed.

Procedural complexities very often work as deterrents to India–Bangladesh trade. The customs offices in South Asia still require excessive documentation, especially for imports, which must be submitted in hard copy form.⁸ This often changes the composition and direction of trade in South Asia.

Most of the LCSs suffer from limited warehouse capacity and the lack of banking and foreign exchange facilities. In some cases, banks are located several kilometres from the border (e.g. Burimari, Panitanki and Karkabitta). Adequate foreign exchange facilities are also unavailable at these borders. Some LCSs do not even have a foreign exchange facility, such as Burimari and Banglabandh in Bangladesh, Kakarvitta in Nepal, and Phulbari and Panitanki in India.

None of the LCSs in South Asia has adequate capacity (in terms of either software or hardware) to deal with goods in transit. In most cases, officials were unaware of their country's commitment under General Agreement on Tariffs and Trade (GATT) Article V and the obligations therein. It appears that South Asian countries have promoted bilateral transit agreements/arrangements that are not consistent with all other commitments on trade facilitation and with the objective of reducing trade barriers. Therefore, they need to co-operate and co-ordinate in designing and applying bilateral and regional transit agreements/arrangements. Moreover, South Asian countries did not take full account of international standards and instruments when designing and applying those agreements or arrangements.

The Indian government's Integrated Check Post (ICP) project should help improve its border infrastructure serving South Asian neighbours (Box 10.3). At the same time, we need to upgrade the other side of the border at the same pace. Smaller countries surrounding India may not have adequate funds and capacity to implement ICPs in their part of the border. Helping them financially and technically would be extremely useful in achieving a compatible, harmonised and improved border to serve the trade of the region.

South Asian countries should put the utmost importance on making inefficient border customs stations efficient. If the objective is equitable growth of trade and traffic in South Asia, all the border corridors and LCSs have to improve their efficiency over time. In particular, LCSs in Afghanistan, Bangladesh, Nepal and Bhutan need special

Box 10.3 Integrated Check Posts (ICPs) in India

To undertake measures aimed at simplifying control and accelerating procedures in the border customs points, the Indian government has planned ICPs at identified entry points on land borders. In order to facilitate trade among contiguous countries, each ICP is planned to serve as a single window facility covering customs, immigration and warehousing, health facilities, shopping complex and parking facilities under one roof. The Land Ports Authority of India (LPAI) oversees the construction, management and maintenance of ICPs, which are being developed as publicly funded projects. The LPAI is empowered to notify entry points on land/riverine borders as land ports, to plan, develop, construct and maintain terminal and ancillary buildings, parking areas, laybys, warehouses and cargo complexes, etc., and to establish such facilities as may be required for facilitating trade and traffic. About 13 ICPs, with one on the India–Pakistan border, four on the India–Nepal border, one on the India–Myanmar border and seven on the India–Bangladesh border are being planned. Already the ICP at the India–Pakistan border (at Attari) has been operational since April 2012. The cost of setting up 13 ICPs has been estimated at INR7.34 billion. Of these, four ICPs at Petrapole, Moreh, Raxual and Wagah are proposed to be set up in Phase I at a cost of INR3.42 billion. In Phase II, the balance of nine ICPs at Hili, Chandrabangha (both in West Bengal) Sutarkhandi (Assam), Dawki (Meghalaya), Akaura (Tripura), Kawarpuchiah (Mizoram), Jobgani (Bihar), Sunauli (UP) and Rupaidiha/Nepalganj (UP) will be established at a cost of INR3.94 billion.

Source: LPAI, New Delhi and ECO Secretariat

attention since they lack the facilities offered by developing South Asian countries, thereby showing a tremendous asymmetry and adding to the costs of transaction. A regional approach would be useful particularly for those who lack adequate capacity to upgrade the LCSs. Perhaps, a regional organisation for development of LCSs and corridors in South Asia would pave the way for the transfer of technology in the region. This regional co-operation among the LCSs is essential in order to remove the infrastructural asymmetry between the LCSs. This will also help the exchange of information, training human resources, adapting to new technology, and better utilising the resources in an effective manner. Thus, the requisite policy agenda should help stimulating the evolution of border corridor services, promulgating new performance standards, and encouraging their implementation. At the same time, to improve performance, border corridor management authorities (here, mainly governments) need to constantly evaluate operations or processes related to providing, marketing and selling of services to the users. Nonetheless, the performance of LCSs and border corridors would be contingent upon regional transit in South Asia.

10.3.4 Lack in regional transit

‘Freedom of transit’ means ‘freedom to trade’. Freedom of transit in South Asia is long overdue. Mistrust among South Asian countries along with lack of institutional capacity

Table 10.5 Trade and transit arrangements in Eastern South Asia

Agreement	MFN trade	MFN transit	WTO signatories
India–Bangladesh	Yes	No	Yes
India–Nepal	Yes	Yes	Yes
India–Bhutan	Yes	Yes	India – member; Bhutan – observer
India–Pakistan	Yes ^a	No	Yes
Pakistan–Afghanistan	Yes	Yes	Pakistan – member; Afghanistan – observer
Bangladesh–Nepal	Yes	Yes	Yes
Bangladesh–Bhutan	Yes	Yes	Bangladesh – member; Bhutan – observer
Bhutan–Nepal	Yes	No	Nepal – member; Bhutan – observer

^a Proposed.

Source: De (2011)

have caused long delays in accepting regional transit, although bilateral transit exists between countries (e.g. India and Bhutan). In spite of WTO membership countries in South Asia do not exchange most favoured nation (MFN) transit (Table 10.5).

Transit is an intrinsic element of any cross-border movement of goods and vehicles, and exercises significant influence on national economies. Among the major causes of high trade transaction costs in South Asia are the cumbersome and complex cross-border trading practices, which also increase the possibility of corruption. Goods carried by road in South Asia are largely subject to transshipment at the borders, which is a serious impediment to regional and multilateral trade. The position is further compounded by a lack of harmonisation of technical standards. The foremost critical factor prohibiting South Asia in achieving its regional connectivity is the absence of regional transit trade. Unlike the European Union, the South and South West Asia regions do not have a regional transit arrangement, although partial transit exists for landlocked countries like Afghanistan, Bhutan and Nepal. Given South Asia's emergence as a free trade area since 2006, following the South Asian Free Trade Area (SAFTA), regional transit will help South Asian countries to achieve the potential benefits of moving into an effective free trade regime. Therefore, transit is one of the central challenges facing the South Asian countries. Economic Cooperation Organization (ECO) member states have adopted a regional transit in 1995, which offers valuable lessons to South Asia (Box 10.4).

The econometric evidence strengthens existing hypotheses of linkages between trade costs, transit and trade flows: the higher the transaction costs between each pair of partners, the less they trade. In a study, it was estimated that a 10 per cent fall in transaction costs at the border in South Asia has the effect of increasing a country's exports by about 3 per cent.⁹ In parallel, a regional transit would enhance regional trade, controlling for other variables. At the same time, implementation of e-governance at a border is found to be a significant determinant of trade flows, thus indicating that e-filing of custom formalities has been helping trade to grow in South Asia.

Box 10.4 Economic Cooperation Organization (ECO) Transit Trade Agreement

Considering that improvement of transit trade through ECO is essential, ECO member states signed a Transit Trade Agreement in 1995. The member states have realised that uniform, simplified and harmonised administrative formalities including customs procedures in the field of regional trade, in particular at border crossing points, sea ports and airports, are necessary for achieving the objectives of the Treaty of Izmir. Article 3 of the agreement tells the purpose of the agreement, which is to facilitate trade between two member states when the goods transported have to pass *en route* through other member state/states. Its scope, as noted in Article 4, suggests the transport of goods with or without intermediate re-loading, across one or more borders between a Customs Office of departure of one member state and a Customs Office of destination of another, while passing through the customs jurisdiction of other member state/states. In this agreement, goods transported by means of road vehicles, railway carriages, ships, aircraft or any combination thereof. Goods transported under this agreement are not subject to the payment or deposit of import or export duties and taxes while in transit through the territory of any member state. The Guaranteeing Association undertakes to pay the export or import duties and taxes together with default interest, due under the customs laws and regulations of the country in which an irregularity has been noted in connection with the article. Goods transported under this agreement are not, as a general rule, to be subject to examination through the customs jurisdiction *en route*. In exceptional cases, however, in order to prevent abuse, the customs authorities may examine goods only when irregularities are suspected. In order to avail of the facilities provided under this agreement, goods must be carried either by ships or aircraft or in sealed road vehicles, containers, railway carriages, or a combination thereof, and sealed according to the regulations determined by the Guaranteeing Association. In order to monitor the progress of transit trade under this agreement an ECO Committee on Transit Trade has been constituted having one representative from each signatory member state.

A regional transit will not only bring a steady revenue stream of transit fees but will also help develop industry and service enterprises in the border areas. Once transit between India and Bangladesh is allowed, Bangladesh can earn hefty revenue as transit fees from Indian vehicles travelling to and from India's North Eastern Region (NER) to the rest of India using Bangladeshi soil. The amount may rise if other corridors between India and Bangladesh are also counted. Similarly, a transit arrangement between India, Pakistan and Afghanistan will fetch a hefty royalty to Pakistan for the movement of vehicles between India and Afghanistan using Pakistani soil. There are also huge gains associated with energy conservation due to transit and the efficient use of resources.

The benefits of regional transit favour LDCs in the region, such as Bangladesh. Bangladesh could earn hefty revenues as transit fees from Indian vehicles travelling

to and from India's NER region to the rest of India, using Bangladeshi territory through two corridors. The amount may go up if other corridors between India and Bangladesh are also counted. Similarly, transit arrangements between India, Pakistan, and Afghanistan would provide hefty royalties to Pakistan for the movement of vehicles between India and Afghanistan, using Pakistani territory. Studies indicate that there are also huge gains associated with energy conservation due to transit and efficient use of resources. Due to condition, roads in Bangladesh lack the capacity to carry heavy traffic, particularly the transit traffic which is expected to come from India, Nepal and/or Bhutan. Hence, rail or maritime routes may be promoted where road routes are not supportive to transit traffic.

Therefore, agreeing to a regional transit would mean a 'win-win' gain for all the countries in the South Asian region. The reasons are primarily as follows: first, smaller countries in South Asia (e.g. Afghanistan, Bhutan, Bangladesh and Nepal) are experiencing higher trade with the region. However, lack of transit trade is impeding their intra-regional trade and economic exchange from growing and integrating further. Second, bilateral transit trade (MFN type) does not exist among all the countries in South Asia on a reciprocal basis, mainly as a result of geographical asymmetry and political misunderstanding, among other problems. For example, India and Bangladesh or India and Pakistan do not have transit arrangements even though both the countries are adjacent and share a common border. At the same time, India has a bilateral transit arrangement with Bhutan and Nepal, with which India shares an international border. Third, transit would help smaller countries to earn revenue from transit, which could be utilised for the country's social and infrastructure development and enterprises at border areas. Fourth, South Asian countries have agreed on the regional free trade agreement (FTA) (SAFTA) and they are signatories of GATT. With Pakistan's offer of MFN (also known as NDMA) to India, the greater benefits of SAFTA and multilateral free trade are clearly contingent upon regional transit.¹⁰ However, there are some serious challenges such as the standardisation of laws and regulations relating to transportation, security, maintenance of corridors, etc., which countries have to overcome through continuous dialogue and deeper co-operation.

SAARC has an Inter-Governmental Group (IGG) to advise on facilitation of transport in South Asia. A battery of proceedings of IGG shows that harmonisation of standards and mutual recognition in the transport sector has been the key issue in South Asia. There have been some important developments in regional transportation in South Asia. As per the directives of the Fourteenth SAARC Summit held in New Delhi in April 2007, the ministers of transport of SAARC countries met for the first time in New Delhi on 31 August 2007. Taking note of the recommendations of the SAARC Regional Multimodal Transport Study (SRMTS), SAARC transport ministers agreed to accord a Regional Transport and Transit Agreement, and a Regional Motor Vehicle's Agreement in 2008.¹¹ Member states have been discussing a Motor Vehicle Agreement (MVA), and a final decision on this is yet to be taken.¹²

The scope and issues of transit have become extremely important since regional trade in South Asia has expanded. South Asian countries have agreed to South Asian

regional transport corridors. However, they have not yet taken a firm decision on regional transport and transit arrangements for the cross-border movement of goods and vehicles. It is apt that they should sign both the MVA and the Regional Transport and Transit Agreement together. A regional transit arrangement will help South Asia to better integrate the region and also to strengthen the globalisation process.

10.4 Vision of an integrated South Asia: The regional co-operation agenda

Progress in transportation links and trade facilitation in Asia so far has been made through several subregional initiatives. Although some subregions have successfully implemented cross-border corridors and progressed much further in strengthening connectivity, such as the GMS, or have introduced regional transit arrangements, such as ECO, few others (such as the SAARC) have made any major breakthroughs. The subregional transport corridors, such as the GMS transport, and trade facilitation programmes have created a demonstrable effect in Asia and have become a role model for other subregions in Asia (such as the Central Asia Regional Economic Cooperation (CAREC) programme). The improvement of the subregional transport corridors in the GMS has resulted in significant savings in vehicle operating costs and reduced travel times. Although several benefits are apparent from completed subregional projects, three main issues hamper the full delivery of these benefits: first, the subregional transport corridors ('hardware') in Asia are not always supported by trade facilitation ('software'), except perhaps in the GMS; second, missing infrastructure links in many subregions have reduced the effectiveness of the completed projects; and third, lack of synergy between national and subregional transport corridors is very common. As a result of the road improvement, national traffic has increased across the corridors, indicating that national-level benefits have been high. It is apparent that international traffic has been slow to grow, partly as a result of the absence of an agreement to facilitate the cross-border movement of vehicles and absence of strong and stable pan-Asian transport networks. The pan-Asian transport corridors as well as country strategies continue to depend on national institutions for planning and national funds for implementing the projects. The overall attitude toward AH and TAR projects apparently favours addressing national constraints rather than developing regional arrangements.

Unlocking the region's trade potential is a daunting task. Costs for not having uninterrupted road or railway connectivity across the region or facilitation of border trade can offset gains appearing from trade preferences as proposed under several FTAs and other arrangements such as SAFTA. Therefore, the need for a better enabling environment for trade that offers lower trade costs has gained momentum throughout Asia. However, a favourable regional climate to create a seamless infrastructure that can operate to its full potential is missing in South and South West Asia. Because of this, the agenda of the regional co-operation has to go beyond 'tariff-based policy' barriers and include 'non-tariff policy' barriers like regional connectivity in both its hardware (transport corridors) and software (facilitation of movements of goods and vehicles across borders). A scrutiny of

subregional programmes across the world clearly shows that most of them have now undertaken exclusive projects to improve subregional connectivity.¹³ To realise the potential of these subregional networks, it may be necessary to integrate them with the pan-Asian arteries such as the AH and TAR, or those initiated by development organisations like the World Bank and the ADB. Therefore, in order to promote seamless connectivity in South Asia, the primary challenging task is two-fold: first, to integrate the different subregional transport corridors and modes (railways, roads, air and maritime shipping), which will facilitate the movement of goods and services in South Asia and beyond; second, to overcome institutional constraints and bottlenecks that are deteriorating regional competitiveness by making trade expensive; and third, following ASEAN, the South Asia region should have a list of priority projects in connectivity (Box 10.5).

With SAFTA and the SAARC Agreement on Trade in Services (SATIS), the next stage would then be to achieve customs union and economic union in coming years. To unleash the trade potentials of these countries and to realise the benefits of regional connectivity, the prime objective of South Asian regional co-operation should be to improve national and international infrastructure. Perhaps more focus should be given to international infrastructure that enhances regional connectivity. The objective of regional co-operation in the present context would be to achieve an integrated Asia. There is high potential for co-operation in connectivity and trade facilitation areas in South Asia, and a blueprint is given in the next section.

10.4.1 Multimodal transportation and opening of regional transit

South Asian countries are now looking towards closer economic integration in the region. Recognising its importance, several SAARC Summits decided to strengthen transport, transit and communication links across the region. An integrated overland connectivity would provide substantial benefits to small landlocked countries such as Bhutan and Nepal by giving access to the South Asian market at lower costs. An integrated transportation network would yield much larger economic benefits whilst minimising risk. Integration of the transport networks of South Asia is especially crucial to landlocked countries, such as Afghanistan, Nepal and Bhutan, and landlocked areas within countries, such as India's North Eastern Region or Pakistan's North Western Region, as this could serve to end their landlocked or semi-isolated status and provide shorter transport and transit links. However, there is an urgent need of prioritisation of SAARC corridor projects in South Asia and to enhance regional integration through regional transit in a time-bound manner. In general, the task ahead is to revive, renovate and re-establish the region's transportation linkages, which have played a pivotal role in integrating the region, and establish new cross-border infrastructure in order to reduce the trade transportation costs across borders.

We also should encourage inter-modal links of both maritime and land routes. The maritime route would be from Jawaharlal Nehru port to Bandar Abbas port in Iran, whereas the land route will follow the Asian Highway 1 from the Iranian port Bandar Abbas. Another option is to use Chabhar port in Iran, to access Afghanistan and Central Asia.

Box 10.5 Master plan of ASEAN connectivity: List of priority projects

The master plan also identified prioritised projects from the list of key actions stipulated under the various strategies mentioned above, especially those whose implementation will have a high and immediate impact on ASEAN connectivity. These include:

- (i) completion of the ASEAN Highway Network (AHN) missing links and upgrade of Transit Transport Routes (TTRs);
- (ii) completion of the Singapore Kunming Rail Link (SKRL) missing links;
- (iii) establishment of an ASEAN Broadband Corridor (ABC);
- (iv) Melaka–Pekan Baru Interconnection (IMT–GT: Indonesia);
- (v) West Kalimantan–Sarawak Interconnection (BIMP–EAGA: Indonesia);
- (vi) study of the roll-on/roll-off (RORO) network and short-sea shipping;
- (vii) development and operationalisation of MRAs for prioritised and selected industries;
- (viii) establishment of common rules for standards and conformity assessment procedures;
- (ix) operationalisation of all National Single Windows (NSWs) by 2012;
- (x) discussion of options for a framework/modality towards the phased reduction and elimination of scheduled investment restrictions/impediments;
- (xi) operationalisation of the ASEAN agreements on transport facilitation;
- (xii) easing visa requirements for ASEAN nationals;
- (xiii) development of ASEAN Virtual Learning Resources Centres (AVLRC);
- (xii) development of ICT skill standards;
- (xv) ASEAN community building programme.

Source: ASEAN Secretariat (2010)

The initiatives for building the supply capabilities and trade liberalisation in the South Asian region need to be complemented by a new approach towards connectivity and transit facilities for interconnecting the sub-continent that existed in the past. India is the only country in the region which shares land borders with its neighbouring countries, namely Afghanistan, Bangladesh, Pakistan, Nepal and Bhutan, and sea routes with Sri Lanka, Maldives, Pakistan and Bangladesh. Road and rail links between the regional countries have to pass through the Indian territory. Multimodal transportation, thus, would be useful to landlocked countries like Nepal and Bhutan

or smaller island countries like Maldives to access third country markets using South Asian soil.

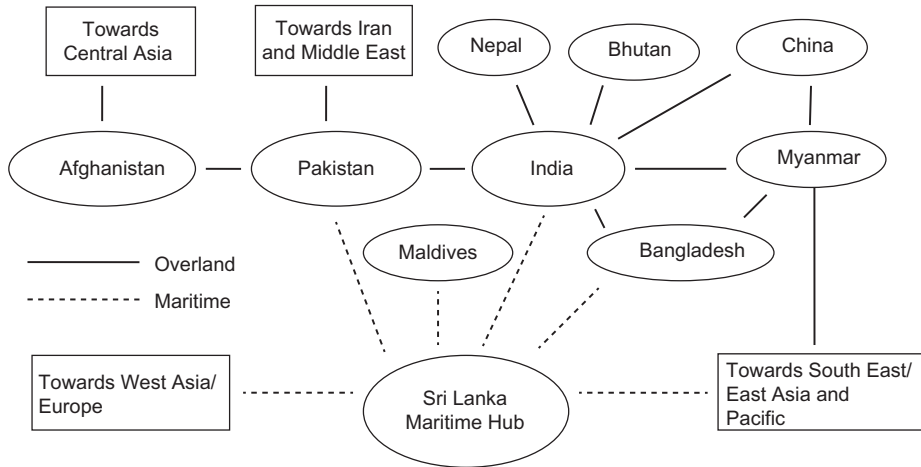
One of the most crucial non-physical barriers appeared to be the lack of a bilateral transport agreement to facilitate uninterrupted movement of goods and vehicles across the borders in South Asia. As a result, goods are required to be transshipped at the border between the trucks of neighbouring countries. South Asian countries have to eliminate some important non-physical barriers such as lack of parking, immigration and customs offices, baggage scanning equipment, telephone and warehousing at border posts, as well as EDI/IT and standardisation of working hours and weekly holidays, as well as use of complicated customs procedures and lack of transparency in inspection. To allow movement of vehicles, goods and passengers across the region on a door-to-door basis, South Asian countries should adopt the Regional Transport and Transit Agreement. The Agreement will be the stepping stone to reducing delays and costs at the borders and also to create a transportation 'hub' for each other.

For bigger countries like India and Pakistan, the economic benefits from trade agreements would be modest since their trade with South Asian neighbours is small in relation to their overall trade. If services and investments are included, the gains of bigger countries like India and Pakistan would stem from expanded exports, appearing from an integrated transport network. However, the gains of larger economies in South Asia from expanded trade in the region would be limited if they do not attempt, in a greater way, to rebuild the region's transportation infrastructure and associated software at the borders. Bigger countries would stand to benefit more from the continuation of their policies of unilateral liberalisation, setting in place improved infrastructure at the borders, extending support to capacity building in smaller South Asian countries, among others.

10.4.2 APIBM corridor: Asia's southern silk route

An integrated South Asia could be achieved only by setting in place an integrated overland connectivity and associated soft infrastructure at borders. We need to approach all the pending proposals for transit across the sub-continent with an open and positive mind.

Integration of the transport network of South Asia is especially crucial to landlocked countries such as Nepal and Bhutan and regions such as the NER of India, as this could serve to end their landlocked or semi-isolated status and provide shorter transport and transit links. A regional overland road link from Islamabad to Dhaka via Delhi can be revived for regional trade with some effort. A major part of this corridor is domestically operational, dual carriageway, and an integral part of the old Sher Shah Road, or Grand Truck (GT) Road. The opening of the route will mark a revival of the old linkages in South Asia dating back to the British Period. Therefore, the APIBM corridor represents an Afghanistan-Pakistan-India-Bangladesh-Myanmar Transport Corridor, which is meant for making each and every country in South Asia a transport hub for trade in the broader region, and deserves a high priority for operationalisation (Figure 10.4).

Figure 10.4 Potential transport hubs in South Asia

Source: Drawn by author

The importance of the APIBM corridor is not only for trade but it would also facilitate investments in the infrastructure sector in South Asia. It will also bring many rich rewards for bordering regions. It can make Pakistan and Afghanistan hubs for India's trade with Iran, the Middle East and Central Asia although that would need an upgrading of infrastructure and LCSs at Afghanistan's border with the Central Asian countries (Turkmenistan, Uzbekistan and Tajikistan). Similarly, Bangladesh will become a hub for India's trade with Myanmar and other South East Asian countries, besides serving as a transit for India's NER. Myanmar itself will become a transit hub for India's trade with other ASEAN countries (see Figure 10.4). Sri Lanka is already well placed to be a maritime hub in South Asia with a lot of India's trade transshipped through the port of Colombo. Apart from transit revenues, there are huge gains associated with energy conservation due to transit and the efficient use of resources. This APIBM corridor would be Asia's new silk route, linking Central and West Asia with East Asia, where South Asia is the land bridge and would be a most vital corridor for expanded trade and transportation.

10.4.3 Building a South Asian railway network

India has the best railway system, among developing countries, in the world. Railways played an important role in integrating the Indian sub-continent during the pre-independence period. Railway is the only mode of transport which can play a positive role in integrating the South Asian region by allowing cross-border movement of bulk goods. However, compared with highways, the connectivity of the South Asian railway network might require greater effort in view of gauge mismatch and multiple missing links between the countries. For example, India and Pakistan have broad gauge, all-weather railway networks, whereas the Bangladeshi railway system is based mostly on meter gauge. However, with a definitive

objective, there should be continuous effort in establishing an uninterrupted and harmonised railway network in South Asia. India's vast experience in managing a modern railway system would be very useful in re-establishing South Asia's railway link from Kabul to Dhaka. For example, India has been playing an active role in linking Bhutan with India's railway network, and also helping Nepal in extending the railway line from Birganj to inside the country. The restoration of an India–Bangladesh railway link is most important. India and Bangladesh again resumed the passenger train service between Kolkata (India) and Dhaka (Bangladesh) on 14 April 2008. This is a welcome step towards fostering closer communication linkages between the two countries which would facilitate the movement of goods and people.

Another major barrier to intra-regional movement by railway is the lack of standardisation of technologies, operation and maintenance practices including different types of gauges, braking systems, incompatibility of rolling stock, etc. South Asian countries have to eliminate some of the other major physical barriers such as inadequate loop lengths, some missing links of shorter lengths in the border areas, lack of physical infrastructure at interchange points, load restrictions on bridges, lack of co-ordination for gauge conversion programmes on different railway systems and capacity constraints in certain sections of the identified corridors. Islamabad and Istanbul already have a container train between them which also touches Tehran. If we manage the railway gauge, a direct container train can easily be operated between Islamabad and Dhaka touching Lahore, Delhi and Kolkata. Ultimately, this will link Dhaka with Istanbul. A multilateral rail transport agreement would pave the way to the faster movement of bulk transporting goods and services.

Besides standardisation of the railway tracks, the major challenges for ensuring smoother connectivity on the eastern side are as follows: (a) to link India's Manipur with India's main railway corridor, and (b) to re-establish and renovate railway networks in Afghanistan, Pakistan and Bangladesh. Indian Railways is actively engaged in the harmonisation and construction of railway tracks in the NER of India. The Jiribam–Imphal rail link may be extended to Mandalay as part of the Delhi–Hanoi railway project. Without having a compatible and strong railway system inside Myanmar and Bangladesh, closer communication between India and her immediate eastern neighbours will not be possible. Similarly, the railway infrastructure in Afghanistan and Pakistan will have to be developed. India may extend its expertise to other South Asian countries for railway infrastructure development.

10.4.4 Strengthening inland waterways, ports and shipping, and aviation

In the case of inland waterways, there is formal understanding between India and Bangladesh, which is renewed on a monthly basis. It serves the interest of only Bangladesh and India, where levels of traffic in both intra-country and transit transport had been reducing over years, although during certain periods bilateral traffic has been substantial. It was, however, recognised that inland waterways transport has great potential to provide a cost-effective transport service between

India and Bangladesh. Therefore, the two countries should accord the Inland Water Transport (IWT) Agreement for the longer term, and similar understanding should also be encouraged between India and Nepal, and India and Pakistan.

With regard to maritime transport, the major barriers include likely capacity constraints at many of the maritime gateways, together with heavy siltation at navigation channels where depths fluctuate with tide, inadequate and poor maintenance of channel markings, old technology in cargo and ship handling equipment, as well as floating crafts. Some other barriers impacting port performance include lack of professional management and computerisation, as well as EDI/IT to link up stakeholders. Customs procedures are found to be too complicated, while cumbersome port documentation is still in use and labour unrest was also noted in some maritime gateways.

Transshipment between India and Pakistan is a long-standing unresolved bilateral issue. In the absence of direct calls between Indian and Pakistani vessels, maritime trade between India and Pakistan is routed through a third country. The India–Pakistan Shipping Protocol, signed in 1975 as per the Simla Agreement of 1972, restricts transshipment cargo destined for a third country carried by the vessels of either country. As a result, capacity utilisation for a service run either by an Indian or a Pakistani flag vessel is badly impacted, as an Indian vessel cannot pick up cargo for a third country from Pakistan and similarly a Pakistani vessel cannot carry cargo from Indian ports to a third country. Interestingly, a flag other than India and Pakistan stands to benefit, as it falls outside the purview of the protocol. In order to boost up bilateral trade, the governments of India and Pakistan should amend this Protocol.

Supply-side constraints are posing a serious threat to maritime transportation infrastructure. Except India, the remaining South Asian countries do not have an adequate fleet of vessels or workforce. In view of rising merchandise trade, South Asian countries have to strengthen their maritime profile for self-reliance on national carriers. India can play a major role in strengthening ports and the shipping sector, particularly, Bangladesh, Maldives, and also Myanmar, in terms of training human resources in marine engineering and nautical science, and costal management, among others. India has established the National Maritime University in Chennai, which can be made operational for all South Asian countries.

South Asia has a long coastline which offers good potential for short sea or coastal shipping. Maritime costs are a significant determinant of trade flow across the region. On the one hand, goods and passenger traffic in South Asia have been growing, and on the other, ocean freight is rising day by day. Instead of relying on foreign vessels, short sea/coastal shipping in this region will help the LDCs and small island countries in South Asia to effectively gain from rising trade and transportation. Added to this, complementary policy reform, accompanied by improved procedural and operational efficiency, in the shipping sector is essential to support regional maritime connectivity. To start with, a regional agreement to allow short sea shipping in South Asia will not only enhance ferry services across the region but also strengthen the maritime profile of the countries.

With regard to aviation, South Asian airports suffer from tremendous capacity constraints, on-shore and off-shore, for both passengers and cargo, in terms of runways, parking areas for aircrafts, passenger handling areas, cargo processing facilities (green channel, cold storage, etc.), as well as security and baggage handling facilities. There is urgent need for pilots and ground handling staff in airports. It would be useful if South Asian countries jointly set up a regional aviation training institute in the region. In addition, an Open Sky Policy for airlines and freight originating from within the region may help in strengthening the connectivity between important cities.

For advancing regional and global aviation connectivity, we need stronger regional co-operation in South Asia. To start with, this co-operation may consider some important areas such as aviation safety, for instance co-operative development of operational safety and airworthiness, development of infrastructure, standards, co-operation among air traffic controls, etc. The South Asian region may look at the ASEAN template of regional aviation co-operation. ASEAN countries adopted the ASEAN Multilateral Agreement on the Full Liberalisation of Air Freight Services on 20 May 2009. This Agreement is one of the components of the Roadmap for Integration of Air Travel Sector and the Action Plan for ASEAN Air Transport Integration and Liberalisation 2005–15, adopted at the Tenth Transport Ministers Meeting in Phnom Penh in 2004.

10.4.5 Harmonising rules, regulations, and standards

In order for the infrastructure hardware of a South Asia-wide transport network to function effectively, necessary soft infrastructure, such as relevant rules, regulations, and standards, needs to be in place. Rules, regulations, and standards must meet at least a common regional structure, but preferably an international design. Participating countries need to formulate and agree on a harmonised set of rules, regulations, and standards.

Trade facilitation initiatives in the area of standards and conformance – through reduction of technical barriers to trade (TBT) – focus on addressing differences between national laws, standards and conformity assessment procedures, towards a broader horizontal approach at the regional level. We therefore need to harmonise national standards with international standards and develop MRAs among member countries in South Asia.

There is a need for higher-level co-ordination among many concerned stakeholders and agencies, such as transport, customs, immigration and quarantine authorities. At the same time, the capacity of concerned national institutions, particularly for least developed countries, needs to be enhanced for effective implementation of these agreements. There is also a need for a uniform or compatible standard (preferably an international standard) for development of cross-border transport networks to make the networks effective and beneficial for all stakeholders. Establishment of an efficient management system and associated capacity building to look after the harmonisation of standards relating to cross-border transportation would pave the way to achieving regional connectivity. This would ultimately help achieve single-stop and single-window customs across the region.¹⁴

10.4.6 Financing cross-border transport projects

Connecting South Asia requires a large investment. It will be a difficult challenge to mobilise such a large investment, particularly because of the ongoing financial and economic crisis. This calls for an appropriate financing mechanism to mobilise the region's huge savings for infrastructure development. This financing scheme should aim to raise resources from the public sector, multilateral development banks and the private sector on a public–private partnership model. Bigger economies such as Japan, Korea, China and India have leading roles in filling the financing gap. They should unilaterally come forward to fill resources gaps in the South Asian corridors, particularly in terms of financing and managing missing links and bridges.

10.4.7 Strengthening co-ordination among countries and stakeholders

Weak co-ordination, like high tariffs, prohibits trade among countries. The poor co-ordination between planning, implementing, and financing agencies causes high-level inefficiency in infrastructure development. Co-ordination among various concerned agencies or institutions within a country is also required because each may have different objectives. In order to have timely implementation of vast South Asian corridors, effective co-ordination between countries and other stakeholders is vital. Without such co-ordination, it is unlikely that an optimal cross-border infrastructure will come into existence. Thus, an effective co-ordinating institution will be necessary to generate willingness from countries to participate in the projects. It can also resolve conflicting interests, if any arise, between the governments and stakeholders.

10.4.8 Projects to strengthen regional integration

Some key projects that would pave the way for achieving the target of a customs union and economic union are as follows:

- strengthen cross-border infrastructure (move from road corridors to economic corridors);
- open South Asian regional transit;
- secure technology for managing regional infrastructure corridors and security;
- facilitate investment in regional infrastructure;
- promote multimodal transportation (rail transit, regular container trains in the region);
- improve the efficiency of border corridors (both sides of border, with improvements in ICP project in parallel);
- strengthen and harmonise rules, regulations and standards relating to transportation and customs;
- set up South Asian Single Window (customs);
- simplify and harmonise trade procedures, most particularly at the border;

- strengthen co-ordination among countries and stakeholders; and
- streamline NTMs.

10.5 Conclusions

South Asia's economic performance during the 2000s has been commendable. Undoubtedly, South Asia is a major economic force in the world. However, the quality and capacity of South Asia's infrastructure, both on the national and cross-border levels, is certainly a matter for concern. The lack of regional connectivity is one of the major constraints hindering the potential of regional growth and economic integration. The experiences of Europe, Latin America and other parts of Asia (such as GMS), where the presence of cross-border infrastructure is comparatively high, and, to a lesser extent, Africa, where the development of cross-border infrastructure has taken a new shape, suggest that regional co-operation promotes greater prosperity and stability for participating countries. A major success factor is their ability to build regional initiatives that are based on shared strategic vision, as captured in the Initiative for the Integration of Regional Infrastructure in South America (IIRSA). South Asian co-operation programmes have to be much stronger to address the regional infrastructure needs and to enable institutions and policies to be established. Therefore, what is important for South Asian countries is to enhance the facilitation of trade and transport across borders. Integrated regional connectivity would provide substantial benefits to landlocked and small island countries as well as poor, smaller countries by giving them access to world markets at lower costs.

To realise the benefits of regional connectivity and trade liberalisation, South Asian countries have to follow policies that help them to reduce the costs of trade at border, on the one hand, and that absorb new transportation technologies, improve productivity and increase their labour force's knowledge and skills, on the other. Since countries in South Asia do not start with the same endowments, there will be both winners and losers. Countries that do not have adequate capacity to engage with the integration process may lose out, while those endowed with higher infrastructure stocks will win. The shared objective of the regional co-operation should then be to eliminate this asymmetry between countries in South Asia and help the countries lagging behind to move ahead through a deeper co-operation.

In order to encourage integration in South Asia, a comprehensive approach is needed to address the physical infrastructure issues, including roads, rail, inland waterways, maritime transport, dry ports, airports, sea ports, and information and communication technology, as well as the non-physical soft infrastructure issues, including cross-border transit facilitation measures, customs clearance, and other facilitating policies and regulations. Addressing these issues, requires collaborative efforts among South Asian countries, multilateral development banks, the United Nations agencies, intergovernmental organisations, bilateral donor agencies, the private sector and professional associations. In particular, high-level policy direction and commitments are important for providing mutually beneficial regional connectivity in the region and beyond. In this regard, a commonly agreed strategic regional connectivity plan

like the one ASEAN has recently developed (master plan of ASEAN connectivity) is needed to facilitate closer co-operation and achieve an integrated South Asia.

There are many possible areas of co-operation in South Asia for raising low regional trade to a higher level. Undoubtedly, improved physical connectivity and regional transit, increased FDI and the energy trade are important factors in unlocking regional trade potential. Moreover, greater engagement in these areas would generate employment opportunities and other economic and social activities, which in turn would help reduce poverty (particularly in the bordering areas), enhance foreign direct investment flows, and generate new business opportunities for the private sector. At the same time, a regional transit arrangement would help South Asia to better integrate the region and also to strengthen the globalisation process. Use of improved technology to manage transportation and security would help reduce trade costs through higher efficiency and take care of additional traffic. Stronger regional co-operation with other regions and countries is thus essential in order to secure the technology to manage the transportation corridors, trade and security.

Notes

- 1 See, for example, De (2009, 2011).
- 2 See Duval and Uthoktham (2011).
- 3 Sourced from World Development Indicators (WDI) Online Database, World Bank.
- 4 Cited in UNESCAP (2012).
- 5 See International Civil Aviation Organization (ICAO) Data, available at: www.icaoodata.com.
- 6 See SAARC Secretariat Press Release dated 30 August 2011.
- 7 The coefficient of variation is 82 per cent in the case of export time.
- 8 Improvements in customs procedures have definitely reduced the amount of informal payments needed for clearing cargo. Even so, under-the-table transactions to clear exports at the borders remain high. The actual amount is negotiated between the shipper and the customs agent, with both agreeing on the amount per shipment that will be reimbursed without an invoice and which will therefore be available for paying customs officials to expedite cargo clearance.
- 9 See De (2011).
- 10 See De et al. (2012).
- 11 See SAARC Secretariat Newsletter, January 2008.
- 12 See the Press Release titled 'India's Chairmanship of SAARC', issued by the SAARC Division, Ministry of External Affairs, Government of India, dated 22 April, 2008, New Delhi.
- 13 See, for example, ADB-ADBI (2009); UNESCAP (2012).
- 14 In this context, the ASEAN Single Window (ASW) may be mentioned which is designed to expedite customs clearance and release shipments coming to and departing from ASEAN. This is broadly defined as an environment where a single window in each country in ASEAN (i.e. NSW) operates and integrates. The NSW is a prerequisite of the ASEAN Single Window. Six ASEAN countries are now implementing ASEAN Single Window.

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Chapter 11

Productive Integration of Least Developed Countries into Regional Supply Chains: The Case of South Asia

John Serieux

11.1 Introduction

The use of regional supply chains in production implies the geographic dispersion of the stages of production (of goods and services) across national borders within a given region.¹ As such, these supply chains often involve a complex web of inter- and intra-firm transactions across and within national boundaries engaged in various aspects of production and marketing of a single or related range of products. (Some investigators have, perhaps more correctly, referred to them as supply networks. This web of firms is able to extract the potential benefits from variations in comparative advantage across countries and across country- or region-specific trade advantages (or sidestep trade or regulatory restrictions) to lower production costs and increase market access (Kimura and Obashi 2011). In addition, stiff competition between firms at certain stages along the production chain can serve to maintain strong downward pressure on costs (Wills and Hale 2005). However, the geographic dispersion of the production process also means that the viability of regional supply chains is predicated on the ability to transfer goods across space and national borders both quickly and inexpensively. Those requirements pose a substantial challenge to the introduction and expansion of regional supply chains in developing regions, in general, and the participation of least developed countries (LDCs), in those chains, in particular.

The infrastructural, human capital and institutional demands of this form of production has meant that, heretofore, LDCs have not typically been major participants in these supply chains. Even in East Asia, where this structure of production is most pervasive, the LDCs of the region (Cambodia, Lao PDR and Myanmar) have been the last to be integrated into the regional supply chains, and their participation, though increasing, remains constrained (UNESCAP 2007). One can reasonably conclude, from this record, that the further development of regional supply chains in South Asia, in general, and the integration of South Asian LDCs into these supply chains, in particular, would likely face significant hurdles – and that is indeed the case.

As a region, South Asia is unique in many respects. Though its regional population is large, only eight countries make up the region and half of these are LDCs. Moreover, the level of intra-regional trade is the lowest of any of the major developing regions. However, in terms of infrastructural, human capital and institutional endowments, South Asian LDCs (with the notable exception of Afghanistan) are typically better

placed than most LDCs. This suggests that the prospect of integrating these economies (again, excepting Afghanistan) into regional supply chains may be a formidable but not insuperable challenge.

In this chapter we examine the nature of the constraints likely to be faced by LDCs in attempting to integrate into regional supply chains. This is followed by an enumeration of some of the initiatives that LDCs can undertake to improve domestic and regional conditions for participation in regional (and global) supply chains. The chapter then looks more specifically at the situation and prospects for South Asia and concludes with a summary of its main findings.

11.2 Major constraints to least developed countries' participation in regional supply chains

Supply chains offer a competitive advantage only if the gains to be obtained from the spatial separation of production are large and are not exceeded by the many potential costs of linking production blocks. Cheap, instant, and reliable modes of communication between firms along the chain of production are critical for co-ordinating the production process and ensuring responsiveness to evolving conditions. Logistics services in the form of minimal transit times, safe handling of goods, reliability and security are critical for minimising cost and maximising certainty as goods move along the chain of production. To promote local firm participation in these supply chains, a country must, therefore, be able to offer the necessary physical, communication and institutional infrastructure, as well as the policy conditions that can accommodate the requisite quality of communication and logistics services. Moreover, the importance of links between multinational corporations (MNCs) and local firms in these supply chains also means that countries must be able to offer an environment that is conducive to the quick and effective initiation and execution of commercial activity.

Among the definitional attributes of LDCs, only human capital deficiencies immediately suggest potential challenges with respect to the integration of LDC firms into regional supply chains. However, LDCs are more likely to demonstrate institutional and infrastructural weaknesses, which can constrain these countries' ability to participate meaningfully in the trade and investment activities that are critical to the formation of regional supply chains. Furthermore, LDCs that are also landlocked, or small island countries, face additional (or more acute) constraints that (directly or indirectly) derive from these geographic attributes. Most impediments to trade-related activities generally, and participation in regional supply chains in particular, derive from various forms of domestic supply constraints (UNCTAD 2008), including, among others: high costs of transport and logistics; limited telecommunications infrastructure; high transaction costs of doing business; shallow and inefficient finance; weak human resources; and limited capacity to produce public goods. However, beyond these internal constraints, some aspects of the external environment, in particular, residual and implicit trade barriers, also constrain the potential participation of LDCs in regional supply chains.

11.3 Policies and programmes to improve the conditions for the operation of supply chains

The list of potential constraints enumerated above might, at first blush, suggest that the integration of LDCs (and, more particularly, South Asian LDCs) into regional supply chains may need to await significant further development. However, the experience of East Asia, with respect to the (mostly) successful integration of Cambodia, Lao PDR and Myanmar into East Asian supply chains, and the success of efforts at expanding the export manufacturing sector in Bangladesh, indicate that, by taking advantage of existing strengths, directly addressing the most binding constraints and using bridge institutions and technologies over the short and medium term, LDCs may be able to begin the process of integration into regional supply chains well before all the major constraints are ameliorated.

One of the lessons of the East Asian experience is that countries need not wait for progress on formal processes of regional trade liberalisation and economic integration – most of the programmes and policies that engender the development of regional (and global) supply chains are unilateral initiatives taken by individual countries. However, whereas formal regional agreements may largely follow, rather than lead, progress on economic integration, region-wide attempts at improving transportation links both at the level of physical infrastructure and ‘soft’ infrastructure (such as the simplification of cross-border procedures) can have a large effect on transportation and logistics costs in intra-regional trade.

The initiatives that can be taken will be grouped under three headings: a) transport and trade facilitation; b) resource mobilisation; and c) directed industrial policy.

11.3.1 Transport and trade facilitation

The importance of transport quality and cost in reducing the cost of linking production blocks in a supply chain are easy to recognise. However, improving the speed and cost of movement of goods can depend just as critically on trade facilitation measures. Maur (2008: 2) refers to trade facilitation as ‘the sum of efforts undertaken at the national, regional and multilateral levels designed to reduce the transaction costs of trade’. Thus, improvements in transport infrastructure and trade facilitation measures should serve to enhance the movement of goods, services and investment within and across borders. In so doing, such programmes address the biggest potential weakness of supply chain-based production – its geographic spread and consequent dependence on the rapid and assured movement of goods and services across long distances. Such programmes encompass a wider range of initiatives, only some of which will be enumerated here.

- *Improvement in physical infrastructure* – An adequate road or rail infrastructure is an imperative for reducing transit time, direct cost and maintaining quality in production. An insufficient or poor quality road or rail network means that transit times are long, delivery is unreliable and quality may be difficult to guarantee. Ports and cargo-handling facilities are also an important part of that infrastructure

since poor quality or low efficiency of these facilities impose additional costs, time and uncertainty on the movement of goods (Brooks 2008).

- *Accelerating customs and logistics procedures* – Reduced transit time leads eventually to lower production costs. Extended procedures at border crossings or transport junctures increase the amount of time it takes for goods to move between production blocks and add to the uncertainty of the timing of such movements. Supply chains that use the just-in-time approach to inventory management are particularly vulnerable to uncertainty in the movement of goods between production blocks. Accelerating customs and logistics procedures reduces the effect of spatial dispersion and opens up larger areas to participation in supply chains. Djankov et al. (2010) found that an extra day of transit time reduced trade volumes by 1 per cent.
- *Improved power grid infrastructure* – Though the power grid infrastructure may not be an integral part of the transportation network it is important for reducing interruptions that hinder trade, particularly at transportation nodes such as ports (ADB 2001). The efficient operation of ports and other transportation notes is predicated on the assured provision of electricity for both the movement and storage of goods.
- *Investment in telecommunication infrastructure* – Cheap and reliable communication networks are a necessary part of ensuring that the correct goods are shipped at the correct time between production nodes in a supply chain. Therefore, reducing the transaction costs of trade also means improving the means of communication within and across national borders. This is also an area where the presence of large externalities suggests significant rewards for regional co-operation (Brooks 2008).
- *Enhancing regional economic co-operation* – Harmonisation of regulations and procedures, along with lower tariffs, are some of the outcomes of regional trading arrangements that are a critical part of reducing transit cost and time across borders (UNCTAD 2008). Movement along this front will certainly enhance the potential for the expansion of supply chains but, as was noted earlier, progress need not await formal regional institutional arrangement and can be made long before these agreements are enforced. A loose arrangement, which concentrates on the provision of regional public and quasi-public goods may offer more immediate rewards than the development of more formal institutions aimed at increased trade and regional integration. The experience of the Greater Mekong Subregion (GMS) (see Box 11.1) is a clear illustration of this as well as the importance of transport and trade facilitation.

11.3.2 Resource mobilisation

The development and expansion of regional supply chains, like the initiation or expansion of other forms of production, requires the development and/or expansion of new firms and the capital investments that this implies. Sources of invested capital can either be internal or external. For LDCs the main source of external investment

Box 11.1 The Greater Mekong Subregion: Intra-regional transportation and trade facilitation initiatives

The GMS refers to the five countries (Cambodia, Lao PDR, Myanmar, Thailand and Vietnam) and two Chinese provinces (Yunnan and Guangxi Zhuang) that occupy the drainage basin of the Mekong River. The basin covers a land area of 795,000 square km and is home to a population of 326 million people (ADB 2012). Four of the five core countries of the GMS are the CLMV countries (Cambodia, Lao PDR, Myanmar and Vietnam) – considered the economic laggards of the ASEAN group. In fact, three of them are LDCs. The GMS countries sought assistance from the Asian Development Bank (ADB) to develop a programme that enhanced the connection within that subregion, improved competitiveness and fostered a greater sense of community. The result was the GMS Economic Programme of 1992. Among the nine priority areas slated for action were improving transportation infrastructure, and enhancing transport and trade facilitation.

Notably, the GMS Programme did not attempt formal *institutional integration* of the subregion. The institutional framework that ensures programme implementation is rather loose. At the policy level the programme is guided by a ministerial conference and implementation of programmes and projects are overseen by sector-specific forums or working groups (Duval 2008). The GMS Programme, instead, emphasised *market integration* with significance attached to provision of public and quasi-public goods to increase ‘connectivity, competitiveness and a sense of community’ (Menon and Melendez 2011).

In 1995, the GMS adopted the Transportation Master Plan which identified priority transport links that could generate immediate improvements in transportation infrastructure, thereby reducing travel time and costs. These included three major road construction projects: the North–South Economic Corridor (NSEC); the East–West Economic Corridor (EWEC); and the Southern Economic Corridor (SEC). An additional six corridors were added to the plan in 2007 (Stone and Strutt 2009). To improve transportation and trade facilitation the countries entered into a cross-border transportation agreement (CBTA) in 2003 to ‘facilitate the cross-border movement of goods, vehicles, and people between and among [the member countries]’ by reducing border crossing formalities; exchanging commercial traffic rights; establishing transit traffic regimes, and setting common standards and requirements for road vehicles and cross-border traffic (Stone and Strutt 2009).

An examination of the impact of the NSEC found that, between 2000 and 2006, shipping costs between Bangkok (Thailand) and Kunming (China) were reduced by 27–33 per cent (depending on the route taken) and parallel transit times were reduced by 32–40 per cent (Banomyong 2007). The EWAC was found to have reduced travel time between Dansavahn (Lao PDR) and Kahnthabouly (in

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Vietnam) by 75 per cent (from twelve to three hours) (Luanglatbandith 2007). The SEC was similarly found to have reduced transit times and transportation cost (Phyrum et al. 2007). These gains from improvements in transport infrastructure together with ongoing progress in trade facilitation measures (under the CBLT) was estimated to have generated at least a 40 per cent increase in intra-regional trade by 2006 (Stone and Strutt 2009).

capital is foreign direct investment (FDI). Internal sources are mainly allocated through the banking sector (and, sometimes, the government budget). We briefly examine some of the most salient issues in both respects.

- *Foreign direct investment* – LDCs do not have a very good record of attracting FDI into areas other than natural resource exploitation. It is important that countries define (and emphasise) their comparative advantages and provide the necessary information to potential investors with regard to those advantages. Furthermore, expensive incentives such as tax holidays, tax reductions and grants do not have a particularly good record of success, yet come with a high relative cost to poorer countries. In fact, emphasis on lowering the transaction cost of doing business and assuring the rules of engagement may be a more effective way of attracting external investment (UNESCAP 2007).

With respect to regional supply chains, much of the production expansion is likely to come from the expansion of firms within the region (from more advanced economies in the region to LDCs). Therefore, particular attention needs to be paid to the factors that encourage the flow of intra-regional FDI. In that regard, regional economic arrangements and other efforts at economic integration may pay particular dividends (UNESCAP 2007; Kumar 2007). Box 11.2 on the experience of Vietnam speaks directly to those factors.

- *Domestic resource mobilisation* – In the environment of shallow finance that is typical of LDCs, firm financing can be a challenge. As noted earlier, the formal financial system (largely commercial banks and near banks) is designed to serve the needs of large established firms. The informal sector and microcredit organisations typically serve the need of microenterprises. The entrepreneurial middle, consisting of SMEs, are typically left unserved – starved of both long- and short-term credit.

For firms engaged in production for export, the instruments most successfully employed for directing short-term credit to these firms have been various forms of trade credit. Instruments include pre-shipment guarantees, export production guarantees and post-shipment guarantees. Both public sector and external concessional resources have been used to leverage bank financing for these schemes. Yet to be tried, but potentially feasible for supply chains, is inter-firm trade credit. Larger or better-financed firms may be able to provide trade credit to lower financed firms within their network if given the right incentives, such as tax

Box 11.2 Attracting FDI: The Vietnam experience

Vietnam began its transition from a centrally planned economy to a market economy (the *Doi Moi* period) in 1986. This liberalisation and reconstruction was implemented through a series of laws aimed at formally recognising the right to private and foreign ownership of property as well as the right to conduct business. These included The Land Law in 1987 (with revisions in 1993 and 1999), a Bankruptcy Law (in 1993), laws that liberalised the financial sector, and a law on foreign investment (1987) (Bui 2009). One of the responses to this new 'opening up' was a spectacular increase in foreign direct investment (FDI). It rose from nearly zero in 1989 to 12 per cent of GDP in 1994 (Figure 11.B1). Investors perceived potential large and untapped markets in this country of over 66 million people and a cheap but relatively well-educated labour force that could be used to produce goods for export. In addition, Vietnam was the beneficiary of heightened investor interest in Asia during that period as well increasing intra-regional investment flows (Freeman 2002). However, little of this inward flow of finance was directed at supply chain-based production. Most of this early investment took the form of joint ventures with state-owned enterprises aimed at producing goods for the local market or direct production for export (Leung 2010).

That euphoric period came to a halt with the Asian Financial Crisis in 1997. However, that crisis may have merely accentuated a decline that was already in progress. The difficulties of doing business in Vietnam were becoming more apparent and there were fears that reforms were stalled (Freeman 2002). FDI did not disappear altogether but its level (relative to GDP) had fallen to 3.4 per cent by 2002 (from 9.6 per cent in 1997). Thereafter, while the rest of South East Asia recovered its previous levels of FDI, Vietnam's FDI levels continued to stagnate until 2006 (Figure 11.B1).

The second wave of reforms began at the turn of the century with the revision of the Law on Foreign Investment, and new Enterprise Law (2001). This was followed by a Second Enterprise Law (2005) and a Common Investment Law (2006). The purpose of these laws was to further even the playing field for the private and state sectors and local and foreign firms (Leung 2010). Though these initiatives result in a marked increase in the rate registration of new businesses, they did not have an effect on the rate of FDI flows (Figure 11.B1). It was Vietnam's accession to the WTO which appeared to revive FDI flows. Membership of the WTO may have been seen as a guarantee that Vietnam would 'play by the rules,' thus 'locking in' reforms and a promise of further market liberalisation as Vietnam moved to meet WTO requirements. The increase in FDI that followed was rapid and was, by and large, maintained through the global economic crisis of 2008–2010 (Figure 11.B1).

Unlike the previous wave of FDI, much of this new wave was directed at supply chain-based production. This can be seen in several attributes of the new inflows. Seventy per cent of the new FDI was concentrated in industry (Bui 2009). An

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*(continued)***Figure 11.B1 FDI in Vietnam in absolute and relative terms****Source:** UNCTAD STAT

increasing number of firms became involved in labour-intensive manufacturing, such as garments, footwear and furniture, and intermediate good imports from China increased sharply (Lueng 2010). The shift to more supply chain-based production was partly engendered by the fact that new laws allowed multinational enterprises to acquire more than 30 per cent of domestic enterprises (as opposed to the joint ventures of the previous wave) and non-labour production and transit costs such as electricity, transportation and telephone were reduced as these sectors (formally monopolised by state-owned enterprises) were opened up to competition (Leung 2010).

concessions, insurance or limited guarantees.⁴ This may have the added benefit of making production within supply chains more attractive to nascent firms.

Long-term credit has been an even greater challenge. The use of development banks (or similar public or quasi-public agencies) has been one of the means of providing long-term credit to SMEs. However, novel approaches that seek to change the incentive structure in order to overcome the risk aversion of commercial banks have the advantage of avoiding the added administrative and organisational costs of specialised public agencies. Also, such approaches can use public sector resources (as well as external concessional aid) to leverage domestic bank credit. (Box 11.3 describes a novel and, by and large, successful attempt to improve the financing of SMEs.)

- *Aid for Trade* – the Aid for Trade rubric was developed (at the 2005 WTO ministerial meeting in Hong Kong) precisely to address developing country needs for assistance in trade-related development and adjustment challenges. More precisely, it was meant to help developing countries expand supply-side capacity and trade-related infrastructure to increase potential benefits from WTO agreements (WTO 2005).⁵ Among the six recommended areas of emphasis suggested by the resulting Aid for Trade Task Force, two are of particular relevance to supply chain development and maintenance. These are:
 - *Trade development* – support for: building institutions to support business activity, public-private sector networking, development of e-commerce, and trade finance.

- *Building trade related infrastructure* – providing financial and technical assistance for the construction of roads, ports, rail, etc. (at both the national and regional level) as well as support for programmes aimed at improving trade facilitation (WTO 2006).
- Given the limited resource availability that is typical of the LDC context, the ability to access (additional) bilateral and multilateral resources specifically aimed at engendering and supporting trade can prove to be a critical element in improving countries' ability to develop and implement programmes aimed at lowering trade transaction costs in general and encouraging the development of supply chain production in particular.

The GMS endeavours (discussed in Box 11.1) and Cambodia's successful branding of its garment industry (discussed in Box 11.4) are both examples of successful Aid for Trade endeavours. In the case of the GMS, the participating countries have successfully directed external assistance toward the reduction in transportation and logistics costs by improving the quality of the physical infrastructure as well as the 'soft' infrastructure related to trade facilitation (WTO and OECD 2011). In the case of the Cambodia garment industry, aid was used to facilitate a public–private network that allowed the government, on the one hand, to negotiate increased access to the US market and, on the other, to successfully engage the private sector in developing and implementing a programme aimed at guaranteeing adherence to international labour standards (ODI 2009; WTO and OECD 2011).

Box 11.3 Small and medium enterprise financing in Bangladesh

Since the 1980s, both the government of Bangladesh and the central bank, the Bangladesh Bank, have taken a number of initiatives to provide financial assistance to SMEs. These programmes include setting up of a bank, namely the Bank for Small Industries and Commerce (BASIC), in 1988, requiring commercial banks to reserve five per cent of the total loan portfolio for SME financing, and special interest and credit guarantee scheme (Jesmin 2009). Despite all these arrangements, availability of institutional credit for the SME sector still remained grossly inadequate.

In 2004 Bangladesh Bank set up a BDT 10 billion (approximately US\$160 million) refinancing scheme for credit to SMEs. According to this programme, participating institutions paid a five per cent interest rate to Bangladesh Bank but were free to choose the lending rate of interest to enterprises. This removed a large part of the risk involved in such lending and allowed the lending institutions to move away from the collateral-based lending approach that had restricted the flow of credit to those enterprises. The International Development Association (IDA) added a further US\$10 million to the scheme and the Asian Development Bank (ADB) added a further US\$30 million. As of 2011, 43 banks and non-bank financial institutions had used that facility to lend out approximately US\$278 million to over 21,000 SMEs (Bangladesh Bank 2011).

Box 11.4 The garment industry in Cambodia: The advantage of reputation

The development of the garment industry in the mid-1990s was initially motivated by the desire of garment manufacturers in China and other Asian countries to overcome the restrictions of the Multifibre Arrangement (MFA). Exports from these countries were constrained by the quota restriction of the MFA and they sought further access to developed country markets by exporting garments out of countries like Cambodia for whom quota constraints were not yet binding. This advantage was further enhanced when Cambodia signed the Cambodia Bilateral Textile Agreement with the United States of America in 1999. That agreement linked quota access to the US market to garment factory compliance with international labour standards, to be verified directly by International Labour Organization (ILO) monitoring. Within Cambodia, the government, in collaboration with the garment producers and the ILO, developed the Better Factories Programme along with capacity building initiatives to monitor compliance with labour standards and assist factories in meeting and maintaining those standards (ODI 2009). Cambodia was thus able to earn a reputation among buyers as a location of socially responsible garment production (Sotharith 2011). In short, Cambodia guaranteed that the trademark 'made in Cambodia' was equivalent to a guarantee that garments were not produced under 'sweatshop' conditions. Between 1995 and 2005 the number of garment factories in Cambodia increased from 20 to 247 and employment in the industry increased from 18,700 to 283,900 (Ngov 2011).

With the end of the MFA on 1 January 2005, most analyses of the global garment market suggested that Cambodia, with the loss of the particular advantage offered by most favoured nation MFN quotas, would struggle to compete with the larger low-cost producers like China and India and likely lose market share (Nordas 2004). However, contrary to those predictions, garment production in Cambodia continued to expand after the end of MFA quotas until the onset of the global economic crisis (in 2008). Export increased from US\$2.2 billion in 2004 to US\$2.9 billion in 2007. The number of factories increased from 247 in 2005 to 292 in 2007, and employment increased, from 283,900 to 335,000 in the same period (Ngov 2011). Given that Cambodia did not experience a significant decrease in cost, it is very likely that it was able to continue to expand garment production and exports because of its ability to trade on its reputation.

11.3.3 Directed industrial policy

The limited institutional, financial, and human resources (as well as administrative capacity) of most LDCs governments does not make broad-based industrial policy a practical option for these countries (UNCTAD 2008). However, policies aimed at reducing or side-stepping specific constraints are well within the capability of all

LDCs and are part of the efforts to improve the operational environment for supply chain-based production. These include:

- *The use of geographically or institutionally constrained programmes* – While economy-wide liberalisation, and immediate improvements in physical and economic infrastructure may be infeasible for most LDCs, it may well be possible to offer these advantages within a confined geographical space. Export processing zones (EPZs) and export oriented unit (EOU) schemes, for example, allow countries to offer nearly idealised environments for production and trade (in terms of simplified rules, adequate physical infrastructure (for EPZ) and minimal taxes and tariff rates) well before the general economy has the capacity to offer a significantly improved environment for production and trade (UNCTAD 2008; USAID 2005). As Box 11.4 indicates, Cambodia was not only able to use its EPZs to offer to lower transaction costs for firms well below what it could offer these advantages on an economy-wide basis; the country was also able to enhance its comparative advantage beyond cheap labour by attaching socially desirable attributes to its products.
- *Targeted improvements in the business climate* – As the Rwandan experience (Box 11.5) demonstrates, an LDC can, and should attempt to, make significant improvements to the business climate by targeting specific laws and regulations and developing organisations that advance both the needs of the private sector for clarity and speed (in the determination and execution of administrative protocols) and the general society's need for a functional and coherent commercial code that protects the public trust.

Box 11.5 Rwanda: Removing impediments to commerce

Although a densely-populated and landlocked LDC, Rwanda has become one of the easiest places in Africa, and indeed the world, to engage in business activity. According to the 2014 rankings based on the Ease of Doing Business Index published by the International Finance Corporation, Rwanda placed 32nd out of 189 countries and 2nd in the Sub-Saharan African region, behind only Mauritius (World Bank 2013). What makes Rwanda a favourable place for investors?

Following the genocide in 1994, the immediate priorities for the Rwandan Government were to restore peace, resettle displaced people, and promote national reconciliation. Thus, the first phase of reform from 1995 to 1997 mainly focused on reviving economic activities, restoring macroeconomic stability and budget management (Government of Rwanda 2001). However, in the second phase of economic reform (1998–2003), Rwanda focused on promoting private industry, along with macroeconomic reforms and trade liberalisation. The measures taken included: simplifying business licensing requirements and revising the labour code to remove restrictions on the movement of labour. During the same period, the government established the Rwanda Investment

(continued)

(continued)

and Exports Promotion Agency (RIEPA) to facilitate private investment and business activities. One of the most significant achievements of the government during the late 1990s was to implement the Investment Promotion Act in 1998, which established a one-stop centre to promote private investment, exports, and enterprise development. In April 2000, the government-run Chamber of Commerce was abolished in favour of the Rwanda Private Sector Foundation (comprising of various private sector organisations) to represent private sectors interests (Government of Rwanda 2001).

Since 2004, Rwanda has undertaken a number of initiatives to improve its position in the Doing Business Index ranking list. In 2005, the law reform commission was established to review the existing business laws and recommend efficiency. A new company law was passed to simplify business start-up and strengthen minority shareholder protections. Additionally, two new laws were implemented to facilitate business. The first law allowed for the securing of lending using a wider range of assets as collateral. The second law made out-of-court enforcement of movable collateral available to provide creditors with absolute priority bankruptcy proceeding (*Business Times Magazine* 2009). In 2007, the Government of Rwanda established the Rwanda Commercial Registration Agency to reduce administrative hassle. During the same year, the cabinet directed RIEPA to co-ordinate the regulatory reforms and improve Rwanda's ranking in the Doing Business Index. A new Doing Business Unit was also established in December 2007 to support the national steering committee on doing business. In August 2008, the Rwanda Development Board was established by bringing together all the government agencies responsible for business registration, investment promotion, environmental clearances, privatisation and specialist agencies that support the priority sectors of information and communication technology (ICT) and tourism as well as SMEs and human capacity development in the private sector.

Rwanda jumped ten positions in the Doing Business Database index from 2008 to 2009 and the 2010 Doing Business Report recognised Rwanda as the top reforming country in the world.

11.4 South Asian least developed countries in context

11.4.1 Country-level profiles

The constraints listed above would seem to suggest that LDCs, in general, face significant hurdles in trying to integrate into regional supply chains. However, even among LDCs, these constraints are neither universal nor immutable. Many LDCs demonstrate profiles that indicate that they have either overcome some of these constraints (quite profoundly in some cases) or were always exceptional in particular areas. In general, South Asian LDCs are advantaged relative to the LDC group. With respect to many (though not all) of these attributes, they tend to cluster near the

lower end of the spectrum (in terms of the magnitude of the constraints) or have demonstrated rapid improvement in recent years. This suggests that the impediments to rapid integration of these countries into regional supply chains may be lower than it would be in other regions. However, in terms of precursors and preconditions, this region has both negatives and positives with which to contend. On the negative side, its record of intra-regional trade is poor. It is structurally less differentiated than East Asia, and faces significant historic and political challenges to regional co-operation. On the positive side, all of the countries in the region, including the LDCs (with the notable exception of Afghanistan) have already developed some capacity in export manufacturing (particularly in the garment industry), the region is proximal with East Asia and, crucially, formal institutions of regional economic integration do not appear to be critical to the development of regional supply chains. Below, we discuss some of the structural attributes of the South Asian LDCs and how they compare with other LDCs.

Relative to the LDC average, South Asia does not perform particularly well in terms of transportation costs, transit speeds, and the quality of logistics services, in general. However, this is, in large part, a reflection of the landlocked status of three of the four South Asian LDCs. Across all the criteria examined in Table 11.1, Bangladesh performs above the LDC average, in terms of transportation cost, and better than Senegal (which recorded the best logistics performance of all LDCs). Among the landlocked countries, Afghanistan, not unexpectedly, performs below the LDC average in all criteria examined, but Bhutan and Nepal both face cheaper transportation costs than Uganda (also landlocked but relatively high-performing), though they did not perform comparably in terms of logistics services and time to market.

Table 11.1 Measures of transportation and logistics efficiency: South Asia and others

Country name	Overall Logistics Performance Index: (1=low, 5=high)	Cost to export (US\$ per container)	Cost to import (US\$ per container)	Time to export (days)	Time to import (days)
Afghanistan	2.2	3,545	3,830	74	77
Bangladesh	2.7	965	1,370	25	31
Bhutan	2.4	2,230	2,805	38	38
India	3.1	1,095	1,070	16	20
Maldives	2.4	1,550	1,526	21	22
Nepal	2.2	1,960	2,095	41	35
Pakistan	2.5	660	705	21	18
Sri Lanka	2.3	715	745	21	19
Benin	2.8	1,049	1,496	30	32
Senegal	2.9	1,098	1,740	11	14
Uganda	2.8	2,880	3,015	37	34
LDCs	2.4	1,825	2,262	33	37

Source: World Development Indicators (World Bank)

In terms of the availability and cost of communication, the picture for South Asian LDCs is mixed. Only Bhutan has a better connection density than the LDC average and Bangladesh is, surprisingly, very far below the average (Table 11.2). However, countries in the South Asian region appear to be making significant progress in terms of reducing communication costs. As Table 11.3 shows, three of the top ten countries, in terms of the rate of price reduction for telecommunications services, are from South Asia and two of them (Bhutan and Bangladesh) are LDCs. Therefore, though connectivity, and particularly broadband connectivity, still remains well below the rate of other regions, such as East Asia, progress on the price front is encouraging.

Table 11.2 Internet connection: South Asia and other LDCs

Country name	Fixed broadband subscriptions per 100 inhabitants	Fixed internet subscriptions per 100 inhabitants
(Latest data from 2006–10)		
Afghanistan	0.0	0.0
Bangladesh	0.1	0.0
Bhutan	1.4	1.2
India	1.5	0.9
Maldives	5.3	4.8
Nepal	0.4	0.2
Pakistan	1.9	0.3
Sri Lanka	1.4	1.1
Tuvalu	8.2	3.3
Dejbouti	1.3	0.9
Yemen	2.4	0.4
LDCs	0.7	0.2

Source: ITU Database

Table 11.3 Decrease in ICT price basket (top ten economies)

Country	ICT price basket 2008	ICT price basket 2010	Percentage change 2008–10 (%)	Value change 2008–10
Azerbaijan	9.9	1.8	81.7	–8.1
Bhutan	14.7	3.6	75.4	–11.1
Sri Lanka	7.3	2.4	67.4	–4.9
Bangladesh	36.4	12.6	65.2	–23.7
Venezuela	4.3	1.6	62.9	–2.7
Guyana	17.7	8.5	51.6	–9.1
Uganda	61.8	30.2	51.1	–31.6
Austria	1.1	0.6	50.4	–0.6
Moldova	10.8	5.4	49.8	–5.4
Tanzania	57.0	31.4	44.9	–25.6

Source: International Telecommunication Union (ITU)

As Table 11.4 shows, some LDCs, in various regions, have managed to reduce the number and cost of (electrical) power outages as well as the value lost due to these outages to levels comparable with those of some industrialised developing countries. This clearly suggests that unreliable utility provision is not something the LDCs have to live with. However, only Bhutan, in South Asia, has indicators that suggest just a modest number of electrical outages (and, therefore, a modest loss of value as a result). South Asian countries (non-LDCs included) do not have a very good record of electricity provision and the LDCs of the region (excepting Bhutan) have a particularly poor record. This is definitely an area in which rapid progress is desirable.

In terms of the transaction costs of doing business (as summarised in the Ease of Doing Business Index), South Asian LDCs (with the exception of conflict-ridden Afghanistan) rank above the LDC average (Table 11.5). With respect to the specific transaction costs of registering a business; the number of procedures involved; and the time required to complete the process, all four South Asian LDCs (including Afghanistan) perform at or above the LDC average. In fact, their registration procedures are simpler than those of both India and Sri Lanka – countries that are perceived as being significantly more economically advanced. In terms of the time required to resolve insolvency, however, only Afghanistan (among the LDCs) performs better the LDC average. In any case, there is still a great deal of room for improvement, given that Rwanda, another LDC, demonstrates significantly better performance than any South Asian LDCs has been able to achieve across all criteria (see Box 11.5).

With the exception of Afghanistan, South Asian LDCs appear to outperform non-LDCs in the region in terms of financial depth (at least that of the banking sector) and, though evidence is limited, the efficiency of financial intermediation (as

Table 11.4 South Asia and others: Effect of electrical power outages

Country name	Number of power outages in a typical month (firm level)	Value lost due to electrical outages (% of sales)
(Latest data for 2006–10)		
Afghanistan	20.3	6.5
Bangladesh	101.6	10.6
Bhutan	3.1	4.3
India		6.6
Maldives		
Nepal	52.0	27.0
Pakistan	33.9	9.2
Sri Lanka		
Eritrea	3.0	0.2
Vanuatu	2.3	1.2
Mozambique	3.0	2.4
Lao PDR	1.5	4.3

Source: World Development Indicators (World Bank)

Table 11.5 Comparative transaction costs of doing business

Country name	Ease of Doing Business index (1=most business-friendly)	Cost of business start-up procedures (% of gross national income per capita)	Start-up procedures to register a business (number)	Time required to start a business (days)	Time to resolve insolvency (years)
Afghanistan	160	25.8	4	7	2
Bangladesh	122	30.6	7	19	4
Bhutan	142	7.2	8	36	
India	132	46.8	12	29	7
Maldives	79	8.9	5	9	1.5
Nepal	107	37.4	7	29	5
Pakistan	105	11.2	10	21	2.8
Sri Lanka	89	4.7	4	35	1.7
Rwanda	45	4.7	2	3	3
Samoa	60	9.7	4	9	2.5
LDCs	143	88.9	8	36	3.7

Source: World Development Indicators (World Bank)

measured by the spread between lending and deposit rates) is at least comparable to that of the non-LDCs in the region (Table 11.6). South Asian LDCs also compare favourably with the better performing LDCs outside the region. The overall level of financial depth and quality of intermediation of LDCs, in general, and South Asia, in particular, would need to improve substantially to accommodate the needs of SMEs in the context of supply chains, but at least one LDC in the region appears to have explicitly taken up this challenge (see Box 11.3).

In terms of their ability to offer a literate and skilled work force, South Asian LDCs (except for Afghanistan) are well behind India, Maldives and Sri Lanka but have better profiles than Pakistan (Table 11.7). The youth literacy rate and the level of enrolment at the secondary and tertiary level suggest that potential investors in these economies can have a reasonable expectation of a relatively literate population with a significant proportion with secondary education. Enrolment in tertiary education still remains low in South Asian LDCs, but the levels are still above the LDC average.

With respect to governance capability, South Asia presents a mixed bag relative to other LDCs when compared in terms of government effectiveness, quality of regulations and the rule of law (Table 11.8). Not unexpectedly, Afghanistan performs very poorly (well below the LDC average) on all measures. In terms of government effectiveness, only Bhutan performs above the LDC average. In terms of quality of regulations, Bangladesh and Nepal are above the LDC average and, in terms of evidence of the rule of law, Bangladesh and Bhutan are above the LDC average (the latter strongly so). In short, with the exception of Afghanistan, the performance of

Table 11.6 Indicators of financial depth and quality of intermediation

Country name	Broad money (% of GDP)	Domestic credit to private sector (% of GDP)	Interest rate spread (lending minus deposit rate, %)
Afghanistan	28.6	10.5	
Bangladesh	61.5	47.1	5.9
Bhutan	69.6	43.3	
India	69.6	49.0	
Maldives	60.9	64.6	6.3
Nepal	71.3	55.6	4.4
Pakistan	38.5	21.5	5.9
Sri Lanka	34.8	26.6	3.3
Mozambique	36.6	25.8	6.6
Samoa	49.9	45.0	8.0
Tonga	44.9	42.0	7.5
Vanuatu	87.4	65.8	

Source: World Development Indicators (World Bank)

Table 11.7 South Asia: some education indicators

Country name	Literacy rate, youth total (15–24 yrs, %)	School enrolment, secondary (% gross)	School enrolment, tertiary (% gross)
Afghanistan		45.5	3.3
Bangladesh	75.5	49.3	10.6
Bhutan		70.1	8.8
India	81.1	60.2	16.2
Maldives	99.3		
Nepal	82.0	43.5	
Pakistan	71.1	34.2	5.4
Sri Lanka	98.0	26.6	15.5
LDCs	73.9 ^a	35.7	5.7

Note: ^aAverage across 36 countries, most recent year from 2006–2011.

Source: World Development Indicators (World Bank)

Table 11.8 Performance of South Asian LDCs in terms of government capability

Country	Percentile rank in terms of:		
	Government effectiveness	Quality of regulations	Rule of law
Afghanistan	3.3	2.9	0.5
Bangladesh	16.7	23.3	27.8
Bhutan	64.8	13.8	59.4
Nepal	18.1	23.8	17.9
LDC Average	21.8	22.1	25.3

Source: Worldwide Governance Indicators (World Bank)

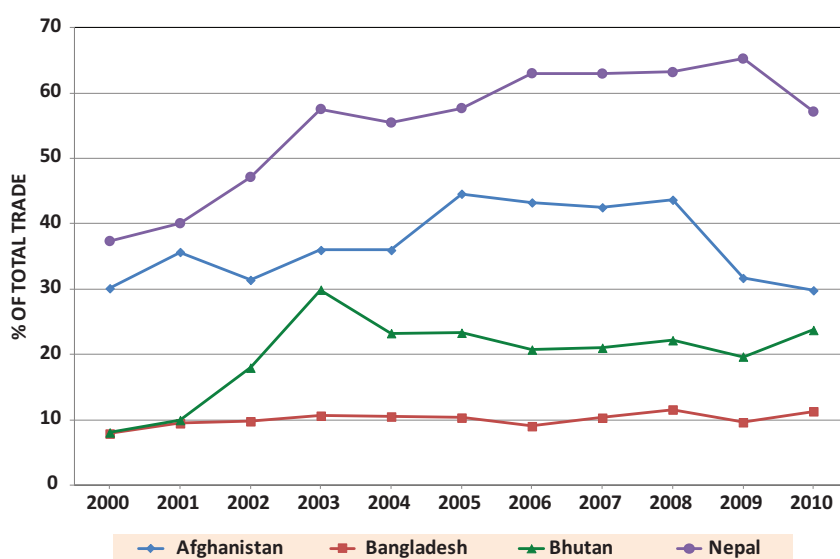
these countries is uneven across measures of governance – suggesting that (except for Afghanistan) the region's LDCs are, more or less, typical.

11.4.2 A regional profile

The current trading profile and degree of structural differentiation does not necessarily make South Asia an obvious region for the operation of regional supply chains. Intra-regional trade is not only very low, it is lower in South Asia than any other developing region. Moreover, intra-South Asian trade does not appear to be growing relative to regional output. Even an upward revision to accommodate the large amount of unrecorded intra-regional trade (a consequence of the persistent high tariffs and long stretches of unpatrolled borders) would not likely change that picture substantively (Srinivasan 2002). Intra-regional trade accounts for a higher than (regional) average proportion of the total trade of landlocked Afghanistan and Nepal, and even Bhutan (which is also landlocked) has very limited trade with its regional neighbours and Bangladesh, has even less (Figure 11.1). The development of supply chains in the region will have to overcome the extra-regional trade biases that these figures suggest.

In terms of productive structure, South Asia shows limited structural differentiation across countries compared, for instance, to East Asia. As Table A11.1 indicates, the importance of manufacturing (in total output) and of high technology exports (as a proportion of total exports) vary much more widely across East Asian nations than across South Asian nations. In fact, even relatively industrialised India exports a lower proportion of high-technology goods than unindustrialized Mongolia. It is, therefore, not obvious that the chain of production that stretches from design and invention in South Korea and Japan to labour-intensive assembly in Lao PDR or Cambodia (with intermediate steps in other East Asian countries) is immediately

Figure 11.1 South Asian LDCs and intra-regional trade



Source: Direction of Trade Statistics (IMF)

reproducible in South Asia. However, this may be balanced by the fact that the export of manufactured goods is already dominant for all but two of the South Asian countries. Thus, while limited differentiation may mean that, in the immediate term at least, regional supply chains might need to be less differentiated than most Asian supply chains (or only part of the production chain can be located in this region), the prevalence of manufactured product in regional exports also means that some basic infrastructure for the production of manufactured goods already exists in South Asia. Countries such as Bangladesh, Nepal, and Pakistan may be able to host, simultaneously, both labour-intensive assembly-type activities and more technically demanding intermediate activity across different supply chains, while India may be able to straddle all but the most technically demanding aspects of the production process. In short, it is unlikely that South Asia will replicate the 'flying geese' model in the classic sense, so famously attributed to East Asian industrial development.

For South Asia, there are at least two alternative (origins and) configurations for regional supply chains, and they are not mutually exclusive. One possible configuration would be South Asian integration into larger Asian supply chains. To some extent this is already happening. Japan and Asian newly industrialised countries (NICs) already invest in South Asian countries. South Asian LDCs may offer location advantages at least comparable to those offered by the CMLV countries, while others, such as India, may have comparable location advantages to the ASEAN four (Indonesia, Malaysia, Philippines and Thailand). Another configuration could be a closer regional integration in which South Asian countries try to develop forward and backward linkages across the region within (and across) existing industries. A study of the textiles and clothing (T&C) sector in South Asia, as presented in chapter 5 of this volume shows: (1) that there is substantial potential for forward and backward linkages in the textile and garment industries in the region; and (2) that given that some countries appear to specialise in the production of garments (Bangladesh and Sri Lanka) while others seem to specialise in the production of textiles (Pakistan), there is some potential for country specialisation in various aspects of the production of clothing from the production of raw materials (cotton and silk) to ready-to-wear apparel. It might be noted further that the establishment of regional supply chains within a well-established industry may make it easier to develop additional supply chains in other industries because it would likely involve lower initial costs to establish service links than would be the case for new industries while producing opportunities for static and dynamic economies of scale (in transport and logistics) for other industries (once these links are established).

Though one can identify dominant countries in all regions (either in terms of economic or population size), South Asia is unique even in that regard. The size of India, in relation to its neighbours in South Asia, is much greater than the relative size of any other country (including China) in its region (Table 11.9). This makes the Indian economy, its trade and investment policies, and its political stance even more critical to the economic fortunes of the region. The fact that India is the most industrialised of the South Asian countries serves only to magnify its relative economic and political influence. This actual and potential regional hegemonic weight has (and is likely to continue to do so) complicated efforts at regional co-operation, since other

Table 11.9 Relative dominance of regional powers

Region (largest country)	Income (% or regional total)	Population (% of regional total)
East Asia and Pacific (China)	36.5	60.8
Eastern Europe and Central Asia (Russia)	7.4	15.9
Latin America and the Caribbean (Brazil)	40.8	33.1
Middle East and North Africa (Saudi Arabia)	17.6	
Middle East and North Africa (Egypt)		21.2
South Asia (India)	82.6	75.0

Source: World Development Indicators (World Bank).

countries in the region may be overly sensitive to any set of institutions or policies that are seen to add to India's already dominant position. This may be a large part of the reason South Asia has been slow in constructing formal institutions aimed at regional economic integration. The SAFTA was not signed until 2004 and the planned achievement to a zero tariff regime for non-LDC countries was not expected to occur until 2012 (SAARC 2004). Moreover, despite the signing of the trade agreement, actual implementation has been held hostage to politics. Pakistan did not accord India with most favoured nation (MFN) status – a fundamental requirement of the trade agreement – until 2011. However, based on the East Asian experience, it would appear that formal agreements are not critical to supply chain expansion. Therefore, much progress may be possible with unilateral and informal arrangements that aim to ease the movement of firms as well as goods and services.

11.5 Conclusion

This chapter began by providing an assessment of the challenges and constraints facing LDCs wishing to integrate into regional supply chains. We then looked more specifically at South Asian LDCs in terms of how they compared to other LDCs, and then examined the prospect of supply chain development in the South Asian region.

In general, this chapter finds that the LDCs of South Asia (with the notable exception of Afghanistan) are relatively well appointed when compared to other LDCs. They are already engaged in significant levels of manufacturing for export, have reasonably well educated populations (in LDC terms), and have rapidly falling telecommunications costs. However, the transaction costs of doing business in the LDCs of this region remain high, its governance indicators are uneven, and the region is structurally quite different from East Asia – the region most noted for the development of supply chains. Also, progress on regional trade and economic integration has been slow and the potential hyper-dominance of India may make further progress less attractive than it might have been. However, the East Asian experience suggests that most of the accomplishments needed to engender the development of regional supply chains can be accomplished either as unilateral policy initiatives by individual countries or as the product of relatively informal arrangements to produce regional public and quasi-public goods. Moreover, instigating the links between spatially separate activities may be the most difficult part of supply chain development and, in that

area, South Asia may have an advantage. There are already opportunities to develop forward and backward linkages within and across existing industries that are region-wide. Success will likely require complementary policies in improving transport and logistics services across the region, attracting intra-regional and extra-regional FDI, improving financing to allow greater participation of local SMEs, and improving the local transaction costs of doing business across regional LDCs in particular and the region in general. These are significant challenges that will likely require external assistance (through Aid for Trade and other initiatives) but the experiences of other LDC and low-income countries suggest that these are achievable objectives.

The limited differentiation of South Asia and, in particular, the absence of a developed knowledge-based economy in its midst, may mean that the top-down development of supply chain linkages that occurred in East Asia is unlikely in South Asia. However, South Asia may be able to use its proximity to East Asia to develop South Asian regional branches of larger Asia-wide or global supply chains. Current FDI flows from Japan and the Asian NICs into South Asia suggest that, to some extent, this may be occurring already.

Notes

- 1 Of course, such supply chains can also be (and often are) global, linking countries across several world regions.
- 2 Logistics, in this context, refers to 'the part of the supply chain process that plans, implements, and controls the efficient, effective flow and storage of goods, services, and related information from the point of origin to the point of consumption, in order to meet consumers' requirements' (de Souza et al. 2007).
- 3 Density is measured with respect to the combined number of mobile and landline phones. All of the increase has been with respect to the former, since the latter remained stagnant relative to 2001.
- 4 Inter-firm financing through trade credit was a very important tool in the early industrialisation of Japan.
- 5 Compensation for the loss of trade preferences and the loss of revenue from the adoption of more liberalised trade regimes were also considerations (ODI 2009).

Appendix 11.1

Table A11.1 Profile of manufactured exports in South and East Asia

	Manufacturing value added (% of GDP)	Manufactured exports (% of merchandise exports)	High-technology exports (% of manufactured exports)
South Asia			
Afghanistan	13.1	19.6	
Bangladesh	17.9	88.3	1.2
Bhutan	8.4	69.5	0.1
India	14.2	63.8	7.2
Maldives	3.8	0.1	0.0
Nepal	6.6	72.3	0.6
Pakistan	16.8	74.1	1.7
Sri Lanka	18.0	66.5	1.0

(continued)

Table A11.1 Profile of manufactured exports in South and East Asia (Continued)

	Manufacturing value added (% of GDP)	Manufactured exports (% of merchandise exports)	High-technology exports (% of manufactured exports)
East Asia			
Cambodia	15.6	96.1	0.1
China	29.6	93.6	27.5
Indonesia	24.8	37.5	11.4
Japan	18.1	89.0	18.0
Korea, Rep. of	30.6	89.0	28.7
Lao PDR	7.6		
Malaysia	26.1	67.2	44.5
Mongolia	7.3	5.6	7.4
Myanmar	19.5		
Philippines	21.4	85.8	67.8
Singapore	22.2	73.1	49.9
Thailand	35.6	75.3	24.0
Vietnam	19.7	60.1	6.2

Source: World Development Indicators (World Bank)

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Chapter 12

International Trade, Regional Integration and Food Security in South Asia

Ramesh Chand

12.1 Introduction

South Asia is home to more than 23 per cent of the global population but it accounts for less than 3 per cent of global output (GDP). All countries in South Asia are classified in the low-income or low-middle-income categories. Poverty and hunger are the most serious problems faced by the region. About 43 per cent of the poor and 36 per cent of the undernourished population of the world is concentrated in South Asia. Despite rapid growth of some of the economies in the region, the incidence of poverty, hunger and malnutrition has not seen perceptible decline. All these countries, except India, have been net importers of food, as their own production has not been sufficient to meet domestic requirements.

Historically, South Asian countries have followed inward-looking trade policies both in terms of trade within the region and in terms of trade with rest of the world. Though these countries sometimes faced the situation of availability of cheap food in the international market, trade was not considered a reliable source to meet the main food needs of the domestic population. There have been apprehensions about the effect of trade liberalisation on domestic agriculture and long-term sustainability of food security. Moreover, unlike other regions such as South East Asia, the EU, and North America, regional integration in South Asia has remained shallow, and strong barriers exist for trade between the neighbouring countries. Apart from the Sri Lanka–India free trade agreement (FTA), other trade pacts in the region have not succeeded in promoting the free movement of goods between these geographically contiguous nations. Thus, both intra-regional and inter-regional trade have remained below their potential.

Some countries in South Asia import food from distant countries when their neighbouring country export the same food to outside the region. Deeper regional integration resulting in greater intra-regional trade would be very beneficial for consumers (lower prices) and for producers (lower transaction costs). This would also result in reducing inefficiencies in production by promoting competition and by harnessing complementarities and comparative advantage.

Quite often when one South Asian country faces short supply of a food commodity, another country in the region has surplus production. This offers tremendous scope for stabilising supply and prices through trade. South Asia is experiencing high growth in population in the region of 1.5 per cent per annum. Demand for agri-food commodities in the region is projected to rise at a much higher rate than population

growth, as there is a large consumption deficit. Per capita consumption of most of the food items is much lower than what is required for a healthy diet and healthy living. Moreover, with rising per capita income, and changes in tastes and preferences, demand patterns in South Asian countries are diversifying. Demand for a variety of new products and attributes is on the rise. Demand for processed food products is rising much more rapidly than demand for raw products. These trends and shifts in demand patterns and preferences cannot be addressed through local production and processing and they open new avenues for trade in agri-food commodities and investments in agri-food processing.

Realisation has been growing about the benefits of increasing trade and regional integration among South Asian countries and of improving food and nutrition security through the free movement of agriculture and food commodities. In order to actualise such benefits there is a need to identify (i) country-level and regional-level production and utilisation and the surplus and deficit of agri-food commodities, and (ii) inter-dependence of agricultural markets. Against this backdrop, the present chapter intends to do the following:

- Examine regional surpluses and regional deficits in food and other agricultural commodities and outline the importance of regional integration and co-operation in the context of food security in the region.
- Undertake country-level analysis in terms of surpluses and deficits in the identified agricultural commodities, including food, and estimate the potential for regional trade.
- Estimate the extent of co-movement in prices of the identified agricultural commodities in South Asian countries, and its impact on formal and informal trade in agricultural commodities.
- Examine the extent and importance of liberalisation in food processing industries.
- Assess the potential for FDI in food processing industries in LDCs of the region.
- Examine the constraints (economic, political and social) to trade and investments in agricultural commodities in South Asia, with special focus on LDCs
- Suggest ways forward and possible steps for regional integration and co-operation in agriculture in the context of food security.

The chapter begins by presenting socio- and agro-economic characteristics of South Asian countries and then proceeds to address the above-mentioned aspects of trade, regional integration and food security.

12.2 South Asia in a global setting

South Asia is the most populous region in the world. With a total population of 1.57 billion (in 2011), it accounts for 23 per cent of the global population. The share of the region in land and water resources is much lower than its share in population. The arable land per capita in South Asia is lower than the world average, despite

Table 12.1 South Asia in a global setting

Variable	Year	South Asia	World	Share (%)
Gross national product (US\$ billion)	2009	1,735	59,163	2.93
Population (million)	2009	1,568	6,775	23.14
Land area (sq. km)	2009	4,771,220	129,710,719	3.68
Arable land (% of land area)	2009	41	11	
Arable land derived (sq. km)	2009	1,973,940	13,859,525	14.24
Poverty (people living on less than US\$1.25 a day) (million)	2005	596	1,374	43.38
Prevalence of under nutrition (%)	2005–09	22	14	
Prevalence of under nutrition derived (million)	2009	345	949	36.37
Total merchandise export (US\$ million)	2009	2,047,60	12,492,190	1.64
Total merchandise import (US\$ million)	2009	323,199	12,595,548	2.57

Source: World Development Indicators (2011)

the fact that 41 per cent of the land in the region is arable as compared with 11 per cent for the world as a whole. There is a stark contrast between the share of South Asia in global population and economic output. South Asia generates only 2.9 per cent of global national product, which is less than one-seventh of South Asia's share in population. Low per capita income in the region is associated with a very high incidence of poverty and hunger. Some basic facts relating to population, per capita income, land resources, poverty and under nutrition, and trade are presented in Tables 12.1 and 12.2.

More than 43 per cent of the world's poor, based on a per capita daily income of less than US\$1.25, live in Asia. Similarly, more than 36 per cent of total undernourished persons in the world are inhabitants of South Asia. Trade ratios for South Asia are quite low. The region constitutes 1.64 per cent of global merchandise export and 2.98 per cent of global merchandise import. These shares are smaller than its share in global output, implying that South Asia trades a lesser share of its production compared with the world average.

12.2.1 Socio and agro-economic profile of South Asian countries

Agriculture is the mainstay of economies of South Asian countries. About 18–34 per cent of national output and 33–66 per cent employment are contributed by this sector in various countries in the region. Among the five major countries in the region, per capita income is highest in Sri Lanka (Table 12.2) followed by India with a per capita income of US\$1,220. Nepal comes last with a per capita income of US\$440. Bangladesh is a notch above Nepal with a per capita income of US\$580. Even the country with highest per capita income in the region is ranked at 151. This shows that South Asia has a very low level of income compared with most other countries.

Table 12.2 Salient features of economy of South Asian countries

Particular	Reference year(s)	Bangladesh	India	Nepal	Pakistan	Sri Lanka
Per capita income (US\$)	2009	580	1,220	440	1,000	1,990
Arable land (hectare per capita)	2008	0.05	0.14	0.08	0.12	0.06
Poverty, people living on less than US\$1.25 a day (%)	2004–07	49.6	41.6	55.1	22.6	7.0
Share of agriculture in GDP (%)	2009	19	18	34	22	13
Workforce in agriculture	2006–10	48.1	56.1	65.7	45.1	32.5
Agriculture value added/worker (US\$ constant 2000 prices)	2009	435	468	238	903	926

Note: Workforce data taken from Key Indicators, Asian Development Bank (2011).

Source: World Development Indicators (2011)

Per capita arable land varies from 0.06 hectare in Sri Lanka to 0.14 hectare in India. More than one-third of total national output in Nepal is contributed by the agriculture sector. Agriculture contributes around one-fifth of national output in Pakistan, Bangladesh and India. In all the countries, the share of agriculture in employment is much higher than its share in output. In Nepal, two-thirds of the workforce is engaged in agriculture, which is more than double the employment share of agriculture in Sri Lanka.

Agriculture value added per worker is meagre in Nepal, where two-thirds of the workforce is employed in the agriculture sector. Sri Lanka, which has the lowest share of employment in agriculture, is at the top in agriculture value added per worker. Agriculture value added per worker in Sri Lanka and Pakistan is far higher than Bangladesh and India (Table 12.2).

More than half of the total population in Nepal and Bangladesh suffers from poverty based on the World Bank definition of less than USD \$1.25 per person in daily income. Similarly, more than 40 per cent of people in India live in poverty. Poverty in Pakistan based on this definition was 22.6 per cent. Sri Lanka shows the lowest incidence of poverty in South Asia. High dependence on agriculture for livelihood and slow growth in employment opportunities in the non-agriculture sector are the salient features of South Asian countries and these are largely responsible for widespread poverty and under nutrition in the region.

12.3 Hunger and nutrition

Hunger is generally estimated from dietary energy intake. A person having dietary energy intake below a threshold level is classified as hungry. Such persons are also termed as undernourished. Country-wise information on dietary energy intake, the incidence of under-nutrition and the number of persons undernourished during 1990–92 and 2006–08 is presented in Table 12.3. The table also provides estimates of hunger and nutrition for developing countries and the world as a whole in order to make comparison with South Asia.

As can be seen from Table 12.3, dietary energy intake in all South Asian countries has remained lower than not only the world average but also the average of developing countries. Further, this gap in dietary intake of energy has increased from 1990–92 to 2006–08, for India, Bangladesh, Nepal and Pakistan. Though all South Asian countries have experienced some improvement in per capita energy intake the increase has been very small, in the range of 3 to 16 per cent over a period of 16 years.

Prevalence of under nutrition during 2006–08 varies from 17 per cent (in Nepal) to 26 per cent (in Bangladesh). Dietary energy intake among the South Asian countries show a very narrow variation, 2270–2370 kcal/person/day. Despite small improvements in per capita calorie intake, the prevalence of undernourishment shows large improvements in Bangladesh and Sri Lanka. The latest data provided by the Food and Agriculture Organization (FAO) show that prevalence of under-nutrition based on dietary energy intake remains highest in Bangladesh, despite tremendous progress made by the country in the improvement of under-nutrition. The percentage of the population facing under-nutrition in Bangladesh has declined from 38 per cent during 1990–92 to 26 per cent during 2006–08. There has been little progress in reducing prevalence of under-nutrition in India, Sri Lanka and Nepal. Despite a decline in the percentage

Table 12.3 Incidence of hunger and under nutrition in South Asian countries and world

Country	Dietary energy consumption (kcal/person/day)		Prevalence of undernourishment in total population (%)		Number of undernourished persons (million)	
	1990–92	2006–08	1990–92	2006–08	1990–92	2006–08
Bangladesh	1,960	2,270	38	26	44.4	41.4
India	2,290	2,360	20	19	177.0	224.6
Nepal	2,190	2,340	21	17	4.2	4.7
Pakistan	2,210	2,280	25	25	29.5	42.8
Sri Lanka	2,170	2,370	28	20	4.8	3.9
South Asia	2,270	2,360	22	20	267.5	330.1
Developing countries	2,440	2,640	20	15	833.2	839.4
Total world	2,610	2,790	16	13	848.4	850.0

Source: State of Food Insecurity, FAO

of the population facing under nutrition, the number of undernourished persons has increased over time in all countries except Sri Lanka and Bangladesh. The number of undernourished persons in India has increased from 177 million 1990–92 to 225 million in the late 2000s.

12.4 Production, consumption and surplus at regional level

Agricultural production in South Asia as a whole shows sharp year-to-year fluctuations. These fluctuations are much stronger at country level than at regional level. Because of this, a single-year estimate does not capture the correct situation for agriculture and food and trade in the region or a country. Therefore, in order to have credible information on surplus or deficit of different food items, this chapter uses three-year averages of production, trade and stock. Surpluses and deficits have been computed from data available on production and consumption and related aspects reported by the FAO in a food balance sheet for individual countries. The regional data was arrived at by summing up country-level production, consumption, trade, stock, etc. The estimates of surplus for South Asia for major food commodities are presented in Table 12.4.

The chapter covers cereals (total, rice and wheat), pulses, vegetable oil, sugar, vegetables, fruits, eggs, meat and milk. This list leaves a very small fraction of total agriculture which consists of several small items. Cereals, mainly rice and wheat, are the staple food for all countries in South Asia. Average production of cereals in the region during 2007–09 was 286 million tonne (mt). South Asia as a whole consumed 238 mt of cereal as food. Consumption of cereal for other uses such as seed, feed processing was 34.2 mt. Total utilisation of cereal per year in South Asia during 2007–09 was estimated at 272.6 mt. Based on these estimates South Asia was found to have a surplus of 13.4 mt of cereals, which is 4.7 per cent of cereal production in the region.

Rice and wheat account for 84 per cent of total cereal production in South Asia (rice 47.5 per cent and wheat 36.1 per cent). Total annual absorption (consumption in all uses) of rice in the region during 2007–09 was 126 mt comprising 115 mt of food and 11 mt of other uses. Total utilisation of wheat was 103 mt comprising 94 mt of food consumption and 9 mt of other uses. South Asia was found to have 10.3 mt rice surplus, while it had a small deficit in wheat of 0.5 per cent of production.

Pulses (dried leguminous vegetables) are a regular part of the South Asian diet and also a major source of protein. Pulses are consumed both by vegetarian as well as non-vegetarian populations in various forms. Over time, pulse production in South Asia has remained either stagnant or experienced very slow growth. Green revolution technology rendered pulse production relatively much less remunerative than cereals. Thus, production of pulses has shifted in a large amount towards production of cereals; in some places pulses have been pushed to less fertile or marginal lands. As a result, production of pulses in the region could not keep pace with growth in population, and per capita production and consumption of pulses has witnessed sharp decline over time. This, in turn, has had an adverse effect on protein intake in the region.

Table 12.4 Production and utilisation of major food products in South Asia during 2007–09, million tonne

Item	Production	Food consumption	Other consumption	Total utilisation	Surplus or deficit	Surplus or deficit as % of production
Cereals – excluding beer	286.14	238.51	34.21	272.73	13.41	4.69
Rice (milled equivalent)	136.17	114.96	10.96	125.92	10.26	7.53
Wheat	103.40	94.92	9.03	103.95	-0.55	-0.53
Pulses	15.98	16.58	3.10	19.68	-3.70	-23.13
Vegetable oils	8.72	11.07	4.29	15.36	-6.64	-76.22
Sugar (raw equivalent)	29.57	26.19	0.03	26.22	3.35	11.32
Vegetables	100.39	92.55	6.58	99.13	1.27	1.26
Fruits – excluding wine	78.66	68.17	10.52	78.69	-0.03	-0.04
Eggs	3.93	3.33	0.50	3.84	0.09	2.37
Meat	8.75	8.14	0.01	8.15	0.61	6.95
Milk – excluding butter	145.59	116.49	29.18	145.67	-0.08	-0.05

Source: FAO Food Balance Sheet and FAOSTAT 2007.

During 2007–09, average production of pulses in the region was close to 16 mt. Total utilisation of pulses was close to 20 mt, which leaves a gap of about 4 mt between regional production and utilisation. The level of deficit of pulses is 23 per cent of the total production.

The quantity of vegetable oil consumed as a food was 27 per cent more than production in the region. Then there was consumption of edible oil in other uses of 4.29 mt. The total utilisation of vegetable oil in the region was 15.4 mt, which is 76 per cent more than the regional production. This leaves a deficit of 6.6 mt of vegetable oil in the region. The deficit in terms of oilseed is much higher and is given by the deficit of vegetable oil divided by extraction rate of oil to oilseeds. A crude estimate shows that South Asia need to raise oilseed production by about 19 mt to match the deficit in production and consumption of vegetable oil in the region.

South Asia produced 29.6 mt of sugar (raw equivalent) against a total utilisation in the region of 26 mt. During 2007–09 the region, on average, had 3.4 mt of surplus sugar.

Vegetable production in South Asia was estimated to be 100 mt and total utilisation was reported to be 99.13 mt. About 93 per cent of the total utilisation of vegetables is for food. The region has a surplus of 1.27 mt vegetables. Fruit production is estimated at 78.7 mt and total consumption is also the same. About 86 per cent of fruit production is utilised as food and the remaining 14 per cent for other uses. At the 2007–09 level of production and consumption, South Asia has a small deficit (30,000 tonnes) of fruits (30,000 tonnes).

Among livestock products, milk is the largest item of production and consumption in the region. Total production of milk per year is 145.6 mt and total utilisation is estimated to be 146 mt. About 80 per cent of total milk utilisation is used as food. This production and consumption balance leaves 80,000 tonnes of milk deficit in the region. The deficit was 0.05 per cent of the total production. Total egg production in South Asia during 2007–09 was 3.93 mt. The amount of egg used as food was 3.33 mt and 500,000 tonnes of eggs were consumed in other forms. This makes total utilisation of egg to be 3.84 mt. South Asia shows surplus in egg production of the order of 90,000 tonnes. Ratio of surplus to total production is 2.37 per cent. Meat production in the region was close to 9 mt and total utilisation was 8.15 mt. South Asia shows a surplus of 0.61 mt of meat.

From the regional food balance it is concluded that South Asia has a large surplus of rice, sugar and meat and a small surplus of eggs and vegetables at the 2007–09 level of consumption. The region shows a large deficit of vegetable oils and pulses.

12.5 Country-wise production, domestic use and surplus/deficit

Country-wise production, utilisation and surplus or deficit for various food items are presented in Tables 12.5–12.14.

Table 12.5 Production, utilisation and surplus of rice in South Asian countries during 2007–09, million tonnes

	Production	Domestic use	Surplus or deficit	Surplus or deficit as % of production
India	94.29	87.96	6.32	6.71
Bangladesh	30.36	29.18	1.18	3.88
Pakistan	6.42	3.25	3.18	49.46
Sri Lanka	2.35	2.39	−0.04	−1.68
Maldives	0.00	0.01	−0.01	—
Nepal	2.76	3.13	−0.37	−13.56

Source: FAO Food Balance Sheet and FAOSTAT (2007)

Table 12.6 Production, utilisation and surplus of wheat in South Asian countries during 2007–09, million tonne

	Production	Domestic use	Surplus or deficit	Surplus or deficit as % of production
India	78.35	78.66	−0.31	−0.39
Bangladesh	0.81	2.72	−1.91	−235.55
Pakistan	22.76	20.18	2.58	11.32
Sri Lanka	0.00	0.89	−0.89	—
Maldives	0.00	0.02	−0.02	—
Nepal	1.48	1.48	0.00	0.00

Source: FAO Food Balance Sheet and FAOSTAT (2007)

Table 12.7 Production, utilisation and surplus of pulses in South Asian countries during 2007–09, million tonne

	Production	Domestic use	Surplus or deficit	Surplus or deficit as % of production
India	14.44	17.09	−2.66	−18.41
Bangladesh	0.22	0.67	−0.45	−199.62
Pakistan	1.06	1.48	−0.43	−40.21
Sri Lanka	0.02	0.18	−0.16	−765.00
Maldives	0.00	0.00	0.00	—
Nepal	0.24	0.25	−0.01	−2.38

Source: FAO Food Balance Sheet and FAOSTAT (2007)

12.5.1 Foodgrains

India is the largest producer of rice and wheat in the region. It produced 94 mt of rice and 78.4 mt of wheat per year during 2007–09. The second largest producer is Bangladesh for rice and Pakistan for wheat. During the three-year period from

Table 12.8 Production, utilisation and surplus of milk in South Asian countries during 2007–09, million tonne

	Production	Domestic use	Surplus or deficit	Surplus or deficit as % of production
India	107.59	106.56	1.03	0.96
Bangladesh	3.06	3.43	-0.37	-11.94
Pakistan	33.28	33.40	-0.12	-0.36
Sri Lanka	0.19	0.77	-0.58	-313.64
Maldives	0.00	0.02	-0.02	–
Nepal	1.48	1.50	-0.02	-1.40

Source: FAO Food Balance Sheet and FAOSTAT (2007)

Table 12.9 Production, utilisation and surplus of meat in South Asian countries during 2007–09, million tonne

	Production	Domestic use	Surplus or deficit	Surplus or deficit as % of production
India	5.31	4.70	0.62	11.63
Bangladesh	0.59	0.59	0.00	0.00
Pakistan	2.43	2.43	0.00	0.13
Sri Lanka	0.13	0.14	0.00	-3.82
Maldives	0.00	0.01	-0.01	–
Nepal	0.28	0.28	0.00	-0.36

Source: FAO Food Balance Sheet and FAOSTAT (2007)

Table 12.10 Production, utilisation and surplus of eggs in South Asian countries during 2007–09, million tonne

	Production	Domestic use	Surplus or deficit	Surplus or deficit as % of production
India	3.082	2.983	0.099	3.20
Bangladesh	0.247	0.248	-0.001	-0.39
Pakistan	0.511	0.512	-0.001	-0.21
Sri Lanka	0.059	0.060	-0.001	-1.92
Maldives	0.000	0.002	-0.002	–
Nepal	0.032	0.032	0.000	0.00

Source: FAO Food Balance Sheet and FAOSTAT (2007)

2007–09 average absorption of rice in India was 87.96 mt, which left the country with a surplus of 6.32 mt of rice. Bangladesh and Pakistan also used less rice than they produced resulting in a surplus of 1.18 and 3.2 mt, respectively. Sri Lanka and Nepal had a small deficit of rice.

Table 12.11 Production, utilisation and surplus of fruits in South Asian countries during 2007–09, million tonne

	Production	Domestic use	Surplus or deficit	Surplus or deficit as % of production
India	66.702	66.557	0.144	0.22
Bangladesh	3.559	3.680	−0.121	−3.41
Pakistan	6.518	6.448	0.071	1.08
Sri Lanka	0.722	0.737	−0.015	−2.06
Maldives	0.013	0.031	−0.018	−
Nepal	1.142	1.235	−0.093	−8.14

Source: FAO Food Balance Sheet and FAOSTAT (2007)

Table 12.12 Production, utilisation and surplus of vegetables in South Asian countries during 2007–09, million tonne

	Production	Domestic use	Surplus or deficit	Surplus or deficit as % of production
India	88.393	86.446	1.946	2.20
Bangladesh	3.364	3.557	−0.194	−5.76
Pakistan	5.301	5.539	−0.238	−4.49
Sri Lanka	0.729	0.903	−0.174	−23.84
Maldives	0.011	0.019	−0.008	−
Nepal	2.596	2.663	−0.067	−2.57

Source: FAO Food Balance Sheet and FAOSTAT (2007)

Table 12.13 Production, utilisation and surplus of sugar in South Asian countries during 2007–09, million tonnes

	Production	Domestic use	Surplus or deficit	Surplus or deficit as % of production
India	25.500	20.523	4.977	19.52
Bangladesh	0.147	0.693	−0.546	−371.35
Pakistan	3.780	4.328	−0.548	−14.50
Sri Lanka	0.034	0.543	−0.509	−1,496.88
Maldives	0.000	0.007	−0.007	−
Nepal	0.107	0.126	−0.019	−17.48

Source: FAO Food Balance Sheet and FAOSTAT (2007)

During the three-year period selected for the study, India's production and domestic use of wheat were closely balanced with a deficit of only 0.31 mt. Pakistan showed the highest surplus of wheat in South Asia. The country produced 22.8 mt and consumed 20.2 mt, leaving a surplus of 2.6 mt. Nepal was self-sufficient in wheat with 1.5 mt of

Table 12.14 Production, utilisation and surplus of vegetable oil in South Asian countries during 2007–09, million tonne

	Production	Domestic use	Surplus or deficit	Surplus or deficit as % of production
India	7.405	10.979	–3.575	–48.28
Bangladesh	0.148	1.316	–1.168	–788.89
Pakistan	1.032	2.550	–1.517	–146.97
Sri Lanka	0.071	0.406	–0.334	–468.42
Maldives	0.000	0.004	–0.004	–
Nepal	0.059	0.104	–0.045	–76.56

Source: FAO Food Balance Sheet and FAOSTAT (2007)

production. Sri Lanka does not produce any wheat but it consumed close to 1 mt, thus it had a deficit of the same magnitude. The case of Maldives is similar, which showed a deficit of 20,000 tonnes of wheat.

All South Asian countries consumed more pulses than they produced. Pulse production in India during 2007–09 was 14.4 mt and consumption was 17.1 mt. This leaves a deficit of 2.66 mt of pulses in India. Bangladesh produced 0.22 mt and consumed 0.67 mt resulting in a deficit of 0.45 mt. Pakistan produced 1.06 mt and consumed 1.48 mt showing a deficit of 0.43 mt. Sri Lanka consumed 180,000 tonnes of pulses and produced only 20,000 tonnes showing a gap of 160,000 tonnes. Nepal produced 240,000 tonnes and consumed 250,000 tonnes and faced a deficit of 10,000 tonnes. Pulses are not a part of the regular diet in Maldives.

12.5.2 Livestock products

India showed surplus production of milk, whereas all other countries in the region showed consumption exceeding production. Average production in India was 107.6 mt and domestic use was 106.6 mt. India showed a surplus of 1.03 mt of milk. Milk consumption in Bangladesh exceeded production by 0.37 mt. Pakistan produced 33.3 mt of milk and consumed 33.40 mt, thus having a deficit of 0.12 mt. Milk production in Sri Lanka is below 0.2 mt, whereas consumption was 0.8 mt. Sri Lanka has a milk deficit of more than 500,000 tonnes. Both Maldives and Nepal showed a milk deficit of 20,000 tonnes each.

In the case of meat, India showed a surplus, whereas Bangladesh and Pakistan were just balanced. Nepal showed a small deficit and Sri Lanka consumes 4 per cent more than it produced. The magnitude of surplus of meat in India was 62,000 tonnes. The country produced 5.3 mt and consumed 4.70 mt of meat during 2007–09.

Except India, all South Asian countries showed an excess of consumption of eggs over production. India showed a surplus production of 0.10 mt, which corresponds to 3.20 per cent of total egg production in the country. Egg production and consumption in Bangladesh is about 250,000 tonnes. Pakistan produces and consumes a little more than 500,000 tonnes of eggs.

12.5.3 Horticultural products

Fruit production in agriculture in India was 66.7 mt and domestic use was 66.56 mt. Production exceeded domestic consumption by a small amount of 0.14 mt. Bangladesh produced 3.56 mt of fruits and consumed 3.68 mt. The country had a deficit of about 120,000 tonnes. Pakistan produced 6.5 mt of fruit and consumes almost all of it. Sri Lanka, Maldives and Nepal showed a deficit of 10,000 to 90,000 tonnes of fruits.

Vegetable production and consumption exceeds production and consumption of fruits in India, Sri Lanka and Nepal, whereas it was lower in Bangladesh and Pakistan. India had a surplus of 1.95 mt of vegetables, which was 2.2 per cent of its total production. Bangladesh showed a deficit with production at 3.36 mt and consumption at 3.56 mt. Nepal consumed 67,000 tonnes more vegetables than it produces. Pakistan, Sri Lanka and Maldives showed small to moderate deficits of vegetables.

12.5.4 Sugar

In South Asia sugar is produced on a large scale in India and Pakistan, while some production also takes place in Bangladesh and Nepal. During 2007–09 India produced 25.5 mt of raw sugar equivalent and utilised 20.5 mt of it. This leaves close to 20 per cent production consisting of an equivalent 5 mt of raw sugar as a surplus in India. Pakistan produced 3.8 mt of sugar, which is 14.5 per cent less than domestic use (Table 12.13). Thus, Pakistan and all other countries, except India, in the region are having a deficit production as compared with domestic absorption.

The level of deficit of sugar is a little more than 500,000 tonnes in Bangladesh, Pakistan and Sri Lanka each. Nepal showed a deficit of 20,000 tonnes. Maldives does not produce any sugar, therefore, the entire domestic use consisted of 10,000 tonnes is a deficit.

12.5.5 Vegetable oil

All South Asian countries consumed more vegetable oil than what they produce (Table 12.14). Domestic use of vegetable oil in India is 48 per cent more than domestic production. While Nepal showed a deficit of 76 per cent, Pakistan used 147 per cent more vegetable oil than it produced. The deficit level of vegetable oil was very high in Sri Lanka and Bangladesh. Sri Lanka consumed more than five times and Bangladesh consumed more than eight times their domestic production of vegetable oil. India produced 7.4 mt of vegetable oil and it consumed about 11 mt, leaving behind a deficit of 3.5 mt. The deficit level of Pakistan and Bangladesh were 1.52 and 1.17 mt. Sri Lanka had a deficit of 330,000 tonnes while Nepal showed a deficit of 50,000 tonnes.

12.5.6 Per capita food supply

The FAO food balance sheet for the year 2007 shows significant variations in per capita supply and use of various food items as food in various countries in South Asia (Table 12.15). Per capita annual supply and use of cereals as food among the

Table 12.15 Per capita supply of various food items in South Asian countries, 2007, kg/year

Item	India	Bangladesh	Pakistan	Sri Lanka	Nepal	China	World
Cereals excluding beer	152.6	180.9	129.8	143.5	171.3	152.5	146.6
Rice (milled equivalent)	70.9	159.7	14.5	97.3	78.0	76.8	52.9
Wheat	60.2	14.7	106.1	44.1	37.9	67.4	65.9
Pulses	12.9	4.8	8.1	8.0	8.4	1.3	6.5
Vegetables	64.8	19.7	30.0	40.1	77.9	279.9	119.4
Fruits – excluding wine	45.1	20.7	36.5	27.2	38.8	64.4	69
Eggs	2.1	1.3	2.4	2.2	1.0	17.4	8.6
Meat	3.3	3.6	13.4	6.8	9.8	53.4	40.1
Milk – excluding butter	68.7	16.2	159.0	36.1	40.9	28.7	85.1
Sugar (raw equivalent)	17.3	5.3	23.9	24.6	4.3	8.3	20.3
Vegetable oils	8.2	6.2	11.5	4.1	6.8	9.4	11.4

Source: FAO Food Balance Sheet and FAOSTAT (2007)

five major countries of South Asia was lowest in Pakistan, which showed highest prevalence of an undernourished population. Furthermore, cereal consumption in Pakistan was highly concentrated in favour of wheat, which accounts for more than 80 per cent use of all cereals in country. However, Pakistan topped in per capita supply of milk. The level of supply of next country in the ranking of per capita supply of milk was not even half of that in Pakistan. Similarly, Pakistan also topped in per capita supply of sugar, meat and vegetable oils. Bangladesh topped in per capita supply of cereals, 88 per cent of which consists of rice. Except rice, cereal and meat, per capita supply of all other food items in Bangladesh was lowest in the region. India topped in consumption of pulses, vegetables and fruits. Per capita supply of these items was 13 kg of pulses, 65 kg of vegetables and 45 kg of fruits. India was at the bottom in per capita supply of meat, closely followed by Bangladesh.

Per capita supply, which is the same as absorption of food, showed very wide variation across countries. The minimum variation was found in cereals. Per capita absorption varied between 5 and 13 kg for pulses, 16 and 159 kg for milk, 4 and 24 kg for sugar and 4 and 11.5 kg for vegetable oil. Sri Lanka comes last in per capita absorption of vegetable oil and Nepal last in per capita absorption of eggs and sugar.

It is interesting to compare intake of various food items in South Asia with the world average and with China, which has a very low level of undernourishment. The undernourished population in China is reported to be 10 per cent, which is less than half of the incidence of under nutrition in South Asia (World Development Indicators (WDI) 2011: 110). Per capita supply and use of vegetables and fruits was extremely low in Bangladesh, Pakistan and Sri Lanka as compared with China and the world average. Cereals accounted for close to 70 per cent of physical supply of

food in Bangladesh. In other South Asian countries this share varied between 31 and 49 per cent. The world average for share of cereals in total food supply for food was 29 per cent.

These results show that food intake in South Asia is highly skewed toward cereals. Bangladesh shows the highest per capita supply of cereals and lowest supply of vegetables, fruits, eggs and pulses, indicating a dominance of calorie but poor supply of protein in consumption. Except for milk in Pakistan, per capita supply in all the South Asian countries needs to change in favour of livestock products and horticultural products for a balanced diet and to achieve the required level of proteins, nutrients and minerals.

12.6 International trade at regional and country level

Regional export, import and net trade in different food items are presented in Table 12.16. It is interesting to point out that some of the items are exported as well as imported. This could be due to year-to-year fluctuations or composition of the group. During 2007–09 the total export of cereal from the region was 10.8 mt and import was 7.7 mt. The region has net trade (export–import) of 3.1 mt of cereals. Average export of rice from the region was 6.6 mt. The region also imported small amounts of rice. Net trade of rice was 5.8 mt. The trade scenario of wheat is almost the reverse of what is witnessed in rice. The average import of wheat exceeded 6 mt and net trade in wheat was – 5.6 mt.

South Asia imported more than 4 mt of pulses and more than 10 mt of vegetable oil each year during 2007–09. The region also exported a small quantity (0.51 mt) of vegetable oil. The level of export of sugar was 2.94 mt and imports were 3.2 mt. The region exported 2.6 mt of vegetables and 1.4 mt of fruits. The level of export was higher than for import for vegetables, whereas the reverse holds true for fruits. Among livestock products, South Asia exported 7,000 tonnes and imported 2,000

Table 12.16 Export, import and net trade in various food items, total of South Asia during 2007–09, million tonne

Item	Export	Import	Net trade
Cereals – excluding beer	10.794	7.702	3.092
Rice (milled equivalent)	6.572	0.766	5.807
Wheat	0.756	6.380	–5.625
Pulses + (total)	0.156	4.246	–4.090
Vegetable oils + (total)	0.516	10.249	–9.733
Sugar (raw equivalent)	2.937	3.171	–0.233
Vegetables	2.572	1.911	0.661
Fruits – excluding wine	1.413	1.714	–0.300
Eggs	0.068	0.002	0.066
Meat	0.550	0.020	0.530
Milk – excluding butter	0.686	1.221	–0.535

Source: FAO Food Balance Sheet and FAOSTAT (2007)

tonnes of eggs. Export of meat was 0.55 mt with net trade of 0.53 mt. Milk import exceeded export by 500,000 tonnes.

12.6.1 Country-wise trade

Country-wise information on quantities of export, import and net trade in selected food items is presented in Tables 12.17–12.22. Trade in wheat during 2007–09 shows that Pakistan was the highest exporter of wheat in the region. Its average export of wheat was a little more than 500,000 tonnes. However, Pakistan also showed an average import of wheat close to 1.7 mt. A country exporting and importing a particular food product at a large scale is the result of sharp year-to-year fluctuations in production and self-sufficiency at the margin. For instance, in the case of Pakistan, it exported more than 1 mt of wheat during 2007 but imported 1.8 and 3.1 mt of wheat during 2008 and 2009. As countries import in some years and export in others, this chapter has used a three-year average to estimate levels of trade and surplus. During the three-year period, i.e. 2007–09, Pakistan remained a net importer of wheat to the tune of 1.1 mt.

The level of fluctuation in production and in net trade of wheat in India is much lower than that of Pakistan, even though, similar to Pakistan, sometimes India imports and sometimes it exports. On average, India shows net import of wheat of 0.9 mt. Bangladesh was the largest importer of wheat in the region. Its average import amounts of wheat to 2.7 mt. Sri Lanka has an average import of 1 mt of wheat. Nepal imports as well as exports around 2,000 tonnes of wheat. It is interesting to point out that all South Asian countries are net importers of wheat to varying degrees.

Rice is the largest traded agricultural food commodity in the region. Both India and Pakistan figure among top exporters of rice not only in the region but also in the world. The average exports of rice from India are around 3.7 mt and from Pakistan 2.8 mt. Bangladesh showed average imports close to 500,000 tonnes (Table 12.17). Nepal and Sri Lanka imported 147,000 and 87,000 tonnes of rice on average, respectively.

As all South Asian countries have a deficit of pulses, they import moderate to large quantities of pulses to meet their domestic requirements (Table 12.18). India imported on average 3 mt of pulses during 2007–09. The country also showed a small amount of export (137 mt). The level of import of pulses in other countries was 0.52 mt in

Table 12.17 Export, import and net trade in wheat and rice, in South Asian countries during 2007–09, thousand tonnes

Country	Wheat			Rice		
	Export	Import	Net trade	Export	Import	Net trade
India	64	952	–888	3,707	7	3,700
Bangladesh	1	2,705	–2,704	11	496	–485
Pakistan	536	1,692	–1,156	2,849	4	2,845
Sri Lanka	153	1,003	–850	5	87	–83
Maldives	0	26	–26	0	24	–24
Nepal	2	2	–1	0	147	–146

Source: FAOSTAT

Table 12.18 Export, import and net trade in pulses in South Asian countries during 2007–09, thousand tonnes

	Export	Import	Net trade
India	137	3,099	–2,962
Bangladesh	0	528	–528
Pakistan	9	412	–403
Sri Lanka	8	165	–157
Maldives	0	1	–1
Nepal	2	41	–39

Source: FAOSTAT**Table 12.19 Export, import and net trade in vegetables and fruits in South Asian countries during 2007–09, thousand tonnes**

Country	Vegetables			Fruits		
	Export	Import	Net trade	Export	Import	Net trade
India	2,297	570	1,727	868	1,009	–142
Bangladesh	16	571	–555	14	232	–219
Pakistan	235	393	–158	434	294	140
Sri Lanka	18	258	–240	79	43	36
Maldives	0	21	–21	0	22	–22
Nepal	6	97	–90	18	112	–95

Source: FAOSTAT**Table 12.20 Export, import and net trade in eggs and meat in South Asian countries during 2007–09, thousand tonnes**

Country	Eggs			Meat		
	Export	Import	Net trade	Export	Import	Net trade
India	67.5	0.0	67.5	525.7	1.4	524.4
Bangladesh	0.0	0.0	0.0	0.1	0.5	–0.4
Pakistan	0.4	0.0	0.4	19.7	7.5	12.1
Sri Lanka	0.1	0.5	–0.3	1.6	3.2	–1.6
Maldives	0.0	1.3	–1.3	0.0	7.6	–7.6
Nepal	0.0	0.0	0.0	3.4	0.1	3.3

Source: FAOSTAT

Bangladesh, 0.41 mt in Pakistan and 0.16 mt in Sri Lanka. Nepal imported around 41,000 tonnes of pulses per year.

Trade in vegetables showed that India was a large net exporter and the other South Asian countries are large net importers (Table 12.19). Average export of vegetables from India was 2.3 mt. India also imported 0.57 mt of vegetables. Vegetable exports exceeded imports by 1.7 mt. Bangladesh imported some amounts of vegetables, like India, but its exports of vegetables were only 16,000 tonnes. Thus, Bangladesh was

Table 12.21 Export, import and net trade in milk in South Asian countries during 2007–09, thousand tonnes

	Export	Import	Net trade
India	598.5	99.6	498.9
Bangladesh	0.3	353.9	–353.5
Pakistan	55.9	190.7	–134.8
Sri Lanka	4.7	516.9	–512.2
Maldives	0.0	29.6	–29.6
Nepal	26.6	30.3	–3.7

Source: FAOSTAT

Table 12.22 Export, import and net trade in vegetable oils and sugar in South Asian countries during 2007–09, thousand tonnes

Country	Vegetable oils			Sugar		
	Export	Import	Net trade	Export	Import	Net trade
India	388.7	6,737.7	–6,349.0	2,814.0	1,001.9	1,812.1
Bangladesh	1.0	1,265.3	–1,264.2	0.0	1,281.9	–1,281.9
Pakistan	39.3	1,888.6	–1,849.2	117.2	289.7	–172.5
Sri Lanka	41.5	188.2	–146.7	0.4	559.4	–559.1
Maldives	0.0	7.7	–7.7	0.0	11.2	–11.2
Nepal	45.7	161.8	–116.0	5.8	26.8	–21.0

Source: FAOSTAT

a net importer of vegetables, exceeding 500,000 tonnes. Pakistan exported 235,000 tonnes of vegetables but at the same time imported close to 400,000 tonnes. This renders Pakistan with negative trade balance in vegetables to the extent of 158,000 tonnes. Sri Lankan import and net trade of vegetables was close to 250,000 tonnes during 2007–09. Nepal was net importer of vegetables to the extent of 90,000 tonnes. Net export of vegetables from India was 70 per cent more than the combined net import of other South Asian countries.

Fruits figure on both sides of trade, export and import. As there is a diverse composition of fruit, a country may be exporting some fruits and importing other fruits. The average export of fruit from India during 2007–09 was 0.87 mt, which was lower than import, which was placed at 1 mt. Thus, India remains a net importer of fruit to the extent of 142,000 tonnes. Bangladesh exports a small quantity of fruit but its imports are much higher (232,000 tonnes). Pakistan and Sri Lanka were net exporters of fruit. Nepal is involved in more than 100,000 tonnes of fruit imports and its exports are around 18,000 tonnes.

Trade in eggs and meat showed that, except India, other countries had very small trade. India exported 68,000 tonnes of eggs and more than 500,000 tonnes of meat (Table 12.20). The import of these two items by India was less than 1,000 tonnes. Pakistan exported on an average 20,000 tonnes of meat and imported 8,000 tonnes.

Trade in milk shows that India exported 0.6 mt and imported 0.1 mt, thus having a net export of 500,000 tonnes (Table 12.21). Bangladesh does not have any export of milk and it imports 354,000 tonnes. Sri Lanka was the largest importer of milk in the region with more than 500,000 tonnes imported. Pakistan imported 191,000 tonnes and exported 56,000 tonnes. Nepal was involved in a small amount of export and import in milk with net trade in favour of import.

Trade data in vegetable oils and sugar is presented in Table 12.22. All South Asian countries imported large volumes of vegetable oil, while India also exported close to 0.4 mt of vegetable oil. The level of import was 6.7 mt for India, 1.9 mt for Pakistan and 1.3 mt for Bangladesh. Sri Lanka and Nepal imported 188,000 and 162,000 tonnes of vegetable oil, respectively.

Like wheat, sugar production and trade in India and Pakistan showed large fluctuations and shifts between positive and negative net trade. In 2007, India exported 4.9 mt of sugar, a value that plummeted to less than 44,000 tonnes in the 2009. On the import side, the quantity of imports of sugar by India was 2.6 mt in 2009 compared with just 25,000 tonnes in 2007. During the three-year period of the study, India's exports were close to three times its imports with a net trade of 1.8 mt. Average exports of sugar from Pakistan were 117,000 tonnes and imports were 290,000 tonnes. Sri Lanka imported more than 500,000 tonnes of sugar. The sugar imports of Nepal were 27,000 tonnes. The three-year average of trade data shows that India's net exports were almost the same as the total net imports of other South Asian countries. Thus, at a regional level there was a perfect balance between import and export. However, to meet the deficiency of some countries from the surplus of other countries year-to-year fluctuations in production and trade need to be smoothed.

12.6.2 India's food export to South Asia and the world

India's position in the region is highly strategic because of (a) the size of the country, population, and economy and (b) because of its geographic contiguity with SAARC countries. No two countries in South Asia share common land borders a part from with India. India is closest to Sri Lanka, which does not share a land border with any other country. Therefore, in terms of geography, India has a strong advantage over other countries in South Asia for intra-regional trade. The level of surplus and net trade in various agricultural products from India shows that India can meet the level of deficit in supply over demand in South Asia for most of the products (see Table 12.23).

Table 12.24 presents India's agricultural exports to the world and South Asian countries during the three-year period from 2008–09 to 2010–11. It reveals the potential for meeting regional deficit of food and improving food availability through intra-regional trade. India's average rice export during this period was 2.3 mt, out of which 0.26 mt was exported to South Asia. South Asia imported 0.66 mt of coarse cereals, mainly maize, out of 3.37 mt of export from India. Even though India itself is the largest importer of pulses in the world, it also exports some pulses. Out of a total export of 147,000 tonnes of pulses from India, 39 per cent were exported to South Asia and about 80 per cent of were imported by Pakistan. Some countries in South Asia imported a large quantity of fruits

Table 12.23 Correlation coefficient between producers' prices in South Asian countries

Commodity	Country	India	Nepal	Pakistan	Sri Lanka
I. Rice	Bangladesh	0.89	0.84	0.89	0.85
	India		0.67	0.74	0.88
	Nepal			0.80	0.56
	Pakistan				0.65
II. Wheat	Bangladesh	0.88	0.88	0.73	
	India		0.99	0.61	
	Nepal			0.58	
III. Maize	Bangladesh	0.61	0.63	0.53	0.86
	India		0.74	0.76	0.85
	Nepal			0.73	0.75
	Sri Lanka			0.60	
IV. Chickpea	Bangladesh	−0.04	0.92		
	India		−0.13		0.13
	Sri Lanka				
V. Groundnut	Bangladesh	0.11		0.21	−0.10
	India			0.36	0.91
	Sri Lanka			0.22	
VI. Mustard	Bangladesh	0.44		0.64	
	India			0.92	
VII. Onion	Bangladesh	−0.28	−0.43	0.07	−0.46
	India		0.91	0.74	0.69
	Nepal			0.66	0.89
	Pakistan				0.49
VIII. Potato	Bangladesh	−0.33	0.95	0.40	−0.14
	India		−0.30	0.62	0.05
	Nepal			0.42	0
	Pakistan				0.06
IX. Cow Milk	Bangladesh	−0.20	−0.25	−0.17	−0.15
	India		0.73	0.85	
	Nepal			0.74	0.84
	Sri Lanka			0.53	
X. Eggs	Bangladesh	0	−0.27	−0.10	0.16
	India		0.92	0.94	0.95
	Nepal			0.81	0.82
	Sri Lanka			0.88	

Source: FAOSTAT

and vegetables, sugar and dairy products from India. Despite this, South Asia's share in total exports of these products from India remains less than 45 per cent. Bangladesh imported 810,000 tonnes of fruits and vegetables and 428,000 tonnes of sugar from India. India was the major supplier of these products to Pakistan, Sri Lanka and Nepal. By importing 5,700 tonnes of dairy products, Bangladesh constitutes about 12 per cent of total overseas supply of dairy products from India.

Export to South Asia constituted 11 per cent to 45 per cent of India's total export of cereals, pulses, fruits and vegetables, sugar, poultry and dairy products. South Asia

Table 12.24 India's agricultural exports to South Asian countries from 2008–9 to 2010–11, metric tonne

Country	Rice	Coarse cereals	Pulses	Fruits and vegetables	Sugar	Poultry	Meat	Dairy product
Bangladesh	203.0	483.5	0.0	809.8	427.8	1.8	0.1	5.7
Bhutan	4.1	1.3	0.0	0.3	3.1	3.2	0.1	0.5
Maldives	16.8	0.1	0.0	16.6	7.2	61.3	0.4	0.0
Nepal	24.7	70.4	0.2	191.6	12.9	0.5	0.1	2.6
Pakistan	1.0	64.9	43.7	190.3	338.9	65.6	3.1	0.7
Sri Lanka	14.7	43.5	13.6	170.2	190.9	6.2	0.0	0.6
South Asia	264.3	663.6	57.6	1,378.9	980.8	138.6	3.8	10.1
World	2,309.1	3,371.3	147.6	3,115.1	2,205.8	897.7	590.9	47.1
South Asia share %	11.45	19.68	39.00	44.27	44.46	15.44	0.64	21.44

is the final destination for close to one-quarter of India's agricultural (excluding fish) exports. As this share is very small, India can easily meet substantial increases in import demand from South Asian countries.

12.7 Price and market integration

Price and market integration in South Asian countries was studied by examining the association between producer prices expressed in US\$ during the last ten years covering the period 2000–09. Producer prices represent the overall price situation for the whole country and are thus not restricted to a single market.

There are several ways to study integration. This chapter examines market integration by estimating simple correlation between producer prices for various pairs of countries in South Asia. It is important to mention here that prices expressed in US\$ did not show any common trend between two countries. Nor did they exhibit rising or falling trends, in most cases, when these prices are expressed in US\$. For this kind of data series, simple correlation can be used to find the presence and strength of market integration.

The correlation coefficient between price series of various items in South Asian countries is presented in Table 12.23. The critical values of correlation, below which the results were not statistically significant, was 0.73 at 1 per cent of level of significance and 0.60 at 5 per cent of level of significance. The first panel in the table provides correlation coefficients for prices of rice. The table shows that producer prices of rice in all South Asian countries were strongly correlated. The degree of correlation was more than 0.85 in most cases. Except correlation between Sri Lanka and Nepal prices, all other price series were statistically significant at either 1 per cent or 5 per cent level. Among the different countries, rice prices in Bangladesh showed the strongest relationship with prices in other countries. These results can be used to infer that rice markets in South Asia, in terms of producer prices, are strongly integrated.

The results for wheat are presented in panel 2 of the table. Similar to rice, the producer price series for wheat also showed significant positive correlation across countries. Except for Pakistan and Nepal, wheat prices were statistically significant in all other pairs. Producer prices for wheat in Nepal showed a correlation of 0.99 with wheat prices in India. Similarly, wheat prices for Bangladesh–India and Bangladesh–Nepal were also strongly integrated.

The results for maize price are presented in panel 3. Like rice and wheat, maize prices also showed significant positive correlation in prices prevalent in various countries. Except the correlation between Bangladesh and Pakistan, price series in all other countries showed significant correlation.

Price data for chickpeas was available only for Bangladesh, India, Nepal and Sri Lanka. Among these four countries, only the Bangladesh and Nepal markets showed significant correlation. The correlation between prices for India–Bangladesh and India–Nepal was close to zero.

Data on groundnut prices were not available for Nepal. Among the other countries, Sri Lankan and Indian prices alone showed significant correlation, which was more than 0.9. The results showed that there was no integration in groundnut markets in South Asia, except for between Sri Lanka and India.

Correlation coefficients for onion prices are presented in panel 6. Onion prices in Bangladesh showed either negative or close to zero correlation with prices in other countries. This indicates that the onion market in Bangladesh did not have any integration with markets in other countries in the region. In contrast to this, onion prices for India–Nepal, India–Pakistan, India–Sri Lanka, Nepal–Pakistan and Nepal–Sri Lanka were significantly correlated. Onion prices in Sri Lanka and Pakistan showed positive but non-significant correlation.

Similar to onions, potato prices in Bangladesh did not show significant correlation with prices in India, Pakistan and Sri Lanka. However, potato prices in Bangladesh had a very high correlation with potato prices in Nepal. Potato prices in Sri Lanka also did not show any significant correlation with other countries in the region (Table 12.23). The correlation matrix for potato prices shows that the Bangladesh–Nepal and India–Pakistan markets had significant correlation.

Producer price data for mustard were available only for Bangladesh, Pakistan and India. Prices of mustard in Bangladesh showed significant correlation with Pakistan but not with India. Mustard prices in Pakistan and India were much more strongly correlated.

The correlation coefficient between milk prices in different countries indicates that Bangladesh prices were not linked to any other country in the region. The milk markets for India–Nepal, Pakistan–Nepal, Sri Lanka–Nepal, India–Pakistan and India–Sri Lanka were strongly integrated.

The egg markets in India, Nepal, Pakistan and Sri Lanka were strongly integrated. The correlation between producer prices in these countries ranged between 0.81 and 0.95. However, egg prices in Bangladesh did not show any significant association with any other country.

It is concluded from the correlation matrix in price series that the rice, wheat and maize markets in South Asian countries are strongly integrated with each other. Integration was selective and generally missing in the case of chickpeas and groundnut. Onion prices were integrated except for Bangladesh. Potato markets were integrated only in a few cases. Milk and egg prices are integrated across countries except for the Bangladesh markets, which did not show any co-movement with prices in the region.

12.8 Trade liberalisation: Potential and constraints

Regional integration in trade and investment has become an increasing feature of world trade and globalisation. Particularly following the WTO agreement, it was expected that the regionalism bill would gradually give way to multilateralism. However, the number of regional trading agreements/preferential trading agreements has seen explosive growth. Even those countries that previously adopted a cautious approach to regionalism are gravitating towards regional integration and seeking deeper integration with neighbouring countries. South Asia remains the least integrated region in Asia. Intra-regional trade in South Asia constitutes 5 per cent of total trade in the region.

One of the major factors for low volume and low share of intra-regional trade seems to be the poor trade facilitation for intra-regional trade. The Asian Development Bank prepared a very valuable report on intra-regional trade and investment in South Asia, which quantified the impact of logistics on trade in these countries (ADB 2009). The report prepares a logistics index based on existing customs procedures, infrastructure and timeliness to analyse the impact of these factors on trade. The results of the study showed that the effect of importers' trade facilitation on trade was quite significant, whereas the effect of exporters' trade facilitation was non-significant. Further, the effect of trade facilitation factors was much stronger on agriculture trade than trade in manufacturing, textiles and clothing, and automobiles. Another very interesting result of this study was that the effect of tariffs on agriculture trade was much smaller than the effect of trade facilitation factors (ADB 2009, Table 2.5). Trade facilitation was also found to be a major factor in the growth of intra-regional and total trade from South Asia in other studies (Jain and Singh 2009; Wilson and Otsuki 2006).

Using a computable general equilibrium (CGE) model, the ADB study estimated the direct and indirect impact of enhancing trade facilitation on trade in South Asia as well as trade with the rest of the world. The results show that trade facilitation has a very large impact on trade flows. The estimated effect for agriculture is presented in Table 12.25. The study projects a 20 per cent increase in inter-regional trade and a 63 per cent increase in intra-regional trade. The distribution of intra-regional trade over different countries shows more than a doubling of trade in respect of Bangladesh. India is projected to witness a 66 per cent increase in intra-regional trade and a 5 per cent increase in inter-regional trade. Pakistan shows a higher increase for inter-regional trade than intra-regional trade. The results for Sri Lanka are mixed – a decrease in inter-regional trade and an increase in intra-regional trade in agriculture. The rest of South Asia is showing about a 50 per cent increase in both types of trade.

Table 12.25 Macro economic effect of trade facilitation reforms obtained from CGE model: Change in trade volume (%)

Country	Agriculture		All sectors	
	Intra-regional	Inter-regional	Intra-regional	Inter-regional
All South Asian countries	63	20	75	22
Bangladesh	109	102	103	62
India	66	5	75	14
Pakistan	32	57	97	33
Sri Lanka	7	-27	38	17
Rest of South Asia	50	49	60	39

Source: Table 2.9, ADB (2009)

Similar results were reported by Wilson and Otuski (2007), who projected a gain of US\$2.6 billion in intra-regional trade from capacity development in trade facilitation. The gain was US\$1,224 million due to service infrastructure, US\$712 million due to port efficiency, US\$429 million due to custom modernisation and US\$278 million due to regulatory reforms.

There seems to be a tremendous potential to raise intra-regional trade in agriculture and food. It is shown above that some countries have a surplus and some a deficit in the same products. Similarly, some countries are net importers and some are net exporters of the same product. Trade in sugar, vegetables, fruits and milk can be increased by simply synchronising deficits and surpluses in SAARC countries. A second way to increase intra-regional trade is to meet the shortages and demand and supply imbalances arising from seasonal or year-to-year fluctuations from within the region. Seasonal shocks in the supply of various food products are being experienced frequently. Neighbourhood trade is a very efficient and time-effective source for moderating the effects of such shocks. Third, improvements in per capita income brought by growth of these economies will accelerate dietary diversification and changes in consumption patterns. This will create demand which may not be economical to meet from domestic production. Harnessing this potential for intra-regional trade will depend upon trade facilitation, foreign direct investment (FDI), the dismantling of non-tariff barriers (NTBs) and the elimination of negative lists in SAFTA. Out of these, some progress is being made for improving trade facilitation and removing tariff and NTBs, but there is hardly any focus on regional FDI in agriculture and the food sector.

India's expanding domestic market and the rapid growth of organised retail in the country have created great potential for sourcing from within the SAARC region to meet the opportunities created by growing local demand. This requires efficient value chains. The existing agricultural marketing system in the whole region is very inefficient, fragmented and outdated. It serves the interests of neither producers nor consumers. Modernisation of the agricultural marketing supply system requires development of new supply chains and production networks in the region. This is

not possible without investment by an organised private sector. Regional FDIs can play an important role in this. As South Asian countries have lots of similarities in production portfolios, regional FDI can also serve as an instrument for the transfer of technology in the region.

Agriculture is now being received with renewed importance and emphasis globally and in almost all the South Asian countries. This is for several reasons. The global food crisis of 2007–08 has awakened the world from complacency on the adequacy of food supply in meeting demand. Contrary to their historical behaviour and defying several predictions, agri-food prices have been increasing in real terms and they have not returned to pre-2005 levels. The global community is seriously concerned about meeting future growth in agri-food demand. There is a rising preference towards ‘bios’ – bio-energy, bio-pesticides, bio-medicine, bio-cosmetics, bio-fertiliser, bio-remediation. Agricultural crop-based innovations are likely to create a lot of new opportunities in commerce, trade and manufacturing. Addressing the various challenges in the agriculture sector and harnessing emerging opportunities require investments in various spheres of agriculture spanning from inputs to output supply to consumers. No single country in the region has expertise or comparative advantage in all the areas of agriculture. Therefore cross-border investments in the region are needed for harnessing the potential of agriculture in the region.

12.9 The way forward

SAFTA has resulted in bringing down tariffs, but it could not achieve much progress in improving trade facilitation for regional trade. There is large scope for extending regional trade in food and agriculture and promoting investment in this sector in South Asia. There is also a large volume of informal trade in the region which reflects the need for increasing formal trade. Economic gains from regional integration are generally complemented by the build-up of political goodwill, which helps in creating a stable environment. India, being a large country and having a dominant economic position in the region, has a special responsibility to consolidate South Asian economic integration. This requires action to improve trade facilitation through improved linkages by road, rail, air and shipping, and better connectivity, for example, providing landlocked Nepal with transit facilities to promote its trade. South Asian countries can enhance their growth and development through trade-promotion strategies. This requires action in such areas as trade facilitation, reducing barriers to FDI, further lowering of tariffs, pruning of the negative list and removal of NTBs.

Out of all the above-mentioned areas, trade facilitation, in the form of simplification of customs and other border formalities; transport linkages; transparency of regulation; improved logistics for rail, road, air and maritime transport; information networks, etc., is most important for increasing intra-regional trade. Improved trade facilitation and logistics will reduce the transaction costs of trade to a more significant extent than cutting tariffs. South Asian countries must promptly take up measures individually and as a group for achieving higher trade facilitation.

Reducing barriers to regional FDI and trade facilitation are complementary to each other. Thus, along with trade facilitation, there is a need to provide a liberal and

conducive environment for FDI in the area of food chain development and food processing. These will be beneficial for producers as well as consumers and for improving food security.

Due to year-to-year fluctuations in production at a country level, a surplus in a South Asian country is not considered to be a reliable source of supply to meet deficits and import demands by other countries. This needs to be overcome by building regional stocks of food under SAFTA. SAFTA could also be used as an appropriate forum, not only to address intra-regional trade disputes but also for taking a collective stand on agriculture and food security-related issues in WTO.

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Chapter 13

Promoting Regional Energy Co-operation in South Asia

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13.1 Introduction

It is well established that supply of adequate, reliable and reasonably priced energy is one of the key inputs for sustainable socio-economic development of any region. South Asia is not only the second fastest growing region in the world; it is also one of the poorest, which puts energy at the very heart of the development process in the region. According to the United Nations (UN) World's Economic and Social Situation and Prospects 2013, the region registered a growth rate of 8.3 per cent and 5.8 per cent in the years 2010 and 2011 respectively, with projections of 4.4 per cent in 2012. Despite this, significant progress remains to be made. With a population of over 1.6 billion, the region is home to half of the world's poor. This huge population growth coupled with expanding economies has spurred ever-increasing pressures of energy demand for countries in the region. The International Energy Agency (IEA) has projected that South Asia could have the highest growth rate of energy consumption in the world by 2020.

This chapter looks at the developmental challenges faced by the South Asia Subregional Economic Cooperation (SASEC) formed by Bangladesh, Bhutan, India and Nepal, and builds a case for stronger regional energy co-operation to accelerate the development process. Section 13.2 highlights the developmental challenge faced by the region and brings out the urgent need to intensify efforts to develop the energy market. Section 13.3 presents a discussion of historical and ongoing efforts of regional co-operation. Finally, Section 13.4 puts forth areas of possible future co-operation and suggests ways in which this can be achieved.

13.2 Challenges faced by the subregion

13.2.1 Income and energy poverty

The majority of South Asia's 1.6 billion population is concentrated in the eastern subregion formed by four SASEC countries, i.e. Bangladesh, Bhutan, Nepal and India. The four countries not only share important social-economic characteristics but they also face similar challenges in terms of the provision of energy services. In 2011, the average Human Development Index (HDI) for the region, based on three measurable dimensions of human development: living a long and healthy life, being educated and having a decent standard of living, stood at 0.548 against a world average of 0.682 (Table 13.1). Poverty levels in the region, as defined by National Poverty Lines, have

Table 13.1 Key indicators – SASEC region

Indicator	Bangladesh	Bhutan	India	Nepal
Total population (million) (2011)	150.5	0.70	1,241.5	38.5
Rural population as % of total population (2011)	71.4%	64.5%	60.7%	80.8%
GDP per capita (US\$) (2010)	1,810	6,200	3,400	1,210
Population below poverty line (National Poverty Line)	31.5%	23.2%	29.8%	25.2%
Population below US\$1.25 a day (2009)	50.5%	26.2%	42.2%	55.1%
Growth rate of GDP (2010–11)	6.1%	5.9%	7.2%	3.5%
Human Development Index (HDI) Rank (2011)	146	141	134	156
Human Development Index Value (2011)	0.50	0.522	0.547	0.458
Traditional fuel consumption as % of total energy requirements (recent available figures)	30%	78%	24.5%	85.8%
Access to electricity as % of population (2009)	41%	61%	66.34%	43.6%
Per capita electricity consumption in kWh (2010)	148.6	256.6	498	162

Sources: Human Development Report 2011; World Development Indicators 2012; UN's World's Economic and Social Situation and Prospects; www.indexmundi.com; <http://data.un.org>; www.nationmaster.com

come down from as high as 49.8 per cent in Bangladesh, 30.9 per cent in Nepal, 26.1 per cent in India and 25.3 per cent in Bhutan (ADB 2006) to 31.5 per cent, 25.2 per cent, 29.8 per cent and 23.2 per cent, respectively, in the year 2010 (World Bank 2012). Per capita income (in purchasing power parity terms) varies from as low as US\$1,210 for Nepal, US\$1,810 for Bangladesh, and US\$3,400 for India against a world average of US\$11,066 (World Bank 2012). Providing energy to its vast population remains a massive challenge for the entire region. A significant proportion of the population in the region still does not have access to modern means of energy and continues to depend on traditional sources such as biomass and fuelwood for most energy needs. High use of biomass fuels is not only associated with the depletion of scarce natural resources but also causes serious environmental and health concerns. Each year, about 2 million women and children in developing countries are killed by the fumes from indoor biomass stoves (IEA 2012). Many of these are in the SASEC countries. Per capita commercial energy consumption in the region is dismally low, ranging from 201 Kgoe for Bangladesh to 560 Kgoe for India and 338 Kgoe for Nepal, while the world average stood at 1,788 Kgoe in 2009 (World Bank 2012). The percentage of the population in the region with access to electricity is also one of the lowest in the world. Access to electricity in Bangladesh has increased from a mere 28 per cent in 2006 to 41 per cent in 2009. Eighty-five per cent of Bhutan's total population still live in villages and continue to be dependent on biomass for meeting their energy needs. About 39 per cent of the total Bhutanese population do not have access to electricity. Bhutan has the highest per capita fuel wood consumption in the world as a significant share of the total primary energy supply is met through traditional fuels. As per Bhutan's Ninth Five-Year Plan,

annual consumption of fuel wood is 1.2 million cubic metres or 1.9 cubic metres per capita (Ninth Five-Year Plan, RGoB). In Bhutan, fuel wood accounts for nearly 78 per cent of the total energy consumption in the country. Approximately 69 per cent of India's population lives in rural areas, and 55 per cent of the total rural population does not have adequate access to electricity (Census of India 2011). According to official statistics, 84 per cent of the villages in the country are electrified (CEA 2011). However, with 100,000 villages still without electricity connection, much remains to be done. According to the Census of India (2011), 56 per cent (74 million) of rural households had access to electricity. Nearly 75 per cent of the rural population in India still depends on traditional biomass for cooking and heating (Census of India 2011). Rural-urban disparities within these countries also pose a challenge.

13.2.2 Need for power market development

Poor state of power supply

Rapidly growing power demand coupled with inadequate power supplies is a challenge throughout the SASEC region. The region's average per capita electricity consumption is far below the world average of 2892 kWh. (HDR 2011). Time and again availability of power has been falling short of the demand, which might prove to be a major roadblock for the overall growth prospects of the region. Power losses due to theft and poor-quality transmission and distribution are high. At 31.45 per cent, Nepal had the highest transmission and distribution losses in South Asia followed by India at 24.4 per cent for the year 2009. Inadequate investment in the transmission and distribution network and outright theft are the main reasons for high transmission and distribution losses in India. The associated financial losses have been estimated at 1.5 per cent of the national GDP for India. A study prepared as a background on the Poverty Reduction Strategy Paper (PRSP) for the World Bank showed that Bangladesh loses an equivalent of US\$1 billion each year because of power supply interruption and shortage which, in turn, results in a 0.5 per cent reduction in its annual GDP growth (Tamim and Gulen 2004). Another study carried out by USAID in 2002 valued lost production from power outages at US\$772 million a year, equivalent to 11.5 per cent of industrial production and 1.7 per cent of the 2001-02 GDP. Given the situation, it doesn't come as a surprise that an assessment of the investment climate in Bangladesh found that the erratic and poor quality of the electricity supply was the dominant constraint to business development and growth (World Bank 2004). India's Ministry of Power has estimated that, in order to support a GDP growth rate of around 7 per cent per annum, the rate of growth of the power supply needs to be over 10 per cent annually. The country, however, continues to struggle to meet the immense challenge of meeting its increasing electricity demand. The demand for power in India was growing at a rate of 7.6 per cent in the late 2000s. During 2011-12, the demand was 858 BU in terms of energy and 130 GW in terms of peak power requirements. During the same period, power shortage was 8.5 per cent in energy and 10.6 per cent in peaking power (CEA 2013a). Nepal too is plagued by power shortages. The situation is all the more distressing given that the country has tremendous hydropower potential which holds immense economic growth opportunities. Nepal has hydropower potential of 83,000 MW, of

which economically feasible potential is estimated at 40,000 MW. A mere 600 MW of this potential has been developed to date.

Ambitious electrification programmes

All SASEC countries have embarked on ambitious universal electrification programmes. The Government of Bangladesh has the vision to electrify the whole country by 2020. Bhutan's Tenth Five Year Plan (2008–13) set a target of providing electricity access to all and achieving universal electrification by 2013 to improve quality of life and reduce poverty. Particular attention is given to harnessing renewable energy for providing access to those households (around 12 per cent) that will not be connected to the national electricity grid. The development of solar energy resources, micro-hydro, alternative energy experimental activities and institutional strengthening and capacity building in these relevant areas comprise some of the priority activities under the renewable energy programme (Tenth Five-Year Plan, RGoB). The Government of India introduced the scheme Rajiv Gandhi Grameen Vidhyutikaran Yojana (RGGVY) in April 2005, which aimed at providing electricity to all villages and habitations within four years and providing access to electricity to all rural households. Although there have been no shortfalls in achievement of financial targets set for RGGVY during the Tenth and Eleventh Five-Year Plans, time overrun has been observed in the implementation of RGGVY projects. Even after completion of the project and the energisation of newly connected habitations, it has been noticed that certain regions do not get power for the sufficient duration of 6–8 hours per day due to overall shortages of power (Government of India 2012). Nepal's Water Resources Strategy 2002 has set the target of providing 38 per cent of households with access to electricity by 2017 and 60 per cent of households with access to electricity by the year 2027. Successful implementation of these goals calls for co-ordinated action by all agencies and stakeholders involved in the electrification process right from the central government, donor agencies, local bodies, and non-governmental organisations (NGOs) to the community levels. Designing, developing and implementing financially viable institutional models will be critically important. Substantial funds need to be ring-fenced for achieving these goals. Concerted efforts will also be required for the monitoring and benchmarking of schemes so that long-term access goals are achieved.

Investment requirement

Meeting increasing electricity demand in the region is a huge challenge. The significant prospect of developing the huge hydropower potential of Nepal and Bhutan could help in meeting a significant portion of the growing electricity needs of the region but would call for huge investments. Resource mobilisation for transmission and distribution investment poses a huge challenge. The high technical losses in the region reflect the lack of investment in the distribution sector and its inability to mobilise adequate financial resources. Most countries in the region are looking at private and foreign investments for power sector development, which calls for stable and predictable policy and regulatory regimes conducive to investors. According to an estimate, Bangladesh requires an investment in the range of US\$6 to 8 billion over the next ten years for power sector development. The proposed projects under Bhutan's power

system master plan will require an investment of US\$3.36 billion over the 20-year period from 2003–22. As per the recent projections of the Working Group on Power for the twelfth Five-Year Plan (2012–17), an estimated investment of nearly US\$254 billion is needed by the Indian power sector during the said period. Nepal's combined investment needs for generation and transmission for the next ten years is estimated at US\$1.22 billion (Ystgaard 2005). These massive investment requirements pose a challenge not only for the respective countries but also for the development of the region as a whole and call for a co-ordinated strategy for power sector development.

13.2.3 Increasing oil import dependency

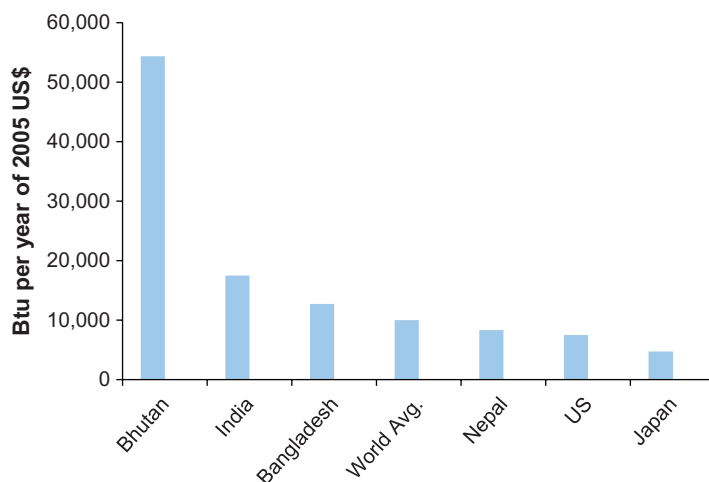
Steadily increasing oil import dependency in the region is another crucial concern from an overall energy security standpoint. Net energy imports of South Asia are expected to more than triple from 132.6 mtoe in 2005 to 447.6 mtoe in 2030 (IEA 2012), growing at an annual rate of 5 per cent. Oil imports have implications both in terms of physical supply of crude oil and various petroleum products and also in terms of their impact on the balance of payments and inflation. Unprecedented high oil prices are also reinforcing the energy vulnerability of the region. As per International Energy Agency (IEA) estimates, the loss of GDP average is 0.8 per cent in Asia and 1.6 per cent in very poor, highly indebted countries in the year following a US\$10 increase in oil price (IEA 2004). Petroleum is the single largest imported item in Bangladesh, and its oil import bill increased to nearly \$4.5 billion in 2011–12, posting a rise of nearly 45 per cent year on year. Given the availability of cheap hydropower in Bhutan, imports of petroleum products are primarily used to power motor vehicles. However, since Bhutan is an import-reliant country, and as most items in the consumer price basket are imported, the country is not isolated from the indirect effects of global oil price increases. From India's perspective, given its high oil import dependency, rising crude oil prices have an implication for the trade deficit, and thereby the currency, and also on inflation. In 2005–06, India imported 99.4 million tonnes of crude oil with a massive foreign exchange outgo of around US\$38.77 billion (Government of India 2006). In 2004–05, India's dependence on imported crude stood at 77 per cent of its crude processing requirement. While the total quantum of crude imports by the country grew at a CAGR (compound annual growth rate) of 15.72 per cent during the period 1997–98 to 2004–05, the total import bill shot up by more than double this rate (33.03 per cent) during the same period (Misra et al 2005). For the period 2012–13, India's oil import bill has risen 41 per cent to over US\$132 billion, which accounts for nearly one-third of all imports. India's oil consumption is projected to increase from 2.1 mbd in 2000 to 5.6 mbd in 2030, which would make its import dependency increase to 94 per cent. The situation in Nepal is also precarious because it is a landlocked country with no proven oil or gas reserves. Petroleum products accounted for 19.56 per cent of the total imports in the last fiscal year 2011–12. Rising energy needs has made petroleum products the number one import commodity. Nepal's gasoline import bill jumped 27.2 per cent in 2011. Dependence on energy import has put a burden on the foreign currency reserves of Nepal. Fuel imports absorb over one-quarter of Nepal's foreign exchange earnings. World Energy Outlook projects that South Asia's growing energy demand will have to be met by imports. Oil import dependency, in particular, is

expected to increase from 73 per cent in 2005 to 91 per cent in 2030. In absolute terms, South Asia's net energy imports are expected to more than triple from 132.6 mtoe in 2005 to 447.6 mtoe in 2030 (ADB 2009), growing at an annual rate of 4.7 per cent. In South Asia, India's expected increase in oil and gas demand will be increasingly met by imports. With international oil prices touching unprecedented levels and volatility in international energy markets, a well thought out strategy to ensure the energy security of the region has become more critical than ever before.

13.2.4 Need for greater energy efficiency

Though per capita energy consumption in the region is one of the lowest in the world, energy intensity, i.e. energy use per unit of GDP, continues to be very high. In 2010, average energy intensity in the region was higher than Japan's by five times and three times that of the USA, which indicates a low level of energy efficiency in the region (Figure 13.1). At 54,366 Btu per dollar of GDP, Bhutan has the highest energy intensity in the region followed by India with 17,514 Btu per dollar of GDP year, Bangladesh with 12,726 Btu per dollar of GDP and Nepal with 8,319 Btu per dollar of GDP (all figures are based on 2005 US\$ market exchange rates). Considerable scope for energy conservation through demand-side management and end-use energy efficient measures exists in all the countries of the region but remains to be realised. In India, for example, it has been assessed that at least a 23 per cent reduction of electricity consumption from the present level is possible in different sectors, without forgoing any of the end-use benefits of energy. This would entail savings of about 30 per cent in the agricultural sector, 30 per cent in the industrial sector, 20 per cent in transportation, and 30 per cent in the domestic sector (Powerline 2004 and TERI's estimates). Lack of awareness, proper ring-fencing of funds for dispute settlement mechanism (DSM) programmes and an absence of proactive policies are the main reasons for the huge untapped energy saving potential in the region.

Figure 13.1 Energy intensity in SASEC countries



Sources: EIA 2010

13.3 Regional co-operation: Historical context and ongoing efforts

The quadrilateral formed by the SASEC countries Bangladesh, Bhutan, India and Nepal is well endowed with natural resources and there is tremendous scope for co-operation in the field of energy. The four countries are complementary not only in their geographical proximity, but also in terms of the basket of energy resources available, the seasonal characteristics of energy demand and supply, and the vast pool of institutional and technological expertise available within the region. These characteristics of the region make development and integration of energy infrastructure all the more feasible. There is much to be gained by each country by developing synergies in this important sector. Several studies have been undertaken to encourage energy co-operation in this subregion but these have lacked a holistic approach and were, hence, unable to pass political scrutiny. As a result, what we are seeing is the most basic form of co-operation, i.e. bilateral arrangements between countries. Bilateral energy co-operation exists between India and Nepal and India and Bhutan in the form of some energy exchanges. Most of this has been limited to some hydropower and there remains a lot of scope for further collaboration in the field of energy.

13.3.1 Co-operation between India and Nepal

India has been assisting Nepal in the development of its hydropower potential. Four hydroelectric schemes, namely Pokhara, Trisuli, Western Gandhak and Devighat, with an aggregated installed capacity of about 50 MW, have been implemented in Nepal with financial and technical assistance from the Government of India (GoI). The Pancheshwar Multipurpose Project (5600 MW) on river Mahakali, Sapta Kosi High Dam Multipurpose Project (3300 MW) on the river Sunkosi, and Naumure Hydro Electric Project (225 MW) on West Rapti river are under discussion and are being co-ordinated by the Ministry of Water Resources, Government of India. There is a good potential in exploiting the inherent load pattern diversity between India and Nepal to improve the overall system reliability of the two countries. The GoI nominated the Power Trading Corporation (PTC) as the nodal agency to deal with matters relating to power exchange with Nepal in July 2001. PTC is also the sole agency from the Indian side for finalising all commercial and technical arrangements/systems with the Nepal Electricity Authority (NEA) and co-ordination with associated Indian agencies. Sale of surplus power is to be dealt with by PTC and NEA directly on a commercial basis based on the market conditions. In order to have interaction at a higher level pertaining to the co-operation in the field of water resources, including implementation of various agreements and understandings, a Nepal–India Joint Committee on Water Resources (JSCWR) has also been set up (Ministry of Water Resources GoI 2006). The bilateral exchange of power at the borders between the two countries is at a level of 50 MW. As per the water resources strategy of Nepal, by 2017 Nepal aims to develop hydropower to meet the projected demand of 2,230 MW including 400 MW for export to India. Under a high-growth scenario, the strategy projects that by 2027 the country would earn significant

national revenue by developing a total hydropower capacity of 22,000 MW including 15,000 MW for exports (WRS 2002; CPD 2003). The power exchange between India and Nepal is made possible by interconnections at the voltages of 11, 33 and 132 kV at 22 interconnection points. In 2010, 75 GWh of electricity was supplied to India fetching revenue of INR 604 million to the country (Table 13.2). Considering India's increasing power demand and Nepal's tremendous hydropower potential, both the governments have set a target to extend transmission lines at three border points to enhance the exchange of electricity from the current level of around 50–150 MW. For this, three 132 KV interconnections are to be made, namely Butwal–Sunauli–Anandnagar, Parwanipur–Birgunj–Mothihari and Dhalkebar–Bhittamod–Sitamarhi.

Various viable projects have been identified for bilateral co-operation between India and Nepal and some initial steps have been undertaken in respect of projects such as West Seti (750 MW), Pancheshwar (6,480 MW), Karnali (10,800 MW) and Saptakosi (3,000 MW). Pancheshwar Multipurpose Project is the centrepiece of the Mahakali Treaty signed between India and Nepal in February 1996. The project will have power, irrigation and incidental flood control benefits for both the countries. A Joint Project Office (JPO) was established in Kathmandu in December 1999 to carry out additional investigations and for preparation of the detailed project report (DPR). The JPO was closed in July 2002. A draft DPR has been prepared by the Indian side, which is to be mutually agreed upon. A joint inception report to take up the joint field investigations, studies and preparation of a DPR has also been finalised for the Saptakosi High Dam Multipurpose Project and Sunkosi Storage cum Diversion Scheme. The salient feature of the project is its reservoir size, which can hold sufficient water for generation of one month of energy at full capacity and this makes the project capable of producing peaking power for 7–8 hours a day almost round the year. Besides the above, a number of other projects, such as Burhi Gandaki (600 MW) and Upper Karnali (300 MW), are also under discussion between India and Nepal. Joint

Table 13.2 Revenue generated in Nepal from electricity sale to India

Year	Bulk supply to India (GWh)	Revenue (in INR million)
2000	95.00	327.80
2001	126.00	396.06
2002	133.86	514.12
2003	192.20	809.00
2004	141.20	673.70
2005	110.70	608.51
2006	96.55	579.33
2007	76.87	428.93
2008	60.10	361.14
2009	46.38	295.49
2010	75.07	604.85
2011 ^a	29.59	230.84

^aProvisional figure subject to final audit.

Source: Nepal Electricity Authority, Fiscal Year 2010/11 - A Year in Review

Technical Expert Groups have been constituted for the above projects for guidance in carrying out investigations and preparation of the DPRs (TERI 2006).

13.3.2 Co-operation between India and Bhutan

India has had a long association in providing technical and financial assistance to Bhutan in the development of its hydropower resources. India is also Bhutan's largest trading partner. Electricity is Bhutan's principal export commodity and the largest revenue earner. Bhutan's hydro-electricity power potential is estimated at about 30,000 MW, out of which about 16,000 MW is estimated to be technically and economically feasible.

In the late 2000s, Bhutan exported about 1,000–1,200 MW surplus power to India from its three hydro projects namely Chukha (336 MW), Kurichhu (60 MW) and Tala (1,020 MW). Chukha power is evacuated through 220 kV transmission lines – one S/C 220 kV Chukha (Bhutan)–Birpara (India) and one D/C 200 kV Chukha–Birpara line. Surplus power from the Kurichhu project is being exported through a 132 kV S/C transmission line from Gelephu (Bhutan) to Salakati (Assam). Another 132 kV link between Bhutan and India (Assam) is being commissioned for providing an alternate evacuation route for Kurichhu power through the North Eastern Grid. West Bengal State Electricity Board and Damodar Valley Corporation are beneficiaries of surplus power evacuated from this project on a 50:50 basis. The two 400 kV D/C transmission lines evacuate power from the Tala project at two different locations at the India–Bhutan border. The transmission system in India carries power from the border to a pooling point at Siliguri (West Bengal) and beyond to the Eastern and Northern Grid (Obaidullah 2010). Chukha hydropower project (336 MW) has been an important project developed as a joint venture between GoI and RGoB with GoI providing the funds for the project. About 84 per cent of energy generated from the Chukha plant is exported to India. Power Trading Corporation (PTC) has been made the nodal agency for India by the GoI and has taken over the trading of this power from 1 October 2002. PTC has entered into a long-term agreement with the Department of Energy in Bhutan and continues to import power from three hydroelectric projects, namely Chukha Hydroelectric Project (336 MW), Kurichhu Hydroelectric Project (60 MW) and Tala Hydroelectric Project (1,020 MW), in Bhutan under long-term bilateral trade. PTC's cross-border trade volume from Bhutan constitutes 25–30 per cent of its portfolio. During the year 2010–11 (up to 31 December 2011), a total of ~5,366 MU were traded with Bhutan. The total power transfer capacity between Bhutan and India through transmission interconnection is about 2,500 MW, which is sufficient to meet the requirements. With the commissioning of Tala hydropower project, electricity exports from Bhutan have increased significantly.

13.3.3 Co-operation between India and Bangladesh

With increasing pressure of power demand, Bangladesh has also been keen on importing electricity from Bhutan and Nepal. Bangladesh is surrounded by the Eastern region of India on the western side and by the North Eastern region of India on the eastern side and is in close proximity to Nepal on the north west side.

Discussions have been underway for several years about the possibility of Bangladesh connecting its electric grid to those of India, Nepal, and Bhutan.

A 400 kV transmission interconnection between India and Bangladesh is under various stages of development. This 125 km-long proposed transmission line will connect Behrampur in India and Bheramara in Bangladesh, which would enable the transfer of electricity from the former to the latter. Of the total line length, 40 km would fall in the Bangladesh territory while the rest would be in India. The transmission systems of India and Bangladesh, which are based on 400 kV alternate current (AC) and 230 kV AC respectively, are proposed to be synchronised by installing a back-to-back high voltage direct current (HVDC) link. The line will have an initial transfer capacity of 500 MW, which will later be upgraded to 1,000 MW. In June 2010, the Asian Development Bank (ADB) approved a US\$100 million loan for constructing the cross-border line. ADB's loan will finance the transmission and sub-station components of the project. A power purchase agreement is being discussed by the Northwest Territories Power Corporation (NTPC), which will involve an Indian supplier and the Bangladesh Power Development Board. The proposed transmission interconnection project will help in addressing the significant power shortages in Bangladesh.

However, there are no links between India and Bangladesh. To tap the hydropower resources of Bhutan and Nepal, Bangladesh would have to explore opportunities through co-operative arrangements with India, such as the joint development of hydropower projects or in the form of swap deals for exchange of power with the Eastern and North Eastern states of India.

Given the potentially large natural gas reserves in Bangladesh, India has been keen to source gas from Bangladesh. Following the discovery of world-class gas fields at Bibiyana, Moulvibazar, Jalalabad and Sangu fields in Bangladesh, Petrobangla, along with other exploration and production players in Bangladesh, was considering a gas-export pipeline along with the GoI from North Eastern Bangladesh to the markets in West Bengal and Central and Northern India. However, these plans have been stalled due to various concerns of Bangladesh about the actual size of these finds and the demand for gas in the domestic market.

India has also been keen to import hydrocarbon resources from Myanmar and more so with the discovery of between four and six TCF gas fields in Myanmar's Rakhine State in early 2004. The discovery was made by the consortium headed by South Korea's Daewoo International, which has a 60 per cent share in the venture. State-owned Indian companies Oil and Natural Gas Corporation and Gas Authority of India have 20 and 10 per cent shares respectively. South Korea's Korean Gas Corporation (KOGAS) also has a 10 per cent share. One option to export this gas to India is to set up a pipeline that would link the gas field to the Indian state of Tripura before crossing Bangladesh to West Bengal in India. According to an estimate, Bangladesh would have received US\$350 million in investment and earned US\$100 million in annual transmission fees from the project. In addition, Bangladesh also expected to get another US\$100 million as a one-off right of way charge from the project and US\$25 million each year for sharing management. Despite the win-win

situation for all the countries involved, the pipeline project has not come through. In exchange for the passage, Bangladesh wanted India to reduce the huge bilateral trade deficit, allow transit to Nepal and Bhutan and the sale of electricity from these countries to Bangladesh through Indian territory. After a long period of negotiations, no common ground could be reached on terms of agreement. India has now decided the pipeline will bypass Bangladesh. The failure of negotiations is a big loss to both India and Bangladesh. Bangladesh has lost a lucrative opportunity to earn huge revenue. At the same time, the pipeline could have been used to carry gas within the country and Bangladesh wouldn't have to lay separate pipelines to take gas to the Northern region. The longer route will inflate the estimated cost of the pipeline for India by US\$3 billion (*Financial Express* 2006). In another instance, India's Tata Group had submitted a US\$3 billion investment proposal for developing a steel plant with 2.4 metric tons per annum (mtpa) capacity, captive and IPP power plants, an open cast coal mine, and a urea fertiliser plant with one mtpa capacity in Bangladesh (*The Daily Star* 2006). However, the proposal was recently shelved by the Tata group on account of political uncertainty and delay by the Bangladesh authorities in taking a final decision on the proposal.

13.4 Encouraging the potential for subregional energy co-operation: A suggested approach

The subregion formed by Bangladesh, Bhutan, India and Nepal is extremely complex with peculiar geographic and market characteristics that challenge regional co-operation in energy. The previous section brought out the limited progress that has been made so far. The need of the hour is to pursue a multipronged strategy for subregional energy co-operation encompassing softer options aimed at confidence building to more substantial and larger-scale co-operation. The following section suggests various efforts required to make this possible.

13.4.1 Information collection and sharing

Lack of comprehensive and quality data is a serious constraint for development of the energy sector in the region. All countries of the region have a poor database, which makes it difficult to undertake effective energy planning. There is an urgent need to undertake an exhaustive exercise in resource mapping and to understand the drivers of energy demand and supply in the region. This would require a combination of aerial mapping and ground-level surveys to be undertaken. Technological and technical experience should be pooled in order to ensure a good database across the region.

Yet another area of weakness that constrains optimal development of the sector in the region is a reliable estimation of demand and loads. Building on the above database, designated institutions across the SASEC countries should work together to develop a common understanding of energy demands and an optimal exploitation of resource potential that would enhance energy security in the subregion as a whole. A detailed exercise in this area would provide a sound basis for defining subregional energy co-operation projects, while highlighting the economic costs and benefits, by country, of the same.

13.4.2 Knowledge networking and technology co-operation in rural energisation

As discussed in Section 13.2, a large percentage of the population in South Asian countries is rural based and does not have access to commercial energy forms. While Bangladesh has had a very successful institutional and revenue model for rural energisation, India is embarking on a huge programme for rural energisation based on a combination of grid extension and decentralised/distributed generation options. The sheer size of India's market would go a long way in reducing the costs of rural technologies (through scale economics) and a judicious selection of technologies based on demand aggregation across the SASEC countries could further the gains to all countries. Considering the dispersed nature of the rural population in the region and the difficult terrain, distributed generation based on locally available renewable resources also merits consideration and needs a planned approach. Apart from technology access, as understood by all experts in these countries, the design of markets and institutions is critical for effective rural energisation. Sharing of ideas and experiences in this sphere would be enormously beneficial to all countries in terms of not only energy access but also the related social and economic progress that could contribute to the overall stability of the region.

Governments, NGOs and donor agencies must promote holistic energy-driven rural development. This would call for compiling comprehensive information on the rural energisation policies in the countries of the region and their relative effectiveness. At the same time, a systematic study for estimating rural energy demand in the region needs to be carried out. Moreover, a knowledge management system should be established with information on existing grid-based as well as decentralised rural energy programmes, financing mechanisms, available technologies, manufacturing capabilities and commercial viability.

13.4.3 Building greater energy efficiency

There is a strong case for a concerted effort in the area of energy conservation in the region which would reap multiple benefits in terms of bridging the gap between energy demand and availability, reducing the cost of generation in the short term and reducing the investment needs for electricity production in the long term. With rising international oil prices, it has become all the more critical for all the countries in the region to adopt energy-efficient practices. However, for any effort to increase the energy efficiency of the region to be successful it is critical to put sound legal frameworks in place, provide sufficient short-term and long-term financing arrangements, have co-ordinated technical standards and increase public awareness about the need and benefit of actively participating in such programmes.

13.4.4 Enhancing the role of the private sector in energy development and trade

All the countries of the region are inviting private participation in the development of energy resources and are engaged in reforming the energy sector to allow the sector to function along commercial principles. India, for example, has opened up

the electricity sector to allow trading entities to operate freely. It has designated the PTC to undertake trading activities in the region. PTC would probably find it easier than governments to enter into multilateral commercial transactions, which could potentially allow Bangladesh to source hydroelectricity from either Nepal or Bhutan by defining alternative commercial models that all parties could find acceptable. Such relationships could then be developed purely on commercial principles with each party determining for itself the costs and benefits of such transactions (not necessarily in monetary terms). Similarly, a situation could be envisaged wherein the corporate sector of one country could invest in the development of energy resources in a second country to benefit one or more countries of the subregion. However, for these kinds of arrangements to bear fruit, we would need reforms in the approach to regional co-operation and a conducive macro environment, as detailed below.

13.4.5 Evolution of co-ordinated legal and regulatory frameworks

The long-term success of regional co-operation efforts calls for the harmonisation of energy policies and the promotion of legal and regulatory frameworks conducive to regional trade. Traditionally the energy sector in the region was regulated and owned by various government agencies and organisations. The role and participation of the private sector was limited to specific areas of small jurisdiction and consumer base. The government performed the multiple roles of developer, promoter and regulator of the sector. With the reform process underway, this situation has changed considerably. The energy sector in the region has been undergoing significant changes in terms of restructuring, unbundling and commercialisation. There is much to be learnt by the sharing of expertise and experience. India has made significant headway in power sector reforms in terms of independent regulation, while the Bangladesh regulator is still at a nascent stage. Any successful regional co-operation effort would require due diligence on various issues related to tariff setting, as tariffs would play a key role in determining comparative advantages involved in regional trade negotiations. A logical start towards co-ordinating regional energy co-operation would thus be a review of legal and regulatory frameworks in region. This would entail a thorough analysis of their approach to private investment, tariff-setting principles, various interconnection issues and ways for harmonising energy regulations and standards throughout the SASEC region.

13.4.6 Back-to-back arrangements

As mentioned previously, we have a situation wherein Bangladesh is keen on importing electricity from Bhutan and Nepal. On the other hand, India is keen to utilise the hydroelectric potential in the Northeastern states. The needs of all these countries could be satisfied by a commercial entity (public or private), engaged in the business of electricity trading, setting up appropriate back-to-back arrangements.

The Four Borders Study prepared for the USAID-SARI Energy programme has identified that it is technically feasible to build transmission interconnection in the Four Borders area that would benefit all four countries in the region. By introducing an interconnection between Bangladesh, Bhutan, India, and Nepal, it will be possible

to plan a generation and transmission system expansion on a regional basis (Nexant 2001). Based on preliminary cost estimates, the study has identified the investment requirements for the various interconnection options to be in the range of US\$9.5 million to US\$52.4 million.

13.4.7 Lagged co-operation

Another option for co-operation could be lagged energy exchange arrangements between Bangladesh and India. Under such arrangements, Bangladesh could begin to provide gas to India for a stipulated period, in exchange for which India would be obligated to provide it with a contracted amount of energy in the future. Given Bangladesh's concerns about the size of its resources vis-à-vis the domestic demand and the development of new gas finds in India, this option could prove to be beneficial to both the countries. A detailed study needs to be carried out to assess the modalities of any such arrangements in terms of cost and to evaluate the discounted value of future benefits.

13.4.8 Assessment of externalities of regional energy co-operation

Energy is a fundamental input for economic growth, and access to reliable energy sources at reasonable cost is a critical factor for sustainable economic development. Energy co-operation in the SASEC region would not only reap several direct benefits but also several externalities in terms of indirect benefits associated with regional co-operation. Increased availability of modern means of energy for the vast rural population in the SASEC subregion, for example, will catalyse economic expansion, raise living standards and have implications for the large-scale environmental degradation, the costs of climate change and indoor pollution problems associated with the use of fuel wood. Moreover, there would be impacts on health, education and increased security of the region that need to be assessed. A thorough study is required to assess and quantify, to the greatest extent possible, various externalities associated with regional energy co-operation.

13.4.9 Joint research and development efforts

Another crucial area for possible co-operation in the region is joint research and development (R&D) efforts in the energy sector. There is much to be gained by all the countries through joint initiatives, from R&D efforts to product development to marketing of new and efficient technologies and policies suitable for these markets. India has been actively pursuing development of clean technologies. It has one of the world's largest programmes for renewable energy. Moreover, it has also made progress with waste-to-energy projects, bio-gasification and is now actively pursuing commercial development of bio-fuels. There is a need to undertake joint R&D initiatives to develop commercially viable and efficient technology options that would meet the growing energy needs of the region and increase self-sufficiency.

13.5 Conclusions

Given the similar socio-economic structure of SASEC countries and the convergence of the challenges faced by their energy sectors, there is a strong economic case for

exploring greater integration within the SASEC region. To meet the increasing pressures of the growing energy needs of the region it is paramount to have significant investments in energy infrastructure. At the same time, there is a need to optimally harness the vast resource base available in the region that would call for sound energy demand and supply management strategies. Regional sharing and planned use of available resources would address many of the growing energy security concerns and accelerate economic development of the region. At the same time, it would open a window of new opportunities through greater levels of cross-border trade and investments, larger markets and higher social stability in the region as a whole. Despite tremendous benefits to be derived out of regional co-operation, the region has had limited energy co-operation in the past. It is high time for policy-makers, civil society, NGOs and financing institutions to push for a greater integration of the SASEC energy sector. It is also critical for all stakeholders to recognise that delays in decision-making to ensure stronger and mutually beneficial co-operation efforts are associated with high costs, not only to the energy sector but for the development agenda of the region.

Note

- 1 This chapter updates the information contained in the paper 'Promoting Regional Energy Co-operation in South Asia' by Leena Srivastava and Neha Misra, Energy Policy 35 (2007) 3360–3368. The authors would like to thank the Asian Development Bank (ADB) for supporting this chapter as part of its regional initiative – South Asia Subregional Economic Cooperation (SASEC) programme. Special thanks to Mr P Abeygunawardena, Energy Division, South Asia Department (SARD), ADB for his valued inputs. Please note that this chapter does not necessarily reflect ADB's views on regional energy co-operation.

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Chapter 14

Commodities Super-cycle: Implications for South Asia

Machiko Nissanke and Sophie van Huellen

14.1 Introduction

At the beginning of this millennium, there was a significant turnaround in primary commodity prices. After two decades of low, and at times dwindling, prices, many primary commodity prices have registered a steep increase since 2002. The marked price increases began to gather pace first in 2002–03 and then in 2006–07, culminating in an all-time high peak in nominal terms in 2008 across commodities, just before the onset of the global financial crisis. The sharp increase in *nominal* prices was so marked that it has also resulted in a sharp upturn in *real* commodity prices in the first decade of the new millennium, though the scale of the increase differs among commodities and the *real* prices of agricultural commodities are still lower than the peaks previously attained during the Korean war and oil shocks of the early 1970s. This price movement has led many observers to conclude that commodities had entered into a new price *super-cycle* in the early 2000s (e.g. Kaplinsky 2010).

The soaring commodity prices hit the world economy at the time of the severe financial crisis initially triggered by the sub-prime mortgage crisis in the US against the background of global macro economic imbalances. The rapidly increasing prices of basic goods such as fuel and food had sparked off social and political disquiet and unrest across the globe in the immediate period preceding the global financial crisis. The rising fuel cost and food shortages then hit the livelihoods of the urban and rural poor in developing countries particularly hard. This extreme high volatility is an equally or even more defining feature of commodity prices to date. At the onset of the global financial crisis in mid-September 2008, commodity prices experienced almost a free fall across the board in the last quarter of that year. The fear of accelerating inflation and fuel and food shortages worldwide had been suddenly overtaken by a greater fear of global recession engulfing all economies, including those in the developing world. Subsequently, several ‘high-profile’ commodities have continued experiencing large swings and bounced back nearly to the pre-crisis peak level in 2011. As the world became concerned about the possibility of renewed food and fuel crises that could jeopardise the fragile global recovery, commodity prices experienced a marked fall again in connection with the sharp slowdown of the global economy amidst the worsening Euro Zone crisis. In 2012, emerging agricultural production data seem to indicate a forthcoming global shortage of the supply of staple food crops. A new short-term boom–bust cycle of commodity prices is already in the making.

Indeed, the recent boom–bust price cycles once again highlight the high vulnerability of commodity-dependent low-income developing countries to price shocks and their associated difficulties in managing their economies over commodity price cycles, while placing an escalating burden on countries heavily dependent on imported essential commodities. Thus, both the prospect of the persistent commodities super-cycles and the continuing extremely high price volatility will have significant implications for all developing countries, both for commodities exporters as well as commodities importers.

These concerns are of particular relevance to South Asia, a region which experienced its own historically high growth in the 2000s. The region contains both exporters and importers of several strategically important commodities. As a region, South Asia has been largely self-sufficient in basic cereals, but is emerging as a net exporter of rice and a net importer of wheat. It is also a net importer of oil seeds but a major exporter of a number of agricultural commodities such as tea, cotton and jute. Demand for metals and minerals has been rising for almost all countries in the region, while India is emerging as an important exporter of iron ore, copper and foremost petroleum products.

This chapter examines the economic implications of commodity price movements for the region. Set against this objective, it is structured as follows: Section 14.2 discusses South Asia's role in commodity trade and changing trends during the 2000s. Section 14.3 then evaluates implications of super-cycles for South Asian economies. Section 14.4 offers concluding remarks, including policy implications from analyses of commodity price cycles and some concrete policy proposals to deal effectively with commodity-related developmental problems.

14.2 South Asia's role in commodity trade

With the high growth rates since the 1990s as well as the environmental and demographic changes, the pattern of commodity demand and supply in South Asia has shifted dramatically. At the same time, the region's pattern reflects largely that of India, which is by far the biggest economy in South Asia and an economic driver for the region. For energy and metal commodities, both demand and supply capacities have concomitantly increased as the economies have grown. However, the region faces pressing challenges in feeding a growing population with decreasing agricultural yields and arable land per capita. Though the region was formerly more or less self-sufficient in the production of staple food commodities such as rice and wheat, it is becoming increasingly dependent on food imports. Changing dietary patterns coupled with growing income further contributes to the increasing demand of nutrition-rich food commodities besides staples.

14.2.1 Major features and overall trends

Clearly, India is the largest economy in the region and home to 20 per cent of the world's total population. This alone makes it a major player on global food commodity markets (World Bank 2010). However, historically, India's food commodity imports.

were relatively low compared with other densely populated regions such as East or South East Asia. India has followed a policy of self-sufficiency regarding its domestic food supply (Francis and Winters 2008). Its agricultural sector is highly subsidised in order to achieve adequate returns to farmers by providing incentives for production. Policies include minimum prices for key agricultural products as well as input subsidies for the electricity needed for irrigation, water, fertiliser and pesticides.

However, such policies have made the Indian agricultural sector the most irrigation dependent in the world, which resulted in decreasing ground water levels in many regions (*ibid.*). Water shortages have brought about new environmental challenges causing – among other factors – agricultural productivity to stagnate. Combined with increasing population growth, energy shortages and preceding urbanisation, these factors eventually turned India and the region as a whole into a net importer of some food and agricultural commodities. As there is no quick solution to the rising challenges, India's imports of staple foods and other agricultural products are likely to increase further. Moreover, with further economic growth food consumption patterns are likely to shift from staples, such as wheat and rice, towards a more balanced diet, including meat, oils, and vegetables (*ibid.*).

As a major consumer, South Asia would have some decisive impacts on world demand for wheat and sugar, and hence on prices, especially in times of significant fluctuations in domestic production due to weather and climate conditions. Since India lifted its export ban on rice in 1994, and one year later also on wheat, it became one of the largest rice producers globally and together with Pakistan it accounts for more than one-quarter of world rice exports. However, it was only during the commodity price peak in 2008 that the Indian government among others re-imposed export bans on rice and other staples (Timmer 2009; Brahmabhatt and Christiaensen 2008). Such policy decisions are seen to have major impacts on world prices. Given the increasing demand pressure from growing population and stagnating or decreasing agricultural yields, such policy interventions might occur more often in the future.

South Asia could maintain its key role in global tea, cotton, and jute trade and production. However, net exports for tea have declined steadily over the years due to growing domestic demand. For jute, net exports decreased for some time, but are increasing again. Intra-regional trade is strong in both tea and jute. Unlike jute, tea is also exported to other regions, including West Asia and to a lesser extent North America and Europe. Likewise, cotton produced in South Asia is traded within the region in order to meet regional demand. South Asia has also become a net exporter of cotton to the rest of world.

India is clearly dominating the region's overall trade patterns in minerals and metals. However, India's role in global commodity trade in this category is still relatively small, especially compared with China. The relatively low share of South Asia as a whole and India in particular in metal and mineral trade can be explained by the fact that economic reform policies promoted and commenced by the Indian government since the early 1990s have favoured services over the industrial sector (Francis and Winters 2008). In 2010, services accounted for approximately 55 per cent of India's total gross domestic product (GDP) while industry had a share of only 26 per cent.

This is in sharp contrast to China, where industry contributed 47 per cent of total GDP value added (World Bank, World Development Indicators 2010). Given that industrial production is a strong driver of metal demand, India's economic growth patterns partly explain the relatively minor role – relative to India's share in world GDP as well as remarkable economic growth during the 2000s – in global metal demand.

However, the increasing focus on the industrial sector (World Bank 2010; Francis and Winters 2008) coupled with India's endowments in iron ore and bauxite may change South Asia's role in mineral and metal commodity trade in future. India's steel industry is expected to grow exponentially due to the predicted rapid growth of its economy throughout the twenty-first century (Datamonitor 2011b). Similar patterns can be expected for copper ore imports as well as copper and aluminium production.

One of persistent challenges for the region's mining and metal industry is uninterrupted power supply, which is still a major concern – and not only for India (Dutta and Mukherjee 2010). Further, high tariffs and export bans in times of high world commodity prices, as a policy tool for domestic price control, could further hinder South Asia's and India's participation in global commodity trade. During the 2008 price hikes, for instance, the Indian government imposed not only restrictions on grain exports but also on cement exports, in order to maintain a smooth domestic coal supply (*ibid.*).

India is also the main driving force behind South Asia's energy commodity trading patterns. India accounted for 83 per cent of South Asian total energy commodity demand and is already the third largest consumer of coal and fourth largest consumer of oil in the world, though it is still far behind the United States and China in total energy consumption. On the production side, India accounts for approximately 1 per cent of the global production of oil, and has 0.5 per cent of proven reserves. Likewise, for gas, India accounts for 1.1 per cent of global production and 0.6 per cent of world gas reserves (Francis and Winters 2008). India, however, has significant coal deposits and accounts for 6.6 per cent of global production and 10.6 per cent of global coal reserves, making it the third largest producer of coal (behind the USA and China, which together produce 60 per cent of the world's coal) (*ibid.*).

Overall, India was the fourth largest energy consumer in 2009, after the United States, China and Russia. With increasing economic growth as well as population growth, India's energy demand is likely to increase further in future, which puts pressure on the government to provide for its growing energy needs as a fundamental input for industry, manufacturing as well as agriculture. The International Energy Agency (IEA) estimated a total increase of 116 per cent in Indian energy demand over the period from 2007 to 2030, which should be increasingly met by nuclear energy and gas as well as oil and coal (IEA 2009). Given India's low natural endowments in oil, its dependency on oil imports – already high – is likely to increase further. Also coal imports are likely to increase because of growing demand from its metal and mining industry for high quality coal. Given the country's yet untapped potential for gas production, net imports are likely to increase only slowly or even decrease once the

Indian gas industry unleashes its potential. If the economic growth prospects of the remaining South Asian economies stay strong, import dependency on coal as well as petroleum and crude oil is likely to increase for these countries.

14.2.2 Agricultural commodities: Grains and food

Rice, wheat and sugar make up 60 per cent of the average daily caloric intake per capita in South Asia. South Asia is the second largest rice consuming region in the world after East Asia, with rice accounting for 30 per cent of the daily caloric intake.

However, with economic growth, dietary patterns have been changing and are likely to change further in the future (Talukder 2005; Kumar et al. 2007). While rice remains an important staple food, wheat increasingly replaces sorghum, millet and pulses. Further, per capita consumption of vegetable oils, milk and butter as well as fish, meat and eggs, has increased steadily since the late 1980s, while rice and wheat remain the most important staple food commodities.

South Asia as a region is a net importer of wheat and a net exporter of rice. However, within the region, domestic demand–supply gaps, and hence trade patterns, are quite diverse. While Pakistan and India are net exporters of cereals, Bangladesh and Sri Lanka are net importers. The volatility in the volume of annual imports and exports of cereals is very high, especially for India.

South Asia is a net exporter of cereals as a whole, since it is dominated by its net exporter position in rice, while it is a net importer of wheat and a relatively small exporter in other cereals. Vegetable oils and vegetables and fruits constitute increasingly significant import bills for the region, while export earnings from fish, meat and tea have steadily increased. On the whole, import bills of wheat, and vegetables and fruits have started exceeding export earnings, so that the region has become a net importer in these commodities since the mid-2000s.

According to the food balance sheet published by FAOStat, for seven out of the eight South Asian countries, rice was among the three most important food crops produced annually. India was the second largest rice producer worldwide after China, and together with Pakistan it was the largest rice exporter of the South Asian region. India increased its domestic rice production from 50 million tonnes in 1980 to more than 100 million tonnes by the late 2000s. Bangladesh also more than doubled its rice production over the same period from 14 million tonnes to 29 million tonnes. India and Bangladesh are the two biggest South Asian rice producers. However, only since the mid-1990s has India become a net exporter of rice, exporting about 6 per cent of its total production. Bangladesh remains a net importer despite its rising production level. Pakistan's large export share in rice is a result of its lower domestic consumption of rice so that more than 50 per cent of domestic production could be exported according to FAOStat data.

According to United Nations (UN) Comtrade data, which provide detailed breakdowns by trading partners, Bangladesh, Saudi Arabia and the United Arab Emirates are the major destinations of Indian rice exports.¹ Other major importers of Indian rice include Nigeria, Kuwait, Iran, the United Kingdom, Nepal, Sri Lanka

and Madagascar.² For Pakistan, three major export partners, measured in trading volume, were the United Arab Emirates, Iran and Kenya for 2003–10. In terms of export values Saudi Arabia replaces Kenya as the third most important market for Pakistani rice exports, followed by Afghanistan (the fourth largest importer of Pakistani rice over the period), Oman and Qatar as well as several African countries (e.g. Cote d'Ivoire, Mozambique, South Africa and Madagascar). Indian rice exports accounted for 9.2 per cent of world rice exports (in volume) in 2010, which made it the world's fourth largest rice exporter, right after Pakistan with a share of 15.5 per cent of world exports. Indian and Pakistani rice exports were only outperformed by Thailand (33 per cent) and the United States of America (17 per cent). Hence, India and Pakistan are important rice suppliers, not only to South Asian, but also to East and South East Asian, African and Middle Eastern countries. Pakistani and Indian exports provide rice supply around the Arabian Sea and Indian Ocean, where major trading partners (except the United Kingdom) are located.

Wheat is the second most important staple food in South Asia in terms of daily caloric intake per capita. India and Pakistan are the biggest wheat producers in the region. Although production increased steadily from 40 million tonnes in 1980 to more than 100 million tonnes by the late 2000s according to FAOStat data, the region remains largely a net importer for wheat. The increase in production since the 1980s can be attributed to India's increased capacity, where wheat production almost trebled over the time period. However, South Asia as a region remains a net importer of wheat, except in 2001–03.

According to UN Comtrade data, Canada was the largest supplier of wheat to South Asia, followed by Russia, for 2000–10, while India was a main supplier of wheat for smaller South Asian countries. For example, more than 55 per cent of Indian wheat exports were destined for its smaller neighbours in 2008. Australia, Argentina and the United States also export wheat to the region. South Asia accounted for about 10 per cent of Canada's entire wheat exports, 12 per cent of Russia's, and 7.5 per cent of Argentina's in 2008. Although South Asia accounted for only about 3–5 per cent of world total wheat imports in 2008–10, it is important to note that demand was increasing much more rapidly than in the rest of the world, with an annual average increase in South Asia of 15–16 per cent between 2000 and 2010 compared with an annual average increase of only 2 per cent in world demand. However, demand patterns fluctuated a lot over the period.

For sugar, South Asia is one of the largest consuming regions worldwide. Sugar accounts for 7 per cent of the daily caloric intake on average in the region and is the third most important source of daily nutrition. Pakistan and India are the region's two major sugar consumers as well as producers. Sugar production in both countries has steadily increased since the 1980s from 5 million and 0.6 million tonnes to 25 million and 3.5 million tonnes of annual production in 2010 for India and Pakistan respectively. However, domestic demand increased in tandem with domestic production. Imports fluctuate heavily in order to meet demand in the face of volatile domestic production, hence the region could become a substantial net importer or net exporter of sugar, depending on domestic sugar cane harvests.

14.2.3 Agricultural commodities: Tropical beverages and agricultural raw materials

India and China are the world's largest tea producers with an annual average of 0.85 million tonnes of production each in the three decades since the 1980s.

India and Sri Lanka are the main producing areas. While Sri Lanka increased its annual production from 0.2 million tonnes in the early 1990s to 0.3 million tonnes in the late 2000s, India steadily increased its production from 0.35 million tonnes in 1960 to 0.95 million tonnes. However, India is also the largest tea consumer and consumption increased at an equally steady rate from 0.15 million to 0.8 million tonnes over the same time period, resulting in a relatively stable export level for Indian tea, according to FAOStat data.

In 2010, Afghanistan, Bhutan, Maldives and Pakistan were all net importers of tea, while Sri Lanka, Nepal and India were net exporters. Sri Lanka was the region's largest exporter with a share of about 60 per cent of total South Asian exports in net weight and 67 per cent of total exports in dollar value. India holds a 38 per cent and 32 per cent share in volume and value, respectively. The difference in market share measured by net weight and dollar value indicates higher prices are paid on world markets for Sri Lankan tea than for Indian tea. Pakistan was by far the largest importer in the region, followed by Afghanistan. The latter accounted for 20 per cent of South Asian net imports in 2010 according to UN Comtrade data.

The five most important export partners for India in 2010 were Russia, the United Arab Emirates, the United Kingdom, Iran and the United States. While Iran and the United Kingdom are historically important trading partners, the United States only started importing Indian tea from the late 2000s. For Sri Lanka the most important export partners are Russia, Iran, the United Arab Emirates, Syria and Turkey. Together these countries account for over 50 per cent of total Sri Lankan tea exports. Hence, Middle Eastern countries, i.e. the West Asian region, are the major destinations for South Asian tea exports.

For jute, Bangladesh and India are the main producers in the region. Their production level was on a par with each other until the late 1980s. However, since then it has diverged as production decreased slowly over time in Bangladesh, while it steadily increased in India. The region as a whole is the world's largest jute producer. Despite its large production, India is a net importer of jute, whereas Bangladesh does export a significant proportion of production, though fluctuating considerably from year to year (e.g. it exported only 20 per cent in 1994 but it went up to 80 per cent in 2007).

Total South Asian net exports, however, decreased since the 1960s until the mid-1990s to a marginal level. This decrease in net exports occurred despite a relatively stable level of jute production in Bangladesh, which fluctuated between 1 and 1.5 million tonnes per year over the entire period, and an even, steadily increasing production level of Indian jute from around 1 million tonnes in the mid-1970s to 1.8 million tonnes in 2007. However, domestic jute demand in India and Pakistan increased sharply, exceeding the growth in production. Largely owing to an increase in Bangladeshi exports, net exports from the region have started increasing again since 2004.

For cotton, the region, in particular Pakistan and India, is a major producer in the world together with China and the United States. While production of cotton lint increased in both India and Pakistan in parallel until 1983, Pakistan's production increased sharply to reach the same level as in India, and both countries produced in the range of 1.5–2.5 million tonnes until 2004. However, India trebled its cotton production during 2002–2007, outperforming Pakistan again after 2004. Pakistan and India increased their production from 0.3 million and 0.9 million tonnes in 1961 to 2.0 and 4.4 million tonnes in the late 2000s respectively, according to FAOStat data.

Since Bangladesh, India, Nepal, Pakistan and Sri Lanka all have a vibrant garment and textile industry with a huge demand for cotton lint, not much of the cotton produced is actually exported and South Asia has even become a net importer of cotton as a region since the late 1990s. In particular, Pakistan's cotton exports peaked in 1989 and have experienced a decline since then. In 2000, the country became a net importer of cotton and has remained so since then according to UN Comtrade data. Bangladesh has increased its import volume since the early 2000s. In contrast to these two countries, India has increased its net exports substantially since 2004, as its export volume peaked in 2007, and it has remained a significant net exporter since then. In 2010, India's exports were 1.5 times the volume reached in 2007. As a result, the region has been an overall net exporter of raw cotton since 2006.

14.2.4 Metals and minerals

India is the only country in the region with a considerable large metal and mining industry. All other countries are net importers of aluminium, iron and steel, coal and base metals (lead, zinc, copper, nickel and tin). South Asia as a region has become a major exporter of iron ore and to a lesser extent copper since 2002 and 2005, respectively, while it is a net importer of copper ores and concentrates, which have increased substantially since 2003. It has also imported iron and steel as well as silver since then, registering a significant increase in value terms.

In 2011, India became the world's seventh largest aluminium producer, fourth largest zinc producer and fourth largest iron ore producer (US Geological Survey 2011). As of May 2012, India is among the five largest crude steel producers with 6.2 million tonnes of output, roughly 4.75 per cent of the global steel supply, after registering an annual growth of 4.24 per cent in production. This production level is similar to Russia's and only slightly lower than production in the United States (Worldsteel 2011, 2012). However, India's production is only one-tenth of China's steel output, which accounted for 47 per cent of global production (*ibid.*). Besides India, Bhutan and Nepal are also exporters of iron and steel, which accounted for 40 per cent of Bhutan's export earnings and for 12 per cent of Nepal's export earnings in 2010. Although for both countries iron and steel exports are important, they are marginal exporters in relation to world iron and steel trade.

The iron and steel industry is India's most lucrative metal and mining sector with total revenue of US\$78.5 billion in 2010, which was about 74 per cent of the sector's overall value (Datamonitor 2011a, 2011b). With growing production capacity, India steadily increased its exports of iron and steel from 1.2 million tonnes in 1990 to

7.2 million tonnes in 2006. Since 2006, India's exports of iron and steel suffered a decline and its exports were 3.7 million tonnes in 2010. This significant reduction in export volume can largely be attributable to the impact of the price fall across commodity classes in the last quarter of 2008, which hit the Indian steel industry hard (Datamonitor 2011b). However, world price in iron and steel bounced back thereafter, so that although the volume of total exports decreased by 45 per cent for 2008–10, the export value in US\$ decreased by only 15 per cent. Despite its growing iron and steel industry and exporting capacity, India remains a net importer of this product, with net imports steadily increasing since 2002, reflecting its fast-growing domestic demand. Besides India, Pakistan, Bangladesh, and Sri Lanka also account for some of the region's iron and steel imports. However, India contributes by far the largest share. Therefore, the region as a whole is a net importer of iron and steel, with net imports between 2 and 4 million tonnes of annual imports for 1990–2002. Mainly driven by India, total imports have steadily increased since 2002 to 18.7 million tonnes in 2010, resulting in 13.4 million tonnes of net imports in the same year. If we exclude India from the South Asian aggregate, net imports peaked in 2007 with 6.6 million tonnes and since then have been on a declining trend. Unlike iron and steel products, India was a net exporter of iron ore, earning export revenue of US\$6 billion in 2010 with its rich deposits.

India is also well endowed with bauxite – the raw material for aluminium production – ranking as the fifth largest producer of aluminium in the world. Net exports of bauxite (aluminium ore) increased until 2007 and since then have been on a decline as a result of rising domestic consumption. Although Indian bauxite is of high quality and its reserves are estimated to account for five per cent of the world's total deposits, production is still less than 10 per cent of China's (Dutta and Mukherjee 2010). However, India's production has been increasing, emerging as an important producer of primary aluminium. It already accounted for 4 per cent of global primary aluminium production in 2010 (European Aluminium Association 2010).

However, the region as a whole is a net importer of aluminium and articles thereof, reaching more than US\$1 billion in total value of net imports in 2010, with India accounting for the largest import share despite having its own domestic aluminium industry. Given that the main end-use markets for aluminium are construction and transportation, demand for aluminium is expected to increase further (EAA 2010).

Turning to copper, India is also a major producer, ranking as the fifth largest copper smelter, accounting for about 4 per cent of the world's copper smelter production after China (24 per cent), Japan (22 per cent), Chile (10 per cent), and Russia (5 per cent) in 2010 (ICSG 2010).³ Although India has a relatively large smelting industry, its natural endowments of copper ores and concentrates are relatively low. Hence, India is a large net importer of copper ores and concentrates, amounting to an import bill of US\$ 4.6 billion. India was the third largest importer in 2009 after only China and Japan (*ibid.*).

Since other South Asian countries account for copper imports and exports only marginally, South Asia's trading patterns mainly reflect Indian imports and

exports. The region became a net exporter of copper and copper articles in 2002. Simultaneously, net imports of copper ores and concentrates increased dramatically. From 2005 to 2006 net imports more than trebled from 0.75 million tonnes to 2.4 million tonnes and have stabilised since then at an annual level of about 2 million tonnes of net imports.

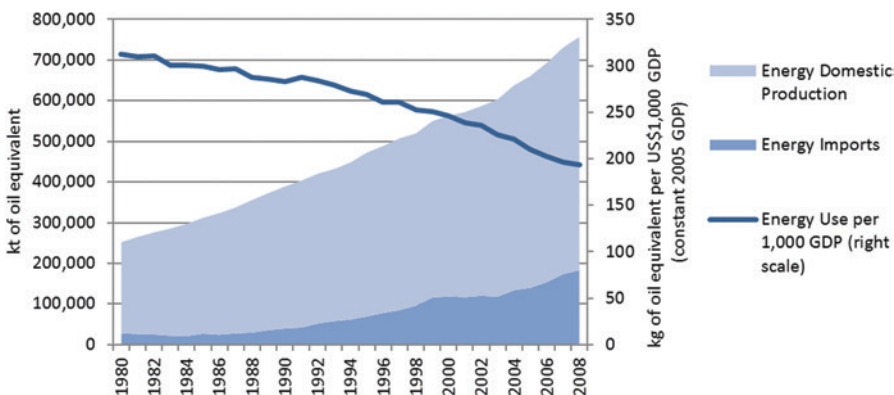
14.2.5 Energy commodities

Energy consumption in South Asia has risen as well as economic growth. Although efficiency of energy use increased steadily with a decrease of one-third in the ratio of energy use per US\$1,000 GDP between 1980 and 2008, absolute energy consumption increased by almost 300 per cent between 1970 and 2008. The increasing regional demand could not be fully matched by increasing levels of domestic energy production. Hence, South Asia as a region became more dependent on energy commodity imports (Figure 14.1).

This development is accompanied by changing patterns in the composition of sources for electricity production. In the 1970s, hydropower and coal had an equal share in energy production. Since then the percentage share of hydropower in total energy production has decreased by 30 percentage points, while the importance of coal and also natural gas has increased (Figure 14.2).

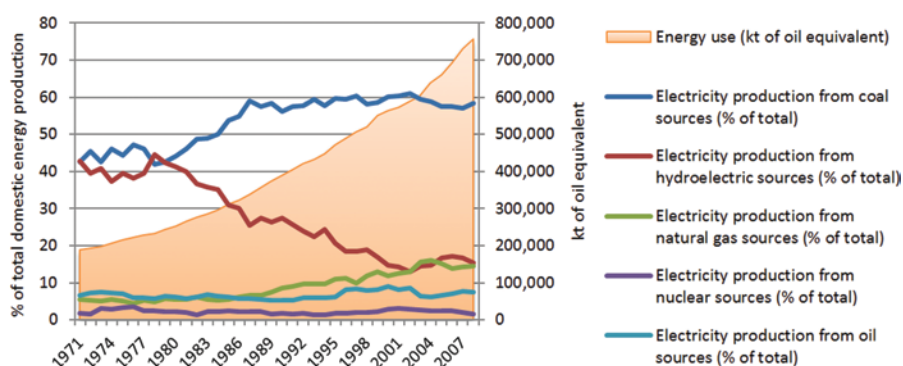
However, this pattern is dominated by India's energy production and consumption, by far the largest energy consumer. India was even the fourth largest energy consumer in the world after the United States, China and Russia in 2009 (IEA 2009). The composition of sources for energy production as well as dependence on energy commodity imports of the other countries in the region differs quite substantially. For South Asian countries other than India, the share of biofuels and waste in domestic energy production is much larger, accounting for the largest source of overall energy production, though with a declining share. This large share of biofuels and waste reflects still insufficient energy provision at household levels, and many – especially

Figure 14.1 South Asian domestic energy production, imports and energy efficiency (1980–2008)



Source: World Bank (2011), World Development Indicators

Figure 14.2 Sources for domestic energy production and domestic energy use in South Asia (annually, 1971–2008)



Note: Due to data constraints Afghanistan, Bhutan and Maldives are not included in the aggregation.

Source: World Bank (2011), World Development Indicators

rural – households rely on traditional sources such as biofuels and fuel wood for daily heating and cooking (Srivastava and Misra 2007). Further, the decline in the share of biofuels and waste as an energy source in total energy production is accompanied by a rising importance of natural gas. This development is probably driven by the trend in Bangladesh, which relies on natural gas for almost 90 per cent of its energy source. Coal, however, does account for a very minor share in energy production in countries other than India.

South Asia as a region does have only minor oil reserves, and hence up to 80 per cent of crude oil demand is supplied by imports. As India is relatively well endowed with coal reserves, the share of imports in domestic coal demand is relatively low, though following an increasing trend. This is largely due to the Indian iron and steel industry's demand for high-quality coal. For other South Asian countries, coal has to be largely imported so that the share of imports in total needs has increased from about 50 per cent in 2000 up to almost 75 per cent in 2009, driven largely by demand from Pakistan and Bangladesh where coal consumption more than doubled over the same period (Remme et al. 2011). Driven by demand from India and Bangladesh, the import share of natural gas has also increased over the last decade to about 30 per cent of total domestic gas consumption (Corbeau 2010).

South Asia as a region is a net importer of almost all energy commodities but oil products, for which it turned into a net exporter in 2006 as a result of India's growing oil refining capacity. With 21 refineries reported in 2011 (Ministry of Petroleum and Natural Gas (MPNG) 2011a, 2011b), India is self-sufficient in refining capacity for domestic consumption and became a net exporter of petroleum products, especially to its neighbouring countries (EIA 2010). However, the industry remains highly dependent on imports of its key input factor, crude oil. In 2011, India ranked fourth in global petroleum consumption. If India is excluded from the South Asian aggregate, the region remains a significant net importer of crude oil⁴ as well as refined oil products.⁵

Nepal almost entirely produces energy from hydropower stations. Sri Lanka followed hydropower electricity production until the mid 1990s. Since then the use of oil has increased and reached an equal share with hydropower. Bangladesh relies heavily on natural gas as a source of energy production, while Pakistan relies on hydropower, natural gas, and oil as energy sources with each accounting for an equal share. Overall, oil has become an increasingly important energy source since the early 1980s.

Not only the composition of energy sources but also the import dependency varies across countries. Sri Lanka has the largest import dependency with an import share of about 45 per cent of its overall energy sources. It imports its entire demand for oil products, crude oil and coal. Only energy from biofuels and waste as well as hydropower are domestically produced. Nepal has the lowest import dependency with about 12 per cent, because of its low level of domestic energy supply (the lowest in the region) and its heavy reliance on biofuels and waste for energy production. Only coal as an additional source of energy has to be imported from India. Bangladesh, on the other hand, is rich in natural gas reserves, which satisfy more than half of its energy demand already, while the share of traditional sources (biofuels and waste) for households' energy consumption has steadily declined. For India and Pakistan the import share in domestic energy consumption is 25 per cent, which is still low in a world comparison. Indian energy imports almost entirely comprise crude oil imports (although the significance of natural gas and coal imports are on the rise). In contrast, Pakistan satisfies its increasing energy demand largely with natural gas. Domestic natural gas reserves are for the time being sufficient to meet domestic demand, resulting in low import dependency in this regard. However, crude oil and coal, which accounted for 12 per cent and 5 per cent of energy sources respectively in 2009, have to be imported for up to 70 per cent of its needs.

14.3 Implications of the super-cycle for South Asia

14.3.1 Balance of payments implications from the commodity price boom of 2002–08

South Asia as a region can be a net exporter or net importer depending on the commodity in question. Hence, in terms of balance of payments management, it can be either a winner or a loser from commodity price hikes as observed for 2002–08. For example, while South Asia as net exporter of some agricultural commodities as well as metals and minerals has gained in export revenues from the price rise over the latest commodity price boom, an increase in import bills, especially paying for higher energy costs, has exceeded any additional gains from the price boom between 2002 and 2008. Table 14.1 presents our estimates of gains/losses from price movements for selected commodity groups. These are calculated as the sums of annual differences between net export values actually recorded and hypothetical values if prices stayed at levels observed in 2002.

According to this estimation, South Asia as a region earned extra revenues from the price hike of rice, amounting to US\$7.1 billion. Since export bans imposed to prevent

Table 14.1 Net changes in import bill/export earnings due to the price increases of 2002–08 (in US\$ millions)

Type	Commodity	South Asia	South Asia (ex. India)
Food commodities	Rice	7,144.24	3,672.49
	Wheat	–3,027.36	–2,451.37
	Edible oil	–5,213.97	–3,071.72
	Tea	1,305.58	1,196.60
Agricultural raw materials	Cotton	63.17	500.32
	Jute	299.96	–108.95
Metals and minerals	Iron ore	16,414.13	–128.36
	Iron and steel	–6,671.58	–2,840.81
	Aluminium ore	322.39	–0.11
	Aluminium	–6,286.62	–1,909.47
	Copper ore	–10,743.35	1.43
	Copper	5,045.24	–27.24
Energy commodities	Coal	–13,818.81	–848.09
	Natural gas	–3,337.71	–422.20
	Crude oil	–170,388.41	–15,937.49
	Refined oil products	19,392.93	–11,846.90

Note: UN Comtrade classification (HS digits as reported): rice 10.06; wheat 10.01; edible oil 15; tea 0902; cotton 52.01; jute 53.03, 53.07, 53.10; iron ore 26.01; iron and steel and articles thereof 72; aluminium ore 26.06; aluminium and articles thereof 76; copper ore 26.03; copper and articles thereof 74; coal 27.01; natural gas 27.11; crude oil 27.09; refined oil products in 27.10.

Source: UN Comtrade (author's calculation)

shortages and to control domestic food prices did limit the traded volume, the extra revenues could have been higher if these measures were not taken. However, it is important to note here that the food security programmes implemented to ensure affordability of staples resulted in an increasing fiscal burden with rising prices. Further, the increase in global wheat prices coupled with rising demand for wheat imports resulted in US\$1.6 billion additional costs for wheat imports in 2008 alone. Should world prices have remained constant at the 2002 level, South Asia's import bill for wheat would have been less by US\$3 billion over the time period of 2002–08.

As tea prices also followed a rising trend, India and Sri Lanka as net exporters of tea gained extra revenues from the price increase, earning together an additional US\$1.3 billion between 2002 and 2008. As the cotton price increase was much less compared with other commodity groups, extra export revenues earned by India and Pakistan as net exporters from the price increase were marginal, at just over US\$63 million, while Bangladesh, Nepal and Sri Lanka, as net importers of cotton lint, had to pay a higher price for imported raw materials for their garment industry.

Turning to metals and minerals, India's gains from its iron ore exports as a result of the price increase are estimated to be about US\$16.4 billion over the period of 2002 and 2008. However, South Asia had to pay an additional US\$6.7 billion for imports of iron and steel and US\$6.3 billion for aluminium imports for sustaining

their booming construction sector and other industrial activities. India's estimated additional bill of US\$10.7 billion for copper ore imports exceeds its copper industry's extra export revenues of US\$5 billion from copper-processed products.

However, it is energy commodity imports, especially crude oil imports, that caused a massive trade deficit from the price hike observed in 2002–08, as the region increasingly depends on crude oil as a source for its overall energy supply. According to our estimate, the increase in world oil prices from 2002 to the price peak in 2008 added US\$170 billion to the crude oil import bill for all countries in the region as net importers. However, for refined oil products, South Asian countries other than India are net importers, while India is now a net exporter of oil products, having developed a large oil-refining industry. While India earned an additional US\$31.2 billion due to the price rise in oil refined products over the period 2002–08, the import bill for the remaining South Asian nations increased substantially by US\$11.8 billion. As demand for coal increased steadily in the entire region the coal price increase added an additional import bill of US\$13.8 billion for South Asia as a whole and US\$13 billion for India alone. Thus, increasing global energy prices, especially fuel prices, together with the region's rising demand for energy commodities resulted in a huge trade deficit recorded since 2003 according to World Bank data. In 2011, the trade deficit of the entire region reached more than US\$200 billion, of which more than US\$100 billion resulted from fuel imports.

14.3.2 Food security

There are two dimensions of food security which have to be considered: first availability or self-sufficiency on the aggregate level (quantity dimension), and second affordability on the individual level (price dimension) (Talukder 2005). The former aspect concerns agricultural productivity and reliance on food imports as well as on the diversification of its import partners, while the latter deals with issues related to food prices as well as their impacts on overall inflation and hence on household real income.

South Asia, as the most densely populated region in the world, has to feed one-fifth of the world's population with only 3.3 per cent of the world's land area (Rasul 2010).⁶ While major progress has been made in raising agricultural productivity the extent of productivity gains varies widely among South Asian countries. Nepal could increase cereal yield per hectare by only 28.7 per cent over the time period 1960–2010, but Pakistan could more than treble its yields over the same time. Bangladesh, India, and Maldives could all more than double their yields. However, the pace of productivity growth has slowed down or even declined recently for major food grains in Bangladesh, India, Pakistan and Nepal. For small countries such as Maldives, Nepal and Bhutan, and those which are frequently exposed to flooding and other natural disasters or have experienced periods of political unrest, conflicts and even war, such as Afghanistan, agricultural yields were extremely volatile, imposing severe threats to food security in terms of availability and self-sufficiency.

Further, increasing urbanisation, population growth, soil degradation and flooding have caused the amount of arable land per person to decrease substantially over the

same period. Whilst green revolution technologies have surely increased agricultural productivity to a remarkable degree in many South Asian countries, these technologies have also affected water, land and the environment (Rasul 2010). India has one of the most irrigation-dependent agricultures. Since the production of two major staple crops of the region, rice and wheat, is extremely water intensive, this development is worrisome (*ibid.*). The decreasing groundwater level makes irrigation more and more costly and energy intensive, which results in ever-higher levels of inputs needed, i.e. fertilisers and costly irrigation methods, to reach the same level of production, hence leading to lower profits for farmers even in times of high world prices.

Additionally, the region is estimated to be hardest hit by the impact of climate change for cereal production (von Braun 2007). This is reflected in, *inter alia*, extreme flooding in increasing frequency (Dorosh et al. 2010). For example, Pakistan experienced floods in July 2010, which left huge damage to agricultural crops and livestock, especially sugar cane, rice, vegetables, cotton and maize (wheat was less affected, as it is cultivated in the winter season) (*ibid.*).

Furthermore, it is important to emphasise that food production is failing to keep pace with population growth in the South Asian region. World Bank data show that arable land per person declined with population growth for all South Asian countries over time. Additionally, total arable land has decreased since the 1980s, due to urbanisation and environmental challenges.

Furthermore, those small economies with a heavy reliance on food imports are highly vulnerable to global price shocks as well as trade disruptions. Table 14.2 shows the import share in overall domestic supply of some of the region's essential staples as measured in daily caloric intake per person in 2007. While Pakistan, India and also Nepal are less dependent on food imports (with the exception of vegetable oils), Bangladesh, Sri Lanka and especially Maldives are heavily dependent on imports to meet their domestic food demand.

Afghanistan, as a war-torn country, though not included in Table 14.2 due to data unavailability, is known to be highly dependent on food imports, mainly wheat from Pakistan (Chabot and Dorosh 2007). Milling products make up for 4 per cent of Afghanistan's total import value already (Comtrade, Country Snapshot

Table 14.2 Import dependency for food commodities in 2007 (in percentage of imports in total domestic supply)

	Cereals (total)	Rice	Wheat	Sugar	Vegetable oils	Milk	Pulses
Bangladesh	11	2	79	87	90	11	67
India	1	0	3	0	40	0	17
Maldives	100	95	100	100	100	100	100
Nepal	5	9	0	10	81	1	4
Pakistan	1	0	1	16	65	1	30
Sri Lanka	38	5	100	95	100	77	89

Source: FAO (2007), Food Balance Sheet: selected countries (author's calculation)

2010). Although relatively self-sufficient in rice production, Nepal remains a food-deficit country and hence dependent on imports from India to smooth domestic consumption (Sanogo and Amadou 2010). The entire region is highly dependent on imports of vegetable and edible oil, which accounts for a substantial part of per capita daily caloric intake. Pakistan and Bangladesh are the biggest importers of this commodity, with edible oil imports accounting for 5 and 9 per cent of their entire import bills in 2010 respectively (Comtrade, Country Snapshot 2010).

While South Asia's strong economic growth has translated into some decline in poverty and improvement in human development, the region is still home to most of the developing world's poor, having the largest number of malnourished people in the world (World Bank 2010). With these pressing challenges, food security in terms of affordability, besides availability, is a major concern in all South Asian countries. Economies of the entire region were badly affected by the international price movements such as the food price hike observed in 2008. In particular, due to strong intra-regional trade in food and agricultural commodities, price policies taken by a few major countries at that time, that is export restrictions imposed by India and Pakistan, resulted in large spillovers into neighbouring countries with higher food prices in Bangladesh, Afghanistan, Nepal, and other South Asian countries (Dorosh 2008; Sanogo and Amadou 2010).

Further, higher prices for fuels and fertiliser squeezed profits for farmers, as discussed earlier. In countries such as India, where the agricultural sector is highly subsidised for ensuring farmers' profitability as well as food affordability for consumers, rising input costs through oil, fertiliser and energy as well as high food prices impose a dual fiscal burden. However, government intervention in food markets for preventing major famine is widely practised in other South Asian countries. Price hikes, as witnessed in 2007–08, hence pose a severe challenge to governments' fiscal positions (Dorosh 2001). For many of the smaller economies, where the government's fiscal space is low, food subsidies are not an option and global price movements hit the poorest of the population directly. Additionally, these economies are exposed to a real threat to food security by policy measures taken in times of scarcity by their larger neighbours like India and Pakistan. Bangladeshi food grain imports, for instance, rose steeply again at the time of rising prices in 2011 as the government sought to build large stocks, despite the high prices prevailing then (Asian Development Bank (ADB) 2012).

We should note that in this region an only slight increase in food prices could throw many under the poverty line and cause a turn back to less nutrition-rich food staples with accompanying health problems (ADB 2012). High and increasing import dependency would make many South Asian countries most vulnerable to global food price movements.

14.3.3 Energy security

South Asia's energy consumption per capita is the lowest in the world, but energy intensity is relatively high, though slowly decreasing (Srivastava and Misra 2007). It is true that many rural households are still relying on traditional sources such as biomass and fuel wood for everyday energy needs (heating and cooking). Bhutan,

for instance, has the highest per capita fuel wood consumption in the world and 54 per cent of Indian rural households do not have access to a electricity connection yet (*ibid.*). Providing a better and secure energy supply for the vast majority of the region's population remains a major challenge. Further, unreliable power supply is a major bottleneck for industrial sectors of South Asian countries. It is estimated that Bangladesh loses US\$1 billion annually from power supply shortages or interruptions. This results in a 0.5 per cent reduction in the country's annual GDP growth (*ibid.*). Likewise, for the Pakistani economy the lack of energy supply is a major bottleneck for its development and it is seen as the main cause for its stagnating industrial and manufacturing sector and sluggish growth performances (ADB 2012).

Given the economic importance of energy prices, many countries subsidise their energy sector highly. Hence, rising prices for energy commodities put increasing pressure on a government's budget. For Bangladesh, a report by the Asian Development Bank (ADB 2012) predicted a further increase in spending on subsidies from 2.2 per cent to 3.4 per cent of GDP in 2012. The foreign exchange reserves needed to pay for the fuel import bills are also becoming scarce for the state-owned Bangladeshi Petroleum Co-operation. With a probable increase in fuel imports by more than half in 2013, this foreign exchange has to be borrowed elsewhere in order to satisfy domestic demand. Likewise, in Pakistan, despite increases in tariffs and fuel price adjustments to global prices, customer tariffs remain below the level needed for cost recovery, and hence require government subsidies to keep the system operating (ADB 2012). Nepal also experiences pressure on its foreign currency reserves resulting from an increasing energy import bill (Srivastava and Misra 2007).

The import dependency of South Asian countries – foremost India – is likely to increase further in the future given the region's economic growth and rising needs from the construction and transportation sector as well as industry (IEA 2009). Given the high dependency of the smaller countries on only a very few trade partners for energy commodity imports, disruption and shortages in those countries put an additional threat on energy security. Further, steadily increasing oil imports together with rising oil prices put a burden on foreign currency reserves, lead to widening external deficits, rising inflation, and threaten the region's energy security.

14.3.4 Macroeconomic effects of commodity price rise

Global commodity prices in nominal terms reached an all time high in 2007 to mid-2008. For South Asia, this commodity price shock had major effects on macro economic conditions, resulting in: i) large terms-of-trade losses, ii) widening external deficits, iii) loss of foreign reserves and iv) higher inflation.

World Bank (2010) reports that terms of trade losses cumulative to May 2008 were about 9 per cent of GDP for South Asian countries on average, and this was the greatest among all developing regions. Further, the balance of payments is under strain from high commodity prices, including increased oil imports for power generation, and weakened exports. Rising subsidy costs for power supply (mainly for fuel) have also intensified fiscal pressures (ADB 2012). The external deficits widened for almost all countries except Nepal and Bangladesh over the commodity price peak due to larger

import bills causing substantial trade deficits. Pakistan's current account deficit as a ratio to GDP reached 9.6 per cent in 2008. Sri Lanka had a similar magnitude of deficit, while Maldives registered a 35 per cent ratio to GDP deficit in 2008. India's current account deficits have widened since 2005, reaching a level of 2.5 per cent as a ratio to GDP in 2008 and after a short decline increased further to more than 2.9 per cent in 2010.

Given the persistently high commodity prices and elevated volatility, South Asian countries face strong inflationary pressure. Core inflation is rising not only with food prices but also with fuel prices. India's food price inflation followed global price movements with a lag and reached an 11-year high at almost 20 per cent (year-on-year inflation rate) by the end of 2009. For rice, sugar, pulses and oil seeds – all major staples and basic food products in South Asia – the price hike was evident (World Bank 2010). As a result of its close link with its neighbouring countries in food and agricultural commodity trade, food inflation in India is spilling over to Bangladesh, Bhutan, Nepal and Sri Lanka (*ibid.*). This is especially pronounced for Nepal and Bhutan, as their currencies are pegged with the Indian Rupee and bilateral trade dependency is extremely high. Especially for smaller countries with a high dependency on imports in their domestic food supply, such as Afghanistan, Bangladesh, Bhutan, Maldives and Sri Lanka, food price inflation was significantly higher than non-food inflation at the time of the price hike in 2008 and their inflation rates closely followed world food prices.

In mid-2008, Bhutan's inflation rate peaked at 12.5 per cent, food price inflation in Maldives reached almost 30 per cent, while for Sri Lanka food inflation peaked at 40.2 per cent. Although less dependent on food imports than its smaller neighbours, for Pakistan the pass-through rate of world food prices to domestic prices was also high. Food price inflation there peaked at 34.1 per cent in mid-2008. India acted to counteract food inflation in 2007–08 by significant policy interventions such as export bans and subsidies, though inflation of fuel and energy prices could not be prevented.

While high food and agricultural commodity prices might be thought to be beneficial for farmers, poor households even in rural areas of South Asia are net buyers of food and hence strongly affected by rising food prices (World Bank 2010). Further, although producer prices were increasing, producer profits were squeezed by higher input costs. Rising input prices offset any gains in producer prices, not only for the agricultural but also for the industrial sector (Datamonitor 2011a). For example, price volatility on global markets for essential input factors like coal is an increasing burden for industry (Dutta and Mukherjee 2010). Steelmakers broke a 40-year tradition of annual pricing in favour of adopting a contract system based on a quarterly index of iron ore and coking coal prices (Datamonitor 2011b). This is probably the industry's reaction to increasing price risk induced by high price volatility. This would leave, especially steelmakers, vulnerable to significant price risk (*ibid.*).

Especially for smaller South Asian economies, highly dependent on commodity imports, the pass-through rate of global commodity prices to domestic prices is high. Such high inflation rates disproportionally affect poor and vulnerable non-poor

households (World Bank 2010). Safety net programmes and food and energy subsidies are costly, imposing an increasing fiscal burden, putting high pressure on the countries' balance of payments and causing depletion of foreign reserves.

14.4 Concluding remarks

South Asia's share in global commodity trade is still much smaller than its neighbouring regions such as East or South East Asia. Further, while several countries of the region other than India, such as Bangladesh, Bhutan, Sri Lanka and Pakistan, are significant players in global trade of food and agricultural commodities, trade in mineral and metals as well as in fuels and energy commodities is dominated by India alone. South Asia's trading in commodities are conducted with East, South East and West Asia as well as Sub-Saharan Africa more than with advanced economies such as those in North America or Europe. Furthermore, since intra-regional trade contributes to a large share of overall commodity trade in South Asia, many smaller countries in the region are heavily dependent on commodity imports and exports from India or Pakistan. Overall, given that India is by far the biggest economy in the region, it serves as an important supplier as well as market for commodity imports and exports of its neighbouring countries. At the same time, India's own reliance on its neighbouring countries for exports and imports is low, and therefore it has engaged more in trade with countries outside the South Asian region. Hence, the region's overall pattern in commodity trade with the outside world reflects largely that of India.

With the high economic growth rates as well as the environmental and demographic changes, the pattern of commodity demand and supply of South Asia has shifted dramatically. Smaller countries in the region have become heavily dependent on these larger economies' supply capacity. Hence, India's decision to re-impose export bans on rice and other staples during the commodity price peak in 2008 had major impacts on the prices and availabilities of staple foods in these smaller economies as well as on world prices of these commodities.

The high price volatility of commodity prices has posed a significant threat to the region's security of strategic commodities such as food and fuels as well as to macro economic stability. High levels and extreme volatility of commodity prices would impose severe constraints on the region's aspiration for accelerating industrialisation and sustaining economic growth, as well as its ambition to provide access to foods as basic human rights to a growing population and to achieve significant poverty reduction. Smaller countries in the region are subject to much higher vulnerability to price shocks as their pass-through rate of import prices to domestic inflation is high. They are also highly vulnerable to trade policies adopted by their larger neighbours, as their dependence on intra-regional trade for supply of basic commodities is very high. Since only a slight increase in food prices could throw both the urban and rural poor under the poverty line, high and increasing import dependency would make many South Asian countries most vulnerable to global food price movements.

With the sharp swings and continued high volatility of commodity prices affecting the course of the global economy in the new millennium, 'commodities and development'

are back on the international policy agenda. The 'revival' of interest in this topic could potentially make an important difference to the plight of low-income developing countries, especially because the commodity-related development challenges facing these countries were eclipsed by the dominant 'free trade and globalisation' agenda in international policy discussions throughout the 1980s and 1990s. At this historical juncture, we should remind ourselves that formulating appropriate policies to address the 'commodity' issues for development would require an in-depth understanding of the nature and sources of the structural vulnerability of these developing countries when they are exposed to shocks originating in world commodity markets, as either exporters or importers.

With this perspective in mind, at the country level, effective commodity sector specific development strategies should be built around realistic and practically feasible goals. These goals should be set with the overall objective of reducing the degree of exposure to shocks as well as building resilience at micro and macro levels through persistent and innovative investment in productive capacity. Hence, any commodity sector-specific interventions should be incorporated into a country's overall development strategy in improving agricultural productivity, poverty reduction and sustainability of its growth and development path. Furthermore, to be effective in fast-changing commodity markets, policy-makers would need to undertake continuous assessments and filtering of available intervention instruments in relation to prior-agreed indicators of commodity-related vulnerability with its negative feedback loop identified in a country-specific context.

We should bear in mind that market-based solutions and instruments do not necessarily provide fragile countries and fragmented producers with workable solutions to improve their competitiveness in commodity production and trade with reduced risks of exposure to huge shocks from price volatility. Greater attention should be paid to building the resilience of commodity producers and consumers through rigorous investment in sustained productivity growth and institutional capability for creating an economic base for advancing social development goals. Given South Asia's high degree of intra-regional trade in commodities, it is also important to achieve much more coherence and co-ordination in policy responses to commodity price shocks within the region.

Further, it is important to note that the continued extreme volatility of commodity prices has become a major source of instability to the world economy. The highly unstable commodity prices have also had profound impacts on the course of economic development of commodity exporting and importing developing countries alike. The instability originating from world commodity exchanges has added considerable strains and setbacks to progress in socio-economic development in low-income developing countries worldwide. The sharp price rise of strategic commodities, such as grains and fuels, hit particularly hard poor countries heavily dependent on imports of these commodities.

Because the problems associated with excessive volatility of commodity prices and the resulting income instability has global dimension and implications, there is a

strong case for coherent global policies and actions. As examined and discussed in details in Nissanke (2010, 2012), the global community should seriously consider establishing two new global facilities to address commodity-related development issues collectively: (a) innovative stabilisation schemes through *virtual* intervention to reduce large swings of commodity prices, well in excess of what could be explained in demand-supply fundamentals of individual commodities and standard macroeconomic variables; and (b) a new compensatory financing facility such as a state-contingent compensating facility as a basis for counter-cyclical macro economic demand management to mitigate the negative impacts of income instability associated with exogenous shocks such as large price swings of strategic commodities. The South Asia region could form a consensus to adopt such global measures on addressing the impacts of commodities super-cycles.

Notes

- 1 Bangladesh is the second largest when it comes to imports per kg and the United Arab Emirates when it comes to import values in US\$.
- 2 In order to assess the importance of each trading partner, total annual exports per trading partner were aggregated over the time period 2000 to 2010 and then ordered by their share.
- 3 Smelting is the pyro-metallurgical process used to produce copper metal (International Copper Supply Group 2010).
- 4 International Energy Agency definition: Crude oil comprises crude oil, natural gas liquids, refinery feedstocks, and additives as well as other hydrocarbons.
- 5 International Energy Agency definition: Oil products comprise refinery gas, ethane, liquefied petroleum gas, aviation gasoline, motor gasoline, jet fuels, kerosene, gas/diesel oil, fuel oil, naphtha, white spirit, lubricants, bitumen, paraffin waxes, petroleum coke and other oil products. The exceptions to this are those finished products which are classified as refinery feedstocks.
- 6 Naturally, the relevant share to consider here is not the world's total land area as Rasul (2010) used, but the arable land area.

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PART III. COUNTRY PERSPECTIVES OF REGIONAL CO-OPERATION

Chapter 15

Tariff and Non-tariff Barriers in South Asia Trade: A Bangladesh Perspective

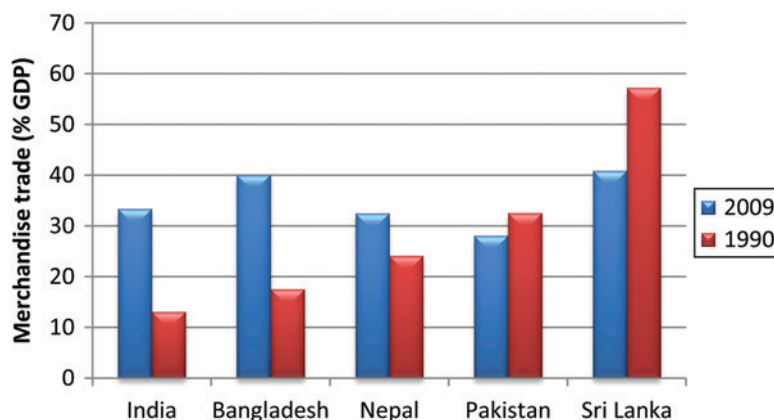
Zaidi Sattar

15.1 Introduction

Regional co-operation leading to economic integration in South Asia in the form of intra-regional trade and investment was uppermost in the minds of South Asian leaders who gathered to form the South Asian Association for Regional Cooperation (SAARC) in December 1985. Since then, top political leaders of member countries have met in summits more than 16 times. Yet, after 27 years of SAARC, 17 years of SAARC Preferential Trading Arrangement (SAPTA), and another 7 years of SAFTA, with its concomitant Trade Liberalization Programme (TLP), progress on the ground has faltered in the area of trade and investment under the regional accord umbrella.¹ This has happened despite several institutional processes having been put in place, such as periodic summits of policy-makers and officials with the objective of removing barriers to trade and investment.

This is not to say that the region as a whole was not making progress on the trade front. All the major countries of South Asia² embarked on trade reforms in the early 1990s, opening up their economies for trade and investment flows. Consequently, the volume of trade expanded significantly as is evident from the general rise in trade-GDP ratio in the countries (see Figure 15.1). South Asian countries as a group have been marching in step with the rest of the world. In the circumstances, a fair question to ask is: why has intra-South Asia trade lagged far behind the growth of the region's trade with the rest of the world. The short answer to this question is that tariff and non-tariff barriers (NTBs) to trade in the region remain substantial, which impede the growth of intra-regional trade and investment despite efforts at enhancing regional co-operation.

This chapter examines tariff and NTBs to trade in the South Asia region from the Bangladesh perspective as part of a regional effort to identify and remove existing impediments and boost intra-regional trade and investment. It will seek to explore the reasons behind the lack of progress in intra-regional trade despite the progress in trade openness, examine the veracity of some of the hypotheses that have been put forward, and then lay down a road map for greater regional integration through removing barriers to trade and increased investment in the region. The principal focus of this chapter will be on the tariff and NTBs that arguably impeded intra-regional trade in South Asia from a Bangladeshi perspective.

Figure 15.1 Merchandise trade as percentage of GDP

Source: World Bank, World Development Indicators, various years

15.2 Lack of integration hypotheses

Several hypotheses have been put forward by analysts to provide the rationale behind the lack of trade integration in the region. The major ones may be listed as follows:

- South Asia is the least integrated region of the world;
- countries in the region discriminate against their neighbours in favour of the rest of the world (RoW);
- similarity of exports of the region puts countries in competition with each other;
- there is lack of trade complementarity among the region's trading partners; and
- tariffs and NTBs are significant enough to impede the growth of trade.

Each of these hypotheses is examined in turn. The chapter concludes with some directions and suggestions for the way forward.

15.2.1 South Asia the least integrated region

South Asia lags behind other regions in economic integration for several reasons. First, high border barriers have traditionally limited all trade – political borders have become barriers to economic integration through trade and investment. For instance, trade and transport infrastructure – which was once fully integrated pre-1947 – remains largely fragmented along political borders making the smooth movement of goods and people tangibly difficult. Though the situation is improving, the region has been historically less welcoming of intra-regional foreign direct investment (FDI), a powerful integrating force in other regions. Political hostilities between India and Pakistan have curtailed officially recognised trade. The attempt in the mid-1990s to promote trade through a preferential trading agreement (SAPTA) was less successful than similar efforts in other regions in generating intra-regional trade. Though tariffs have come down in all countries, they are still high compared

with other major regions of the world (Figure 15.2), thus presenting the first barrier to economic integration. Bangladeshi tariffs sit uncomfortably on the high side, accentuating trade barriers.

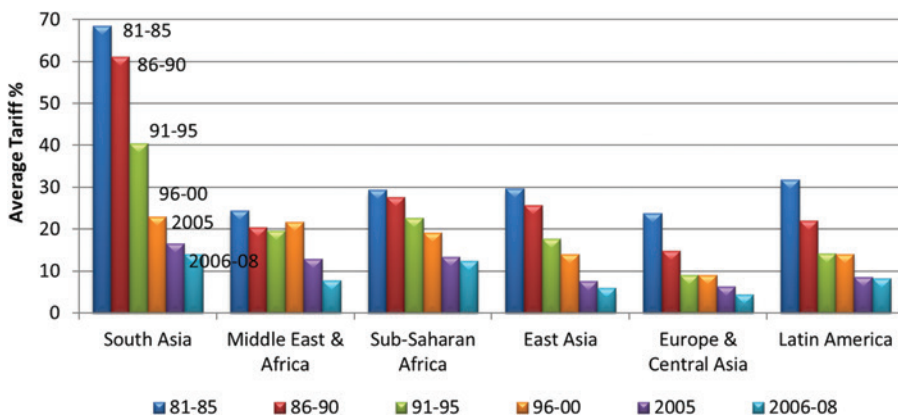
15.2.2 Countries favour trade with the RoW

Whereas the average overall trade–GDP ratio for the region is estimated to be 35 per cent, the intra-regional trade–GDP ratio works out to be less than 5 per cent, indicating a preference for trading with the rest of the world.³ The two largest economies in the South Asia region – India and Pakistan – whose potential for bilateral trade annually is estimated by businesses to be in the region of US\$10 billion, actually trade in the amount of US\$1.7 billion in 2009 officially.⁴ The fact that Pakistan continues to deny most favoured nation (MFN) status to India – a signatory to SAARC and SAFTA – and trades on the basis of a limited positive list of importables serves as the biggest barrier to growth of trade, thus weighing down the quantum of intra-regional trade.⁵ Land ports, which should have been the principal gateway for intra-regional trade, are characterised by limited cargo handling capacity. Moreover, absence of transportation throughput across borders leaves the use of sea ports as the only viable channel for trade in large volumes. Consequently, the comparative advantage of contiguity that South Asian countries have over the RoW is all but lost. As Bangladesh is nestled between the North Eastern region (NER) of India and the rest of its territory, without any transportation throughput across borders, it is a victim as well as a cause of a lack of connectivity between countries of the subregion: NER India, Bangladesh, Nepal and Bhutan.

15.2.3 Is export similarity a problem?

Export similarity among the export basket of South Asian countries has been cited by several researchers as the reason for a lack of intra-regional trade.⁶ Though all countries in the region now have a predominant share of manufacturing exports,

Figure 15.2 Average tariffs in major regions of the world



Source: World Bank, WTO, IMF various years

they compete with each other in global markets of textiles and clothing, erecting high trade barriers for these and other products in which they have export interest, resulting in minimal intra-regional trade in these products. Using data for 1999–2006, Khan (2010) shows that India and Pakistan have the highest export similarity index, which also remained practically unchanged for the entire period. Bangladesh and Nepal have much lower indices implying that they have a higher potential for exports within the region, provided tariff and NTBs are lifted and regional connectivity enhanced.

While many argue that South Asian countries export similar products to the RoW, and thus are unlikely to be trading much among themselves, then consider the case of the huge volume of trade between Europe and North America that takes place in a wide set of largely similar products – agricultural products or technologically sophisticated goods. What makes trade possible and sustained of course is the differentiation and brand sophistication even within a similar class of products. Such a stage in trade might also happen in South Asia once its exports undergo sufficient transformation from low-end to high-value products.

15.2.4 Is trade complementarity the problem?

In trying to explain the low intra-regional trade, some research makes the argument that there is a lack of complementarity in production chains within the region, quite unlike what we see in East Asia⁷, where trade in intermediate goods has now reached close to 70 per cent (Brooks and Hua 2009; Hayakawa 2007). China has indeed become the super assembler in the region, importing much of the parts and components of a wide range of electronic goods, machineries and consumer durables from other countries in East Asia, thus ensuring growth of intra-regional trade. Interestingly, China maintains a trade deficit with source countries for its intermediate inputs, yet ends up with enormous surpluses in its global trade. The strategy of creating an inter-linked production chain within East Asia in accordance with the region's comparative advantage has paid huge dividends to China as well as the component suppliers. It is this inter-linkage of supply chains and vertical integration of production that drives the high volume of intra-regional trade, something that South Asia apparently lacks, if the complementarity argument is to be believed.

But the history of intra-regional trade in South Asia reveals otherwise. At the time of partition in 1947, regional trade within South Asia accounted for 18 per cent of total trade,⁸ suggesting the existence of adequate production complementarity within the region. It follows that the emergence of political borders since then has impeded, if not significantly curtailed trade transactions within the region, by fragmenting trade and transport infrastructure networks. Political borders thus took the form of economic barriers to cross-border trade and investment resulting in a miniscule volume of intra-regional trade.

That said, a closer look at the character of goods trade between Bangladesh and its South Asian neighbours produces interesting insights into the degree of inter-linkages in production chains. An examination of imports from India at a disaggregated level reveals a high degree of intra-industry linkages: basic raw materials (17 per cent),

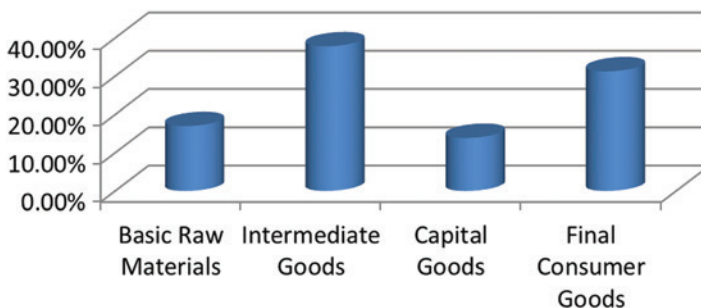
intermediate inputs (38 per cent), capital goods (14 per cent) and final consumer goods (31 per cent), for 2008–09 (Figure 15.3). This pattern remains practically unchanged for in the late 2000s. It reveals strong intra-industry linkage between India and Bangladesh where the latter's industrial sector relies heavily on inputs from India. However, there is a difference in this form of inter-industry linkage from that of East Asia. Bangladesh's major export industry – ready-made garments (RMG) – is only partly relying on Indian supplies of yarn while most of its inputs of fabric, cotton, and even yarn are sourced from China, Korea and elsewhere. So Indian inputs are essentially feeding Bangladeshi manufacturing which caters to the domestic market. As such the current flow of inputs from India is not generating the kind of jobs and income possible were these inputs going into the export-oriented sectors.

On the other hand, India's exports have been growing at an average of 15–20 per cent since the early 1990s while continuing to be significantly diversified. Given strong export–import linkages, and supporting import liberalisation, the Indian economy also experienced rapid import deepening, reaching an import–GDP ratio of 24 per cent by 2009. With Bangladesh lacking a diversified manufacturing base with little or no production of intermediate goods, Bangladesh could hardly be the supplier of intermediate inputs, parts and components to the rapidly expanding export sector of India, at least not yet. That was the case with China playing the assembler of multifarious exports whose parts and components were supplied by their East Asian neighbours. Thus, while strong intra-industry linkage between India and Bangladesh is evident, it is not of the East Asian variety that would have reversed or at least mitigated the large unfavourable trade balance that now exists for Bangladesh with India.

15.2.5 High tariffs remain as trade barriers despite SAFTA

The low levels of regional trade cannot be faulted for the dearth of efforts at the highest policy level. Top political leaders have repeatedly endorsed moves to open up respective markets with India taking the lead. These moves notwithstanding, freer trade still faces serious antithetical political economy developments in each member country. At the ground level, therefore, results are not so notable, as mind sets of

Figure 15.3 Imports from India by categories (%) fiscal year 2008–09



Source: Policy Research Institute staff estimates and NBR ASYCUDA database

business leaders and bureaucrats are still mired in the old tradition of suspicion and occasional downright resistance to opening their own markets.

Realising that South Asian countries had some of the highest tariffs globally, something that was surely hurting intra-regional trade, the leaders agreed to scale down these tariffs on an accelerated schedule under the auspices of SAFTA, though giving the least developed countries (LDCs) of the region slightly more time to adjust. As is shown in Table 15.1, India moved to the ultimate tariff range of 0–5 per cent within two years of SAFTA implementation. LDCs like Bangladesh had until 2013 to implement the reduction schedule which also has been complied with (Table 15.2). SAFTA customs duty (CD) rates are significantly below applied general rates of duty (Figure 15.4). Table 15.3 shows that, given current CD tariff slabs, Bangladesh will be in compliance of the 0–5 per cent range of CD by 2013. However, the problem, as far as Bangladesh is concerned, lies with the significant proportion of para-tariffs in

Table 15.1 SAFTA tariff reduction schedule: India

Date	Pace of Reduction
1 July 2006	33.33% MoP
1 July 2007	33.33% MoP
1 July 2008	0–5%

Note: MoP = means of production

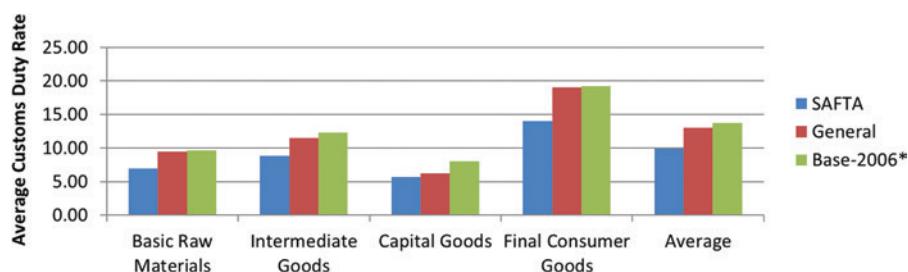
Source: SAFTA agreement

Table 15.2 SAFTA tariff reduction schedule: LDCs

Date	Pace of reduction
1 July 2006	10% MoP
31 December 2006	30% MoP
31 December 2007	30% MoP
31 December 2008	25–30% MoP
31 December 2008 up to 31 December 2012	15% MoP per year

Source: SAFTA Agreement

Figure 15.4 Bangladesh: Comparison of unweighted average SAFTA custom duties with general applied rates, fiscal year 2009–10



Source: NBR ASYCUDA database

Table 15.3 Status of Bangladesh tariffs and SAFTA reduction schedule

Tariff slabs	31 December 2006, scheduled reduction: 5% MoP	31 December 2007, scheduled reduction: 5% MoP	31 December 2008 – 31 December 2013, 0–5% ^a
25	23.75%	22.50%	4.50%
12 ^b	11.4%	10.80%	2.16%
5	4.75%	4.50%	0.90%
3	2.85%	2.70%	0.54%

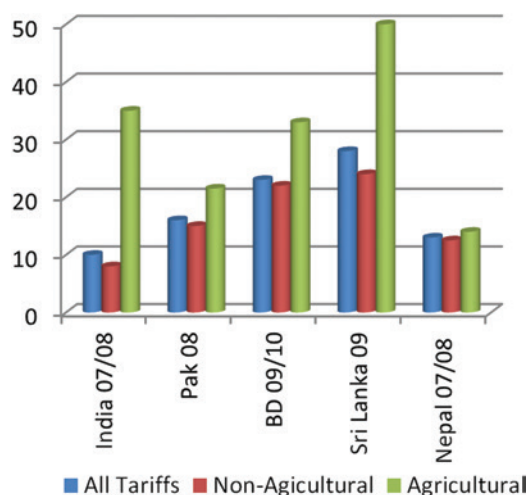
^aSubject to reductions of equal annual instalments of not less than 10% annually.

^bThe budget of fiscal year 2013–14 scaled down this slab to 10% from 12%. So the final SAFTA reduction will be affected proportionately

Source: SAFTA Agreement

its nominal tariff structure, whereas SAFTA reductions only encompass CD, leaving effective protective tariffs at relatively high levels.

Figure 15.5 summarises South Asian tariffs in the post-SAFTA period, which are lower than the pre-SAFTA tariffs. One more problem that remains is the substantial size of sensitive lists (World Bank 2010a). Though members tried hard to limit the proportion of SLs to 10 per cent, they had to reach a cap of 20 per cent of 5224 HS six-digit codes, along with rules of origin requirements that did not help matters either. That allowed a lot of scope for keeping markets restricted for most products that members produced (Table 15.4). In mapping the SLs to imports of SAFTA member countries, Weerakoon (2010) finds that some 53 per cent of South Asian imports are actually excluded from the SAFTA tariff liberalisation scheme (Table 15.5), rendering the tariff reductions largely ineffective in significantly

Figure 15.5 South Asia tariffs post-SAFTA

Sources: India and Nepal – UNCTAD TRAINS database; Pakistan, Sri Lanka – Policy Research Institute staff estimates from various country reports; Bangladesh – NBR ASYCUDA database

Table 15.4 Size of sensitive lists and rules of origin

Country	SL tariff lines	Rules of origin
India	480 LDC 865 non-LDC	CTH + 40%
Bangladesh	1,249 LDC 1,254 non-LDC	CTH + 30%
Bhutan	137	CTH + 30%
Maldives	671	CTH + 30%
Nepal	1,335	CTH + 30%
Pakistan	1,183	CTH + 40%
Sri Lanka	1,065	CTH + 35%

Note: CTH change in tariff heading, SL sensitive list

Source: SAFTA Agreement

Table 15.5 Trade impact of sensitive lists under SAFTA

	Value of imports from SAARC subject to SL (%)	Value of exports to SAARC subject to SL (%)
Bangladesh	65	22
India	38.4	56.5
Maldives	74.5	57.6
Nepal	64	46.4
Pakistan	17.2	34
Sri Lanka	51.7	47
Total	52.9	

Source: Weerakoon (2010)

boosting regional trade. The array of SLs formulated by the SAFTA members makes a classic study of the political economy of South Asian trade regimes. A remarkable confluence of protectionist mindsets among bureaucrats, policy-makers and business leaders continues to guide and influence trade policy decisions. Looking at the SLs in their totality, they practically cover the entire spectrum of goods produced by the member countries for their respective domestic markets or for exports. The exclusion mechanism of the sensitive lists therefore effectively obliterates potential competing imports from the region.

In so far as tariffs are concerned, Bangladesh is not in a good position. Prior to 2002, India had the highest average tariffs and the most restrictive trade regime in South Asia, with Sri Lanka as the most open economy. However, post-war Sri Lanka has become the most protected economy in view of heavy revenue demands coming after the end of its insurgency. Bangladesh continues to have average tariffs at relatively high levels, with para-tariffs assuming significant proportions in the nominal tariff structure (Table 15.6).

Earlier, we described the state of current Bangladesh tariffs in light of the TLP under SAFTA. It was also noted that, like other SAFTA members, Bangladesh is on track to meet the phased reduction of tariffs in accordance with the agreement. However, it

Table 15.6 Trends in nominal protection rate with customs duty and para-tariffs

Fiscal year	Avg. CD	Avg. para-tariffs	Avg. NPR	Para-tariff in NPR (%)
FY 01	21.10	7.44	28.54	26.07
FY 02	21.02	8.41	29.43	28.58
FY 03	19.91	6.51	26.42	24.64
FY 04	18.82	10.29	29.11	35.35
FY 05	16.31	10.19	26.50	38.45
FY 06	15.49	10.98	26.47	41.48
FY 07	14.85	9.42	24.27	38.81
FY 08	15.93	7.94	23.87	33.26
FY 09	13.82	6.26	20.08	31.18
FY 10	13.68	10.20	23.88	42.71
FY 11	13.52	10.16	22.11	38.94

Source: National Board of Revenue (2010)

would be premature to make an assessment of the degree of removal of tariff barriers on the basis of reduction in CD alone when Bangladesh's tariff structure comprises other levies and charges on imports in addition to CD. In order to make an assessment of the degree of trade openness created under the SAFTA umbrella, it is necessary to look at the broad structure of tariffs and their restrictive impacts on imports from the region or RoW.

In reviewing the structure of Bangladeshi tariffs, what is clear is that trends in CD alone fail to give the true picture of trade restrictiveness arising from tariff barriers, because of the existence of other levies and charges, such as supplementary duty (SD), infrastructure development surcharge (though removed in 2008), and even the supposedly trade-neutral VAT, all of which take the shape of para-tariffs. The fact is that the SAFTA TLP applies only to CDs, leaving para-tariffs out of its ambit.

A review of trends in Bangladesh's overall tariff structure, based on ex ante levels of tariffs and para-tariffs during 2001–10, reveals the actual state of affairs. Average unweighted CDs have indeed trended downwards, from 21 per cent in 2001 to 13.7 per cent in 2010. But the decline in the average nominal protection rate (NPR) appeared less steep thanks to the presence of para-tariffs which trended upwards, their share in NPR rising from 26 per cent in 2001 to 43 per cent in 2010. A closer look at the trend in para-tariffs reveals the predominance of SDs which were ostensibly levied on top of the top CD rate of 25 per cent in order to discourage imports of luxury and non-essential consumption goods. In reality, a closer examination of the range of goods subject to SDs shows that roughly 70 per cent of SDs imposed on some 1,100 tariff lines serve protective ends.⁹ To conclude, NPR trends give a better picture of the restrictiveness of Bangladeshi tariffs on imports from SAFTA countries as well as from RoW. With over 40 per cent of protection coming from para-tariffs, SAFTA tariff concessions that apply only to CD have little effect in stimulating SAFTA imports into Bangladesh. Consequently, growth of SAFTA imports has lagged behind typical growth of imports from RoW.

15.2.6 Non-tariff barriers to SAFTA trade

As far as tariffs are concerned, SAFTA TLP appears to be on track with all members complying with the agreed phased reduction in tariffs. India took early initiatives and implemented an accelerated schedule. In the previous section, we described the problem with the Bangladeshi tariff structure where the existence of significant para-tariffs undermines SAFTA tariff reductions. Nevertheless, it is fair to conclude that tariffs facing intra-regional trade are now substantially lower than existed in the late 1990s. Yet the outcome in terms of trade volumes appears minimal with little or no noticeable improvement in intra-regional trade. In the circumstances, attention has now shifted to NTBs with a chorus of complaints from members about significant NTBs faced by exporters to the region.

By far the largest number of NTB complaints has been directed against India, the largest importer and exporter of the region. These complaints range from problems with inter-state movement of imported goods to the standard World Trade Organization (WTO)-compatible rules relating to sanitary and phytosanitary (SPS) and technical barriers to trade (TBT) measures (Ratna and Sidhu 2009). Often there appears to be confusion with regard to SAFTA tariff concessions and the WTO-compliant practice of national treatment when imports into India cross state boundaries leaving SAFTA concessions at the border (Taneja and Prakash 2010). It turns out that imports are subject to the same state taxes and levies as domestically produced goods. However, it is also true that WTO-compliant rules such as SPS, TBT, anti-dumping and countervailing duties could all be stretched to serve protective ends and restrict trade. This is seen to happen in bad times such as the 2008 global economic crisis, which saw enormous growth of anti-dumping proceedings, including by India. There is ample evidence around the globe of countries manipulating WTO-compliant rules to serve protectionist ends. Such efforts tend to rise when times are bad. The challenge for SAFTA policy-makers is to ensure that member countries, while adhering to WTO-compliant regulations, do not let administrators get carried away to the point that these legitimate rules turn into trade barriers or NTBs in the region.

15.3 Potential non-tariff barriers for exports to Bangladesh

This section comments on the current status of NTBs on exports to Bangladesh.

1. Specific limitations on trade:

- (a) Sensitive list: The first NTB faced by SAFTA exporters to Bangladesh is the large sensitive list (1,245 tariff lines).
- (b) Quotas: Bangladesh has a clean slate as far as protective quantitative restrictions (QRs) are concerned, though restrictions apply for health, national security, religious or environmental grounds.
- (c) Import licensing requirements were also eliminated back in 1991.
- (d) Proportion restrictions of imported inputs in domestic goods (local content requirements) are non-existent.

2. Customs and administrative entry procedures:

- (a) Valuation system: Though Bangladesh is a signatory to the WTO Agreement on Valuation, which stipulates duty assessment on the basis of normal values (typically invoice values of imports), the customs administration is generally suspicious of invoice values and tends to impose its own valuation criteria. Pre-shipment inspection (PSI) certification of a clean report of findings (CRF), now covering some 50 per cent of tariff lines, usually averts any valuation hassles. Typically, imports from South Asian countries are valued at an average of 5 per cent above invoice values for assessment purposes. Disputes over valuation could delay import clearance unless the importer chooses to go along with the customs assessment of value.
- (b) Though all SAFTA members follow World Customs Organization (WCO) classification standards of HS six-digit codes, at the eight-digit national classification in Bangladesh, some classification disputes arise due to discrepancies between SAFTA notification and Bangladesh Customs Tariff.
- (c) For a number of tariff lines with bulk imports (e.g. sugar), tariff values are assigned which amounts to arbitrary fixation of value.
- (d) Anti-dumping practices: this could assume the role of an NTB but Bangladesh has not instituted any anti-dumping proceedings so far, though the requisite act exists.
- (e) Documentation requirements: Bangladesh has adopted United Nations Conference on Trade and Development (UNCTAD)'s import-export clearance package, ASYCUDA++ (Automated System for Customs Data), which does help rapid clearance. There is plenty of scope to improve electronic clearance of customs cargo with greater utilisation of ASYCUDA capacity with the imminent installation of the next version, ASYCUDA World.

3. Standards – SPS and TBT:

- (a) Lack of harmonisation of standards creates hurdles for cargo clearance.
- (b) Bangladesh Standards and Testing Institution (BSTI) is not recognised for its efficiency and competence in performing an acceptable job of testing and certification and lacks regional or international recognition. Intergovernmental acceptances of testing methods and standards can improve the situation. Efforts are under way to raise the capacity of BSTI.
- (c) Packaging, labelling and marking: These TBT requirements are being applied universally. Improvements in Bangladesh's domestic market on these aspects of product marketing will ensure minimal hassles for cross-border trade.

4. Para-tariffs:

- (a) Supplementary duties (SDs): Bangladesh applies supplementary duties on the top rate of CD (25 per cent) for a wide range of consumer products – 1,100 tariff lines. Though originally conceived as a trade-neutral tax to ostensibly discourage import of luxury and non-essential goods, SD has,

over the years taken the form of a protective para-tariff that restricts competing imports.

- (b) Variable levies: a number of variable levies exist, such as advance trade VAT (ATV) of 2.5 per cent, and advance income tax (AIT), and a 1 per cent administrative fee levied as a landed charge. An across-the-board infrastructure development surcharge (IDSC) was removed in 2008.

5. Others:

- (a) Restricting imports through land borders, partly on grounds of capacity limitation and partly to restrict imports (Table 15.7). The restriction is implemented through the framing of a positive and/or negative list.

Table 15.7 Restrictions on imports via land ports

Land port (tax stations)	Importable Goods	
	Positive list	Negative list
Benapole Jakiganj	All other importable goods Livestock, fries, fresh fruits, plant, seed, wheat, stone and boulders, coal, chemical fertiliser, china clay, wood, timber, onion, chilli, garlic, ginger, quartz, ball clay, dry fish, limestones and those goods that satisfy the rules and regulations of the circular posted by ERD on 19 September 2002, SRO 255-law/2002/1973/tax by maintaining the quality of the good, amount, price and tax classification certified	Milk powder and yarn Fish, yarn, milk powder, sugar, potato (HS code 0701.90.19 and 0701.90.29)
Hilly	All other importable goods	9) Duplex board, newsprint, craft paper, cigarette paper, all kinds of paper and paper board, yarn, milk powder, juice, tobacco
Dorshona	Livestock, fries, fresh fruits, plant, seed, wheat, stone and boulders, coal, chemical fertiliser, china clay, wood, timber, onion, chilli, garlic, ginger, quartz, rice corn, poultry feed, ball clay limestone	Fish, yarn, milk powder, sugar, potato (HS code 0701.90.19 and 0701.90.29)
Shona Masjid	All other importable goods	Duplex board, newsprint, craft paper, cigarette paper, all kinds of paper and paper board, yarn, milk powder, juice, tobacco

Source: NBR

- (b) Customs administration in Bangladesh has some way to go before it is able to take full advantage of available IT capacities. Bangladesh ranks poorly in terms of days taken for import clearance (Ahmed et al. 2010), thanks to procedural inefficiencies or corruption in customs administration, which becomes an NTB.
- (c) Inadequate port infrastructure (land and sea ports) could pose serious problems for handling import–export cargo. Lack of warehousing and testing facilities at land ports are problems.
- (d) Rules of origin requirements, if made too stringent, could pose as NTBs as well. Together, these conditions, (a–d), could severely impede trade facilitation.

15.4 SAFTA, regional trade and Bangladesh

Post-war developments of the world economy showed the potential of trade as an engine of growth and a catalyst for improving living standards across the globe. With that record before them, South Asian leaders saw the need for stimulating trade in the region as a way to prop up their own growth performance and reduce poverty. When the 1995 preferential trading agreement, SAPTA, failed to stimulate regional trade, SAARC member countries agreed to forge deeper liberalisation of their trade regimes for one another in the hope that this would eventually foster greater intra-regional trade. The signing of SAFTA in 2006 brought about deeper tariff cuts but intra-regional trade still shows no sign of a pickup. In 2009, while the South Asia region recorded total trade volume of US\$350 billion, intra-regional trade at US\$10.5 billion was barely 3 per cent.

Just as more trade has been good for the world economy and its standards of living, so also is expansion of regional trade expected to accelerate growth in South Asia and reduce poverty. Why is SAFTA not yielding results? What more can be done within or outside the SAFTA regime that will remove barriers to trade further and augment trade volumes in the region?

From the Bangladesh perspective, the key rationale behind its membership of an regional trade agreement (RTA) lies in the opening of markets. The largest market of course is that of India, but other regional markets are no less important to a country whose domestic market is far too limited to create jobs for the millions joining the labour force every year. SAFTA does provide preferential access to these markets but, as we have seen earlier, NTBs and sensitive lists remain major impediments to the smooth access to markets for competitive exports from Bangladesh. Its primary export – RMG – is included on the sensitive list of all SAFTA partners thus robbing it of significant immediate economic benefits from an RTA like SAFTA. It proves the point that preferential arrangements are not enough to open markets if such arrangements are riddled with provisos that render them quite ineffectual.

That said it is also important to reflect on the fact that the largest potential market – India – has reduced tariffs to internationally competitive levels thus opening up its own market for stiff international competition, particularly in manufacturing. To take

advantage of this openness along with SAFTA concessions, Bangladesh has to come up with items of non-traditional exports that are internationally competitive. This is where Bangladesh's own trade regime does not help. First, Bangladesh's manufacturing is dominated by the production of final consumer goods which are produced under high tariff protection not geared to facing stiff international competition. Second, the domestic incentive structure is heavily biased in favour of final consumer goods with little practical support for the intermediate goods industry that is yet to emerge. If the East Asian model of production chain segregation across diffused regional networks is to be emulated, one particular configuration would see a South Asian hub and spoke system taking India (in place of China) as the chief assembler for global markets with SAFTA members supplying inputs, parts and components. This means that for Bangladesh the current dependence on India for manufacturing inputs needs to be reversed, something that will take time. Yet this interpretation of SAFTA market access presents a different perspective as well as a challenge for right positioning of Bangladesh's manufacturing sector to take advantage of regional preferences. This is not to say that Bangladesh should be ignoring further development of a competitive consumer goods sector but that policy needs to be geared to develop backward linkages to the existing manufacturing industries.

15.5 Making SAFTA effective in South Asia

For all its shortcomings, SAFTA is a trading arrangement that can deliver benefits to its members depending on what they put into it. At least five key challenges need to be addressed to make SAFTA yield results:

- *Sensitive lists.* For one, the sensitive list ought to be phased out if trade augmentation is to become reality. Just like the tariff reduction schedule, a phased elimination of sensitive lists should be formally agreed to and made binding upon members. With perhaps the longest sensitive list, Bangladesh has a long way to go. Perhaps this is where Bangladeshi policy-makers face the most formidable political economy challenge. But not dealing with it makes a mockery of the intent to foster regional trade. Bangladesh's sensitive list covers almost all manufactured consumer products assembled in the country. To shield them from regional competition, as is done for RoW, will not make these products competitive in the long run, globally or regionally.
- *Trade diversion costs.* Benefits of SAFTA will depend on whether it is trade creating. If trade diversion costs outweigh any trade creation, negative welfare outcomes will follow. On this score, Bangladesh is in a bind. The existence of high tariffs exacerbate trade diversion costs as preferences are biased in favour of high cost imports from PTA members. Since China and India are the two largest sources of Bangladesh imports, China's exclusion from SAFTA raises the likelihood of high trade diversion costs. These costs can be minimised only through unilateral tariff reductions.
- *Behind-the-border issues.* So far the SAFTA agreement has not focused much attention on several behind-the-border issues that impede if not restrict intra-regional trade. Trade and transport infrastructure – ports, rail and road links,

waterways, transport throughput, connectivity – could facilitate trade and significantly augment trade volumes in the region if managed to create seamless movement of goods within the regional trading arrangement. More attention is needed to improve the payments mechanism for trade in the region. Banking and financing arrangements need to be modernised in order to speed up payment for goods and services in intra-regional trade. This applies to Bangladesh as well as its SAFTA partners.

- *Services and investment.* It has been argued by most researchers on South Asia trade that an important complement to goods trade that is missing under SAFTA is the scope of cross-border investment. Investment regimes in member countries are still riddled with significant restrictions on movement of capital and on sectors open to investment. These restrictions have to be ironed out to make intra-regional investment profitable without limits on profit repatriation. Moreover, as another complement, the focus has to shift beyond trade in goods and on to services – e.g. health, education, finance, tourism.
- *Trade facilitation.* One common problem that South Asia encounters in trade originates from the customs administration which, for all countries, is still geared to the collection of revenue. Trade facilitation is still far from the minds of customs officials whose primary objective is to maximize revenue collection at the border. Such an objective is clearly at odds with the need for trade facilitation that can augment intra-regional trade. It is for this reason that in the component, ‘Trading Across Borders’, World Bank’s Doing Business report shows poor scores for most South Asian countries.¹⁰ Nevertheless, improvements in the time taken for customs clearance are expected as customs administration in all countries move into the electronic environment with post-clearance audits becoming the norm. Bangladesh needs to consider unilateral or joint actions to make a mark on trade facilitation. Steps that may be considered in the future include (a) one-stop border posts with single customs declaration and unified or border crossing processes, (b) harmonisation of transit charges, (c) throughput across borders, with door-to-door delivery of cargo in the offing, regional carriers’ licences, and regionally valid insurance, and (d) steps towards greater connectivity via road, rail and air transportation of cargo and people. Finally, there is no question that trade can be amply facilitated with the simplification of visa and travel rules to facilitate the movement of people.

15.6 The way forward

Overall, the regional effort at trade augmentation through the auspices of SAPTA (1995) and SAFTA (2006) has not produced tangible results so far. This chapter has shown that tariff and NTBs are still significant though India has done its part in substantially scaling down its tariffs during the late 2000s. Bangladesh remains a laggard in this respect when it comes to its multilateral tariff stance. Though technically it is in compliance with SAFTA schedules, the existence of para-tariffs in its tariff structure mars the progress made in terms of CD reduction. Yet, perhaps

the one factor that hits the SAFTA initiative the hardest is the combined coverage of sensitive lists of all members which, as one estimate shows, preclude some 53 per cent of regional imports from taking advantage of SAFTA concessions. Strong protectionist undercurrents among business leaders and policy-makers alike play a key role in bolstering the political economy or formulating and sustaining large sensitive lists thus undermining efforts at meaningful trade openness for intra-South Asia trade.

Yet all cannot be lost on the regional trade front as globalised production and supply chains take hold across the globe. With regard to tariffs, members should continue bringing down tariff peaks unilaterally, providing impetus to their own trade openness on an MFN basis while embedding regional policies in their overall trade strategy. In modernising customs administration with strong IT capacities, the goal should be to shift the focus of customs from revenue collection to trade facilitation in a co-operative venture among members. This is likely to happen as revenue authorities shift their emphasis from reliance on trade taxes to internal domestic taxes – the way of the future is revenue mobilisation.

Opening up trade in services – banking and finance, tourism, health and education – ought to be made an integral part of the SAFTA trade liberalisation process. The scope in this area is vast, as is the potential for cross-border investment that could be the catalyst for cementing inter-industry linkages within a South Asian framework of ‘fragmented agglomeration’ of production in the future, something akin to the highly successful inter-industry linkage forged in East Asia. The strategic policy choice needed for this to happen is keeping rules of origin simple and aspirations for investment protocol limited.

Given that the common dominant theme of national policies in the region is to accelerate growth and reduce poverty, boosting intra-regional trade could be an integral part of that strategy, which gives SAFTA the sound basis for more tangible results in the future than has been observed in the past.

Notes

- 1 This is despite the fact that the much of the tariff-reduction scheme and scaling down of sensitive lists under the TLP has been on track.
- 2 Sri Lanka was the first among South Asian countries to embark on substantial trade liberalisation at the close of the 1970s.
- 3 Indeed, a World Bank (2004) study on South Asia trade famously concluded that South Asian countries tended to discriminate against regional neighbours in favor of the RoW.
- 4 United Nations Commodity Trade Statistics.
- 5 A joint statement in 2012 had set December 2012 as the date by which Pakistan was to grant MFN status to India. That has not happened as of June 2013.
- 6 The latest report from Mahbub-Ul-Haq Human Development Center, ‘Human Development in South Asia 2009’, cites ‘high export similarity’ as a reason for untapped potential for intra-regional trade in South Asia.
- 7 Athukorala and Yamashita (2007); Feenstra (1998); Dobson and Yeu (1997).
- 8 World Bank (2004).
- 9 ‘Structure of Tariffs and Rationalization’ (2010), unpublished report, NBR.
- 10 Bangladesh ranks 119 among 184 countries in the latest Doing Business Report 2013.

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Chapter 16

Tariff and Non-tariff Barriers to Trade in South Asia: An Indian Perspective

Nisha Taneja, Shravani Prakash and Samridhi Bimal

16.1 Introduction

India is the largest economy in the South Asian region accounting for more than 80 per cent of South Asia's GDP. More than 90 per cent of the regional trade of Bangladesh, Nepal and Sri Lanka as well as a major part of their global trade is with India. Trade among the remaining South Asian countries is much smaller than India's trade with any of its South Asian partners. Owing to its central geographical location in the region, India is also at the helm of all regional trade facilitation and transit issues. The pace and direction of economic integration in South Asia, therefore, is largely a function of India's relations with the other economies of the region.

India strengthened its bilateral links with its neighbours by signing free trade agreements (FTAs) with Nepal, Bhutan and Sri Lanka and a preferential trade agreement with Afghanistan. In 2006, India, along with Bangladesh, Bhutan, Maldives, Nepal, Pakistan and Sri Lanka, signed the South Asian Free Trade Area (SAFTA) agreement under the aegis of the South Asian Association for Regional Cooperation (SAARC) (Afghanistan was included as a member in 2007). The main element of the agreement was a reduction in tariffs by all members under a Trade Liberalization programme (TLP), except on items that are included in the members' sensitive lists. Members also agreed to the elimination of para-tariffs and non-tariff barriers and the adoption of trade facilitation measures to remove barriers to the cross-border movement of goods.

India has taken several measures, both bilaterally and under the ambit of SAFTA, to facilitate trade in the region. A number of initiatives have been implemented to liberalise the tariff regimes facing imports from South Asia and to address non-tariff barriers and transport impediments. However, intra-SAARC trade continues to be very low (at about 5% of the region's total trade) and India's imports from the rest of South Asia are less than 1 per cent of its total imports. This is largely due to the high transaction costs incurred while moving goods across the borders in the region. The strained relations between India and Pakistan, the two largest economies in the region, have also prevented fruitful implementation of major trade facilitating measures in the region. In 2011, however, Pakistan took the decision to grant most favoured nation (MFN) status to India (GoI 2011a). Until then, Pakistan permitted imports from India only in a limited number of items referred to as the 'positive list'. In March 2012, Pakistan shifted to a small 'negative' list of 1,209 items that were not permitted into India, giving a new lease of life to India–Pakistan trade relations and

to the SAFTA process (Tuteja 2012). In this changed scenario, further efforts by India would benefit the regional trade integration process more than before. South Asian trade integration needs to be pursued with a greater degree of conviction as trade complementarities exist in both trade in goods and services (Das 2009).

This chapter examines India's trade trends with its major trading partners in SAARC, its role in the South Asian trade integration, the ground covered so far and the challenges that remain in the areas of tariff liberalisation, non-tariff barriers, transport and connectivity, and inter-country transit. Based on the analysis, the chapter draws a roadmap to prioritise India's agenda for future regional integration.

16.2 Trends in trade

India's trade with its major South Asia partners – Pakistan, Bangladesh, Nepal and Sri Lanka – increased sixfold during 2000–01 and 2011–12 (Table 16.1). In 2000–01, Bangladesh was India's largest trading partner accounting for 43 per cent of India's total trade with its South Asia partners. In 2011–12, Sri Lanka became the largest trading partner accounting for 35 per cent. India has had a trade surplus with all its partners except with Nepal in 2000–01. However, the trade balance ratio has improved in favour of Sri Lanka and Bangladesh and worsened for Pakistan and Nepal.

Data at the two-digit level of classification of the Harmonized System (HS) shows that vehicles and their parts constitute India's top five export items for Bangladesh, Nepal and Sri Lanka (Table 16.2). Also, cotton is an important export item to Pakistan, Bangladesh and Sri Lanka. Residues and waste from the food industries, largely in the form of animal fodder, is a common top export item to both Pakistan and Bangladesh.

However, the product composition for imports shows that only mineral fuels and oils, fruits and nuts are common top items that India imports from Pakistan and Bangladesh as against other SAARC partners (Table 16.3). In the category of beverages etc. sweetened flavour waters have been imported from both Nepal and Sri Lanka.

16.3 Liberalisation of tariffs under SAFTA and India's bilateral FTAs

In line with SAFTA provisions, India offered tariff concessions separately to least developed countries (LDCs) and non-LDCs (NLDCs). India also maintained separate rules of origin and sensitive lists for these two groups of countries. However, concessions offered to NLDCs are applicable only to Pakistan, since India has an FTA with Sri Lanka, and any concessions applicable to LDCs are applicable only to Bangladesh, since it is the only LDC member under SAFTA with which India does not have an FTA. (Maldives is too small and accounts for only 0.1 per cent of the GDP of SAARC member countries.)

Thus, from India's standpoint, all tariff liberalisation efforts with SAARC members are done bilaterally. The negotiations with Sri Lanka, Nepal and Afghanistan take place under the respective bilateral trade agreements. With Pakistan, the tariff negotiations

Table 16.1 India's trade with SAARC members in 2000-01 and 2011-12 (US\$ million)

	Pakistan		Bangladesh		Nepal		Sri Lanka	
	2000-01	2011-12	2000-01	2011-12	2000-01	2011-12	2000-01	2011-12
Exports(X)	186.8	1,541.6	935.0	3,789.2	140.8	2,721.6	640.1	4,378.8
Imports(M)	64.0	401.2	80.5	584.6	255.1	550.0	45.0	720.9
Trade balance (X-M)	122.8	1,140.4	854.5	3,204.6	-114.2	2,171.6	595.1	3,657.9
Total trade (X+M)	250.9	1,942.7	1,015.6	4,373.8	395.9	3,271.5	685.2	5,099.7
Trade balance ratio $(X-M)/(X+M)*100$	49.0%	58.7%	84.1%	73.3%	-28.9%	66.4%	86.9%	71.7%

Source: Directorate General of Foreign Trade, Ministry of Commerce and Industry, Government of India

Table 16.2 India's top five exports to SAARC members in 2011–12 (US\$ million)

Product code	Product description	Pakistan	Bangladesh	Nepal	Sri Lanka
89	Ships, boats and floating structure				269.4
87	Vehicles and parts, and accessories		320.7	133.0	1,015.4
72	Iron and steel			305.5	
52	Cotton	87.1	1,076.7		238.3
30	Pharmaceutical products			108.0	
29	Organic chemicals	290.2			
27	Mineral fuels and oils			1,009.4	566.3
25	Salt, sulphur, lime, cement, etc.			75.6	
23	Residues and waste from the food industries	197.2	208.3		
17	Sugars and sugar confectionery		171.5		302.4
10	Cereals		267.0		
9	Coffee, tea, matt and spices	103.7			
7	Edible vegetables and certain roots	146.4			

Source: Directorate General of Foreign Trade, Ministry of Commerce and Industry, Government of India

are done under SAFTA for NLDCs, and with Bangladesh these take place under SAFTA for LDCs. The following sections examine the tariffs and sensitive lists that govern India's trade with each of its major trading partners in SAARC: Pakistan, Sri Lanka, Bangladesh and Nepal.

16.3.1 India–Pakistan

Under the TLP in SAFTA, India had committed to reduce tariffs to 20 per cent in the first two years and further to the 0–5 per cent range by 2013. LDC members are required to bring their tariffs down to the comparable level (0–5%) by 2016. However, India's sensitive list for NLDCs continues to be quite large (even though it was reduced to 614 items in 2012 from 868 items in 2006), especially when compared to that maintained by India for LDCs under SAFTA and under a bilateral trade agreement with Sri Lanka. Taneja et al. (2011a, b, c) suggest a methodology to prune India's sensitive list. Several items on the sensitive list are not exported by Pakistan and are unlikely to be exported to India in the near future. These, therefore, should be eliminated. India also has several items on the sensitive list, which are no longer reserved for the small-scale sector and can now be manufactured by large firms. Hence, there is no rationale for keeping these items on the sensitive list. The items on the sensitive list should include only those items in which Pakistan is competitive in the international market and India is not, as these are items where India is likely to

Table 16.3 India's top five imports from SAARC members in 2011–12 (US\$ million)

Product code	Product description	Pakistan	Bangladesh	Nepal	Sri Lanka
89	Ships, boats and floating structure				54.9
85	Electrical machinery and equipment				47.9
84	Machinery and mechanical appliances and parts thereof				42.1
72	Iron and steel			101.9	
71	Natural or cultured pearls, precious or semiprecious stones	34.6			
63	Made up textile articles		68.4		
55	Synthetic staple fibres			62.0	
53	Other vegetable textile fibres		145.3		
52	Cotton	58.2			
39	Plastics and articles thereof			61.7	
27	Mineral fuels and oils	23.1	17.3		
26	Ores, slag and ash				75.9
25	Salt, sulphur, lime, cement, etc.	55.0			
22	Beverages, spirits and vinegar			29.5	46.0
9	Coffee, tea, matt and spices			50.3	
8	Edible fruit and nuts	81.3	41.6		
3	Fish and crustaceans		75.2		

Source: Directorate General of Foreign Trade, Ministry of Commerce and Industry, Government of India

face competition. Taneja et al. (2011a, b, c) paired revealed comparative advantage (RCA) for items on India's sensitive list and identified those items where India's RCA is less than unity and Pakistan's is greater than unity for inclusion in the sensitive list. It indicated that India could prune its sensitive list to just 67 items. Of these items, 20 are textile products and ready-made garments. India has allowed duty-free access to all other South Asian countries in the region. India, therefore, should remove products in the textiles sector from the sensitive list. The remaining items on the list include vegetable products, fish and natural honey, metal and mineral products, and footwear items.

Another measure regarding specific duties imposed by India has drawn criticism from the other SAARC members. India is the only country in SAARC that imposes specific duties. Specific duties are a sum assessed on an article without reference to its value. Tariffs on the other hand are levied on an *ad valorem* (value) basis. Since the higher of the amount calculated using the *ad valorem* rate or specific amount is levied, in most cases the specific sum levied far exceeds the duty assessed as a

proportion of the value of the product. Most of the specific duties are levied on textile products and imports of these items, therefore, become unduly expensive. In July 2008, India removed specific duties on 144 items for NLDCs.¹ Thus, specific duties remain only on items on the sensitive list as these items are subjected to MFN tariffs.² In the sensitive list of 614 items, 182 are in the textiles category. Of these, 62 items continue to face specific duties. Removal of specific duties is an exclusive privilege that India has offered only to SAARC countries to improve their market access into India.

Bilaterally, India and Pakistan did not have normal trade relations for several years. As Pakistan is in the process of granting MFN status to India, key issues that remain to be addressed include phasing out the negative list of 1,209 items and removing the current restriction on road-based trade whereby only 137 items are permitted to be imported into Pakistan from India. In the roadmap for the future laid down in the 7th Round of Talks between Commerce Secretaries of the two countries, it was decided that following phasing out of the negative list and removal of restrictions on items traded by road, India would bring down its SAFTA sensitive list to 100 tariff lines by April 2013 and Pakistan would simultaneously announce transition dates to bring down its SAFTA sensitive list to 100 tariff lines (from an existing 936 items) within the next five years (Sidhartha and Deshpande 2012).

16.3.2 India–Bangladesh

Under SAFTA, India committed to reduce its tariffs to 20 per cent for LDCs in two years after the commencement of SAFTA and, in the second phase, reduce further to 0–5 per cent in the next five years. India removed all duties for LDCs in December 2007, ahead of the time stipulated under the tariff liberalisation programme for NLDCs (Sawhney and Taneja 2007). Another significant measure taken by India was the removal of specific duties in 2007 ahead of the removal of these duties for NLDCs.

Tremendous progress has been made on tariff concessions offered to LDCs by India under SAFTA to allow them increased market access to the Indian market. Bangladesh has been the biggest beneficiary of the reduction in India's sensitive list from 744 items in 2006 to 25 items from 2012. The original sensitive list had included 158 apparel products, which form the major part of Bangladesh's global exports. To give greater benefits to Bangladesh's textile exports, in 2008, India introduced a provision allowing 164 textile items from Bangladesh to enter its market at zero duty up to a maximum of 8 million pieces per year. This was done ahead of concessions that India offered to all LDCs in October 2008, and meant that the operational LDC sensitive list for Bangladesh excluded all textile products making it much smaller than the official number of 480 items. The limit was increased further to 10 million pieces in April 2011. The agreement required the garment products to be exported by 31 December every year to meet the target. Bangladesh further benefitted when, following Prime Minister Manmohan Singh's visit to Dhaka, 61 items on India's sensitive list for LDCs were allowed duty-free access without any quota restrictions, including 46 items from the textiles category (Taneja and Kaushal 2011). This effectively meant that India removed all 46 lines, which were of interest to Bangladesh, from India's negative list

for LDCs, reducing the applicable duty rate to zero without any quota restrictions. In November 2011, India reduced the sensitive list for LDC countries to just 25 items (tobacco and alcohol), with zero tariffs on all remaining items (GoI 2011b).

16.3.3 India–Nepal

Indo–Nepal economic relations have been governed by the bilateral treaties of Trade and Transit and Agreement for Co-operation to Control Unauthorised Trade signed in 1971, 1978, 1996, 2002 and 2009. The rules of origin criteria have played an important role in determining the course of Indo–Nepal trade. The 1971 treaty allowed duty-free access to items manufactured in Nepal, provided they used 90 per cent Nepalese/Indian material content for export to India. This requirement was subsequently reduced to 50 per cent in 1993. The Indo–Nepal trade treaty of 1996 was a landmark in Indo–Nepal bilateral trade, as India provided duty-free access to all products manufactured in Nepal on the basis of a certificate of origin issued by the Nepali authorities with no minimum requirement of domestic value addition (Mukherjee 2010). Only three products were on the sensitive list – alcoholic liqueurs; perfumes and cosmetics; and cigarettes and tobacco. The 2002 treaty re-introduced the value addition norm of 30 per cent with an additional requirement of a change in classification at the four-digit level of the Harmonized Commodities Description and Coding System (HS) to qualify for preferential access to the Indian market. A tariff rate quota was imposed on four items (vegetable ghee, acrylic yarn, copper products and zinc oxide), under which duty-free access was allowed only up to a specified limit. In the 2009 treaty, the tariff rate quota for copper products was increased by 2,500 metric tons.

The most liberal trade agreement between the two countries was agreed upon in 1996, when no value-added criteria were required for Nepalese products to qualify for tariff concessions on entry into the Indian market. During 1995–96 and 2001–02 there was a surge in imports from Nepal which was accounted for by four major products: vegetable ghee, copper products, acrylic yarn and zinc oxide. The main raw materials required for these products were palm oil for vegetable ghee, copper scrap for copper products, acrylic fibre for acrylic yarn, and zinc ingots for zinc oxide. Nepal's trade with India in these products thrived because it was able to benefit from: (i) the low duties that Nepal imposed on raw material import compared to the prevailing tariffs on raw materials in India; and (ii) zero tariffs offered on all products imported from Nepal by India under the Indo–Nepal FTA. However, India reduced duties steadily on these imports from all countries as part of its reform process. As a result, the gains for Nepal from tariff arbitrage diminished over time and exports of these items also declined. In fact, Nepal's utilisation of the quotas on these products remained largely unutilised (Taneja et al. 2011a, b, c).

16.3.4 India–Sri Lanka

India and Sri Lanka signed an FTA in 2000, six years ahead of the signing of SAFTA. The India–Sri Lanka FTA stipulated that India reduced tariffs to zero in a period of three years and Sri Lanka in eight years. India, however, imposed a tariff quota on garments (8 million pieces) and tea (15 million kg) and specified ports of entry for

these items to qualify for preferential tariffs. India also added the condition that Sri Lanka would have to source fabric for 6 of the 8 million pieces of apparel articles from India to qualify for the preferential tariff (Sarvananthan et al. 2003).

In some cases, Sri Lankan exporters found it difficult to meet the rules of origin criteria. The rules of origin (RoO) requirement of a 35 per cent local value addition for blended tea and a 25 per cent local value addition for blended tea with Indian tea were very restrictive. As a result, less than 1 per cent of Ceylon tea entered the Indian market, amounting to a mere 2.7 per cent utilisation of Sri Lanka's quota limit under the FTA (Deshal de Mel 2010). Tea exports also suffered because of port restrictions. The removal of sourcing requirement in 2008 and the removal of port restrictions in 2007 have played a vital role in increasing exports of ready-made garments to India.

One of the most contentious issues raised by Sri Lanka has been the large sensitive lists maintained by India (Weerakoon and Thennakoon 2008). India's sensitive list under the India–Sri Lanka FTA consists of 431 items. In 2008, India allowed duty-free import of 216 garment items up to a limit of 8 million pieces in the bilateral sensitive list, thereby reducing the operational sensitive list to 215 items.

Even though the India–Sri Lanka FTA does not have any provision for reducing the sensitive lists, given India's asymmetric size in the region it should consider rationalising its sensitive list. Taneja et al. (2011a, b, c) suggest that only those items in which Sri Lanka is competitive in the international market and India is not should be on the sensitive list, as these are items where India is likely to face competition. Based on these criteria, only nine items should be retained on the sensitive list.³ These include coconut, paper and seven items made of rubber.

16.4 Non-tariff barriers

In addition to tariffs, the SAFTA agreement contains provisions to address non-tariff, para-tariff and direct trade measures. Under the aegis of SAFTA, a committee of experts (COE) was formed to monitor, review and facilitate implementation of the agreement. Under the COE, a sub-group looked into problems related to non-tariff measures (NTMs) and para-tariff measures (PTMs) faced by member countries while entering into each other's territory. Pakistan, Bangladesh and Nepal notified to this committee 50 NTMs/PTMs that they faced in accessing the Indian market. Pakistan notified the maximum number of NTMs/PTMs (31), while Bangladesh and Nepal notified 14 each (Taneja et al. 2009). The notified NTMs relate to technical barriers to trade (TBT) and sanitary and phytosanitary (SPS) measures, cumbersome procedures, licences and quotas, para-tariff measures, infrastructure constraints, interstate movement of goods and other NTMs (related to valuation, trading through state enterprises and anti-dumping measures).

An analysis of the NTMs notified against India shows that some of these NTMs did not pose any barrier to entry, as they are applicable to both imports and to domestically manufactured goods and hence in accordance with the principle of national treatment. There are also some other measures where India has already initiated corrective

action but where information on such action had not yet been made available to other countries. For instance, Pakistan and Bangladesh notified that a labelling requirement under the Jute and Jute Textiles Control Order of 2000, which stipulated that each and every imported jute bag must show the 'country of origin', discouraged imports as bags carrying such labelling could not be used for packing goods made in India since the label would appear to suggest that the goods contained in the bag were made in Bangladesh. The marking requirement was amended in 2002 to direct that every jute bag must be marked 'bag made in – country of origin'. However, despite this amendment, Pakistan and Bangladesh had notified that the control order of 2000 was a barrier for exporters (Taneja et al. 2011c). Similarly, amendments of clauses in the Indian Customs Act relating to valuation that were inconsistent with GATT Article VII were made in 2007, yet Pakistan notified this measure as a barrier to the COE indicating a lack of awareness about the amended act.

Only 19 of the 50 notified NTMs were found to impose trade barriers. These included some TBT and SPS measures whose implementation involves cumbersome procedures, either because of involvement of multiple agencies or due to excessive formalities that increase the time and cost of trading considerably. Some TBT and SPS requirements pose as barriers due to inadequate testing facilities at ports that often lead to delays and additional costs because samples have to be sent to distant locations for testing. The absence of testing facilities at the Indian border results in consignments being held up for several days at the borders. It has also often been observed that different customs locations apply different rules to Nepalese exports to India, thereby creating uncertainty. Customs authorities reportedly create unnecessary hassles for exporters and importers while clearing goods at the Kolkata port or at the land customs station.

In other cases, Indian authorities do not accept pre-shipment test certificates from the exporting country, which again leads to delays and additional costs. For instance, India does not recognise/accept test reports from Nepalese-certifying authorities in the case of agricultural and animal-related products and pharmaceutical products. Obtaining quarantine certification for agricultural items is cumbersome. Exporters of medicinal and herbal products also face similar problems, since in the case of pharmaceutical products a certificate of analysis (CoA) is required to be produced for every consignment, product and batch. This adds to the time and cost of transactions. It is for this reason that no pharmaceutical products are exported by Nepal to India, despite the trade potential.

Some labelling requirements have also been notified as barriers. Pakistan and Bangladesh notified that in the case of pre-packaged products such as processed foods, cosmetics, toiletries, spices, etc., Rule 32 of the Prevention for Food Adulteration (PFA) Act pertaining to labelling requirements is complex and detailed. A labelling measure requiring processed food items to have a shelf life of at least 60 per cent of original shelf life at the time of import qualifies as a barrier since it violates the principle of national treatment. This is because there is no such stipulation for domestic goods, which only require the date of expiry to be mentioned on the processed food items.

Trade is also restricted due to regulations that lack transparency. Regulations related to woollen and other textiles and jute products have not been notified to the WTO, thus creating information asymmetries for trading partners. In the case of woollen textiles, the regulation lacks clarity on the requirement of a 'brand owner' certificate which can be applied arbitrarily as it is open to interpretation. Import permits required for poultry, dairy products and meat were reported to be very time consuming. Pakistan and Bangladesh notified that the process of pest-risk analysis (PRA) required for exporting agricultural products to India was complex and non-transparent. A detailed examination of the PRA process revealed that the process of obtaining a PRA is clearly laid down in the Plant Quarantine Order 2003, and is available on the Ministry of Agriculture website. However, it is conducted only when a request for a PRA is made either by an importer in India or an exporter in the exporting country to the Plant Protection Quarantine Department in India. The problems may have arisen due to lack of information on the process or due to its time-consuming nature.

16.5 Transport

Transaction costs of trading in South Asia continue to be high primarily because of poor connectivity across borders by land, which is the cheapest mode of transporting goods. As Nepal is a land-locked country, trade between India and Nepal takes place only by road and rail. Sri Lanka is an island country and, therefore, trade takes place only by air and sea modes. India trades with Bangladesh and Pakistan through all modes of transport, i.e. air, sea, road and rail. India's trade with Nepal is largely by road as this mode accounts for 98 per cent of trade. Road and sea are the most important modes of transporting cargo between India and Bangladesh. While trade by the sea route accounts for 46 per cent, that by road accounts for 47 per cent. In the case of India–Pakistan trade, 60 per cent of the trade takes place by sea, 17 per cent by road and 15 per cent by rail. Rail-based trade is most important for Pakistan, and almost negligible for trade with Nepal and Bangladesh (Table 16.4).

Table 16.4 India's mode wise share of trade with SAARC members in 2011–12

	Pakistan	Bangladesh	Nepal
Road	17	47.3	98.8
Rail	14.8	0.6	0.2
Air	8.2	6.4	1.0
Sea	59.9	45.8	0

Note: a) Shares relate to data for non-export processing zones;
 b) Entire data for trade via the inland container depots are grouped under the sea route even though it is possible that some may be going via the road route

Source: Government of India, Directorate General of Commercial Intelligence and Statistics (DGCI&S), Ministry of Commerce and Industry

Given that Bangladesh, Nepal, India and Pakistan share a common land border, surface transport should be the predominant mode of transport, but this is not the case. Land transport networks in South Asia continue to remain fragmented even though the basic infrastructure and facilities to establish mutually beneficial intra- and inter-regional transport linkages already exist in many countries. Land connectivity by road and rail is poor, imposing significant barriers to trade in terms of added time and cost. These problems are accentuated by poor sea connectivity for intra-SAARC trade.

16.5.1 Road transport

Road transport is the most dominant mode of transport for India–Nepal and India–Bangladesh trade and is growing in importance for India–Pakistan trade as this road route was opened to bilateral trade only in 2005. Despite the importance of this mode of transport, it continues to be underdeveloped due to impediments related to infrastructure and ineffective protocols. Basic infrastructure such as warehousing, parking, scanners, weighbridges, testing laboratories and other border facilities are inadequate and in poor condition. This leads to considerable damage to goods due to long delays in queues, exposure to extreme weather, pilferage, etc. There are multiple agencies involved with no single agency responsible to ensure the co-ordinated functioning of various government authorities/service providers. The access roads leading to the border points are also poorly maintained, narrow and below the capacity needed to handle international traffic (World Bank 2008; ADB 2006; Taneja 2006, 2007; Sikri 2009; Prakash and Taneja 2010).

The numbers of road routes that have been opened up for trade are also limited. For instance, there is only one road route through Attari/Wagah for India–Pakistan trade (Customs Notification No. 63/94-Cus. (NT)). Further, only a limited number of goods are allowed to be traded between India and Pakistan. Pakistan permitted only 14 items to be imported from India by the road route. By 2012 this had increased to 137 items (GoP 2012). At all the road borders, the border gates are common for trucks carrying both exported and imported goods as well as passenger cars and pedestrian movement, causing major congestion at the gates.

A major concern for the region is that customs procedures at land ports remain far less efficient than at sea ports. An electronic data interchange (EDI) system has been installed only at Petrapole at the India–Bangladesh border and at Raxaul at the Indo–Nepal border; however, it does not function properly and manual processing is still required. Congestion also occurs as every truck is physically checked due to security concerns at India's sensitive land borders, especially at the India–Bangladesh and India–Pakistan border.

Another limitation is the necessary transshipment of goods at the borders since Indian trucks cannot move into the neighbouring country's territory and vice-versa. This is mainly due to the absence of road transport agreements for through-movement of goods across borders and restrictions on the size of trucks that move in neighbouring countries. This not only adds to time and cost, but also leads to a higher incidence of pilferage. India–Nepal is the only border where trucks of one country are allowed to cross the border and operate in the other as per the bilateral treaty. However, it has

been observed that trucks still do not cross the border, and in fact goods continue to be transshipped at the border (Pohit 2011). At the Bangladesh border, Indian goods have to be transshipped twice. The goods coming from states outside West Bengal are offloaded and loaded onto local trucks at Bongaon which is 5 km from the border (Pal 2011). The second transshipment occurs across the border when one country's trucks offload goods and load them on to the other country's trucks.

Further, no containerised trucks are allowed to move across the borders, posing a major limitation to cost-efficient movement of goods across borders. There is no container movement by land, so all commodities requiring containerised shipment have to move by sea. Since there is no direct sailing between Kolkata and Chittagong, containerised cargo has to be shipped via Colombo to Indian ports. This significantly adds to transaction costs. Thus, there is a very strong case for opening up land routes for container movement to reduce transaction costs and delivery times.

A number of measures have been initiated by all countries to address the situation of inadequate infrastructure for cross-border movement of persons, vehicles and goods. One major step has been taken in synchronising working hours at both sides on the India–Bangladesh, India–Nepal and India–Pakistan borders. The Indian government initiated setting up 13 Integrated Check Posts (ICPs) at identified entry points on international land borders to provide integrated services for road transport with dedicated passenger and cargo terminals and other facilities in a single complex (GoI 2011c). The ICP at Attari/Wagah on the India–Pakistan border became operational in April 2012 (GoI 2011d). However, a field visit to the facility showed that it is already running at full capacity since the expansion in trade by the road route to such an extent was not envisaged.

16.5.2 Rail transport

Among surface transport modes, the railway has great potential as a mode of surface transport for long-distance freight and passenger traffic movement across South Asia. However, it is not the preferred mode of transporting goods across borders in the region due to a number of barriers that override its cost-effectiveness. Rail movement is constrained by technical problems and the absence of a regional agreement for direct intra-regional movement.

Only limited rail routes are currently operational for cross-border trade, and preference is given to passenger train movement (Arnold 2010), especially on the India–Pakistan and India–Bangladesh routes. This is largely because of the differences in track gauges and braking systems on the two sides of the border and restrictions on the types of wagons that can be used. For instance, Indian Railways wagons are longer and heavier than Bangladesh Railways wagons and, therefore, the trains have to be reconfigured at the border (World Bank 2008). On the other hand, Indian Railways and Pakistan Railways have the same broad gauge railways, but due to problems in the wagon balancing systems, and inadequate infrastructure facilities at the rail cargo station, only Pakistan Railways carries cargo between Amritsar and Lahore. Restrictions on the types of wagon create further restrictions on the types

of commodities that can move by rail along bilateral routes. The quality of rolling stock used for cross-border trade is poor, as wagons, locomotives, coaches, etc. are antiquated and poorly maintained. As in the case of road transportation, there is no containerised rail movement of goods, except between Birgunj and Kolkata where regularised containerised rail traffic is operational but caters mostly to third country trade.

There are also differences in operating standards between Indian railways and railways of other countries. Timings for rail movement are limited as night navigation is not allowed across borders.

Rail cargo movement is constrained by the lack of multimodal linkages of road with railways, and the lack of efficient and cheap transshipment facilities between rail hubs and sea ports in some cases (Roy and Banerjee 2010).

India and Bangladesh have taken steps to improve rail connectivity. In the January 2010 India–Bangladesh Joint Communiqué, both countries agreed to allow for containerised cargo movement by rail to encourage bilateral trade. However, almost three years after the signing of the agreement this facility is still not available.

16.5.3 Sea transport

Even though India, Bangladesh, Pakistan and Sri Lanka have major sea ports connecting them to the world, India's sea connectivity with Bangladesh and Pakistan is not adequate. Even though Chittagong and Kolkata ports are located very close to each other, sea transport accounts for only 1 per cent of total trade between India and Bangladesh. On the other hand, the Jawaharlal Nehru Port Trust port in Mumbai accounts for 13 per cent. Trade between Chittagong and Mumbai takes place through Sri Lanka. Cargo is transshipped in feeder vessels from Chittagong to Sri Lanka where it is transshipped on to larger vessels for onward movement to Mumbai. The cargo traffic between Kolkata and Chittagong is not enough; hence there is not much movement of vessels between these two ports. Sea-based trade between India and Pakistan took place under a very restrictive maritime protocol until 2005 (Taneja and Kalita 2011b). The revised protocol amended the one that had been in operation since 1975, and allowed third country vessels to transport cargo originating from India or Pakistan for other countries. This amendment also allowed Indian and Pakistan vessels to transport cargo destined for a third country from the ports of either country, bringing it on a par with global maritime arrangements (Taneja and Kalita 2011c).

Sea transport is considered the most well developed mode of transporting goods from India and maximum reforms have taken place at sea ports. However, there continue to be a number of inefficiencies in using the sea route for trade within South Asia. There are capacity constraints at many of the ports, together with heavy siltation at channels where depths fluctuate with tides. Physical barriers include old and poorly maintained cargo and ship-handling equipment, old floating craft, poor road and rail connectivity and a lack of roll-on/roll-off (RORO) ferry vessels and passenger handling facilities at Cochin and Tuticorin (ADB 2006).

Draught constraints limit the accessibility of large ships at Indian ports, due to which main line and deep-sea container ships currently call only at Colombo, which serves as the transshipment hub. Chittagong port is the major sea port in Bangladesh. But there are no direct vessels between Haldia and Chittagong. As a result, most sea trade between India and Bangladesh also takes place through Colombo. This circuitous route increases costs considerably.

Customs clearance at sea ports is much more efficient and automated than at land ports, with EDI available at all ports. However, operational efficiency and intermodal connectivity need to be improved.

16.6 Transit

Trading goods across borders is also severely restricted by the lack of transit agreements that would allow seamless movement of goods across the region. Transit is a major issue between Bangladesh, Nepal, Bhutan and India's northeast states. India does not have access to its northeast states through Bangladesh. While transit protocols exist to permit movement of goods between Bangladesh and Nepal, for goods to move between the Kakarvita–Panitanki border point at the Nepal–India border and the Phulbari–Banglabandh border point at the India–Bangladesh border, transshipment of trucks has to be done twice (Rahmatullah 2011). There is some volume of bilateral cargo traffic through the inland water transport (IWT) route. There is an Inland Water Transit and Trade Protocol between India and Bangladesh, under which inland vessels of one country can transit on specified routes through the other country. The protocol was first signed in 1972 and is renewed every two years. For inter-country trade, four ports of call have been designated in each country – Haldia, Kolkata, Pandu and Karimganj in India and Narayanganj, Khulna, Mongla and Sirajganj in Bangladesh.

In the January 2010 India–Bangladesh Joint Communiqué, both countries agreed that trucks carrying goods from Bhutan and Nepal would be allowed to enter about 200 meters into Zero Point at Banglabandh at Banglabandh–Phulbari land customs station. To facilitate development of regional connectivity, Bangladesh and India agreed to allow the use of Mongla and Chittagong sea ports by Nepal, Bhutan and India. The two countries also agreed that the Rohanpur/Singabad–Kathihar–Rauxal–Brigunj broad gauge rail link would be available for transit traffic between Nepal and Mongla Port and that the Akhaura–Agartala rail link would be reconstructed. Ashuganj was also designated as a new ‘port of call’ and transshipment port for onward movement of container/cargo to Agartala by road. Besides, the two countries agreed to allow bilateral trade to be carried in containers through rail and water transport (WT) routes (Taneja and Kalita 2011a).

India and Nepal on the other hand, have a transit treaty in place since 1950. For a land-locked country like Nepal, India is of crucial importance as the nearest sea port is through India. Accordingly, after the first treaty was signed in 1950, it has been renewed periodically. The transit signed in 2009 increased the number of transit points to 27. Efforts have been made to simplify procedures for the transit of Nepalese

import and export cargo and to expand the number of transit points to facilitate Nepal's trade with India and third countries through Indian territory.

Along with the transit treaties, India and Nepal have signed agreements to control unauthorised trade. India's concern has always been about the possible diversion of transit goods into the Indian market. During the 1980s and early 1990s, transit goods were deflected into the Indian market. Tariff differentials between Nepal and India were high, making it profitable to sell third-country goods in India. Sensitive goods have been subject to special provisions to control the unauthorised trade of transit goods. Several transit procedures were designed to check the smuggling of transit goods into India. Currently, the import of sensitive items into India is permitted only through the land customs stations at Kakarbhitta/Naxalbari, Biratnagar/Jogbani, Birganj/Raxaul, Bhairahawa/Nautanwa, Nepalgunj/Nepalgunj Road and Mahendranagar/Banbasa.

Despite various transit treaties being in place, there is no free flow of goods from Nepal. Cumbersome custom procedures as well as poor transit routes from Nepal to Bangladesh through Indian territory have hindered the free movement of goods. The density of traffic at the 'Kakarbhitta (Nepal)–Panitanki (India)–Fulbari (India)–Banglabandha (Bangladesh)' corridor is very low. Appropriate steps need to be taken so that Nepalese trucks and Bangladesh trucks can move through Indian territory without transshipment.

Pakistan has not given any transit rights to India to access the Afghanistan market for its exports. India has used the road route through Wagah for importing goods from Afghanistan since 1948, but not for exports. Pakistan has signed a transit treaty with Afghanistan, which is a landlocked country. Until recently, Afghan transit goods in Pakistan were transferred under the Afghan Transit Trade Agreement (ATTA) signed by the two countries in 1965. In July 2010, Afghanistan and Pakistan signed an amended transit trade agreement, the Afghanistan–Pakistan Transit Trade Agreement (APTTA), which improves the joint transit system to reflect current economic conditions, infrastructure, technology and transport practices. The new transit regime provides for an increased number of transport routes available to trucks from Pakistan and Afghanistan, lowering the cost of imports and making exports more competitive in the global market. However, the APTTA does not allow India's exports to Afghanistan through Pakistan via the land route.

16.7 Prioritising India's agenda for future regional trade integration

India has taken a series of trade integration measures since 2007 and can take further steps to enhance the pace of regional trade integration in South Asia.

The progress on tariff reduction by India has been ahead of what had been envisaged under SAFTA. Going forward, India should offer deeper tariff concessions to NLDCs so that Pakistan gets the same tariff concessions as Sri Lanka. In addition, India's sensitive lists for NLDCs should be pruned so that Pakistan gets greater duty-free

concessions. India allowed duty-free access to Sri Lanka in 2005 to all items except those on the sensitive list, under the Indo–Sri Lankan bilateral FTA. In 2008, India pruned its sensitive list from 431 items to 215 items and reduced it further to 100 items in 2013, thereby liberalising its trade with both Sri Lanka and Pakistan. However, while Sri Lanka would enjoy duty-free access to India for all other items because of the bilateral agreement, a maximum peak tariff of 5 per cent would still be applicable for Pakistan under SAFTA.

To address the various non-tariff barriers, it is important to ensure that regulatory regimes are transparent. One way of doing this would be for all member countries to notify non-tariff measures to the WTO. Making trade-related information available online is another measure that could reduce information asymmetries. India and Pakistan have adopted a unique and simple method to create awareness among Pakistan government officials and businesspersons about their regulatory regimes. The two countries have arranged business-to-business and government-to-business interactions to address information gaps on regulatory regimes. This has served as a powerful confidence-building measure and also an effective way to facilitate further trade. Such an initiative could be adopted for other countries as well.

In order to address TBT and SPS measures, India has actively engaged in capacity building with Nepal and Bangladesh. The measures include assessment of laboratories for export testing; supporting officials to develop certification systems; development of residue monitoring plans (RMP); and establishing a national accreditation system. It is essential that this process of capacity building should be completed within a stipulated timeframe. India should also simplify further its import procedures to help reduce transaction costs. In order to address the issue of non-acceptance of testing and certification, India should enter into equivalence arrangements and mutual recognition agreements with its trading partners. Further, testing facilities should be made available at land borders so that consignments do not have to be sent far away for testing. To reduce the complexity of procedures, India should review and simplify cumbersome procedures for all products, especially food and agricultural products; processed foods; and pharmaceutical products.

Providing transit to landlocked countries has remained a major concern for the region, although several steps have been initiated to address the issue since 2010. The revised Afghanistan–Pakistan transit treaty will open up several additional transit corridors in Afghanistan and Pakistan that will link Pakistan to the Central Asian countries. If Bhutan, India and Nepal are able to formulate and implement transit arrangements as effectively as Afghanistan and Pakistan, then Bhutan and Nepal's dependence on India alone would be greatly reduced and the ground would be laid for a transit arrangement at a regional level. The regional agreement will eventually connect Nepal and Bhutan to Pakistan through the Indian territory, and Afghanistan to Nepal and Bhutan through Pakistan and India.

Removing rigidities that have existed for decades at the borders to enable the movement of goods across at lower cost is part of the unfinished South Asia trade facilitation agenda. There are important lessons that can be learnt from recent

experiences. India has the most liberal road transport protocol with Nepal, whereby trucks are allowed to move in each other's territory. Yet studies have shown that transshipment at the India–Nepal land border continues to take place because of weak institutions that have inhibited the effective implementation of these protocols. On the other hand, the 2005 opening up of the India–Pakistan road route, after more than six decades being heavily-restricted and available for only a limited number of items, did not encounter any resistance, indicating that the institutional framework supporting trade between the two countries is strong enough to counter lobbyists and interest groups that may have opposed this change. It is, therefore, important for countries to strengthen border institutions so that trade facilitation measures can be adopted effectively. Apart from reforming bilateral trading arrangements, India also needs to address domestic issues, especially at the Bangladesh border where transshipment of goods is done twice.

Modernising land borders is an important step that could make borders more efficient. The setting up of ICPs is a positive step in this direction. Use of information technology in all trade procedures is perhaps the first step that countries should make. An inherent weakness of land borders is that the official charges are almost negligible. In comparison, sea port charges are several times higher than those at land ports. But the services provided at sea ports are also commensurate with these charges. South Asian countries should collectively strive to make land ports as efficient as sea ports. The modernisation of land ports should be completed within a targeted period of three to five years.

Trade through all modes should be opened up so that there are enough options available to traders in both countries. However, to begin with, one major multimodal route can be planned so that at least one major sea port in each of country is connected through the land route. For instance, a containerised rail service could be made available between the Jawaharlal Nehru Port Trust port in Mumbai and the sea port at Chittagong. This would not only link the two countries with each other but would also ensure seamless multimodal transportation of goods between the two countries and the rest of the world.

Customs is one area where the most progress has been made in all South Asian countries. However, customs efficiency is still far below potential and addressing this should be accorded high priority. A fair amount of automation has taken place in India with the introduction of the EDI system. However, automation in India and other neighbouring countries has not resulted in streamlining bilateral trade. A significant step that can be taken to increase the efficiency of customs inspection at the land borders would be increased co-operation between customs authorities on both sides of borders and the establishment of one-stop, joint inspection facilities that would eliminate duplication of processes.

16.8 Concluding remarks

Progress in implementing trade-enhancing measures, particularly with respect to India's trade with Pakistan and Bangladesh, is unprecedented. It is unlikely that this

process will be reversed. India's trade with Pakistan has been on a different footing since 2004. Despite politically sensitive events such as the Samjhauta Express bombings in 2007 and the Mumbai terror attacks in 2008, the two countries adopted a series of trade facilitation measures including expanding the positive list, revising the maritime protocol and opening a road route. Similarly, a series of measures were implemented successfully to enhance trade with Bangladesh. With these developments, the risks of failed integration in South Asia have been greatly minimised.

Improved connectivity holds the key to successful integration of trade in goods; however, this will require large investments. While it was extremely important for governments to agree to change the transport and transit protocols, building infrastructure would require financial resources. Member countries would need to think collectively to raise these resources. Otherwise, connectivity in the region may have a setback.

Other challenges include institutional reform at the borders. Since land borders have been rigid for several decades, parties with vested interests are likely to resist change. It is important to identify and adopt strategies to deal with such resisting forces.

Notes

- 1 Specific duty reduced on 144 tariff lines vide Notification No. 83/2008-Customs. Specific duties remain only on almonds for NLDCs.
- 2 Four of the items on the list of these 144 items continue to be on India's sensitive list of 614 items and are subject to specific duties.
- 3 Taneja et al. (2011a, b, c) used paired RCAs for items on India's sensitive list and identified those items where India's RCA is less than 1 and Sri Lanka's greater than 1 for inclusion in the sensitive list.

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Chapter 17

Pakistan: South Asia Trade and Non-tariff Barriers

Usman Khan

17.1 Introduction¹

The purpose of this chapter is to analyse, from the perspective of Pakistan, the future of South Asian integration in light of the changing patterns of trade. The scaling down of tariffs has shifted the focus of researchers working on the South Asian Free Trade Area (SAFTA) towards the plethora of non-tariff barriers (NTBs). The member countries of SAARC have been forthcoming in reducing their tariff barriers as agreed under SAFTA. In fact, India has implemented all of the tariff reductions that were agreed under the SAFTA, well before the deadline. Pakistan, Bangladesh and Sri Lanka have also been responsive in reducing tariff rates in compliance with this agreement. However, this liberalisation of tariffs has had little impact on trade and integration within the region. Whereas, India has allowed duty-free imports for all products except for the ones specified on the sensitive/negative list, it has conversely put in place harsh requirements, which have in turn created procedural complexities, making trade flows unviable.

This chapter makes the case, using Pakistan as an example, that NTBs have become the major obstacle to trade flows. Reducing tariffs and NTBs would provide a stimulus to trade, and having the capacity to supply in accordance with demand is what triggers the real flow of trade. The export competitiveness of a country is extremely important in determining how much trade it can achieve. Within South Asia, India is a clear success story. India has capitalised on its large labour base and large domestic market and converted these into a competitive advantage. If trade and integration is to increase within South Asia then India will have to play a generous role in building capacity of other member countries. The strategy played successfully by the ASEAN region certainly deserves some attention by the policy-makers in South Asia. China being in the lead has consistently fragmented its production by shifting production of various parts to least developed countries while it has itself relied on producing the final goods. In doing so, China has consistently maintained a trade deficit with the ASEAN countries; however, it has had a significant trade surplus against the USA. This strategy has resulted in a high degree of integration, economic betterment and technology spillover within the region and a significant reduction of NTBs. In certain products, India can certainly take the lead and develop regional value chains that will help produce goods that will not only be competitive globally, but will also enhance the level of trade within the region.

In the light of the above argument, this chapter examines the prospects for vertical integration of industries in South Asia. This is done by calculating a time series for a weighted Grubel–Lloyd Index using the trade data from the UN Commodity Trade (Comtrade) Statistics. The index has been calculated for trade between Pakistan and India, Pakistan and Sri Lanka, and Pakistan and Bangladesh. The evidence suggests that currently very limited intra-industry trade exists between these trade partners. It was also found that a higher degree of intra-industry trade existed in textile and yarn, possible because Pakistan has a large cotton base and a significant quantity of exportable yarn production. Again, a strategy to promote product fragmentation/intra-industry trade comes with its costs. Intra-industry trade within the region is only beneficial if the size of trade creation is greater than the size of trade diversion.² Studies have shown that the size of trade diversion in most cases was larger than size of trade creation for most of South Asian partners. Trade diversion is a cost that regional integrations normally have to bear. However, the cost of integration can be minimised if a friendly environment for investment is made available within the region. An attractive investment environment within the region is essential to enable businesses to engage in regional activity and develop regional value chains. Existing literature has discussed that investment flows within South Asia have been on the lower side, again limiting the extent of integration and trade potential.

Finally, for SAFTA to succeed it is imperative that tariff reductions be made in line with the original agreement, NTBs be marginalised and greater scope for investment flows be created to assist firms in developing forward and backward linkages. This chapter also strongly recommends that an agreement on regional investment must follow as part of implementing SAFTA. These elements combined can significantly trigger trade and integration within the region.

17.2 Integration efforts in South Asia

Intra-regional trade in South Asia constitutes only 5 per cent of total trade of the region. The role of politics and protectionism in South Asia are two of the commonly cited reasons for the low levels of intra-regional trade. During the late-1940s, trade among South Asian countries was significantly higher, since most of the South Asian countries were part of British India. There were no tariff barriers, there was a single currency and goods were traded freely. Post-independence, the majority of Pakistan's imports were sourced from India and approximately two-thirds of Pakistan's exports went to India. However, India and Pakistan's bilateral trade relations suffered greatly due to bitter territorial disputes, currency valuations and with the controversies surrounding water distribution. Second, South Asian countries pursued economic development by adopting import substitution rather than export promotion strategies, keeping trade as a low percentage of national production and with little emphasis on regional trade.

Therefore, up until the 1970s, high tariffs and NTBs, pervasive state intervention in the economy, disincentives to foreign investment and stringent foreign exchange policies have rendered South Asia as the least-integrated economic region globally. In addition, border disputes, political tension, and import substitution and protectionist

growth strategies in India and Pakistan, the two largest economies in South Asia, have resulted in low levels of bilateral trade.

The process of preferential trade liberalisation has gradually been introduced in South Asia since the establishment of the regional forum South Asian Association for Regional Cooperation (SAARC) in 1985. Currently, the agreement of the South Asian Free Trade Area (SAFTA) is being implemented. SAFTA has been ratified by all SAARC member states. SAFTA's objectives are to promote and enhance mutual economic co-operation in order to fully realise the region's potential for trade and development.

The SAFTA Agreement also aims to reduce the costs of regional trade by calling for the adoption of trade facilitation measures including harmonisation of standards and mutual recognition of test results, harmonisation of customs procedures and better co-ordination in strengthening transport infrastructure tariffs. The tariff reduction programme is phased, from average weighted tariffs of no more than 20 per cent within two years and 0–5 per cent within five years after completion of the first phase for India, Pakistan and Sri Lanka, with the aim of achieving agreed tariffs on imports no later than 1 January 2009. These targets have been achieved in principle. Bangladesh, Bhutan, Maldives and Nepal are required to have average weighted tariffs of no more than 30 per cent within two years and eight years for the second downward adjustment.

The rules of origin (RoO) is an important provision of the free trade agreement (FTA), which requires the domestic value addition (DVA) of 40 per cent from the non-LDC member countries of India and Pakistan, 35 per cent for Sri Lanka and 30 per cent for LDCs, in combination with a change in tariff heading (CTH) classified at the Harmonized Commodity Description and Coding System (HS) code four-digit level. The SAFTA RoO is similar to the RoO of bilateral FTAs in the region. The most critical provision in SAFTA is the one dealing with sensitive sectors (see Table 17.1). It identifies sensitive industries that should be protected from competitive neighbours. The SAFTA treaty provided room for negotiations to ensure a maximum ceiling on items that can be placed under the negative list by each member country. It was expected that a limited approach would be adopted limiting the negative list to 10 per cent of tariff lines out of a total of 5,224 tariff lines at the HS six-digit level. However, the final decision was to retain a negative list of approximately 20 per cent

Table 17.1 Trade restrictions under SAFTA

	Value of imports from SAARC subject to SL (%)	Value of exports to SAARC subject to SL (%)
Bangladesh	65	22
India	38.4	56.5
Maldives	74.5	57.6
Nepal	64	46.4
Pakistan	17.2	34
Sri Lanka	51.7	47
Total	52.9	

Note: SL = sensitive list

Source: Weerakoon (2010)

of tariff lines. This implies that the actual trade coverage of the negative list of each country is quite high. The provision that SAFTA signatories will review negative lists every four years in Article 7 (3b) is vague and is not formal or binding in requiring the negative list to be reduced over time. By comparison, negative lists of bilateral FTAs in the region are more limited. Mapping the sensitive list of each country to their imports from South Asia reveals that approximately 53 per cent of the total import trade among South Asian countries is excluded from the liberalisation of tariffs proposed under SAFTA.

The SAFTA Agreement has provisions to deal with para-tariffs and NTBs, however, there are no explicit commitments to be fulfilled by countries. The SAFTA Agreement has no provisions to eliminate NTBs on items where tariff reductions are made and NTB issues are subject to negotiations. The SAFTA treaty has been confined to trade in goods. SAARC has taken the initiative to commission a joint study to incorporate services and investment into SAFTA (Weerakoon 2010).

Even though the SAARC is the world's largest regional organisation in terms of its population, the SAFTA Agreement's impact on trade has been negligible, which is invariably attributed to the restrictions imposed within the agreement. In all fairness, the SAFTA Agreement is still in its initial stages; the impact of SAFTA can only be analysed over a longer time period.

India is the strongest trading partner in the region. It not only has a large amount of trade with Bangladesh and Sri Lanka but also Pakistan. Moreover, for all these three countries (Pakistan, Bangladesh and Sri Lanka) the trade balance has always been significantly in favour of India. Pakistan, Bangladesh and Sri Lanka have historically maintained large trade deficits against India, which has left their respective commerce ministries skeptical about opening up to trade with India. Traditional trade theory (Ricardian and Hecksher-Ohlin) predicts that there is limited scope in improving intra-regional trade given the fact that all the countries have relative comparative advantage in producing similar goods, i.e. goods that require a large low-cost labour force such as textiles, garments, light manufacturing and agriculture products. India's high degree of export similarity within South Asia has reduced the opportunities for other member countries to explore the large Indian markets. This high degree of export similarity has led the member countries to adopt protectionist policies using similar tariff structures or by advocating for an extremely large negative list.

In Pakistan there is a large group of people who believe that opening full trade with India is risky, as Indian products will flood local markets and the domestic industry will not be able to compete. On the other hand, this argument is also contested by some sectors in Pakistan which feel that trade with India can help to build a stronger industrial base and will make it more competitive. These proponents often talk about the technology spillover effects and investments that can be made. It is argued that if Pakistan has to defend its global positioning and increase its market size, a shift in its business philosophy is required. Pakistan will have to focus on building its competitive advantage. It will have to focus on research and development, technical innovation, product development and also venture into

brand and market development. There is a lot that Pakistan can learn from India and, hence, a more relaxed trade environment can be extremely useful in attaining this shift. Indian industry has mastered the technique of serving consumers with low purchasing power and the majority of them are living in rural areas where distribution systems are dismal. Industry has been able to innovate within the constraints and has developed products and services that match local needs. Tata Motors' Nano Car for US\$2,000 and Boyce Manufacturing's US\$70 fridge that runs on batteries are two of the many success stories from India. This capability to slash prices and radically change the way products are made and delivered is India's biggest competitive advantage. As Western economies struggle to fight the global recession, Indian manufacturers have found a large domestic unmet demand for low-priced but innovative products. In addition, India has also succeeded in acquiring several internationally established brands, taking its own low-cost goods and selling them under these established brands, i.e. a strategy of reverse acquisition. This presents a significant opportunity for Pakistan to exploit similar comparative advantage conditions to competitive advantage and begin to upgrade its industrial and trade potential.

SAFTA, compared with other bilateral trading agreements (such as the India–Sri Lanka Bilateral Free Trade Agreement (BFTA) and the Pakistan–Sri Lanka BFTA) signed by South Asian countries within the region, is not an 'ambitious' FTA, owing to the fact that member nations retain sensitive lists of commodities, and that services trade and foreign direct investments are excluded from the ambit of the agreement. The RoO may seem stringent, where LDCs have to comply with 30 per cent domestic value addition criteria. On the contrary, a low level of domestic value addition criteria has been set under BFTAs in South Asia. Second, the Trade Liberalization Programme (TLP) under SAFTA does not have commitments for an immediate reduction of tariffs to 0 per cent compared with BFTAs, which have reduced tariffs to 0 per cent for a substantial number of products. The extensive negative list of member countries for trading is also a structural rigidity (Mahbub Ul Haq Human Development Center 2010). Furthermore, the scope of SAFTA in enhancing intra-regional trade in South Asia is under question since SAFTA is emerging under myriad bilateral, subregional and multilateral trade agreements.

The implementation of SAFTA has also faced political impediments. Pakistan and India's political divide has resulted in a delay in Pakistan granting India most favoured nation (MFN) status (the decision was made only in early 2014). Political issues have taken precedence over economic interests; however, the significance of a unified South Asian region under SAARC, and its trade initiative SAFTA, is apparent from the interest shown by China, Japan, South Korea and the USA in the SAARC forum. To date, nine countries have been granted observer status in the SAARC forum, starting with China and Japan, followed by Australia, the European Union, Iran, South Korea, Mauritius, Myanmar and the USA.

The other main area of progress is the sensitive list, and how India undertakes liberalisation ahead of schedule. As mentioned previously, India is viewed as the driving force behind the successful implementation of SAFTA, given its significantly

asymmetric nature of economic power. Given the rapidly changing pattern of trade and investment linkages of India across the wide Asian region, the prospects of integration in South Asia have to be viewed from a broader perspective. This perspective should take into consideration India's own economic interests and growing economic ties with the ASEAN region, how these can relate to the South Asian region, and how other South Asian economies are adapting to newer challenges of reduced tariffs, but more stringent TBT and SPS measures, export competitiveness and supply-side constraints.

India's pattern of import and export trade suggests that India's economic interests lie outside of South Asia. While India's exports to South Asia have stagnated at 5–5.5 per cent of its total exports, its imports in the region are around 1 per cent of its total imports. By comparison, India's trade with ASEAN has been growing at the rate of 30 per cent from 2003–08 (The ASEAN Secretariat 2008), where India is considered as one of ASEAN's main trading partners. This demonstrates India's 'Look East' policy where the Indian economy is developing complementarities with East Asian economies in knowledge-based segments such as microchips, information technology, etc. In addition, Pakistan also witnessed a 20 per cent increase in trade with ASEAN from 2003–08 (The ASEAN Secretariat 2008), where Pakistan is also considered as one of ASEAN's main trading partners. Therefore, what can be observed from the trading patterns of South Asian economies is that there is a strengthening of strategic links with East Asia and a stagnation of trading patterns in intra-South Asian trade (Weerakoon 2010).

17.3 Pakistan's trade relations with South Asia

17.3.1 Pakistan's trade profile

Throughout its history, Pakistan has experienced periods of high growth interrupted by shocks and crises, including natural disasters, and later followed by stagnation. Pakistan's top industries are textiles and apparel, food processing, pharmaceuticals, construction materials, shrimp, fertilizer and paper products. Exports for Pakistan's commodities have traditionally been concentrated in a few markets (such as Germany, Hong Kong, United Arab Emirates, United Kingdom and United States) but there has been a gradual shift to a greater geographical diversification, with the concentration in the traditional markets falling 47.2 per cent in 2006 to 35.3 per cent in 2011. Total exports for 2011 were US\$25 billion and consisted of textiles (garments, bed linen, cotton cloth and yarn), rice, leather goods, sporting goods, carpets, rugs, chemicals and manufactures. The major trading partners, in terms of their share in Pakistan's exports in 2011, were United States (16%), United Arab Emirates (7.3%), Germany (5.1%), United Kingdom (4.9%) and Hong Kong (2%). Pakistan's total imports in 2011 were equivalent to US\$40 billion, and consisted mainly of petroleum, petroleum products, machinery, edible oils, pulses, iron and steel, and tea. The main trading partners in 2011, in terms of their share of Pakistan's imports, were Saudi Arabia (11.3%), Kuwait (8.2%), United States (4.5%), Japan (4.1%), Germany (2.3%), and United Kingdom (1.6%). None of the South Asian countries are in the Pakistan's top seven trading partners.

Considering the composition of exports, primary commodities grew from 11 per cent in 2002 to 18 per cent in 2011; this can be accounted for by improved processes in the production of cotton and higher international demand. For manufactured goods, these constituted 75 per cent of Pakistan's exports in 2002 but the share had declined to 69 per cent in 2011. This decrease indicates that Pakistan has not moved towards technology and innovation-based manufacturing production and exports. The share of the remaining export sector, semi-manufacturing products, also declined.

17.3.2 Pakistan–Bangladesh trade relations

Textile yarn, fabrics, made-up articles, etc. are the largest exported and imported manufactured goods between Pakistan and Bangladesh. Pakistan has a favourable balance of trade with Bangladesh. Pakistan's share of exports and imports from Bangladesh is also very small. Despite the export potential, under SAFTA Pakistan is not getting any concessions on items 65 (SITC Rev 3). More importantly, if we look deep into the trade figures, the main trade is in yarn, as it serves an important input into the value-added textiles industry of Bangladesh. Bangladesh does not have the complete textiles value chain and hence has to rely on other countries for raw materials. However, the value-added textiles sector has seen a significant boom in Bangladesh and this has added to the high demand for exports. However, Bangladesh is fast developing the capacity to produce its own yarn; in fact some of the Pakistani industry has shifted over to Bangladesh. As this transition matures this figure is also expected to decrease. The second largest item of export from Pakistan to Bangladesh is machinery. However, the size of this export is only a minimal amount of total Bangladeshi imports.

There is significant opportunity for Pakistan to enhance its exports of synthetic filament to Bangladesh; however, this is included in the sensitive list. In respect of woven fabric of synthetic staple fabric and yarn of synthetic staple fibres there can be significant export potential but these products are all included in the sensitive list of Bangladesh. Parts and accessories for motor vehicles and special purpose motor vehicles are also included in the sensitive list of Bangladesh.

Bangladesh has made significant progress in liberalising its trade regime. Customs duty rates have been reduced, the import permit system is now automatic and the cumbersome procedure for opening letters of credit has been simplified.

However, in terms of NTBs Pakistani exporters have identified the following constraints that limit export to Bangladesh.

- ***Lack of harmonisation of standards*** – The Bangladesh Standards and Testing Institute (BSTI) was created through an ordinance (Ordinance XXXVII 1985) as a result of the merger of the Bangladesh Standards Institution and the Central Testing Laboratories. Bangladesh has developed a host of product-wise standards that are mandatory for any product to meet. Exporters have complained that these standards are on the stricter side and often make it difficult to export. Furthermore, the exporters also face information gaps. The amendments made in the standards, the requirements of the standards, etc. are not readily available on

the internet. This information is normally requested through a written request. All these activities take time. If the standards are harmonised with international standards they will become easier to follow. The information gap is a big hurdle. For example, 10 per cent of total fan exports of Pakistan go to Bangladesh. The electric fans have to comply with BDS 818 standard, which requires several tests and safety precautions. The exporters do not complain on the difficulty of obtaining these certifications, instead, the problem lies in acquiring all the information required.

- *NTBs and para-tariffs* – Some exporters have complained about requirements that products face once they enter into Bangladesh. An often-quoted example is the industrial development charge that they face. In addition, there is a product labelling policy for chemical, agriculture and food products. This policy has again slowed down the pace of exports from Pakistan and has increased costs due to development of new labels and packaging.
- *Transportation* – There are no direct shipping lines between the two countries and the option of a land route passing through India is not yet available.
- *Sensitive list* – Bangladesh under SAFTA has included 1,245 items in its sensitive list. This large list, by any standard, covering many items in which Pakistan has comparative advantage significantly lowers the possibility of exports from Pakistan.

Other trade restraints include a lack of banking facilities and a robust trade dispute resolution mechanism.

On the other side, exporters from Bangladesh also face technical and quality standards when sending their products into Pakistan. A major problem area that has been highlighted is Bangladeshi pharmaceutical imports to Pakistan that have been restricted, as the registration process is governed by a very strict law. The Government of Pakistan has exempted all domestically produced pharmaceutical-related inputs from its General Sales Tax (GST). Imported pharmaceutical inputs are subject to a 10 per cent customs duty but are also exempt from payment of GST. In addition, visas for entry into Pakistan are only obtained for specific cities. Similar to Pakistani exporters, Bangladeshi exporters also face constraints due to lack of information, absence of direct shipping links and cargo flights. Moreover, Pakistan has not offered the special and differential treatment accorded to Bangladesh as an LDC. Exporters suffer from the non-recognition of testing institutes and laboratories for conformity assessment. Pakistan also maintains a large sensitive list for Bangladesh which hinders the trade potential.

In January 2000, the Pakistani government began implementing a transactional valuation system, pursuant to which 99 per cent of import valuation is based on invoice value, in accordance with the WTO's Customs Valuation Agreement. However a number of traders in food and non-food consumer products have reported experience of irregularities and deviations in the application of that system. On 30 June 2005, Pakistan Standards and Quality Control Authority (PSQCA) established over 21,000 standards (including 15,500 ISO standards) for

agriculture, food, chemicals, civil and mechanical engineering, electronics, weights and measures, and textile products. However, not many sources have stated these to be a problem due to inadequate capacity for strict implementation and lacking infrastructure to monitor.

17.3.3 Pakistan–India trade relations

There was a major political breakthrough on trade between India and Pakistan in 2011. During the course of the year, Indian and Pakistani government officials held several high-level meetings aimed at improving trade relations: the respective secretaries of commerce met twice (in April and November) and the ministers of commerce met in September in Mumbai. The two countries' Prime Ministers also discussed trade issues at the Seventeenth SAARC Summit in Maldives November 2011.

On 2 November 2011, the Pakistani government announced it was finally ready to grant MFN status to India, and thereby replace the positive list of items that could be imported from India with a negative list of items that could not be imported. The cabinet's decision was a turning point in trade relations between the two countries, and finally fulfilled Pakistan's obligation as a member of the WTO to reciprocate India's granting of MFN status to Pakistan.³ Following this decision and the visit of the Indian commerce minister, accompanied by a delegation of Indian business leaders in early 2012, Pakistan's cabinet announced on 29 February 2012 that MFN status with India would become operational in 2013. In the interim, a negative list of 1,209 items replaced the positive list of 1,946 items. As a result, more than 7,000 items could now be imported from India. At the end of 2012, the negative list was to be further replaced by a small list covering items normally restricted by all countries, relating to security, religion and health, etc. All other items would be governed by MFN requirements. Despite some initial protests from more nationalist segments against granting MFN status to India, Pakistani business people generally welcomed the decision, as did Indian business and government leaders.

Even though both countries are members of the SAFTA, trade between the two countries is unnaturally low.⁴ Total trade (exports plus imports) between the two countries in 2011 amounted to a little more than US\$2.5 billion, up from a paltry US\$750 million in 2005.⁵

There have been several positive developments in bilateral trade relations recently. In March 2013, the Commerce Ministry of India announced that it will reduce its SAFTA sensitive list of imports from Pakistan at the HS six-digit level to 100 from 634.⁶ However, of these 100 items, 75 will be from the agriculture sector and the remaining from tobacco and liquor. This still leaves Pakistan with a limited range of products to export to India. The precise contents and the timetable for the revised sensitive items list are yet to be made public.

A further positive development includes the formal establishment of the India–Pakistan Joint Business Council on 15 March 2013. The Council will seek to increase bilateral trade and investment between both the countries. The body is being set up under the two Ministries of Commerce and Industry and will constitute 15 business executives from both sides. The Council is expected to meet every six months with its

first meeting planned for August 2013. It is expected that this body will act as a focal lobby group to work with government on both sides to normalise trade relations. The Council will be the advocating force on implementing the MFN regime with India and streamlining Indian NTBs faced by Pakistan.⁷

Following the ministerial-level meetings, several Joint Working Groups were established to examine trade in goods, as well as services and investment. Agreement was reached on the following important issues:

- As agreed by the Secretaries of Commerce last year, a new visa procedure has been developed and signed by the political leadership of both countries. There has been much headway made in terms of ensuring that traders and members of the business community are able to travel easily between the two countries in an attempt to strengthen commercial ties through multiple-entry and multiple-city visas with no entry/exit restrictions.
- Tedious customs procedures are addressed in the Customs Co-operation Agreement (pact approved and signed, but not notified), reducing the arbitrariness of decisions by customs officials on both sides of the border.
- Multiple SPS standards have been addressed by the Mutual Recognition Agreement (pact ready but not approved) which is meant to reduce unnecessary delays in getting approval for quality certifications.
- Redressal of Grievances Agreement (pact undergoing revisions) designed to make the process of resolving trade disputes by the respective governments both simpler and speedier.
- However, the deadline of December 2012 for formally granting MFN and more importantly phasing out the negative list has passed. As such, the current list still contains 1,209 items. Pakistan's Ministry of Commerce, in its media communication, has not given a new date for implementing MFN status with India and eliminating the negative list. Many reasons have been advanced for this delay.

NTBs between India and Pakistan

A firm-level survey was conducted by Taneja (2007) in order to identify NTBs between India and Pakistan. The survey was conducted in Amritsar, Delhi, Mumbai, Kolkata and Indore in India, and in Karachi, Lahore and Islamabad in Pakistan. Interviews were conducted with key stakeholders (exporters, importers and freight forwarders/clearing agents) in both countries. A total of 137 respondents in India and 109 in Pakistan were interviewed during August 2006 to January 2007.

This study focused on identifying TBT and SPS-related barriers, and whether they had been applied in a non-discretionary or trade-restrictive manner. The broad categories of barriers identified in the study include the positive list approach, TBT and SPS measures, trade facilitation and customs procedures, financial measures, para-tariff measures and visas.

TBT and SPS measures in India and Pakistan

The Bureau of Indian Standards (BIS), Ministry of Food and Consumer Affairs is the main standard setting body in India. In Pakistan, the Pakistan Standards and Quality Control Authority (PSQCA) is the sole national standard setting body.

The functions of PSQCA include the establishment and enforcement of national standards, registration of inspection agencies, and assessment of industrial raw materials and finished products for compliance with international standards. According to the United States Trade Representative (2009), PSQCA had adopted over 27,165 standards (including 15,000 International Organization for Standardization (ISO) standards) for agriculture, processed food, chemicals, civil and mechanical engineering, electronics, weights and measures, and textile products. Current estimates indicate that there are 15 certification bodies operating in Pakistan, and close to 2,700 enterprises have been issued ISO 9000, ISO 14000 and Occupational Health and Safety Advisory Services (OHSAS) 18000 certificates. (Initially there were 5,000 but many of the enterprises dropped out of the programme.) All of the certification bodies operating in Pakistan are foreign-based (United States Trade Representative 2009).

Under the Consumer Protection Act, 1986 in India, Consumer Redressal Agencies at the district, state and national levels (also known as consumer courts) protect and promote consumer interests. The implementation of standards is often perceived by Pakistan as NTBs. Consumer protection in Pakistan is still in its infancy and the prevailing trade-related SPS legislation fails to address potential hazards in food supply chains and in processing, such as biological, chemical and environmental contamination. In addition, TBT requirements such as labelling only include the list of ingredients, label terminology and name of producer or manufacturer (Siddiqui 2006). The lack of effective consumer protection laws couples with implementation challenges in domestic standards.

Pakistani exporters face many challenges in complying with the multiple domestic India standards, rules, regulations and requirements of India enforcement agencies. The lack of transparency and informational flows between the two countries further exacerbates the situation. A lack of testing facilities at the land border also causes unnecessary delays.

Pakistan's export interests are in textile and agricultural products. First, India applies import restrictions on these two items through TBT and SPS measures, which are applied in a non-discriminatory manner and are General Agreement on Tariffs and Trade (GATT)-compatible import controls; however, due to the supply-side constraints of Pakistani exporters and their lack of capacity to meet Indian compliance requirements, TBT and SPS measures act as protective NTBs. Second, as far as tariff concessions under SAFTA are concerned, despite granting MFN to Pakistan India has 20 per cent of the items on its sensitive list in the agricultural sector and 34 per cent in textile products. India has 884 items under its negative list and Pakistan has 1,183 items.

Apart from policy, tariff concessions and implementation challenges there are also problems related to the acceptance and confirmation of letters of credit or contracts

offered by banks, but payment guarantees are not ensured. Subsequent defaults in payments are not settled through a formal dispute settlement. The Asian Clearing Union (ACU) was set up in 1974 with eight members, India, Iran, Nepal, Pakistan, Sri Lanka, Bangladesh, Myanmar and Bhutan. All payments related to bilateral trade are made through the ACU. High transaction costs and inefficiency exist in the ACU, particularly in terms of the time taken to settle transactions. There is also a lack of other alternatives, since Indian banks are not allowed to operate in Pakistan, and vice versa.

Para-tariff measures between India and Pakistan are applied in a non-discriminatory manner with high duties; for example, India imposes a countervailing duty of 16.3 per cent on most items, a special countervailing duty of 4 per cent and an education cess of 2 per cent. Pakistan imposes a sales tax of up to 15 per cent and a withholding tax of up to 6 per cent. In addition, for selected products that have a sales tax a federal excise duty is also charged. Pakistani exporters are required to state the minimum retail price on packaged foods but they are unable to do so because they do not always have information on distribution costs that would be incurred in India. Due to the presence of inter-state taxes imposed on the movement of goods in India, Pakistani exporters' costs increase and the costs of their exports become prohibitive. In addition, both India and Pakistan follow restrictive visa regimes. Table 17.2 shows the commodity-wise proportion of tariff lines in the sensitive list between India and Pakistan (Taneja 2007).

In India there are multiple ministries/departments responsible for regulating imports. There are also multiple official publications/compendiums covering information on tariffs, tax rates and procedural formalities for exporters. There are separate tariff and federal excise tax schedules, public notifications and notices that determine current

Table 17.2 Commodity-wise proportion of tariff lines in sensitive list

Commodity group	Share of tariff lines (%)	
	India	Pakistan
Live animals, animal products	3.0	1.7
Vegetable products	20.2	4.2
Animal/vegetable fats, oils, waxes	3.6	2.4
Prepared foodstuffs, beverages, spirits, tobacco	7.6	3.0
Chemical and allied industries	3.8	6.3
Plastics, rubbers	10.7	9.8
Wood pulp, paper, paperboard, scrap/waste paper	1.5	4.0
Textiles and textile articles	34.2	24.1
Footwear, headgear, umbrellas, walking sticks, riding crops	1.9	1.3
Stone, plaster, cement, asbestos, mica, ceramic, glass, glassware	1.0	5.0
Base metals	6.8	11.0
Machinery, mechanical appliances, electrical appliances	3.0	17.2
Vehicles, aircraft, vessels, transportation equipment	0.5	6.0
Miscellaneous manufactured articles	0.3	0.9

Source: Taneja 2007

tariff and tax rates. The decentralised nature of tariffs and the procedural regime, and the presence of an anti-dumping measures, act as an NTB and result in uncertainties and delays. The 4 per cent countervailing duty imposed on all imports, in addition to customs duty, deters imports and makes them uncompetitive. Section 2(41) and section 14(1) of the Indian Customs Act provide officers with the discretion to evaluate goods beyond international norms and practices and this results in multiple queries on bills of entry on Pakistani exports. The Indian Customs Valuation methodology does not reflect actual transactions values and effectively raises tariff rates. In India each state exercises its own rules regarding the inter-state movement of goods, which are subject to further inspection and taxes. These procedures and expenses are to be borne by the exporters. Since Indian banks do not accept letters of credit issued by Pakistani banks, transactions are settled through the ACU. This mode of payment acts as an NTB due to inefficiencies within the ACU discussed earlier.

For the export of products including cement, gelatine, condensed milk, electrical appliances, mineral water, steel products, leather products, X-ray equipment, dry cell batteries, thermometers, helmets and gas cylinders, Pakistani exporters are required to obtain a licence from the BIS in addition to the application/processing charges, which requires the payment of costs of inspection visits from India. These licences are required to be renewed annually for new inspection/testing of samples, raising costs of exports and affecting their competitiveness.

The process of acquiring an import permit for export of primary agricultural products to India is complex and lacks transparency. India imposes import licences on 600 items to ensure protection for human, animal and plant life health. Nearly all livestock agricultural and food products require an SPS or sanitary certificate and import permission issued under the general supervision of the Ministry of Agriculture. All food products imported to India are subject to prevention of food adulteration rules, standards and measures, which also include orders such as the Meat Food Product Order 1973, the Plants Fruits and Seeds Order 1989 and the Livestock Act. In addition, all poultry, dairy products and meat (frozen, chilled or fresh) require import permits from the Department of Animal Husbandry and Dairy. Processed food products have to comply with the Prevention of Food Adulteration (PFA) Act 1954 that requires shelf life to be not less than 60 per cent of original shelf life at the time of import. Leather, leather goods and melamine products also require laboratory testing. Samples of export consignments are sent to testing laboratories far away from customs points. Pre-packaged products, such as processed foods, cosmetics, toiletries, spices, etc., have to carry the declarations in accordance with Rule 32 of the PFA Act. This rule has 30 provisos and provisos within provisos: (a) name and address of the importer; (b) generic or common name of the commodity packed; (c) net quantity in terms of standard unit of weights and measures, and if the net quantity in the imported package is given in any other unit, its equivalent in terms of standard units shall be declared by the importer; (d) month and year of packing in which the commodity is manufactured or packed or imported; and (e) maximum retail sale price at which the commodity in packaged form may be sold to the ultimate consumer. This price shall include all taxes local or otherwise, freight, transport charges, commission payment to dealers, and all charges towards advertising, delivery, packing, forwarding and the like, as the case

may be. The requirements (b), (c), and (d) are justifiable, but (a) and (e) pose great challenges to Pakistani exporters.

Although Indian authorities and independent scholars refer to these SPS measures and rules as fair and in accordance with the WTO Agreement (Taneja 2007), the detailed multiple rules and regulations are often implemented arbitrarily and without transparency at the discretion of the customs authorities, have lengthy procedural formalities, are complex, cause delays and undesirable demurrage, discourage Pakistani exporters and render Pakistani exports to India uncompetitive (Sohail 2010).

Textiles and textile products also have trade restrictive measures applied to the use of AZO dyes in the manufacture of fabrics. A pre-shipment inspection certificate from a textile testing laboratory accredited to the National Accreditation Agency of the country of origin is required and the failure to provide certification requires testing from the notified agencies in India for each and every colour of every consignment. These restrictions are even applicable to EU-accredited labs, which causes delays and additional costs. The Textile (Consumer Protection) Regulation 1988 imposes strict marking requirements for yarns, fibres, and fabrics imported to India. The consignments are examined 100 per cent for verification. These regulations essentially work as quantitative restrictions because there are no written instructions, rules or guidelines for customs officials. Woollen textiles require a certificate of origin even if no concessions are being claimed, accompanied by a certificate from brand owners that the product is genuine and that the exporters and/or manufacturers have the authority to use the brand name. Textiles and textile products are also subject to additional duty of excise and the commodity cess, which are levied as additional duty of customs (Sohail 2010).

Pharmaceutical products have stringent requirements for the registration of the drug with the Central Drug Standard Control Organization. All foreign manufacturers must register and subject their premises to inspection in accordance to the rules prepared by the BIS.

Consumer goods imported in retail packaging are subject to the Directorate General of Foreign Trading (DGFT) notification 44(re)/24.11.2000 on labelling and marking rules for imports issued on 24 November 2000 stipulates that maximum retail price, generic name of product, month and year of entry in trade channel, importer name and address and quantity in standard units must be carried prominently on the 'principle display panel' of the packages. The requirement must be met before import clearance from customs. The stipulations regarding labelling and marking requirements on traded/packaged goods are laid down in a number of central acts and rules. States also have their own regulations on labelling and marking requirements on traded/packaged goods. An amendment made in Section 17.3 of the Custom Tariff Act, 1975 relates to packaged commodities imported into India, which imposes additional duty on the basis of the good's maximum retail price in India, making the imported item very expensive.

The import of rough marble blocks and slabs is subject to licensing procedures, which are considered by an inter-ministerial facilitation committee comprising representatives from various ministries/departments. These licensing procedures are lengthy and cumbersome. This restricts the role of the individual importer.

Sensitive items can only be imported from 11 customs ports out of a total of 21,516 and 1 out of 51 inland container depots. Clothing accessories can only be imported from five specified ports and two inland container depots. Pakistani exports of items on the sensitive lists not only pay higher tariffs but also have to incur higher costs to divert cargo to designated ports.

Other industries where certification, licensing procedures or import quotas are provided in the following list:

- Powdered milk, maize, crude sunflower oils, and refined rape, colza and mustard oil are subject to tariff rate quotas (TRQs). These were introduced to permit small quotas to be imported over moderate tariffs, while applying high tariffs to imports in excess of the quota amounts.
- Tobacco products, motor spirit, polyester filament yarn, motor vehicles and two wheelers are subject to the national calamity duty (NCD).
- Indian State Trading Enterprises (STE) controls imports of rice, wheat, all coarse grains except maize and barley, and copra, including imports of important refined petroleum products.
- The Jute and Jute Textiles Control Order, 2000 stipulates that each imported jute bag must give the country of origin on the bag and DGFT code number of the importer. The requirement must be met before the import clearance at customs (Sohail 2010).

17.3.4 Pakistan–Sri Lanka trade relations

The Framework Agreement of Pakistan–Sri Lanka Free Trade Agreement (PSFTA) was signed in August 2002. The main objective of the Agreement is to promote closer economic integration between the two countries for the realisation of enhanced trade and investment opportunities for the mutual benefit of both countries. As a result of successful implementation, the positive trend is expected to continue in both directions with diversification of exports under the Agreement. The scope of the FTA would be expanded covering areas of services and investment co-operation. After conducting several rounds of bilateral negotiations, Pakistan and Sri Lanka signed a Protocol, which aims at moving towards a comprehensive economic partnership agreement, covering trade in services and investment co-operation.

The value of total trade between the two countries, which stood at US\$97.72 million in 2001, has increased up to US\$271 million in 2009. Items such as fresh pineapple, sports goods, tamarind seeds, coconut, edible oil and activated carbon have gained access to the Pakistani market. Pakistan has also granted duty-free access for Sri Lankan products like tea and betel leaves, albeit with quotas, coconut products, natural rubber, spices, natural graphite, paper boards and articles of aluminium. Major import items from Pakistan to Sri Lanka include cotton, dried fish, potatoes, rice, big-onions, fabrics, medicaments, textile fibres, electrical machines and apparatus, etc.

The PSFTA makes Pakistan the second largest trade partner for Sri Lanka in South Asia. Pakistan had granted 100 per cent immediate tariff concessions on 206 items

in 2002 while Sri Lanka granted immediate duty-free access to Pakistan for 102 products. Under the RoO, only products originating from Pakistan and Sri Lanka would benefit from the agreement, according to the Ceylon Chamber of Commerce. Other products that have some imported materials as inputs have to have 35 per cent value addition. Under cumulative rules of origin to meet the 35 per cent value-addition criteria, a producer can use raw material imported from either of the contracting parties up to the value of 10 per cent and the remaining 25 per cent to be met through value addition at home (Lanka Business Online 2009).

There is limited published research on the specific barriers to trade faced by Sri Lankan and Pakistani traders. The US 'National Trade Estimate Report on Foreign Trade Barriers 2009' has country studies of Sri Lanka and Pakistan's tariff structures and barriers to trade, more specifically with respect to the US trade potential. Currently, 102 items are subject to the Sri Lanka Standards Institution (SLSI) mandatory import inspection scheme. These include food, steel, electrical cables, switches, water heaters and cement. Importers of these items must obtain a clearance certificate from the SLSI to sell their goods. SLSI accepts letters of conformity from foreign laboratories, but retains the discretion to take samples and perform tests (United States Trade Representative 2009).

The bilateral agreement between Pakistan and Sri Lanka has addressed several of the issues relating to tariff and NTBs. There is a greater opportunity available under the BFTA as compared to SAFTA. However, slow dissemination of BFTA in Pakistan is one critical reason that has led to slow growth of trade and investment between the two countries.

17.4 Intra-industry trade in South Asia: Evidence and issues

The literature on trade normally talks about two types of intra-industry trade within economies, horizontal and vertical. Horizontal intra-industry trade normally comprises trade in different varieties of a particular good within the same production stage and in the same quality and price range. This usually occurs as a result of product differentiation and better quality brands that provide superior consumer choice and diversity in consumption. On the other hand, vertical intra-industry comprises trade between goods that are of different quality or goods that are part of a production value chain of a final good (product fragmentation). This chapter focuses on the second type of intra-industry trade that is vertical integration intra-industry trade. Gains from product fragmentation trade rely on how efficiently the product value chain can be sourced from different regions. A hypothetical example of such a value chain would be if a firm was to invest in a fan manufacturing plant in Pakistan, production of motors in Bangladesh, designing facilities in Sri Lanka and market it through India. This should be done ensuring that each stage of production would occur where it is most cost effective to do so, and the final product will be extremely competitive in the international market.

There is also evidence to suggest that South Asia has been slow to take off and take advantage of product differentiation in trade. Khan (2010) constructed the so-called Grubel–Lloyd Index, which gives the ratio of intra-industry trade to total trade. The

index value of 1 shows complete intra-industry trade, while a value of 0 depicts inter-industry trade (i.e. absence of any intra-industry trade).

The complete index values, as presented in Table 17.3, are extremely low, indicating very limited intra-industry trade, even at the SITC two-digit level (i.e. highest level of aggregation). The results also indicate that the highest level of intra-industry trade takes place in textile yarn, fabrics, made-up articles, etc., (Chapter 65).⁸ In addition, the highest level of bilateral trade also takes place within textile yarn, fabrics, made-up articles, etc., (Chapter 65) category between Bangladesh and Pakistan (GL Index 0.02399). There is negligible intra-industry trade between India and Pakistan, while intra-industry trade between Pakistan and Sri Lanka is more prominent than intra-industry trade between Pakistan and Bangladesh. This is a result of the presence of the bilateral FTA between Pakistan and Sri Lanka. Therefore, South Asian co-operation under SAARC has not improved intra-industry trade within South Asia.

Critical reasons for this low level of intra-industry trade include:

- (i) existing sourcing relations and end-buyer preferences already established outside of South Asia;
- (ii) prices tend to be on the higher side within the region due to bureaucratic red tape, energy cost and reliability, transportation cost and availability (port efficiency is extremely low in South Asia and time taken to ship in the Indian sub-continent is substantially higher than that in other regions; shipping times have also increased due to differential duty levels and RoO criteria, and also due to a mismatch between regional and local regulations);
- (iii) tariffs and NTBs;
- (iv) gaps in infrastructure;
- (v) complex political economy;
- (vi) lack of supply capacity and product variety; and
- (vii) limited intra-regional investment.⁹

17.5 Conclusion

This chapter has considered, from the perspective of Pakistan, broad areas impacting trade and integration potential in South Asia. It has discussed in detail the nature and impact of NTBs faced by Pakistan when trading with three major economies (India, Sri Lanka and Bangladesh) of South Asia. Integration is not going to work unless the complexities of trading within the region are eliminated. The respective governments of Pakistan and India will have to think more broadly in terms of regional integration (infrastructural constraints), regional competitiveness, compliance and certification issues, and will have to resolve the political ties without further delay. Political stability is the prime pre-condition for any type of integration measure to work successfully. On the economic front, the two governments intend to tackle a broad agenda, including improving trade logistics; easing visa restrictions; reducing NTBs; facilitating trade via the sea, land, and rail routes; and opening up the banking sectors.

Table 17.3 Weighted GL Index for industries at SITC two-digit level – South Asia (2008)

CODE		Pk-In	Pk-SL	Pk-Bn
5	Chemicals and related products			
51	Organic chemicals	0.0048	0.00245	0
52	Inorganic chemicals	0.0005	0.00172	0.00017
53	Dyeing, tanning and colouring materials	0	0.00017	0
54	Medicinal and pharmaceutical products	0.0001	0.00019	0.00017
55	Essential oils and resinoids, etc.	0.0001	0.00026	0
56	Fertilisers	0	0	0
57	Plastics in primary form	0.0004	0.00369	0.00018
58	Plastics in non-primary form	0.002	0	0
59	Chemical materials and products	0.0005	0.00094	0
6	Manufactured goods classified chiefly by material			
61	Leather and leather manufactures etc.	0.0009	0.00008	0.00078
62	Rubber manufactures	0	0.00004	0
63	Cork and wood manufactures (excluding furniture)	0	0.00023	0
64	Paper, paperboard and articles of paper pulp, of paper or of paperboard	0	0.00022	0.00002
65	Textile yarn, fabrics, made-up articles, etc.	0.008	0.01395	0.02399
66	Non-metallic mineral manufactures	0.005	0.00092	0.00004
67	Iron and steel	0.0003	0.00022	0.00002
68	Non-ferrous metals	0.0032	0.0001	0
69	Manufactures of metals etc.	0.0009	0.0002	0.00112
7	Machinery and transport equipment			
71	Power-generating machinery and equipment	0.0001	0	0.00063
72	Machinery specialised for particular industries	0.0012	0.0011	0.00082
73	Metalworking machinery	0	0	0
74	General industrial machinery and equipment, etc.	0.0006	0.00001	0.0001
75	Office machines and automatic data-processing machines	0	0.00012	0
76	Telecommunications and sound-recording	0	0.00012	0.00001
77	Electrical machinery	0.0005	0.00167	0.00041
78	Road vehicles	0	0.00007	
79	Other transport equipment	0		0
8	Miscellaneous manufactured articles			
81	Prefabricated buildings etc.	0	0	0
82	Furniture etc.	0	0.00006	0.00014
83	Travel goods, handbags, etc.	0		0.00001
84	Articles of apparel and clothing accessories	0	0.00208	0.00223
85	Footwear	0		0
87	Professional, scientific and controlling instruments and apparatus	0.0014	0	0
88	Photographic apparatus, equipment and supplies and optical goods, etc.	0	0	0
89	Miscellaneous manufactured articles etc.	0.0016	0.00618	0.00115

Source: Calculations are based on data from Khan (2010)

Moreover, the countries will have to rationalise NTBs by taking a sectoral approach. The nature of NTBs, especially those relating to quality and standards and technical requirements, can only be resolved if sector-specific issues are addressed. In some cases, simple recognition of country standards will result in immediate benefits, whilst in others a more detailed analysis, capacity building and better understanding may be required. Improvement in the flow of information will also help in reducing the impeding nature of the NTBs; for example, in the case of Bangladesh if all requirements are clearly stated on the internet on official government websites and the standards are defined it will be much easier for exporters to meet those standards. Rationalisation of negative lists and considering reducing the tariffs even below 5 per cent will also help in stimulating trade within the region.

While NTBs are inhibiting trade within the region, other costs incurred due to physical, logistical and bureaucratic barriers to trade are also extremely important. South Asia is often reported to encompass inadequate supply chains and trade facilitation is considered as a major impediment to trade integration in the South Asia.

There is limited evidence of intra-industry/product fragmentation trade within South Asia. The nature of product fragmentation trade is such that it is most viable in relatively high technology production sectors, such as electronics and automobiles. Hence, a pre-condition is that countries engaged in slicing up the value chain need to have the required human resources and skill sets. In South Asia, with the exception of India, the level of skilled human resources is extremely low. This asymmetry is restricting the technologically advanced economy of India from diverting some parts of its product value chain to countries in the region. Furthermore, transport bottlenecks both within and between countries are impacting inter-industry but more so intra-industry trade. South Asia is reported to suffer due to high delivery costs, large transit times and the reliability and predictability of delivery. Finally, all countries will have to work on improving their product lines and shift their focus towards producing goods that have growing market demands both regionally and internationally.

If integration is to succeed in the region, it is essential that the member countries make investments in improving the logistical infrastructure, improving connectivity and improving information flow, make cross-border investments (a framework for investment must follow SAFTA) and work on relaxing NTBs for partner countries. Intra-industry trade is one way of reducing NTBs, improving infrastructure and attracting investment is another. However, the evidence on causality is mixed in terms of differentiating between the causes and the outcomes. It is only by way of working with each other in partnerships that South Asia will be able to achieve its overall challenge of creating a better life for its citizens.

Notes

- 1 This study could not have been completed without the support of several individuals and organisations. I should like to thank the SAARC, Commonwealth Secretariat, Policy Research Institute Bangladesh and Lahore University of Management Sciences for providing me with the opportunity to work on this important issue. I should also like to thank Dr Zaidi Sattar (Chairperson PRI Bangladesh), Dr Ijaz Nabi (Dean, School of Social Sciences, Lahore University of Management Sciences) for providing

overall guidance and direction, Dr Turab Hussain (Assistant Professor, LUMS) for sharing his views on trade and Ms Samar Alam for providing research support. I owe a great debt to numerous representatives of the private sector who took time out from their busy schedules to discuss their problems regarding trading within South Asia. I offer a very warm 'thank you' to all of them.

- 2 Trade creation occurs when an economy is able to trade some parts of its production line with more cost-efficient production within the region due to favourable trade conditions created under the regional trade agreement. Trade diversion occurs when the asymmetric nature of trade barriers between intra-regional and extra-regional countries makes a country trade within the region rather than with economies outside the region that are more cost efficient.
- 3 For a discussion of the granting of MFN, see Khan (2011).
- 4 Both SAFTA and SAPTA are part of the South Asian Association for Regional Cooperation (SAARC), formed in 1985. The original SAARC members were Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. Afghanistan joined SAARC in 2007.
- 5 By way of comparison, India and Sri Lanka have had a free trade agreement (FTA) since 2000, and total Indian–Sri Lankan trade is about US\$4 billion, even though Sri Lanka's GDP is roughly a quarter that of Pakistan's. Also, Indian trade with Bangladesh, which is half the size of Pakistan's GDP, reached \$3.5 billion in 2010.
- 6 Mr SN Rao (Indian Commerce Secretary) stated this at a conference organised by the Indian Council for Research on International Economic Relations (ICRIER), held on 14–15 March 2013 in New Delhi, India.
- 7 Meeting with Syed Yawar Ali, Vice President of the India–Pakistan Business Council, Lahore, 25 March 2013.
- 8 The indices show that the highest level of intra-industry trade within the region takes place in the textile yarn, fabrics, made-up articles and related products category (chapter 65). Although the numbers are not presented in this chapter, if one were to look at the trade relations between other members in South Asia, then the highest intensity of bilateral intra-industry trade takes place within textile yarn between Sri Lanka and Bangladesh – while Sri Lanka exports US\$5,298,956 worth of textile yarn, fabric, made-up articles and related products to Bangladesh, it also imports goods worth US\$4,564,944 of the same category from Bangladesh. Furthermore, it can also be seen that trade between Sri Lanka and India and India and Nepal have a higher propensity for intra-industry trade.
If one further disaggregates trade data at the SITC three-digit level in the textile sector, intra-industry trade is observed to be relatively higher among countries in the region. There is relatively high intra-industry trade in the 'textile yarn' sector with the highest bilateral trade flows in this sector taking place between Sri Lanka and Bangladesh. Apart from Sri Lanka and Bangladesh, there is also intra-industry trade to a notable extent between India and Pakistan and India and Nepal.
- 9 The largest South Asian investment in the region has been by Brandix, a large Sri Lankan apparel exporter – the 1000-acre park which was set up in India in 2005 with an investment of US\$750 million expected to rise to US\$3 billion.

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Chapter 18

Nepal and SAFTA: Issues, Prospects and Challenges

Ratnakar Adhikari and Paras Kharel¹

18.1 Introduction

The Preamble to the Agreement on South Asian Free Trade Area (SAFTA) expects it to act 'as a stimulus to the strengthening of national and SAARC economic resilience, and the development of the national economies of the Contracting States by expanding investment and production opportunities, trade, and foreign exchange earnings as well as the development of economic and technological co-operation' (SAARC Secretariat 2004). Nepali policy-makers believed that joining SAFTA would help Nepal to expand its exports to countries other than India, collectively called the 'Rest of South Asia' (RSA), and thereby contribute to geographic export diversification. If Nepal's intra-regional trade during the first five years of implementation of SAFTA is any guide, this objective is far from being achieved. This is also the plight of most of the LDCs in the region, which are heavily dependent on the two largest economies of the region for their regional trade.

While the faulty Agreement resulting from the mercantilist mindset of trade negotiators in the region is partly responsible for this predicament, we argue that internal inconsistencies in Nepal's trade policy vis-à-vis SAFTA as well as the supply-side constraints are equally responsible for Nepal's inability to fully utilise SAFTA to its advantage.

This chapter discusses Nepal's trade prospects with RSA, the barriers and constraints to tapping the trade potential, and how SAFTA can be strengthened to help address them. It must be pointed out at the very outset that the analysis in this chapter is predominantly in the context of Nepal's trade relations with India. This is because India accounted for 90 per cent of Nepal's exports to South Asia, and 99 per cent of Nepal imports from South Asia in 2009. Although we note that services trade is immensely important² and the SAARC Agreement on Trade in Services³ has been signed, the chapter focuses exclusively on merchandise trade.

The rest of the chapter is organised as follows. Section 18.2 provides a brief background on Nepal's trade performance. Section 18.3 discusses Nepal's trade with India, focusing on the bilateral trade treaty and the barriers faced by Nepali exports. Section 18.4 highlights the implications of SAFTA membership for trade with India. Section 18.5 discusses the trend of Nepal's trade with RSA, assesses the export potential, and sheds light on the barriers and constraints to realising that potential. Section 18.6 is devoted to Nepal's supply-side constraints. The last section summarises the discussion and provides some recommendations.

18.2 Nepal's trade performance

Securing better market access conditions for its exports, achieving product-wise and destination-wise export diversification and reducing trade deficit are key motivations behind Nepal's pursuit of negotiating trade agreements.⁴ Nepal became a member of the World Trade Organization in 2004. Nepal has been party to various regional trade liberalisation initiatives in South Asia: it was a member of the positive-list-based SAARC Preferential Trading Arrangement (SAPTA), which was signed in 1993 and came into force in 1995, and is a member of SAFTA, which has replaced SAPTA and has been in force since July 2006. At the trans-regional level, it is a member of the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) free trade agreement (FTA), which is yet to come into operation. At the same time, Nepal has applied for the membership of the Asia Pacific Trade Agreement (APTA), also known as the Bangkok Agreement.

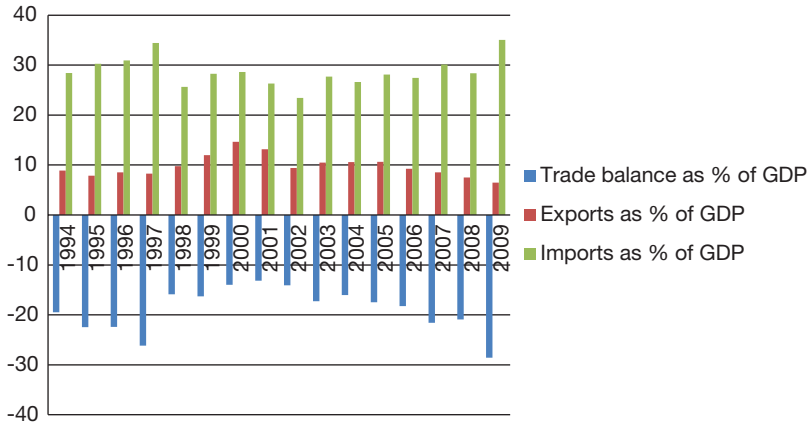
However, Nepal's foreign trade continues to be concentrated on India, with which it has had a bilateral preferential trade agreement since 1950. Trade dependence on India has increased over time, and, more alarmingly, so has the merchandise trade deficit, which is being largely financed by remittances. From 24.5 per cent in the mid-1990s, the share of merchandise exports to India increased to an average of 64 per cent from 2007/08 to 2009/10. Likewise, the share of merchandise imports from India increased from 30 per cent to 59.6 per cent during the same period (Figure 18.1). If informal trade is taken into account, the dependence is even higher, with a study showing informal trade to be 38–103 per cent of formal trade in 2000–01 (Karmacharya et al. 2004).

In the decade 2000–09, the merchandise trade deficit as a percentage of GDP more than doubled to 28.6 per cent (Figure 18.2). The overall merchandise export–import ratio has more or less continuously fallen since 2004/05, reaching 16 per cent in 2009/10 (a slightly better 18.4 per cent with India). The trade deficit with India

Figure 18.1 Nepal's merchandise trade concentration with India



Source: Nepal Rastra Bank, 'Recent Macroeconomic Situation', various issues

Figure 18.2 Nepal's merchandise trade performance

Source: World Bank, World Development Indicators

accounted for, on average, 58.6 per cent of Nepal's total trade deficit from 2007/08 to 2009/10.

After India, Nepal's major export destinations are the European Union (EU), the United States (US), Bangladesh and China (in 2009). Nepal's major sources of imports after India are China, the EU, Saudi Arabia and East Asian countries (in 2009).

18.3 Trade with India

Nepal and India have had a bilateral trade agreement for the last six decades. From Nepal's market access perspective, the Nepal–India Trade Treaty, last renewed in October 2009 for seven years, has been particularly restrictive since 2002, when a much more liberal Treaty signed in 1996 was replaced. The Treaty, which covers only goods trade, provides for, inter alia, exemption from basic customs duty and quantitative restrictions on imports of listed primary (including agricultural) goods on a reciprocal basis; access for Nepali manufacturing products, except for three items on the negative list,⁵ to the Indian market free of customs duties; and preferential entry of goods from India to the Nepali market.⁶ However, a number of restrictive provisions, which were introduced in the renewal of the Treaty in 2002, have diluted the duty-free provision for Nepali products:

- Stringent rules of origin (RoO) requiring Nepali exporters to fulfil the twin criteria of 30 per cent value addition and change in tariff heading at the four-digit level of the Harmonized Commodities Description and Coding System (HS)⁷ for the products to be eligible for preferential market access.
- Tariff rate quota for four major products of export interest to Nepal with zero-duty treatment provided for in-quota items, namely vegetable ghee (100,000 tonnes), acrylic yarn (10,000 tonnes), copper products under HS Chapters 74.00 and 85.44

(10,000 tonnes) and zinc oxide (2,500 tonnes); and most favoured nation (MFN) duty for any exports above these thresholds.

- Requirement for Nepal to submit the criteria applied for RoO on an annual basis.
- Clear specification of safeguard clauses, which define ‘injury’ with a much more convenient trigger mechanism for the imposition of safeguard duty over and above normal tariff.⁸

That a liberal trade treaty, taking into account Nepal’s supply-side constraints, can help work wonders for the country’s export performance with its largest trading partner was demonstrated by the 1996 version of the trade treaty. The most significant provision of the treaty was duty- and quota-free access for Nepali manufacturers, without respect to the origin of raw material inputs in the production process, as long as there was some local value added in manufacturing. Exports increased by 7.6 times between 1995/96 and 2001/02, while imports grew, at a much slower rate, by 2.3 times during the same period. There was a marked shift in the composition of exports, away from primary goods to manufactured goods.⁹

With the revision of 2002, on the one hand, manufacture items exhibiting promising export growth were targeted with quantitative restrictions, and on the other, the onerous RoO, besides hurting existing exports, erected a barrier to emergent and potential exportable goods.¹⁰ The ostensible grounds for introducing RoO – way beyond the capacity of an LDC with a weak industrial base and serious supply constraints¹¹ – were to ‘promote genuine industrialization’ in Nepal and ‘provide clarity and transparency’ to the preferential scheme (Shrestha 2003). In practice, however, RoO has been used as a means of disguised protection. Global experience shows that there is no evidence that strict RoO has helped beneficiary countries create a viable industrial base.¹² Indian goods, however, do not have to fulfil any RoO to gain preferential access to the Nepali market.

Quantitative restrictions are not confined to those stipulated in the Treaty. There are cases of imports of certain products from Nepal being banned unilaterally on and off. Garlic exports are a case in point: imports of garlic from Nepal are banned from time to time with the allegation that Chinese garlic was finding its way into India, although the local certificate of origin attests to their Nepali origin.¹³

Application of sanitary and phytosanitary (SPS) measures and technical standards constitutes another critical impediment to Nepali exports to India. Agricultural and forest products – goods identified by the government for export promotion¹⁴ – as well as manufactured goods like ready-made garments (RMG) and pharmaceuticals face these non-tariff barriers (NTBs).¹⁵ There is no predictability in the way quarantine-related rules are applied (Adhikari 2008). The requirement to subject export samples to testing in India – in some cases, in New Delhi – discourages exports. India does not recognise Nepali pharmaceuticals approved by the Nepal Government’s Department of Drug Administration. A sample from the export consignment has to be taken to the central authority in New Delhi for testing and it takes anywhere between 6 and 12 months for the results to be out, by which time the medicines in the consignment waiting at the border may well have crossed the date of expiry.¹⁶ This is a major reason

why Nepali pharmaceuticals, despite possessing export potential,¹⁷ have not made inroads in the Indian market.¹⁸

Para-tariff barriers are another concern. A case in point is the imposition in 2009 of Special Additional Duty (SAD) on Nepali RMG, for which India has emerged as a major market after the expiry of the Agreement on Textiles and Clothing (ATC) of the WTO that saw Nepal lose a substantial market share in the United States, traditionally the largest market for its RMG exports. Furthermore, countervailing duty (CVD), levied on imports to balance the excise duty imposed on like domestic products, was imposed on the maximum retail price of RMG instead of the border price as is the standard international practice.¹⁹ Besides directly hurting exports, the unpredictability associated with the imposition of such extra duties and charges, even if they are withdrawn later, has undermined investors' confidence in Nepal.

An attempt was made in the 2009 revision to the Treaty to address the problem of the lack of mutual recognition of standards and testing. Much will hinge on the implementation of India's 'best endeavours' pledge made in the Treaty to assist Nepal to increase its capacity to trade through improvements in technical standards, quarantine and testing facilities and related human resource capacities (Kharel 2010a). While the old Treaty was silent on para-tariff and non-tariff barriers – which played havoc with Nepali exports – the revised Treaty of 2009, in its Protocol to Article I, says that the two sides *shall undertake measures to reduce or eliminate* non-tariff, para-tariff and other barriers that impede promotion of bilateral trade. But this is a weak formulation and does not entail a binding commitment to categorically eliminate such barriers.²⁰

While these market-access barriers hurt Nepal's export performance, it must be noted that supply-side constraints within Nepal (to be discussed in section 18.6) also crucially affect its export performance.

18.4 SAFTA membership and trade with India

SAFTA does not offer additional market access for Nepal in the Indian market. Nepal already enjoys basic customs duty-free market access to the Indian market in almost all products, subject to RoO. The RoO under SAFTA is exactly the same as in the Nepal–India Trade Treaty, which as alluded to earlier is extremely onerous for Nepali enterprises to fulfil. The RoO needs to be made simple, transparent and, for LDCs, less stringent (see, for example, Adhikari 2010a).

Preference erosion in the Indian market as India grants more and more concessions to LDCs is a challenge for Nepal. India's sensitive list for LDCs has been reduced to 480 items from the original 763 (Rahman and Rahman 2010). Moreover, the effectively applicable sensitive list for Bangladesh has 323 items (Rahman 2010a). While 157 apparel items still remain in India's sensitive list for LDCs, Bangladesh has been given duty-free access for 8 million pieces, though it has not been able to fully utilise this tariff rate quota (only 2.3 million and 3 million pieces were exported to India in 2008 (April–December) and 2009 respectively) (Rahman 2010a). Likewise, under an FTA,

Bhutan enjoys better market access conditions in the Indian market than does Nepal: duty-free access without quantitative restrictions and RoO. Similarly, under the India–Afghanistan Preferential Trade Agreement, in force since 2003, Afghanistan gets preferential market access (with the margin of preference ranging from 50 per cent to 100 per cent) to the Indian market for 38 listed items, albeit with RoO more stringent than for Nepal.

Although there are no extra benefits in terms of tariff preferences, there could be potential benefits in other areas from SAFTA for Nepal's trade with India. Compared with a bilateral agreement, a regional agreement can provide a more predictable trading environment for the smaller party. An effective dispute settlement mechanism under SAFTA which can be moved to also resolve disputes under bilateral trade treaties can help ensure better implementation of treaty provisions. The dispute settlement body under SAFTA is not independent, with the committee of experts (CoE), comprising government officials, acting as the dispute settlement body. There is no special treatment for LDCs with respect to dispute settlement. Removal of para-tariff and non-tariff barriers/measures and/or making them least trade restrictive under SAFTA may help address Nepal's concerns regarding the same in India.

On the import front, Nepal has placed on its SAFTA sensitive list 140 of 273²¹ agricultural tariff sub-headings (covering Chapters 1, 3, 4, 6–12, 14, 15, 17 and 23 at HS 2007 six-digit level) in which it provides basic customs duty-free access to products from India and Tibet, the autonomous region of the People's Republic of China. Out of the 273 items, 173 were actually imported in 2009. These products, when imported from India, Tibet and China, are subject to a 5 per cent agricultural development fee, which has been falling since Nepal's accession to the WTO, while the MFN tariff is 10 per cent, implying that India, Tibet and China enjoy a 5 per cent duty advantage. Together with China, India accounted for 66 per cent or more of the value of imports in 143 of the 173 tariff sub-headings. RSA, which faces the MFN tariff, accounted for a paltry 0.2 per cent of the total imports of these products.

It appears logical to extend complete duty-free treatment to the same agricultural products from other South Asian countries (and also China). Consumers' choice may increase, import sources may diversify and the cost of trade diversion may reduce, while domestic competitiveness concerns are unlikely to be aggravated by the extension. It may also strengthen Nepal's negotiating position under SAFTA and enable it to secure the removal of some, if not all, products of its export interest from other South Asian partners' sensitive lists.

However, there are concerns about duty-free entry of Indian agricultural products, including subsidised ones, adversely affecting the Nepali agricultural sector. It was to secure the policy space to increase tariffs if needed to protect the agricultural sector that Nepal, when acceding to the WTO, set its bound tariffs on agricultural goods generally at a much higher level than the applied rates – for example, bound rates for cereals are 50–60 per cent.²² Keeping these items on the SAFTA sensitive list, while

affording zero-duty treatment to the same products from India, suggests a lack of clarity on the part of the Government of Nepal as to the protection of the agricultural sector.

In general, Nepal should strive to accord the same treatment on trade matters to all SAARC members. This is important to reduce, if not eliminate, the cost of trade diversion and alleviate the stress on scarce capital for negotiating and implementing multiple trade agreements.

18.5 SAFTA: Trade with other South Asian countries

18.5.1 Exports

In 2009, Nepal's exports to RSA amounted to US\$66 million, or 7.5 per cent of its total exports, compared with 1.5 per cent in 2003 (Table 18.1). This represents an annual average growth rate of 38 per cent during 2003–09, significantly higher than the growth rate of exports to the world (5.2 per cent) and to India (8.7 per cent) during the same period. However, exports to RSA are highly concentrated to Bangladesh. The US\$60.8 million of exports to Bangladesh in 2009 represented 91 per cent of exports to RSA. Accounting for about 7 per cent of Nepal's total exports, Bangladesh was Nepal's third largest export partner after India and the USA in 2009. No other South Asian country was among Nepal's top 20 export partners (out of 144 countries in total), though Nepal exported to all of them in 2009. Barring Bangladesh, individual shares of RSA countries were less than 0.3 per cent.

Exports of lentils to Bangladesh explain the dramatic increase in Nepal's exports to RSA: lentils accounted for 72 per cent of Nepal's exports to Bangladesh in 2009. Nepal exported lentils – its second largest export product – to 27 countries in 2009, with

Table 18.1 Nepal's exports (US\$ million)

	1994	1999	2003	2009	% Annual average growth (2003–09)
World	384.84	524.29	652.69	886.00	5.23
India	44.17	186.60	341.80	562.81	8.67
Bangladesh	0.44	18.19	6.11	60.84	46.69
Bhutan		0.36	1.37	2.52	10.71
Sri Lanka	2.44	0.04	1.19	2.09	9.82
Pakistan	0.01	0.42	0.99	1.11	1.87
Maldives				0.05	
Afghanistan				0.03	
SA	47.06	205.61	351.46	629.45	10.20
RSA	2.88	19.01	9.66	66.64	37.98
Share of SA (%)	12.23	39.22	53.85	71.04	
Share of India (%)	11.48	35.59	52.37	63.52	
Share of RSA (%)	0.75	3.63	1.48	7.52	

Note: SA = South Asia, RSA = Rest of South Asia

Source: UN Comtrade database accessed through World Integrated Trade Solution (WITS), and authors' calculations

Bangladesh being the top importer, accounting for 60 per cent of the export value. It must be noted, however, that the ban introduced in 2006 on lentils exports by India, then the leading source of lentils imports for Bangladesh,²³ largely explains the surge in lentils exports from Nepal to Bangladesh, which, on its part, saw domestic lentils production fall from 2004 onwards and plunge by 40 per cent between 2007 and 2008.²⁴ Nepal's total exports to Bangladesh increased by 122 per cent and 800 per cent in the two years following 2005/06.²⁵ The sustainability of lentils exports is questionable because growth in domestic production has not matched growth in exports.

18.5.2 Imports

Relative to exports, Nepal's imports from RSA are low, amounting to US\$14 million in 2009, implying a trade surplus of US\$42 million with RSA (Table 18.2). Imports from RSA grew at a slower rate than imports from the world (13 per cent) and India (14.3 per cent) during 2003–09. The share of RSA in Nepal's total imports thus fell from 0.6 per cent in 2003 to 0.4 per cent in 2009. In contrast to exports, imports from RSA are relatively diversified across countries. Bangladesh, Bhutan and Pakistan accounted for 38.4 per cent, 32.5 per cent and 23 per cent of imports from RSA respectively. None of the countries in RSA, however, were among the top 20 import partners (out of 141 countries in total) of Nepal in 2009.

In 2009, Nepal's overall trade balance with RSA was positive, recording trade surplus with Bangladesh, Sri Lanka and Maldives, and deficit with the rest (Table 18.3). Notably, the trade surplus with Bangladesh was nearly 84 per cent of bilateral trade. Nepal has consistently had a trade deficit with Pakistan, while no discernable trend is found for trade with others.

Table 18.2 Nepal's imports (US\$ million)

	1994	1999	2003	2009	% annual average growth (2003–09)
World	1,111.04	1,347.48	1,801.62	3,754.39	13.02
India	429.84	619.86	954.91	2,131.93	14.32
Bangladesh	14.67	8.97	4.85	5.40	1.78
Bhutan	2.30	0.79	0.57	4.55	41.43
Sri Lanka	0.55	1.42	1.99	0.75	–14.98
Pakistan	4.49	13.21	3.30	3.21	–0.45
Maldives				0.00	
Afghanistan	0.00		0.03	0.08	18.90
SA	451.85	644.25	965.65	2,145.93	14.23
RSA	22.01	24.39	10.74	14.00	4.50
Share of SA (%)	40.67	47.81	53.60	57.16	
Share of India (%)	38.69	46.00	53.00	56.79	
Share of RSA (%)	1.98	1.81	0.60	0.37	

SA = South Asia, RSA = Rest of South Asia

Source: UN Comtrade database accessed through WITS, and authors' calculations

Table 18.3 Nepal's trade balance (US\$ million)

	1994	1999	2003	2009
World	-726.21	-823.19	-1,148.93	-2,868.39
India	-385.67	-433.26	-613.11	-1,569.12
Bangladesh	-14.23	9.23	1.25	55.44
Bhutan	-2.30	-0.43	0.80	-2.03
Sri Lanka	1.88	-1.39	-0.80	1.33
Pakistan	-4.48	-12.78	-2.31	-2.10
Maldives				0.05
Afghanistan	0.00		-0.03	-0.05

Source: UN Comtrade database accessed through WITS, and authors' calculations

18.5.3 Trade potential

There exists large potentials for the expansion of regional trade in South Asia. As can be seen from Table 18.4, total imports of most South Asian countries have grown faster than world imports during 2005–09. One way to assess the export prospects of a country in a regional trading arrangement is to look at the complementarity index. This index provides an idea of the compatibility of the export pattern of a country with the import of another, with a high degree of complementarity being assumed to indicate more favourable prospects for a successful trade agreement (Mikic and Gilbert 2007).²⁶ Complementarity indices for 2009 show a high degree of complementarity between Nepal's exports and the imports of Maldives, Bhutan and Afghanistan (Table 18.5). Complementarity with Bhutan and the Maldives has increased over time, and was high in the 2000s too. Complementarity with respect to India takes a moderate value of 42.5 with no substantial change since 1999, while it is low (less than 33) with respect to other South Asian countries.

However, it should be noted that when the size differences in the economies is large (i.e. a match in percentage terms does not imply a match in levels), the complementarity index, which is based on shares, may be misleading. Hence, we also use a measure of trade potential – i.e., Nepal's export potential – based on levels

Table 18.4 South Asian market size and growth

	Imports from world, 2009 (US\$ billion)	% annual average growth in imports (2005–09)
Afghanistan	3.34	
Bangladesh	18.37	14
Bhutan	0.53	8
India	266.40	20
Maldives	0.98	10
Pakistan	31.58	8
Sri Lanka	9.43	6
World	12,650.12	6

Source: International Trade Centre (ITC) Trade Map

Table 18.5 Complementarity index between Nepal's exports and its South Asian neighbours' imports

	1999	2003	2009
Afghanistan			60.97
Bangladesh		34.50	31.41 ^a
Bhutan	75.40		80.73
India	41.77	38.59	42.50
Sri Lanka	36.56	27.11	32.49
Maldives	71.56	70.69	80.11 ^a
Pakistan		29.33	28.78

Note: ^aFigures for 2007

Source: WITS

of exports (of Nepal) and imports (of the partner). For each tariff sub-heading at HS six-digit level, Nepal's export potential in a South Asian country is calculated by subtracting Nepal's actual exports to that country from the minimum of Nepal's total exports and the partner's total imports. Summing the export potential in all the tariff sub-headings yields the aggregate export potential of Nepal in the partner. This measure, though based on a static concept, gives an indication of the value of additional exports that Nepal can potentially make to another country, given Nepal's existing export capacity, the existing imports of the partner country and the existing exports from Nepal to that country. We use the trade potentials at HS six-digit level calculated by the International Trade Centre (ITC)'s Trade Map for 2009 and sum them to get the aggregate trade potential (Table 18.6).

The figures in Table 18.6 show that there exists substantial potential for Nepal to increase exports to all of its South Asian neighbours; these markets remain significantly under exploited by Nepal given its existing export capacity. Export potential value ranges from US\$11.8 million to Afghanistan to US\$314 million to

Table 18.6 Trade potential of Nepal (as an exporter) to its South Asian neighbours (importers)

	Trade potential (TP) in 2009 (US\$ million)	Exports in 2009 from Nepal to South Asian countries (US\$ million)	Ratio of TP to actual exports from Nepal to South Asian countries
Afghanistan	11.83	0.03	394.17
Bangladesh	261.39	60.84	4.30
Bhutan	37.23	2.52	14.80
India	170.60	562.81	0.30
Maldives	65.43	0.05	1,258.35
Pakistan	314.84	1.11	283.38
Sri Lanka	269.04	2.09	128.91

Sources: TP: aggregated on the basis of tariff sub-heading-wise trade potentials calculated by ITC Trade Map

Exports value: UN Comtrade database / ITC Trade Map

Pakistan. Even with India, which already absorbs 63.5 per cent of Nepal's exports, an export potential of US\$170 million exists. In the RSA group, following Pakistan in terms of size of trade potential are Sri Lanka, Bangladesh, Maldives, Bhutan and Afghanistan. Trade potential exceeds existing exports by factors ranging from 4.3 (Bangladesh) to 1,258 (Maldives). With India, however, trade potential is 30 per cent of current exports—which is not surprising given the already high concentration of exports in that market.

18.5.4 Market access conditions in RSA: tariff barriers

This section looks at the tariff barriers faced by Nepal in the top four markets in RSA (Bangladesh, Pakistan, Sri Lanka and Bhutan) and the coverage by the sensitive lists maintained by these countries of items of export interest to Nepal.

Bangladesh

Nepal exported products in 19 sub-headings (HS six-digit) to Bangladesh in 2009, with lentils accounting for 72 per cent of total export value. Six of the sub-headings, representing over 97 per cent of the value of Nepal's exports to Bangladesh, are on Bangladesh's sensitive list. In 2008, they attracted tariffs of 0 (in two sub-headings), 7, 10, 12 and/or 25 per cent (in two sub-headings) (Table 18.7). Lentils, which is on the sensitive list, gets zero-tariff access but they are bound at 200 per cent in the WTO schedule of concessions, leaving open the possibility of the tariff being increased to a prohibitive level. Three sub-headings are unbound. Tariff rates in six of the 13 sub-headings not on the sensitive list were already 0 or 5 per cent in 2007. Tariffs in the remaining seven sub-headings were 12 or 23.75 per cent in 2007; they must be reduced to 0–5 per cent by 2016 if they have not been already. The SAFTA Agreement encourages LDC members to reduce tariffs, from the third year onwards, in equal annual instalments, not less than 10 per cent annually. MFN tariffs on items outside the sensitive list are 0 per cent (2 sub-headings), 7 per cent (5), 12 (3) and 25 (3) in 2008.

It is pertinent to look also at whether products in which Nepal has comparative advantage are on the sensitive list of Bangladesh or not (Table 18.8). In 2009, Nepal had revealed comparative advantage (RCA) globally, as measured the RCA index,²⁷ in 478 sub-headings at HS six-digit level. In 154 of these sub-headings, Bangladesh's global imports exceeded Nepal's global exports, implying there is a potential additional market in Bangladesh for these products from Nepal, provided Nepal can increase its export supply.²⁸ Of these 154 items, 62 (40 per cent) are on Bangladesh's sensitive list (which has a total of 1,166 items for the LDC-specific sensitive list), while the rest are outside it. These items represent a market in Bangladesh of US\$1.3 billion, over and above what Nepal exports to the world.²⁹ Items outside the sensitive list also represent a substantial market of US\$323 million.

This suggests that while Bangladesh's sensitive list appears to be a barrier, other factors, such as para-tariff barriers³⁰ and NTBs, transit-related problems and Nepal's own supply-side constraints, should also be taken into account while addressing the issue of sub-optimal utilisation of trade potential.

Table 18.7 Market access conditions in the RSA: tariff barriers faced by Nepal

Market	No. of items sensitive list (SL)	No. of items exported by Nepal	No. of exported items on SL and their percentage of export value	No. of exported items on SL entering duty-free	Applied tariff on exported items on SL	Applied tariff on exported items outside SL
Bangladesh	1,166	19	6 (97.6)	2 [2008]	0%, 7%, 10%, 12%, 25% (2 sub-headings) [2008]	0%, 5% (6 sub-headings) 12%, 23.75% (7 sub-headings) [2007]
Pakistan	1,169	17	5 (48.5)	0 [2010]	10% (1 sub-heading), 25% (4 sub-headings) [2010]	Required to have reduced it to 0–5% by July 2009
Sri Lanka	1,065	6	2 (14)	0 [2009]	28% (1 sub-heading), 28% and a specific duty of LKR 5/kg (1 sub-heading) [2009]	Required to have reduced it to 0–5% by July 2009
Bhutan	150	51	1 (0)	0 [2007]	50% [2007]	19%, 28.5% or 35% (45 sub-headings) 9.5% (2 sub-headings) 0% (2 sub-headings) [2007]

Note: See text for further explanation

Source: Tariff data from ITC Trade Map, Trade Analysis and Information System (TRAINS) and UN Comtrade database (accessed through WITS); rest, authors' calculation

Table 18.8 Coverage by RSA sensitive lists of items of Nepal's comparative advantage

Market	No. of items in which Nepal has RCA>1 and partner's global imports>Nepal's global exports	No. of items in column 2 that are on sensitive list (SL)	Indicative market value in partner for items in column 3 (US\$ million)	Indicative market value in partner for items in column 2 but not on SL (US\$ million)
Bangladesh	154	62	1,300	323
Pakistan	205	60	327.8	1,000
Sri Lanka	181	54	431	163.7
Bhutan	24	4	1	20.8

Note: Indicative market value is calculated as the sum of the difference between partner's global imports and Nepal's global exports of the items in question

Source: Authors' calculation based on UN Comtrade data accessed through WITS

Pakistan

Nepal exported products in 17 sub-headings (HS six-digit) to Pakistan in 2009, with HS 6214.20 (shawls, scarves, mufflers, mantillas, veils and the like (excluding knitted/crocheted), of wool/fine animal hair) accounting for 46 per cent of total export value. Five of the sub-headings, including the top export item, representing 48.5 per cent of the value of Nepal's exports to Pakistan, are on Pakistan's sensitive list. In 2010, they attracted tariffs of 10 (one sub-heading) or 25 per cent (in four sub-headings). The SAFTA Agreement requires non-LDC members to reduce tariffs to 0–5 per cent on products imported from LDC members within three years of the date of entry into force of the Agreement, that is, by July 2009.³¹ MFN tariffs on the 12 sub-headings not on the sensitive list were 0 per cent (2 sub-headings), 5 per cent (4), 10 per cent (4), 15 per cent (1) and 25 per cent (1) in 2008 or 2010.

In 205 of the 478 sub-headings in which Nepal had RCA in 2009, Pakistan's global imports exceeded Nepal's global exports, implying there is a potential additional market in Pakistan for these products from Nepal, provided Nepal can increase its export supply. Some 60 (29 per cent) of these items are on Pakistan's sensitive list (which has a total of 1,169 items for LDCs). These items represent a market in Pakistan of US\$327.8 million, over and above what Nepal exports to the world. The remaining items, those outside the sensitive list, represent an even greater market of US\$1 billion. Tariffs on these items for Nepal were due to have been reduced to 0–5 per cent by July 2009.

As in the case of Bangladesh, while Pakistan's sensitive list may be a barrier, other factors may also be at work. One of the serious issues, as noted by Adhikari (2010a), is the transit problems faced by Nepal while using Indian territory to access Pakistan.³²

Sri Lanka

Nepal exported products in just six sub-headings (HS six-digit) to Sri Lanka in 2009, with lentils accounting for 85.6 per cent of total export value. Two of the sub-headings

are on the sensitive list, representing 14 per cent of the value of Nepal's exports to Sri Lanka. In 2009, they faced tariff peaks (28 per cent), with one also facing a specific duty of 5 Sri Lankan rupees (LKR) per kg.

It is not clear what is the actual tariff rate for lentils, the top export item (85.6 per cent of exports), since Sri Lanka has five tariff lines within HS 0713.40, with the applied rate in 2009 ranging from 2 to 22.4 per cent for LDCs, and the trade data being available at the six-digit level only. MFN tariffs on the three other sub-headings not on the sensitive list were 15 per cent in 2009. As a non-LDC, Sri Lanka was required to reduce tariffs on items outside the sensitive list for LDC members to 0–5 per cent by July 2009.³³

In 181 of the 478 sub-headings in which Nepal had RCA in 2009, Sri Lanka's global imports exceeded Nepal's global exports, implying there is a potential additional market in Sri Lanka for these products from Nepal, provided Nepal can increase its export supply. Fifty-four (30 per cent) of these items are on Sri Lanka's sensitive list (which has 1,065 items in total). These items represent a market in Sri Lanka worth US\$431 million, over and above what Nepal exports to the world. The remaining items, those outside the sensitive list, represent a market of US\$164 million. Tariffs on these items for Nepal were due to have been reduced to 0–5 per cent by July 2009.

Bhutan

Nepal exported products in 51 sub-headings (HS six-digit) to Bhutan in 2009, the highest among RSA export partners. Export value is less concentrated in a few products than with respect to Bangladesh, Pakistan and Sri Lanka.

Only one (HS 9403,50: wooden furniture) of the 51 exported items is on the sensitive list. It faces a prohibitive tariff of 50 per cent and the export value is negligible. As for the remaining 50 sub-headings which are not on the sensitive list, in 2007, 45 faced tariffs of 19, 28.5 or 35 per cent; two faced 9.5 per cent and two entered duty-free (the tariff rate on one item is not known). These must be reduced to 0–5 per cent by 2016 if they have not been already. The SAFTA Agreement encourages LDC members to reduce tariffs, from the third year onwards, in equal annual instalments, not less than 10 per cent annually.

In 24 of the 478 sub-headings in which Nepal had RCA in 2009, Bhutan's global imports exceeded Nepal's global exports, implying there is a potential additional market in Bhutan for these products from Nepal, provided Nepal can increase its export supply. Only four of these items are on Bhutan's sensitive list (which has a total of 150 items). These items represent a market in Bhutan of US\$1 million, over and above what Nepal exports to the world. The remaining items, those outside the sensitive list, represent a much greater market worth US\$20.8 million.

This suggests that Bhutan's sensitive list is in general not a major barrier for Nepal to expand its exports to that country. Nepal would, however, want the reduction of tariffs on items not on the sensitive list to take place at a speedy rate.

From the foregoing analysis, we observe that, overall, the sensitive lists of RSA countries contain items of export interest to Nepal, including those in which Nepal has RCA (for which a substantial market exists). As for items outside the sensitive

lists, which also represent a significant market, it is of interest how fast the tariffs on them will be reduced to 0–5 per cent. In addition, para-tariffs and NTBs, transit-related problems and domestic supply-side constraints must be taken into account.

18.5.5 Nepal's tariff structure

As Nepal itself has the longest sensitive list in SAFTA (1,257 for LDCs and 1,295 for non-LDCs), it should be prepared to prune its own while asking the same of others. Nearly 48 per cent of Nepal's global imports are covered by the sensitive list. In the case of imports from South Asia, the sensitive list coverage is even higher (57 per cent). Some 68 per cent of total imports under sensitive list are from South Asia. Imports from South Asia under the sensitive list amounted to US\$1.2 billion in 2009. The coverage by the sensitive list of imports from individual countries varies, however (Table 18.9): it is in the range of 8–16 per cent for Afghanistan, Bhutan, Maldives and Sri Lanka, while it is 60 per cent for India and 75 per cent for Bangladesh. It must be noted that the huge coverage of imports by the sensitive list is driven by imports of petroleum products under Chapter 27 from India, amounting to US\$558.3 million, which alone make up 46 per cent of sensitive list imports from India and about 15 per cent of total imports (inside and outside the sensitive list).³⁴

As noted in section 18.4, the presence of 140 agricultural products on Nepal's sensitive list is redundant in the light of the fact that basic customs duty-free access is provided to such products from India (and Tibet and China), which also happens to be a predominant supplier of the same. In 2009, Nepal actually imported 97 of the 140 products amounting to US\$80.2 million, with India accounting for 85 per cent and China 8 per cent of the supplies. India and China accounted for 66 per cent or more of imports in 86 of the 97 products. This illustrates the need to rationalise the sensitive list.

Application of objective criteria, backed by stakeholder consultation, should guide the process of pruning the sensitive list. Kharel (2010b) used four criteria for initial consideration of items to be removed from the sensitive list:³⁵ first, at least one South Asian country has RCA greater than unity in the product consistently for

Table 18.9 Import coverage by Nepal's sensitive list, 2009

Imports from	Imports of items under SL (US\$1000)	Percentage of imports covered by SL	Total items imported (HS six-digit)	Total imported items that are on SL
Afghanistan	7.47	9.30	10	5
Bangladesh	4,032.06	74.70	118	80
Bhutan	502.87	11.05	9	6
India	1,216,650.76	60.25	3,783	913
Pakistan	1,421.56	44.23	68	30
Sri Lanka	116.75	15.53	40	23
Maldives	0.08	8.37	2	1
South Asia	1,222,731.54	56.98		

Source: Authors' calculation based on UN Comtrade data accessed through WITS

three years; second, South Asia supplies at least two-thirds of Nepal's imports of the product consistently for three years; third, there exists trade potential (Nepal as an importer) for at least one South Asian country consistently for three years; and fourth, Nepal already provides duty-free access to the product if imported from India.³⁶ The criteria try to ensure that trade is created and trade diversion minimised as a result of sensitive list reduction. Since an important motive for keeping items on the sensitive list for Nepal is revenue (trade taxes on imports made up 21.7 per cent of total tax revenue in 2009/10), the study also assessed the importance of the shortlisted items for revenue purpose. Combining the secondary data analysis with limited stakeholder consultation to assess the potential impact of tariff liberalisation on the domestic sectors, the study identified 129 items for consideration for removal from the sensitive list, while recommending that measures, including provision of state support, be taken to enhance the domestic supply capacity in the sectors concerned.

Apart from providing basic customs duty-free access to listed agricultural products from India, Nepal also provides preferential tariff treatment, albeit marginal, to other goods from India, as per the bilateral trade treaty. In 2010/11, the tariff concession consisted of a 7 per cent rebate on *ad valorem* customs duty for goods attracting *ad valorem* tariff of up to 30 per cent and a 5 per cent rebate for goods attracting *ad valorem* tariff of more than 30 per cent. Besides this general rebate, tariff concessions are provided also to some specific products imported from India.³⁷ Nepal should consider extending the same preferential treatment to all SAFTA members, subject to RoO as agreed under SAFTA, including for India.

Table 18.10 provides a summary comparison between Nepal's MFN applied duty rates and preferential duty rates for SAFTA members for the year 2010 based on the WTO's Tariff Analysis Online database. Considering only *ad valorem* duties due to data constraints, in 2010, Nepal's simple average preferential duty for SAFTA members (LDCs and non-LDCs) is 10.79 per cent, or 1.39 percentage points lower than its simple average MFN applied duty.³⁸ This absolute difference is slightly lower than when the average is taken over non-duty-free tariff lines only. A total of 135 tariff lines are duty-free on an MFN basis (by definition, also applicable to SAFTA members). Available data indicate that there are no duty-free tariff lines exclusively for SAFTA members under SAFTA. Tariff dispersion is lower for SAFTA preferential rates than for MFN applied rates. The minimum and maximum duties are the same for both duty types.

The SAFTA rate is lower than the MFN rate in about 44 per cent of *ad valorem* dutiable tariff lines; the absolute difference of the simple average rates in these 2,173 tariff lines is 3.29 percentage points, which is higher than when the comparison covers all tariff lines. Tariff dispersion is also much lower for SAFTA rates that are lower than MFN rates. Also, the maximum SAFTA rate on the 2,173 tariff lines where the MFN duty is higher than the SAFTA duty is 24 per cent, as opposed to 80 per cent for MFN duty. A total of 117 out of these tariff lines for SAFTA members have tariff peaks, defined as duties equal to or greater than 15 per cent. Since the MFN rate is higher than the SAFTA rate in these tariff lines, by implication these are outside Nepal's sensitive lists

Table 18.10 Summary comparison between Nepal's MFN applied duty rates and preferential duty rates for SAFTA members, 2010

Duties	Number of tariff lines (HS 2007)	Simple average Duty1	Simple average Duty2	Absolute difference (Duty2 – Duty 1)	Standard deviation of Duty1	Standard deviation of Duty2	Min. Duty1	Max. Duty1	Min. Duty2	Max. Duty2
All TL excl. NA	5,127	12.18	10.79	-1.39	8.6	7.36	5	80	5	80
Duty1, Duty2	4,992	12.51	11.08	-1.43	8.48	7.24	5	80	5	80
<i>Ad valorem</i>										
dutiable										
Duty1 = Duty2	2,819	11.92	11.92	0	9.09	9.09	5	80	5	80
Duty1 > Duty2	2,173	13.29	10	-3.29	7.54	3.35	10	80	5	24
Duty1, Duty2	135	0	0	0						
are duty-free										
Duty1 is NA	41									
Duty2 is NA	41									
Preferential duty only for LDCs										
Duties	Number of tariff lines (HS 2007)	Simple average Duty1	Simple average Duty3	Absolute difference (Duty3 – Duty 1)	Standard deviation of Duty1	Standard deviation of Duty3	Min. Duty1	Max. Duty1	Min. Duty3	Max. Duty3
Duty 1 > Duty 3	37	18.51	11.14	-7.37	5.31	1.65	10	30	8	12

TL = Tariff line (national, beyond HS six-digit level where applicable).

Duty1 = MFN applied duty rates

Duty2 = Preferential duty rates for all SAFTA members (LDCs and non-LDCs)

Duty3 = Preferential duty rates for LDCs only

NA = Not available

Source: WTO's Tariff Analysis Online

for both LDCs and non-LDCs. Nepal has until 2016 to phase in its tariff liberalisation programme under SAFTA. The SAFTA duties on these tariff lines will have to fall into the range of 0–5 per cent by 2016.

There are 37 tariff lines in which preferential duty is granted to LDCs only. In these tariff lines, the margin of preference for LDCs in terms of simple average duty is 7.37 percentage points. The minimum and maximum rates for LDCs in these tariff lines are 8 per cent and 12 per cent, respectively, as opposed to the MFN rates of 10 per cent and 30 per cent. The SAFTA duties for LDCs on these tariff lines will have to fall into the range of 0–5 per cent by 2016.

In 2,819 tariff lines the MFN rates are equal to the SAFTA rates. Table 18.10 shows that the simple average duty on these tariff lines is 11.92 per cent, with a standard deviation of 9.09. Of these, 1,327 tariff lines attract 5 per cent duty, while 1,131 tariff lines face tariff peaks.

Now, analysing *ad valorem* duties on HS 2007 six-digit tariff sub-headings (not national tariff lines) available at the WTO's Tariff Analysis Online database for the year 2010, we find that some 1,078 tariff sub-headings on the sensitive list for non-LDCs are subject to tariff peaks, thus indicating considerable scope for further tariff liberalisation by Nepal under SAFTA.

18.5.6 Non-tariff and para-tariff barriers

Perhaps because exports to RSA are limited, the issue of NTBs and para-tariff barriers in these countries has not come prominently to public attention in Nepal. However, going by the experiences of other countries in the region, such barriers are a serious restriction on trade.³⁹ The majority of NTBs relate to SPS, technical barriers to trade (TBT) and other related measures (Asian Development Bank (ADB) and United Nations Conference on Trade and Development (UNCTAD) 2008).

The current institutional mechanism under SAFTA to deal with NTBs and para-tariff barriers is fairly weak. Under the existing rules, the member states notify the SAARC Secretariat of the non-tariff and para-tariff measures they face on their exports on an annual basis. The notified measures are reviewed by the CoE, established under Article 10, in its regular meetings to examine their compatibility with relevant WTO provisions. The CoE recommends the elimination or implementation of the measure in the least trade-restrictive manner in order to facilitate intra-SAARC trade. A majority of notifications and complaints are being dealt through bilateral negotiations (Rahman 2010b). The CoE acts as the dispute settlement body (DSB) under SAFTA, but its role in settling disputes related to NTBs and para-tariff barriers has not been satisfactory.

18.5.7 Transit problems

Nepal completely depends on transit passage through India as well as Indian sea ports for its surface and sea-borne trade with the rest of the world.⁴⁰ Even if Nepal were to use the sea ports in Bangladesh, transit passage through India would still be unavoidable for trade with and through Bangladesh.

The political relationship with India has had an important bearing on the transit facility, an extreme case being the blockade imposed by India on Nepal in 1989–90. Even in normal times, it faces numerous transit-related problems, resolving which is critical for increased trade integration with RSA as well as the rest of the world. A host of transit restrictions is in place, causing delays, raising the landed prices of imports and eroding export competitiveness. The restrictions operate at two levels: transit to access Indian sea ports, and transit through Indian territory to access Bangladeshi markets and sea ports.⁴¹

Cumbersome transit processes, including procedural controls, citing the possibility of trade deflection, are in place. It is customary for Indian authorities to issue unilateral notifications on transit and customs matters, adding to the unpredictability stemming from the bilateral Transit Treaty's lack of unconditional automaticity in renewal. Hassles in the form of multiple checking agencies mar the entire transit process. Actual documentary requirements are higher than those specified in the treaty.

Although the transit treaty requires duty insurance (to hedge the risk of trade deflection and the resulting loss of customs duties for India) only for goods deemed sensitive by the Indian government, the list of such goods is not made public to Nepali traders. The monopoly of the Kolkata-based office of the Indian National Insurance Company Limited on issuing duty insurance policy means a high premium rate (Kaphley 2007). While insurance policy needs to cover only Indian customs duty if the goods are transported by rail, goods transported in private-owned vehicles by road have to be insured to the difference between the market value and the cost, insurance and freight (CIF) value (Kaphley 2007). The premium amount is also artificially raised due to the fixation of the market value by Indian customs at an unreasonably high level, at 200–250 per cent of CIF value (*ibid.*).

Transit through India is subject not only to central government regulations and formalities but also those that are in force in the states. Although the Indian road freight market is generally competitive, Nepal has not been able to benefit from it fully due to the enforcement of minimum freight tariffs for the transportation of Nepali cargo in three Indian states bordering Nepal, namely, Uttar Pradesh, Bihar and West Bengal (Chakra Infrastructure Consultants (CIC) 2001). Nepali cargoes are subject to state-level taxes as well as bribes (Nepal 2006).

Administrative rigmarole, gross inefficiency and congestion – resulting in delays, higher turnaround time, detention and demurrage – define Kolkata and Haldia ports, the gateway ports for Nepal's third country trade. In addition, Nepali importers have to pay penalty charges not only for the delayed portion of the cargo but also on the entire cargo, particularly in the case of bulk cargo, when such cargo is transported in partial shipments. Demurrage is charged even if goods are not cleared due to conditions beyond the control of the importer such as labour strikes (Nepal 2006).

The operationalisation of an inland container depot (dry port) at Nepal's main border point (Birgunj), which is connected by a rail link to Kolkata port through a bilateral rail services agreement signed in May 2004, was expected to reduce

transit costs from 12–15 per cent of CIF to 8–10 per cent and the journey time between Kolkata and Birgunj from ten days to three days (CIC 2001). However, the full benefits are yet to be realised as, among other problems, through bills of lading (BoL) are still not provided (Rajkarnikar 2010). The most important advantage of issuing and receiving BoL at a dry port is that they reduce customs and clearance activities at sea ports to a minimum, with only the transport activities of transit being emphasised (CIC 2001). If all documents are in order, cargoes have to spend three to five days at the port, which could be reduced if BoL are issued and received at the dry port (*ibid.*). Other problems include: non-availability of round-the-clock customs, only the movement of a few types of wagons being allowed, idling of costly reach stackers, non-integration of customs procedures, and deficiency in the infrastructure design of the dry port. Rough estimates suggest that the dry port is underutilised, operating at only 25 per cent of its normal capacity (NITDB 2008a).

Nepal has long sought alternative ports in India, as Kolkata and Haldiya are not only congested and inefficient but also cannot accept mother vessels, necessitating costly transshipment in other ports. Using Jawaharlal Nehru Port (JNP) in Mumbai, for instance, is estimated to reduce transit cost by US\$400 per 20-foot container by, *inter alia*, avoiding transshipment, thereby improving the competitiveness of Nepal's West-bound exports (CIC 2001). India agreed in principle in 1995 to allow Nepal to use JNP and Kandla port on the western coast of India for its third country trade. The pledge was not implemented. Later, another study⁴² recommended using Visakhapatnam Port located on the eastern coast of India in the state of Andhra Pradesh as an alternative to Kolkata port, as the port has spare capacity and draft conditions permitting berthing of mother vessels of up to 100,000 deadweight tonnage and is also much more efficient than Kolkata port in handling containers. In August 2009, India agreed to allow Nepal to use Visakhapatnam Port. However, India has put forth the condition of a double-seal⁴³ system on Nepali cargoes for Nepal to use Visakhapatnam Port, which is not the standard international practice and could complicate transit.⁴⁴

Chittagong and Mongla ports in Bangladesh are potential alternative ports for Nepal. While Chittagong is said to be among the least-productive container ports in the world (Simon 2009), Mongla offers a viable option for carrying out at least part of Nepal's third country trade more efficiently. Although a transit agreement between Bangladesh and Nepal signed in 1976 and a protocol to it give Nepal transit facility to access overseas markets through Bangladeshi territory and sea ports, lack of co-operation with India in providing a railway transit facility to Nepal for third country trade via Bangladesh has prevented Nepal from utilising that option. Mongla port is an under-utilised port (with 80 per cent spare capacity) with a much lower cost of holding of goods than Kolkata port thanks to shorter turnaround time, and lower detention and demurrage. Moreover, the Government of Bangladesh had announced a 50 per cent discount on port charges for Nepali trade handled through Mongla port and the notification could be extended if and when Nepal is able to trade through that port (NITDB/GoN 2008a). Further, Bangladesh has a huge trade deficit with India with the result that cargo trains carrying exports from India to Bangladesh

through a major route⁴⁵ return with empty wagons (*ibid.*). Utilisation of these empty wagons for Nepal's imports from Bangladesh and third countries can potentially take place at competitive railway tariffs (*ibid.*).

In a positive development, the Joint Communiqué issued by the governments of Bangladesh and India at the end of the visit to India by Bangladesh's Prime Minister on 10–13 January 2010 included an agreement to grant railway transit facility to Nepal through the Rohanpur–Singhabad point for its trade with and through Bangladesh. Simple transit procedures and issuance of BoL are necessary to maximise the gains from this agreement for Nepal.

A 1997 agreement between Nepal and India already allows Nepal road transit via a single route for trade with and through Bangladesh (the 54-km Kakarbhitta (Nepal)–Phulbari (India)–Banglabandh (Bangladesh) route). It is estimated that routing trade through this route from Kathmandu to Mongla port will result in time savings of up to 94 hours and cost savings of about US\$35 per tonnes compared with the existing corridor involving Kolkata port (Rahmatullah 2010). But a host of transit problems stymies cargo movement through this route (see Kharel 2009 and Nepal 2006). Cargo movement is allowed only at specified times in daylight hours on weekdays. Trucks carrying cargo-in-transit must move in convoys of a maximum of 20–25 trucks. A security escort is mandatory and provided only when there is a convoy of 25 trucks. There is no permanent customs office at the Fulbari border post in India. Poor implementation of a one-time lock system is combined with the poor state of infrastructure on the Indian side of the border. Indian insurance companies enjoy monopoly power, goods have to be transshipped at the Bangladesh–India border, and there is no provision of BoL by shipping lines. The involvement of third-party (Indian) customs is an additional burden. Besides the problems vis-à-vis India, Bangladesh's policy of not allowing foreign trucks to operate in its territory causes delays at the border, as cargoes have to be transshipped from Nepali trucks into Bangladeshi trucks.

Although, as argued by Faye et al. (2004: 45), 'there is a legal basis for rights of landlocked transit as outlined in Article 125 (1) of the United Nations Convention on the Law of the Sea' (United Nations 1982), this does not mean much as, 'in practice, this right of access must be agreed upon with the transit neighbour (Article 125 (2) and (3)) and is determined by the relationship between the countries.' Moreover, Article V of the General Agreement on Tariffs and Trade (GATT) also provides similar rights, but this has not been invoked so far probably due to conflicting interpretations of the provision (Adhikari 2010a). Discussions on this issue took place in the Doha Round of trade negotiations under the broad rubric of trade facilitation.

In order to remedy this persistent problem of transit, Kharel (2009) makes a case for a regional transit arrangement in South Asia that simplifies and harmonises rules, regulations and procedures for goods and vehicles in transit across countries – backed by investments in infrastructures (including roads, railways and sea ports), and communications systems, and the establishment and improvement of regional transport corridors. Such an arrangement will benefit not just Nepal and the two

other landlocked countries of the region (Afghanistan and Bhutan) but also the non-landlocked ones (*ibid.*). It will also help to create a level playing field for relatively weaker countries in the region. As lowering trade costs this way facilitates trade with the rest of the world as well as with neighbours, they do not give rise to welfare-enhancing trade diversions that can arise from preferential tariff reduction (Hoekman and Wilson 2010).

18.6 Supply-side constraints

Nepal faces severe supply-side constraints, overcoming which is critical for exploiting existing market access opportunities and improving its export performance. An important supply-side constraint (poor transit facility) was discussed in section 18.5.7. This section discusses other supply-side problems.

ADB et al. (2009) identified a number of critical constraints to Nepal's growth which are causing low social returns to investment and/or low private appropriability of returns to investment: (a) limited and low-quality infrastructure (namely, electricity and transport networks and irrigation); (b) weak governance (political instability and corruption), poor industrial relations climate and labour market rigidities; and (c) market failures (information and learning externalities and co-ordination failures) indicated by domestic manufacturing being low in technology quality and not growing, and exports being low in volume and in technology quality. These factors also adversely affect Nepal's export competitiveness.

The major binding competitiveness-related supply-side constraints are inadequate infrastructure for efficient production and transportation of goods; lack of human capital endowed with the education and skills to process exportables; limited access to credit due to conventional/conservative banking practices that rely more on collateral than on the feasibility of business ventures; limited use of technology in the production processes which impedes the prospects of what is known as 'moving up the value-chain ladder'; and the virtual absence of trade facilitation measures which causes delays in the shipment of goods.⁴⁶

These features are also reflected in Nepal's ranking in the Global Competitiveness Report (GCR) published by the World Economic Forum, which bases its analysis on 12 different indicators of competitiveness. Table 18.11 shows that in terms of various competitiveness rankings, Nepal falls below other South Asian countries, in terms of infrastructure, ease of access to loans and technological readiness, although it has a better indicator than Pakistan in the case of health and primary education.

Nepal continues to produce and export 'poor country goods'⁴⁷ and its efforts at enhancing its competitiveness and achieving export diversification have not produced satisfactory results, nor are they targeted at moving up the value-chain ladder. In terms of research and development (R&D), as measured by industrial value addition, the business sophistication index, innovation index and technological readiness index, Nepal ranks much lower than its South Asian neighbours (Table 18.12).

Table 18.11 Select competitiveness rankings and indices, 2010–11

Country/ economy	Infrastructure		Health and primary education		Ease of access to loans		Technological readiness	
	Rank	Index	Rank	Index	Rank	Index	Rank	Index
	<i>n</i> = 139	(1–7)	<i>n</i> = 139	(1–7)	<i>n</i> = 139	(1–7)	<i>n</i> = 139	(1–7)
Switzerland								
(Overall, top)	6	6.1	7	6.6	22	3.7	7	5.6
Bangladesh	133	2.1	106	5	79	2.6	126	2.7
India	86	3.5	104	5.2	39	3.3	86	3.3
Nepal	139	1.8	109	4.8	88	2.5	134	2.5
Pakistan	110	2.8	123	4.3	40	3.3	109	2.9
Sri Lanka	70	3.8	35	6.2	38	3.3	84	3.4
Chad (Overall, bottom)	137	1.8	138	2.9	115	2.1	13	2.3

Source: World Economic Forum's Global Competitiveness Report 2010–11

Like many other indicators of trade competitiveness, Nepal's trade facilitation indicators are poor. The trading-across-borders indicators published by the World Bank's Doing Business Report, which is one way of measuring trade facilitation indicators, show that Nepal ranks 164th among 183 countries and is ahead of only Afghanistan in South Asia in overall ranking (Table 18.13).⁴⁸ Nepal's performance is worse than the South Asian average (and obviously the Organisation for Economic Co-operation and Development (OECD) average by a large margin) in all the indicators.

Similarly, the Logistics Performance Index (LPI) – a composite index of various logistics and trade facilitation indicators – ranks Nepal one of the lowest, i.e., 147 out of the 155 countries surveyed in 2010 (Table 18.14). Nepal's ranking, compared

Table 18.12 Productive capacity, sophistication, innovation and technological readiness in South Asia, 2010–11, *n* = 139

Country	Industrial value addition	Business sophistication index		Innovation index		Technological readiness index	
	(% of GDP) 2007	Rank	Score	Rank	Score	Rank	Score
Bangladesh	29	105	3.4	119	2.6	126	2.7
India	29	44	4.3	39	3.6	86	3.3
Nepal	17	132	3	137	2.3	134	2.5
Pakistan	27	79	3.7	75	3	109	2.9
Sri Lanka	30	39	4.4	40	3.6	84	3.4

Source: World Economic Forum's Global Competitiveness Report 2010–11

Table 18.13 Trading across borders indicators for South Asian countries, 2011

Indicators	South Asian LDCs						South Asian developing countries			South Asia (average)	OECD (average)
	AF	BD	BT	MV	NP	IN	PK	SL			
Doing business – trading across borders (rank out of 183)	183	112	161	138	164	100	81	72			
No. of documents required for exports	12	6	8	8	9	8	9	8	8.5	4.4	
No. of days required for exports	74	25	38	21	41	17	21	21	32.3	10.9	
Cost to export (US\$ per container)	3,865	985	1,210	1,550	1,960	1,055	611	715	1,511.60	1,058.70	
No. of documents required for imports	11	8	11	9	10	9	8	6	9	4.9	
No. of days required for imports	77	31	38	22	35	20	18	19	32.5	11.4	
Cost to import (US\$ per container)	3,830	1,390	2,665	1,526	2,095	1,025	680	745	1,744.50	1,106.30	

Note: AF = Afghanistan; BD = Bangladesh; BT = Bhutan; MV = Maldives; NP = Nepal; IN = India; PK = Pakistan; SL = Sri Lanka.

Source: World Bank, 'Doing Business Report 2011'

Table 18.14 LPI of South Asian countries, 2010

Indicators	South Asian LDCs					South Asian DCs		
	AF	BD	BT	MV	NP	IN	PK	SL
Overall LPI	143	79	128	125	147	47	110	137
Customs	104	90	118	98	130	52	135	143
Infrastructure	139	72	141	111	143	47	120	138
International shipments	141	61	120	125	143	46	66	117
Logistics competence	141	96	127	117	143	40	120	142
Tracking and tracing	128	92	105	121	140	52	93	142
Timeliness	146	70	122	133	139	56	110	125

Source: World Bank's Logistics Performance Indicators 2010

with 2009, has not only slipped by 17 positions, but also been surpassed even by Afghanistan.

Nepal faces severe supply-side constraints on all major fronts, which means that it will not be in a position to fully utilise whatever limited market access opportunity it is granted under SAFTA. The preference erosion that Nepal is facing in the India market, as discussed in section 18.4, is likely to further exacerbate the problem.

The Government of Nepal has been unable to offer meaningful export incentives. Although the budget speech for the fiscal year (FY) 2010/11 offered a cash incentive of 2–4 per cent for exporters depending on the level of value addition, the incentive has not been operationalised so far. Further, as the government explicitly mentioned that such a facility would be provided to only convertible currency-denominated exports, the incentive excludes exports to India as they are denominated in the Indian currency. Although this was apparently done with a view to diversifying Nepal's exports to other destinations than India (both within and outside the region), only a third of exports being eligible for such facility means that most exporters would be deprived of enjoying the benefit, if and when the scheme comes into operation.

18.7 Conclusion

Notwithstanding the coming into force of SAFTA, Nepal's trade with South Asia remains concentrated on India. Trade with RSA is negligible in relation to Nepal's total trade. A substantial export potential exists with RSA, but a combination of market access barriers and supply-side constraints hinders the realisation of this potential. Overall, the sensitive lists of RSA countries contain items of export interest to Nepal, including those in which Nepal has RCA and for which a substantial market exists. As for items outside the sensitive lists, which also represent a significant market, it is of interest how fast the tariffs on them will be reduced to 0–5 per cent. Meaningful pruning of sensitive lists by RSA countries will help Nepal gain from SAFTA.

As Nepal itself has the longest sensitive list in SAFTA, it should be prepared to prune its own while asking the same of others. Application of objective criteria, backed by stakeholder consultation, should inform the process of pruning the sensitive list. The RoO under SAFTA needs to be made simple, transparent and, for LDCs, less stringent. A single criterion of 20 per cent value addition – backed up with a credible deadline for increasing the same (say, in ten years) to ensure enhanced domestic supply capacity – would be helpful for Nepal to expand exports to South Asian countries (Adhikari 2010a). As tariff barriers come down, the importance of NTBs and para-tariff barriers increases.

Implementation of the provision of the SAFTA Agreement for the removal of para-tariff and non-tariff barriers/measures and/or making them least trade restrictive is essential to effectively gain from tariff reduction. A regional mutual recognition agreement on SPS measures and technical standards and eventually a harmonisation of such measures and standards under SAFTA could be an effective way to deal with NTBs. As a least developed country with low capacity to upgrade its standards, however, Nepal needs financial, technical and capacity-building assistance to benefit from such an agreement. Because Nepal is close to eliminating all para-tariff barriers, it can take the lead in pushing for the elimination of such barriers in intra-regional trade. Nepal's major interest in SAFTA effectively dealing with NTBs and para-tariff barriers is that such barriers that Nepal itself faces in its largest export partner, India, could be addressed in the process. Implementation of trade facilitation measures, as provisioned in Article 8 of SAFTA, will also hold significance for Nepal–India trade.

Transit-related problems, which add to trade costs, constrain Nepal's trade with RSA, particularly Bangladesh, Bhutan and Pakistan (and also the rest of the world). A regional transit arrangement, backed by investments in transit transport infrastructure, leading to an effective, efficient, integrated and harmonised transit transport system, will be appropriate to address many of the transit-related problems faced by Nepal.

There is an acute need for an independent dispute settlement body, including an independent appellate body where parties to a dispute can appeal panel reports. The implementation mechanism to ensure compliance with dispute settlement body decisions must be strengthened.

Notes

- 1 This chapter was written and finalised by the authors in 2011 when they were working respectively as the Chief Executive Director and Research Coordinator with South Asia Watch on Trade, Economics and Environment (SAWTEE).
- 2 Services exports and imports accounted for, on average, 42.7 per cent and 18 per cent of total exports and imports of Nepal, respectively, from 2007/08 to 2009/10.
- 3 At the Sixteenth SAARC Summit held Thimpu in April 2010.
- 4 See Nepal's Trade Policy, 1992 and Trade Policy, 2009, which has replaced the former. They are available, respectively, at: www.nepalchamber.org (accessed 3 May 2011) and www.mocs.gov.np (accessed 3 May 2011).
- 5 The items on the negative list are: alcoholic liquors/beverages and their concentrates except industrial spirits; perfumes and cosmetics with non-Nepali/non-Indian brand names; and cigarettes and tobacco.

- 6 Protocol to Article VI states that Nepal, 'with a view to continuing preferences given to Indian exports, will waive additional customs duty on all Indian exports during the validity of the Treaty'. The concession rate has varied over the years.
- 7 Change in tariff heading at the four-digit level entails substantial processing, indicating that goods have undergone transformation from one tariff heading into another. An example relating to the iron and steel sector would be that goods get transformed from stainless steel ingots (HS Chapter 72.18) to flat-rolled products of stainless steel (HS Chapter 72.19).
- 8 See Adhikari (2010a) for further details.
- 9 See Kharel (2008 and 2010a) for details of the impact of the liberal provision.
- 10 See Adhikari (2010a) and Kharel (2008 and 2010a) for analysis of the impact of the restrictive provisions.
- 11 Agrawal (2008), for example, suggests that the steep value addition requirement is not achievable even for Indian industries.
- 12 See WTO (2005).
- 13 See *Republika*, (2010).
- 14 See Government of Nepal (GoN) (2010).
- 15 For example, based on our discussion with Mr Uday Raj Pandey, President, Garment Association of Nepal, we found that India imposes NTBs, such as the requirement to certify that ready-made garments (RMG)s being exported to India are free of certain chemical substances (such as azo) and the requirement to obtain a certificate from a laboratory in New Delhi to certify that certain products contain less than 51 per cent nylon in order to qualify for lower level of countervailing duty (CVD).
- 16 Umesh Lal Shrestha, President of the Nepal Association of Pharmaceutical Producers and Managing Director, Quest Pharmaceuticals Pvt Ltd, in an interview to *Karobar* national business daily ('Nepali pharmaceuticals are of good quality yet low-priced', 8 February 2011, p 12).
- 17 Ibid.
- 18 In 2009, Nepal exported pharmaceutical products (HS Chapter 30) worth US\$1.6 million to India. This was 85 per cent of Nepal's total pharmaceutical product exports for the year.
- 19 See Sharma, (2009).
- 20 See Kharel (2010a) for further details.
- 21 There are 274 such tariff lines as per Customs Tariff Schedule published by Department of Customs, Government of Nepal for 2009/10. But one tariff line is at the eight-digit level (HS 170.111.90), which was ignored for this analysis based on six-digit tariff lines. A few more products were added to the list in the October 2009 revision to the trade treaty with India, which are not considered here.
- 22 See Nepal's schedule of concession available on the WTO website.
- 23 In 2006, India accounted for 35 per cent of Bangladesh's imports of lentils in value terms and 29 per cent in quantity terms (authors' calculation based on UN Comtrade data).
- 24 FAOSTAT, <http://faostat.fao.org> 9 accessed 10 March 2010.
- 25 This is based on data of Trade and Export Promotion Centre, Government of Nepal.
- 26 The index is calculated as the sum of the absolute value of the difference between the import category shares and the export shares of the countries under study, divided by two, and is converted to percentage form (Mikic and Gilbert 2007). The index takes a value between 0 and 100, with a higher percentage indicating a higher level of complementarity, and vice versa.
- 27 A concept developed by Balassa (1965), the revealed comparative advantage (RCA) index, is calculated as the ratio of the share of a country's total exports of a commodity in its total exports to the share of world exports of the same commodity in total world exports (Mikic and Gilbert 2007). An RCA index greater than unity indicates that the country has a revealed comparative advantage in the commodity of interest.
- 28 A major limitation of the RCA index should be noted: it is affected by trade-distorting policies, whether in the exporting country or in other countries. Also, due to data constraints, we computed RCA indices for just one year, although ideally RCA indices over, say, a three-year period would provide a more definite picture. The results should, therefore, be taken as indicative.

- 29 The existing value of exports to Bangladesh was not considered here, unlike in the trade potential index. This is the same for other countries considered.
- 30 This is particularly important because Bangladesh imposes several para-tariff barriers, which appear legal because they represent other duties and charges (ODCs) within the meaning of the General Agreement on Tariffs and Trade (GATT) as noted in the forms of infrastructure development surcharge (IDSC), supplementary duty (SD) and regulatory duty (RD), which add up to the protective effect of trade taxes (WTO 2006). Even the value-added tax (VAT), which is supposed to be a trade-neutral tax, has been applied in a discriminatory manner, as a 15 per cent VAT is imposed on imported items whereas the same product is exempted from VAT when it is produced domestically (World Bank 2006: 21). While tariff barriers in Bangladesh have steadily declined between 1991/92 and 2004/05, para-tariff barriers have actually increased by more than three times during the corresponding period, with the protection of agricultural products rising more rapidly in the recent period. For example, in 1991/92, the simple average weighted tariff was 17.64 per cent and para-tariffs were 2.98 per cent; these figures were 16.39 per cent and 10.23 per cent respectively in the year 2004/05 (World Bank 2006). Although the latest figures are not available, Bangladesh's schedule of concession submitted to the WTO shows that it charges 2.5 per cent licence fees for all imports (see Bangladesh's schedule on the WTO website). Similarly, five-tier SD rates of 20 per cent, 60 per cent, 100 per cent, 250 per cent and 350 per cent are being applied by Bangladesh as of fiscal year (FY) 2008–2009 and revenue from SD on imports was BDT 23 billion in FY 2008–2009, which was one-fourth of the total customs duty collected during the year (Ministry of Finance (MoF) and Government of Bangladesh (GoB) 2010). This indicates that para-tariff barriers are still high in Bangladesh.
- 31 Complete data are not available to verify if this has happened.
- 32 Exporting to Pakistan via the Indian land route is extremely difficult because of transit-related problems. Attempts by the Nepali private sector to utilise the spare capacity of Pakistan International Airlines cargo at a discounted price so as to export to Pakistan to overcome these problems are yet to bear fruit.
- 33 Complete data are not available to verify if this has happened.
- 34 These items are on the sensitive list mainly for revenue purposes.
- 35 Trade data used in Kharel (2010b) were mirror statistics as no direct data were available at UN Comtrade database for the chosen period of 2005–2007.
- 36 The last criterion was applied on a standalone basis.
- 37 A 50 per cent tariff rebate is accorded on cotton vest, cotton underwear, cotton brassier and cotton panty (as per Finance Act 2010/11).
- 38 The tariff lines are at the national level (i.e. beyond HS six-digit level where applicable).
- 39 SAFTA member states notified non-tariff and para-tariff measures they faced in other member states and responded to notifications related to them at the Fourth SAFTA Sub-Group Meeting of the committee of experts (CoE) held in Kathmandu in October 2009. See Rahman (2010b).
- 40 Transit trade through China, which borders Nepal to the north, is restricted by the Himalayas, inadequate transport links as well as the distance to the nearest sea port in China.
- 41 Transit through India is also a problem for Nepal's overland trade with Bhutan and Pakistan. Here, we focus on transit through India to Bangladesh.
- 42 See NITDB (2008).
- 43 Freight forwarders seal the cargo in transit in order to allay the fear of leakage. Not satisfied with this, Indian authorities want to put a second seal to be double sure. This adds to the cost of trading, not least because it adds one more layer of bureaucratic hassle for traders.
- 44 See Shrestha (2011).
- 45 Via the Singhabad–Rohanpur interchange point, the nearest operative point to two major economic hubs of Nepal through which some 87 per cent of Nepal's foreign trade passes.
- 46 See, for example, Raihan et al. (2007); Adhikari and Weeratunge (2007).
- 47 According to Hausmann et al. (2005), 'poor country goods', as the name suggests, are low-value goods produced by poor countries, with low technology and skill components.
- 48 It should be noted that for a landlocked country, the documents, time and cost to import and export are a function not only of domestic factors but also the situation in the transit country and the transit facility.

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Chapter 19

The Way Forward on Tariffs, Non-tariff Barriers, SAFTA, Bilateral Free Trade Agreements: The Case Study of Sri Lanka

Indra Nath Mukherji

19.1 Introduction

The forces of globalisation have led to the freer movement of goods, services and capital (if not labour) across borders. Even though South Asia continues to be the least integrated region in the global economy, considerable liberalisation in trade in goods, services and investment flows has nevertheless taken place. Among the South Asian countries, Sri Lanka stands out as an early liberaliser, since it initiated economic reforms in 1977. Much of this liberalisation today is not only taking place multilaterally under the World Trade Organization (WTO), but regionally and bilaterally. It is also apparent that, in parallel with lowering of tariff barriers, more opaque non-tariff barriers (NTBs)/measures have emerged as the main 'behind the border' instrument restricting the free flow of goods and services.

Technical regulations and industrial standards are important, but they vary from country to country. Having too many different standards makes life difficult for producers and exporters. If the standards are set arbitrarily, they could be used as an excuse for protectionism. Standards can become obstacles to trade.

The WTO Agreement on Technical Barriers to Trade states that the procedures used to decide whether a product conforms to national standards have to be fair and equitable. It discourages any methods that would give domestically produced goods an unfair advantage. The agreement also encourages countries to recognise each other's testing procedures. That way, a product can be assessed to see if it meets the importing country's standards through testing in the country where it is made.

The objective of this chapter is to examine with respect to Sri Lanka the nature of tariff barriers, the incidence of other import charges or para-tariffs on imports, the nature and incidence of NTBs, initiatives taken under regional and bilateral agreements and the reform process initiated, and to suggest the way ahead.

19.2 Import tariff

The Trade, Tariff and Investment Policy Division of the Ministry of Finance and Planning is responsible for formulation and implementation of Sri Lanka's import policy. In addition, the Trade and Tariff cluster of the National Council of Economic Development (NCED) also examines trade and tariff issues and sends

recommendations to the Ministry of Finance and Planning. NCED consists of 22 clusters, representing both private and public sector officials, which examine various sectors of the economy (USTR 2009).

Import tariffs are the main instrument of Sri Lanka's trade policy. In 2006, Sri Lanka's applied tariff rate for non-agricultural goods was 9.2 per cent. Its average bound tariff rate for these goods was 19.6 per cent. However, approximately 70 per cent of Sri Lanka's non-agricultural tariffs are unbound and can be increased any time. Sri Lanka's average applied agricultural tariff was 23.8 per cent (USTR 2009). According to Central Bank of Sri Lanka, the average import duty rate based on total imports and customs duties increased from 4.6 per cent in 2008 to 7.8 per cent in 2009 (Central Bank of Sri Lanka 2009).

The average import duty collection rate for products under different categories is presented in Table 19.1.

If we examine Sri Lanka's changes in average basic import duty collection rates for different categories of imports between 2005 and 2009, it is observed the country's duties on consumer goods almost doubled from 10.4 per cent in 2005 to 19.4 per cent in 2009. The rate was higher for food and beverages, for which average duties increased by about 2.8 times from 9.6 to 26.8 per cent over the same period. However, the basic custom duties of non-food consumer goods declined by almost half from 11.1 to 6.7 per cent over the reference period. The duties on intermediate and investment goods were substantially lower. But while customs duties on intermediate goods increased from 2.1 to 5.0 per cent, those on investment goods declined from 5.8 to 4.4 per cent during the same period.

Until the end of May 2010, Sri Lanka maintained a five-band tariff structure of zero duty for import of essential goods, 2.5 per cent for basic raw materials, 6 per cent for semi-processed goods, 15 per cent for intermediate products and 28 per cent for other finished goods (Central Bank of Sri Lanka 2009). In a major step towards simplifying and broad-basing the tax structure, a press release issued by the government stated that the multiplicity of the customs duty structure has

Table 19.1 Average import duty collection rate, 2005–09^a

	2005	2006	2007	2008 ^b	2009 ^c
1. Consumer goods	10.4	11.2	12.4	12.6	19.4
1.1 Food and beverages	9.6	10.7	13.5	14.8	26.8
1.2. Non-food consumer goods	11.1	11.7	11.2	8.4	6.7
2. Intermediate goods	2.1	1.5	1.5	2.2	5.0
3. Investment goods	5.8	5.2	4.8	5.3	4.4
Average import duty collection rate	4.6	4.3	4.1	4.6	7.8

Notes: ^aAverage import duty collection rate (including special commodity levy whenever applicable) as per cent of total imports (CIF value).

^bRevised.

^cProvisional.

Source: Abridged from Central Bank of Sri Lanka: Annual Report–2009

been simplified with a four-band duty structure of zero duty, 5, 15 and 30 per cent with effect from 1 June 2010. Besides, a 15 per cent surcharge (increased from 10 per cent as of 8 November 2007) was waived. In order to provide a boost to the rapidly recovering post-conflict economy, the 2.5 per cent import duty on most raw materials, plant and machinery has also been removed with effect from 1 June 2010 (GoSR 2010).

The press release further states:

In support of expanding tourist activity and rising levels of tourist arrivals, the government has slashed duties on motor vehicles by 50 per cent. To promote Sri Lanka as an active shopping centre for internationally branded products, phones, wrist watches, cameras and electronics have also been brought down below 10 per cent of overall taxes. These items will be liable for only Port Levy and Nation Building Tax and exempted from VAT and Cess. A distortionary Cess has also been scaled down to boost domestic activities. Cess will be maintained only for selected import affecting domestic activities which require safeguard from unfair import competition. In order to further support for local value-added activities for making raw materials, plant and machinery imports available at zero duty, the Government is also working towards providing anti-dumping legislation, prescription of quality standards etc. to improve the enabling environment for home-based industries.

As the Government is moving towards a simple tax structure, all essential commodities will be liable at the point of imports for only special commodity levy. This will minimise the cumbersome administrative procedures, particularly for small traders who are generally engaged in such import business.

(GoSR 2010)

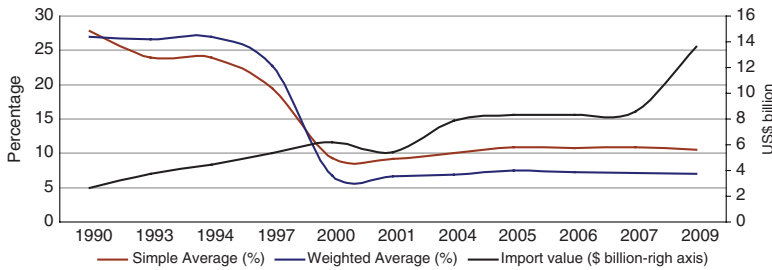
The WTO has also listed Sri Lanka's tariff and duty-free imports as may be seen in Table 19.2.

Table 19.2 Tariff and duty-free imports of Sri Lanka: October 2010

Sectors	Final bound rates	Applied rates (2009)
1. Most favoured nation (MFN) tariffs (all goods (simple average))	30.2	11.2
1.1 Agricultural goods	50.1	24.8
1.2 Non-agricultural goods	19.6	9.2
1.3 Non- <i>ad valorem</i> duties (% of total tariff lines, 2008)	0.5	2.5
1.4 MFN duty-free imports: Agricultural goods (% of total tariff lines: 2008)		0.3
1.5 Non-agricultural goods		42.1
1.6 Tariff binding coverage (%)	38.1	

Source: World Trade Organization: Country Profiles, available at: www.wto.org.in, 9 accessed 28 December 2010

Figure 19.1 Sri Lanka's simple and weighted average tariffs (per cent) and imports (US\$ billion)



Source: UN Comtrade database, accessed 28 December 2010

It sets Sri Lanka's final bound tariffs for all goods at 30.2 per cent and the applied rate for the same at 11.2 per cent. On agricultural goods the final bound rate is 50.1 per cent, the applied rate being 24.8 per cent. For non-agricultural goods the final bound rate is 19.6 per cent and the applied rate is 9.2 per cent. One half a per cent of Sri Lanka's final bound rates are *ad valorem*, while the same is true for applied rates at 2.5 per cent. Sri Lanka's duty-free imports, in respect of applied rates, cover 0.3 per cent of total tariff lines while the same for non-agricultural goods cover 42.1 per cent. Sri Lanka's tariff binding coverage for all products under final bound rates is 38.1 per cent.

The structure of import duties imposed by Sri Lanka on imported goods reflects both its revenue and development objectives. Since consumer goods constituted a large share of Sri Lanka's total imports, and many consumer goods items were considered as non-essential, the duties imposed on their imports were kept relatively high. Since the country wanted to promote industrialisation, it kept its duties on imports of intermediate and investment goods substantially lower.

UN Comtrade data reveals Sri Lanka's simple and weighted average tariffs during the period 1990 to 2008 (Table 19.1). It will be seen that both these rates started falling sharply from 1997 until 2000. Thereafter these rates have stabilised and a mildly increasing trend is visible. Over the period the simple average rate declined from 27.8 per cent in 1990 to 10.54 per cent in 2008, while the weighted average rate declined from 26.96 to 7.05 per cent. Until 1997 the weighted average rate was slightly higher than the simple average rate, but since then the simple average rate has been lower than the weighted average.

The WTO's third Trade Policy Review for Sri Lanka (2010) states that Sri Lanka introduced major changes to its tariff structure in 2007 and 2010. The simple average applied tariff was 11.5 per cent in 2010, up from the 9.8 per cent reported in Sri Lanka's Review for 2003, but lower than the 12 per cent posted in 2009. Tariff rates for most products range from 0 to 30 per cent, with few peaks, mainly for tobacco products. Despite the increase in the average rate, the proportion of duty-free lines rose from 10 per cent of the total in 2003 to 44.4 per cent in 2010, mainly through the elimination of the 2.5 per cent tariff rate and its replacement with duty-free access (WTO 2010). However, as most of the increase in tariff rates since 2007 were in the range of 25–30 per cent, the average tariff rate increased.

Table 19.3 Classification of taxes and levies on imports

Sl. No.	Description	Applicable statutes/ authority	Revenue accounts officer
1.	Import/export duties	Customs Ordinance No. 17 of 1869	Director General of Customs
2.	Import/export licences	Imports and Exports Control Act No. 01 of 1969	Controller of imports and Exports
3.	Ports and airports development levy	Finance Act No. 11 of 2006	Director General of Customs
4.	Import cess levy	Sri Lanka Export Development Act No. 40 of 1979	Director General of Customs
5.	Regional infrastructure development levy	Regional Infrastructure Development Levy Act No.51 of 2006	Director General of Customs
6.	Special commodity levy	Special Commodity Levy Act No. 48 of 2007.	Director General of Customs
7.	Value-added tax	Value Added Tax Act No. 14 of 2002.	Commissioner General of Inland Revenue
8.	Excise (ordinance) duty (liquor)	Excise Ordinance No. 8 of 1912	Commissioner General of Excise
9.	Excise (special provisions duty) cigarettes, liquor, petroleum products, others)	Excise (Special Provisions) Act No.13 of 1989 Act No.13 of 1989	Director General of Excise (Special Provisions)
10.	Social responsibility levy	Finance Act No.05 of 2005.	Director General of Fiscal Policy
11	Nation building tax	NBT Tax Act No.9	Inland Revenue Department

Source: Ministry of Finance and Planning and Treasury of Sri Lanka, available at: www.treasury.gov.lk, 9 accessed 25 May 2010

19.2.1 Para-tariffs on imports

Para-tariffs are a number of charges that an importer has to pay on imports other than customs duties. These para-tariffs are in the nature of levies designed to promote a number of developmental objectives for the country. Generally these are imposed at rates that are similar whether levied on the importer or the domestic manufacturer to create a level playing field for the latter. A list of import charges on top of tariffs is presented under Table 19.3. It will be seen that there are at least ten taxes/levies on top of customs duties relating to the development of infrastructure, protection of agriculture, value-added tax, excise and social sector levy.

Ports and airports development levy

In order to develop ports in Sri Lanka, a Ports and Airports Development Levy imposed in January 2007 was increased to 5 per cent of cost, insurance and freight (CIF) value of import items (other than specifically exempted items) from 1 January 2009.

Export development board (EDB) levy or import cess levy

In 2007, an EDB levy or cess ranging from 1 to 35 per cent was imposed on a range of consumer goods identified as 'non-essential.' Both *ad valorem* and unit rates are specified, and whichever rate is higher, is applicable.¹ The objectives of the levy are (i) to discourage imports of non-essential items; (ii) accord protection to local farmers/manufacturers; and (iii) to mobilise funds for the implementation of the country's Export Development Programme (*ibid.*).²

Cess on edible oils includes soya oil, ground nut, olive oil, sunflower oil, palm oil, etc. and their fractions. The objective in this case is to generate funds for launching programmes for a sustainable development of the coconut sector. The rate applicable is LKR 6/kg. on imported edible oil.³

EDB levy (cess) is charged on imports under some 3,500 tariff sub-headings covering a relatively large range of products, including fruits, vegetables, processed and unprocessed food, shoes, bags, rubber and plastic products, textile products, toiletry and perfumes. The cess is applied on the customs value calculated in rupees, adding a 10 per cent margin, and ranges from 1 to 35 per cent, with most goods at rates at or above 20 per cent (WTO 2010).

Regional infrastructure development levy

With effect from 1 January 2008, regional infrastructure development levy (Act No. 51 of 2006) charged at the time of import of any motor vehicles other than auto rickshaw is liable to the payment of excise duty as per schedule indicated in Table 19.4. It will be seen that that the rate of tax varies from 5 to 10 per cent depending on the cylinder and seating capacity of the vehicles.

Special commodity levy

As the government is moving towards a simple tax structure, and also to keep retail prices of essential food items under check, such commodities will be liable for tax at the point of imports only for special commodity levy. No para-tariffs are applicable on such products. In November 2009, customs duty, port levy, nation building tax, social responsibility levy and value-added tax were replaced by a lower special commodity levy. This levy was reduced further on rice and sugar in December 2009.

Table 19.4 Regional infrastructure development levy

HS Code	Cylinder capacity/ seating capacity/weight of motor vehicle	Rate(%)
87.03	Cylinder capacity not exceeding 1600	5
87.03	Cylinder capacity exceeding 1600 but not exceeding 2000	7.50
87.03	Cylinder capacity exceeding 2000	10
87.02	Seating capacity of less than 13 persons	10
87.02	Seating capacity of 13 or more persons but less than 17 persons	5
87.02	Seating capacity of 17 persons or more	7.50
87.04	Possessing the specified weight	5

Source: <http://taxsrilanka.com/infocentre/index.php/tax-types/35-debit-tax/98-tax-type>

Table 19.5 Special commodity levy-rates applicable on select commodities, per kg (January–May)

Tax Base	2009	2010
Dhal		
-whole	15	1
-splits	20	2
Potatoes	25	10
B' onions	25	10
Sugar	15	1
Chillies		
-crushed	50	25
-not crushed	40	20
Canned fish	85	85
Sprats	30	30
Green gram	15	15
Chick peas	25	15

Source: Fiscal Management Report, 29 June 2010, available at: www.treasury.gov.lk, 9 (accessed 29 December 2010)

This is expected to minimise cumbersome administrative procedures, particularly for small traders who are generally engaged in such import business. Amendments made with effect from 10 May 2010 listed 22 items (classified as HS six-digit) as essential. Such products include sprats, potatoes, onions, garlic, chick peas, peas, green gram, lentils, chillies, salmon, herrings, tunas, mackerel, etc. This list is reviewed every three months. Table 19.5 presents rates of special commodity levy applicable on select commodities in 2009 and 2010 (January–May). Considering the need to soften the cost of living on essential commodities, and their domestic availability, these levies have been brought down. The levy has resulted in lower import duties for the products concerned.

Value-added tax (VAT)

A VAT based on based on four slabs: zero duty, 5, 15, or 20 per cent is being levied on imports in Sri Lanka. While calculating the VAT, an imputed profit margin of 10 per cent (increased from 7 per cent on 1 January 2007), is added to the import price. Locally manufactured products are also subject to VAT, but the imputed margin is not added to the base. The VAT rates of 5 and 15 per cent have been replaced with the VAT band of 12 per cent with effect from 1 January 2009 (USTR 2009). Further exemptions on new items with effect from 1 June 2010 have been announced on import or supply of imported items under the HS Codes given by the Department of Inland Revenue. Electronic calculators, LP gas conversion kit for auto-trishaws, food grinders, shavers, hair dryers, cellular mobiles, digital cameras, electric call bells, wrist watches and video games are certain items exempted from VAT (DPR 2011). The exemption covers 54 products, mainly at six-digit HS classification. The distribution of these products at the level of Chapters is presented in Table 19.6. It will be observed that the largest number of products (27) fall in the category of electrical machinery and equipment (HS 85), followed by optical, photographic,

Table 19.6 Proposed VAT exemption (with effect from 1 June 2010)

HS Chapter	Description	No. of products
84	Nuclear reactors, boilers, machinery and mechanical appliances; parts thereof	2
85	Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers and parts	27
90	Optical, photographic, cinematographic, measuring, checking precision, medical or surgical instrument and appliances and parts and accessories thereof	13
91	Clocks and watches and parts thereof	10
95	Toys, games and sports requisites, parts and accessories thereof	2
	Total	54

Source: Sri Lanka Customs: Abridged, available at: www.customs.gov.lk/news/vat.pdf, (accessed 2 June 2010)

cinematographic products (13), falling under HS Chapter 90. Ten products fall under HS Chapter 91 containing items such as clocks and watches. Such a step has been in conformity to promote Sri Lanka as an attractive shopping centre for internationally branded products of phones, wrist watches, cameras and electronics, which have also been brought down below 10 per cent of overall taxes. These items will be liable only for port levy and nation building tax and have been exempted from VAT and cess.

Excise duty

In support of the expanding tourist activity and rising level of tourist arrivals, the Government of Sri Lanka slashed import excise duty on vehicles by 50 per cent while a reduction of duty on vehicle imports varies according to the engine capacity of each vehicle. However, general customs duty on such items has been increased from 28 to 30 per cent. With effect from 1 June 2010, excise duty is exempted from paints and varnish, air conditioners, vacuum cleaners, hair dryers, rice cookers, telephone sets, video recording, digital and television cameras, monitors and projectors, motor vehicles for transport of ten or more persons including driver and auto trishaws (DPR 2010).

As per gazette notification No. 1656/25 dated 2 June 2010, 50 per cent value addition recommended for exemption on locally manufactured articles has been reduced to 30 per cent of value addition, classified under HS Chapters 84 and 85.

Excise duties are levied on tobacco products, oil products, aerated water, liquor, beer, motor vehicles and certain household electrical items. Although locally manufactured products are also subject to excise fees, when calculating the excise fee on imports, an imputed profit margin of 15 per cent is added to the import price including most other import duties. Applied excise duty rates vary considerably; they may be *ad valorem* or specific and, in some cases, alternate. The highest rates are applied on automobiles and some machinery (WTO 2010).

Social responsibility levy

The social responsibility levy is imposed under the Finance Act and a levy of 1.5 per cent on taxes and levies is chargeable (Table 19.7).

Nation building tax

The nation building tax (NBT) came into operation from 1 February 2009, under NBT Tax Act No.9. It is payable by every person who imports any article (other than personal baggage) in to Sri Lanka. With the approval of the parliament, the tax rate increased from 3 to 5 per cent with effect from 1 May 2009. This tax was to be in effect for only two years as the government hoped to deploy the revenues for the development process in the North and the East (NewsLanka 2009). The NBT will be applicable to every business that earns a daily income of LKR 1,000 or more.

The cascading effect of a plethora of taxes and levies paid on top of customs duties implies that the final price paid by the consumer will be more than double (in some cases such as vehicles, multiple) of what is reflected under basic customs duties.

The cascading effect of tax levies on Sri Lankan imports is best illustrated in a hypothetical import value of LKR 100. It will be apparent that in the case of products where all levies are applicable, the landed import cost would be more than double of the country's CIF import value.

The Sri Lankan Customs website has provided for accessing information on both tariff and para-tariffs in a transparent way. The Tariff Guide in Excel format with the provision of a tariff calculator enables the trader to find out the total incidence of the import levies online. However, the WTO in its Trade Policy Review of Sri Lanka (2010) states:

However, although orders modifying tariff and other import tax rates are published and available online, the frequent resort to this kind of practice adds discretion and creates confusion among importers; limiting the number of changes and converting specific duties into ad valorem charges would help to further foster transparency.

Bank margin requirements

Vide circular No. 35/01/005/0010/1 of 5 December 2008, commercial banks in Sri Lanka were informed that the margin requirements against the letters of credit for the importation of vehicles under Schedule A imposed by the circular No. 35/01/005/0010/01 of 2004 were to be increased from 100 to 200 per cent with immediate effect. Schedule A lists 80 categories under HS eight-digit classification of vehicles under six broad groups.⁴

Under Schedule A1, the products listed are mainly consumer goods requiring 100 per cent margin deposit under letters of credit. This list contains around 41 groups of products.⁵

Under the circular all licensed commercial banks were requested to adhere to a number of requirements on the importation of motor vehicles or related items given

Table 19.7 Tax levies on imports in Sri Lanka

Tax levies	Duty rate	Value – LKR
Cost, insurance and freight		100
Customs duty	0.10%	10
Surcharge	0%	0
Ports and airports development levy	1%	1
Cess levy	30%	33
Value-added tax	10%	18
Excise duty	15%	27
Regional infrastructure development levy	7.5%	14
Social responsibility levy	1.5%	1
Nation building tax	1%	2
Total tax value		106

Note: Modified to remove customs duty surcharge, which has been waived. This can only be used for *ad valorem* rate (percentage) only. Convert the specific rate into a percentage of value where specific rate is applicable. Input the rate of levy into the relevant cages in green. (Input 0 per cent when the rate is free or exempt.)

Source: www.customs.gov.lk/adp/Tariff%20Calculator.xls, (accessed 28 December 2010)

in the Schedule A on documents against acceptance (DA) terms with immediate effect. One requirement is that a 200 per cent margin deposit on the invoiced value which is imported under DA terms should be placed by the importer at the time of release of documents and acceptance of bills by the importer. This margin will apply to the total value of the invoice, even if the same invoice includes items which are not subject to margin requirement. The banks are not to grant any advance to enable importers to place the margin deposit.

19.3 Non-tariff measures/barriers

Non-tariff measures (NTMs)/barriers (NTBs) are all measures other than normal tariffs, namely trade-related procedures, regulations, standards, licensing systems and even trade defence measures such as anti-dumping duties, etc., which have the effect of restricting trade between nations. Some of these measures could be justified under the various provisions or exceptions provided under the various multilateral agreements governing international trade. On the other hand, certain NTMs that cannot be justified under any of these legal provisions are termed as NTBs (GoI 2008). Sometimes even when an action is justified under certain provisions or exceptions, the conditions required to be met by the importer may be too costly or cumbersome to comply with, which in effect becomes a constraint to trade. Thus, the dividing line between NTBs and NTMs may at times be quite thin and often blurred to draw a distinct classification. In this chapter we take a broad view on the subject so that all trade restricting measures, whether or not justified, are taken into account.

Table 19.8 Import licensing requirements in Sri Lanka

Sl. No.	Categories	Items	Licence fee (CIF value)
1.	Drugs	<i>Ayurvedic</i> , western, veterinary, homoeopathy, surgical sutures, Chinese herbal	0.2%
2	Vehicle and vehicle parts	11 categories are listed	Varying from 0.2% 50% and LKR 25,000 to 250.000 per license
3	Chemicals	Chemicals, pesticides, cereals, alcohol, radioactive materials, animal products, live animals, cashew in the shell, etc. and petroleum products (petrol and diesel)	0.2%, for petroleum products LKR 5,000 per licence issued to Ceylon Petroleum Corporation and Indian Oil Company; for other companies 0.2%
4	Telecommunication equipment and miscellaneous	Telecom equipment, cellular phones, sports goods, coins and discs and operated games, refrigerator gas Used refrigerators, deep freezers, and air conditioners Used furniture Coins and metals, dolls and other toys electricity generated, explosives, arms and ammunitions, other miscellaneous Sludge oil	0.2% 5% (Personal) 10% (Commercial) 50% 0.2% LKR 5,000 (per consignment)
5	Exports	Ivory and ivory products, scrap waste materials, repair and return items, timber, gift, re-export, samples, films, ebony handicrafts, old motor vehicles, others	LKR 1,000 (per licence)

Note: Minimum licence fee: Import licence: LKR 1,000 per licence, Amendments: LKR 750 per amendment, Licence abstract: LKR 500 per abstract.

Source: Abridged from Export and Import Control Department; Commodity list under Extraordinary Gazette No. 1574-12, www.imexport.gov.lk, (accessed 4 June, 2010)

19.3.1 Import licensing

Sri Lanka requires import licences for over 400 items at the HS six-digit level, mostly for health, environment and national security reasons (USTR 2009).

Import control licences are issued under following categories and schemes: (i) importation of vehicles; (ii) importation of drugs; (iii) importation of chemicals and bases, and (iv) miscellaneous items. In Table 19.8 a summary of import licensing requirements on various items/categories with applicable licence fees has been presented.

It will be observed that for drugs an import licence fee of 0.2 per cent of the CIF value is imposed. For vehicle and vehicle parts, 11 categories of products are listed, the license fee in respect of which ranges from 0.2 to 50 per cent of CIF value of imports and the licence value per licence ranges from LKR 5,000 to LKR 250,000.

For chemicals the rate is 0.2 per cent of CIF value and LKR 5,000 per licence issued to government oil companies and 0.2 per cent of CIF value for other companies. For telecommunication equipment the fee is 0.2 per cent of CIF value. The same is charged for cigarette papers, dolls, explosives, arms and ammunition, and a few miscellaneous items. For used refrigerators, deep freezers and air conditioning the fee is 5 per cent for personal use and 10 per cent for commercial use. The fee for sludge oil is LKR 5,000 per consignment.

The Sri Lankan government also applies licence fees on export items. For items such as ivory, scrap waste metals, timber, gift, samples, films, re-export items, ebony handicrafts, old motor vehicles and a few other items, the rate is LKR 1,000 per licence.

Generally, licensing requirements (including imposition of quotas and prohibitions) are designed to meet specific objectives such as protection of human and animal

Table 19.9 Spread of NTBs across tariff lines (2004)

Sl. No.	Categories of NTBs	No. of tariff lines
1	Authorisation for protection of human, plant, animal health and to ensure national security	78
2	Finance measures	1
3	Labelling requirements to protect human health	13
4	Licence requirements	102
5	Marking requirements to protect human health	4
6	Production characteristics requirements to protect human and animal health	52
7	Product characteristics required to protect human, plant and animal health	110
8	Prohibitions to control drug abuse, ensure human safety, national security, protect humans, plants and wildlife	48
9	Requirements to use specific points of entry	5
10	State trading administration	19
11	Testing, inspection and quarantine for human and plant health and to ensure safety.	84
Total		516

Sources: Compiled from the World Bank WITS database and extracted from Ram Upendra Das (2009), 'Regional Economic Integration in South Asia: Prospects and Challenges', RIS Discussion Paper No. 157, available at: www.ris.org.in.

health, protection of the environment, protection of cultural heritage, morals, etc. Table 19.9 presents the spread of tariff lines to meet such objectives as in 2004. As many as 516 tariff lines could be identified as having some form of non-tariff measures. It will be seen that the highest number of tariff lines (110) relate to product characteristics to protect human, animal and plant health; licensing requirements in general covered 102 tariff lines; testing, inspection, and quarantine for human and plant health accounted for another 84.

19.3.2 Standards, testing, labelling and certification

Sri Lanka Standards Institution (SLSI) is operating a compulsory Import Inspection Scheme covering 102 products as per regulations. Conformity to the designated products to the relevant Sri Lankan standards is monitored.

Five categories of consignments have been classified. Categories 1–4 relate to quality certifications accompanying the consignments by (i) an international accreditation agency with which SLSI has a memorandum of understanding (MoU); or (ii) by a national standards body of exporting country; or (iii) a certification by a manufacturer/exporter registered with SLSI or (iv) carrying the certification mark of the national standards body of the exporting country.

In all the above-mentioned categories, samples will be drawn from the consignments and subjected to testing either for a random check and released for sale or if there is reasonable doubt regarding the product quality, SLSI may refuse release of such consignments. In case of consignments not accompanied by any certification, the consignment will be sampled at the port, and the consignment will not be released from the port until test report is available (SLSI nd).

The WTO considers Sri Lanka as a fairly open and transparent trade regime, characterised by reliance on price-based measures and scant use of NTMs and in general, relatively low tariffs (WTO 2010).

19.4 Trade liberalisation under preferential/free trade agreements

Apart from multilateral trade liberalisation, Sri Lanka has been liberalising its economy through regional and bilateral FTAs. Under the SAARC Preferential Trading Arrangement (SAPTA), Sri Lanka offered tariff concessions on 302 products of which 167 were offered for least developed countries (LDCs). While the preferential tariff was a modest 10 per cent for non-LDCs, the preferential margin for LDCs varied from 10, 20, and 35 per cent. In only three products, 100 per cent margin of preference was given. As Sri Lanka's most favoured nation (MFN) rates varied from 2.5, 6, 15, and 28 per cent, the offer of preferential margins by Sri Lanka can be considered to be very modest.

Sri Lanka's offer of concessions under South Asian Free Trade Area (SAFTA) and bilateral trade agreements with India and Pakistan is summarised in Table 19.10. It can be seen that under SAFTA Sri Lanka restricted trade liberalisation on 1,065

Table 19.10 Duty concessions offered by Sri Lanka in regional and bilateral trade agreements

Categories of concessions	SAFTA	India–Sri Lanka FTA	Pakistan–Sri Lanka FTA
Negative list ^a (% of import value)	1,065 HS six-digit tariff lines. (26.99% of total import value from region)	1,180 HS six-digit tariff lines (50.5% of import value from India, 2006)	697 HS six-digit tariff lines
Zero duty phased items		342 tariff lines w.e.f. 1 March 2000 880 tariff lines w.e.f. 1 March 2003 Items listed under residual are entitled for duty concession of 70% from 1 March 2006 and it will be 100% w.e.f. 31 March 2008	102 HS six-digit tariff lines For remaining items tariff will be phased out
Products subject to tariff rate quota (TRQ)			Sri Lanka has granted Pakistan TRQ for 6,000 m/t of basmati rice and 1,000 m/t of potatoes per each calendar year on duty-free basis. However, import of potatoes is permitted only during Sri Lanka's off-season, (two-thirds to be imported during June–July and one-third during October–November each year
Trade Liberalization Programme	Tariff to be reduced to 20% over 2 years; and 0–5% over next 6 years		

Notes: ^aNo concessions are permitted: Imports based on MFN duties. Two items relating to cement (HS Codes 2523.21 and 2523.29) will remain on Sri Lanka's negative list. The tariff on these items would nevertheless be reduced progressively in such a manner, so that at the end of eight years, the items shall attract no duty and shall be phased out from the negative list w.e.f. with effect from.

products in its negative list. This accounted for 27 per cent of its imports from the SAARC region. Under the Indo–Sri Lanka Free Trade Agreement (ILFTA) Sri Lanka's negative list contained as many as 1,180 products. This covered more than half of its imports from India. The list of products in Sri Lanka's negative list under the Pakistan–Sri Lanka Free Trade Agreement (PSFTA) contained 697 products. While no estimate is available as to what extent its imports from Pakistan were precluded from liberalisation, it is expected to be substantial. With respect to ILFTA Sri Lanka is providing India duty-free imports on 342 items with effect from 1 March 2000 and on another 880 products with effect from 1 March 2003. On the residual list of items Sri Lanka has brought down its tariffs to zero with effect from 31 March 2008. Thus barring the negative list, Sri Lanka has opened up its market for duty-free imports from India.

Under PSFTA Sri Lanka has opened up its market for duty-free imports of 102 items. For the remaining items tariffs will be phased out. Sri Lanka has applied tariff rate quotas on imports of basmati rice and potatoes from Pakistan.

It has been observed that almost 90 per cent of Sri Lanka's imports have taken place outside the bilateral framework of concessions offered and the top ten items imported by Sri Lanka have been from its negative list with India. Thus the offer of preferences by Sri Lanka to India has not been very effective in increasing India's market access to the Sri Lankan market.

19.4.1 The way ahead

Sri Lanka is on the verge of a new era of growth and developmental challenges as it moves from a war economy to a peace economy. To capitalise on its new opportunities, the country requires urgent policy reforms to rebuild and reconstruct its economy. Sri Lanka is faced with mounting public expenditure and declining revenues. Its tax–GDP ratio has fallen from 24.9 per cent in 1995 to 14.9 per cent in 2008. This has been so in spite of a steep increase in the country's real GDP per capita since the tax base did not sufficiently broaden. Tax evasion, poor tax administration, a plethora of exemptions, and discretionary and ad hoc tax policy changes have contributed to this while making the existing tax structure too complex.

Sri Lanka was the first country in South Asia to initiate reforms in 1977. Over the years, however, many of the reforms were put in reverse as both tariff rates and the incidence of para-tariff measures increased over time.

Sri Lanka needs to widen its tax base in order to reduce its overall tax rate. Unfortunately in Sri Lanka key income groups such as professionals and public employees remain largely outside the direct tax net. This chapter has noted that even though the country's basic customs duties appear modest, there are at least ten other taxes on top of customs duties in Sri Lanka which make the incidence of taxation on imports a multiple of what is reflected under customs. Further, the calculation of the tax itself, using the same base, can be quite complex.

Kelegama using different sources of information, has maintained that high import duties on certain goods have fuelled a growing illegal importation trade (Kelegama

2009). According to an estimate of the Central Bank of Sri Lanka, revenue losses at import entry points due to illegal importation and undervaluation of imports are in the region of LKR 300 million. The Board of Investment has estimated that in the mobile phone market alone, illegal imports, spurred by high duty rates, have cost revenue losses in the magnitude of LKR 600 million. It is possible that a lower flat-rate duty may bring some of this illegal importation into legal channels and earn more revenue. There are proposals to position Sri Lanka, similar to Dubai, as an *entreport* trade hub for portable consumer items, such as mobile phones and other electronic items by imposing a lower tariff rate on such items (Kelegama 2009).

A case in point is the high duty rates on vehicles imports. Demand for imported vehicles has contracted sharply recently, mainly because of high duties and compounded by the global economic crisis. Currently vehicles imported into Sri Lanka cost 200–300 per cent of the CIF price. Now that the Sri Lankan economy is fast moving towards recovery and tourist traffic is on the upswing following the end of hostilities, a lowering of duties on vehicles could see a volume-led rise in revenue.

A slew of measures announced by the Sri Lankan government on 1 June 2010 is designed to address some of the problematic issues in fiscal reform in Sri Lanka. Such measures have perhaps brought down the effective incidence of taxation in Sri Lanka, but do not significantly address the country's 'new protectionism'. Post-conflict Sri Lanka urgently needs to capitalise on its peace dividend. It is hoped that the Presidential Commission on Taxation set up by the government to address the issue of fiscal reform will further deepen the reform process.

Notes

- 1 To illustrate, shampoo 35% or LKR 150/kg.; apparel 30% or LKR 75/unit, biscuits 35% or LKR 60/kg.; oranges 20% or LKR 15/kg. (USTR 2009).
- 2 Not applicable for the purpose processing and re-export, for manufacturing goods for export; to drugs registered under the Cosmetic Devices and Drugs Act; to ayurvedic imani, and siddha preparations.
- 3 Sri Lanka also applies EDB cesses on exports of cashew nuts with shells; raw hides and skins; ferrous metal and non-metal scrap; and natural rubber. Cesses on raw hides and skins to ensure sufficient local supplies for manufacture of leather products. Cess on export of metal scrap to enable continuous supply raw materials required by the local foundry industry at competitive prices; on export/import of rubber to generate funds for developing rubber cultivation in Sri Lanka and to encourage the export of value-added rubber production.
- 4 These are motor vehicles for transport of ten or more, motor cars and other motor vehicles, motor vehicles for the transport of goods, chassis fitted with engines, for the motor vehicles, part or accessories of motor vehicles, and trailers/semi-trailers.
- 5 Some of the products listed are oil and other fractions, chocolates, bakery products, wine, spirits, perfumes, beauty preparations, shaving lotions, soap, tableware, kitchenware, articles of leather, articles of apparel knitted/crocheted, footwear, artificial flowers, wall tiles, ceramic articles, imitation jewellery, locks, refrigerators, dish and household washing machines, electro mechanical domestic appliances, shavers, storage water heaters, electric irons, microwave and other ovens, coffee/tea, toasters, cellular mobile phones, video recorders, televisions, etc.

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Chapter 20

South Asian Trade: What it Means to Maldives

*Ismail Nashid*¹

20.1 Introduction

South Asia, counted among the fastest-growing regions in the world, has the most geographically diverse composition in terms of the size, populations and resources of its countries. It is anticipated that the fast growth in South Asia will benefit from young demographics, new waves of globalisation, increased labour mobility and the rise of the middle class in the coming years (Ghani 2011).

As with globalisation, regional economic co-operation and integration are seen as the route to economic prosperity. Data on South Asia shows much potential for further growth; of the region's total trade volume of US\$400.6 billion in 2011, only 4 per cent was intra-regional trade. Given the advantages of proximity, the similarity in production structures and levels of technology, plus the familiarity of cultures, it is likely that a more pronounced set of benefits will accrue from intra-regional trade and investment taken alongside their extra-regional counterparts.

Although the South Asian Association for Regional Cooperation (SAARC) Preferential Trading Arrangement (SAPTA) and the South Asian Free Trade Area (SAFTA) came into force in 1995 and 2006, respectively, under the objective to stimulate trade and foster deeper integration and regional co-operation, full liberalisation and co-operation have not taken effect. Intra-regional trade is far below its potential level. For example, the region witnessed US\$16.17 billion intra-regional trade against a potential of US\$37.55 billion in 2010. South Asia has succeeded, so far, in achieving only 43 per cent of its trade potential, where the realisation rate (of trade potential) varies from the highest 83 per cent (Maldives) to the lowest 42 per cent (Pakistan) (see Chapter 10). In this context, South Asia as a region has lagged behind in terms of its openness to trade in spite of the fact that most South Asian countries have continued to undertake trade reforms since the 1990s.

A cursory examination of intra-regional trade shows that India has the largest share in total exports at 87 per cent, which is merely 4 per cent of the trade it does with the rest of the world. Maldives having the smallest share with only 0.1 per cent has 8 per cent of its export trade in merchandise within the region (Table 20.1).

When considering overall national trade, Nepal seems to have the greatest linkage of its economy to the region, where 61 per cent and 58 per cent of its exports and imports respectively are traded (Tables 20.1 and 20.2).

Given the fact that intra-regional trade in South Asia is discouragingly low, it is important to note that Maldives has considerable interests tied to the region with

Table 20.1 Share in intra-regional exports of South Asian countries in 2011 (US\$ million)

	Bangladesh	India	Maldives	Nepal	Pakistan	Sri Lanka	Total	Country-wise share(%) in intra-SAARC exports
Bangladesh								
India	3,789.20	289.96	124.60	9.27	43.29	10.82	353.34	2%
Maldives		2.30		2,721.57	1,541.56	4,378.79	12,555.72	87%
Nepal	14.69	254.39			0.77	12.40	14.70	0.10%
Pakistan	352.56	178.64					269.85	2%
Sri Lanka	33.00	376.00	41.00		55.00	169.31	700.51	5%
Total SAARC							505.00	4%
World	23,717.73	338,372.40	179.39	442.30	28,118.00	9,789.00	14,399.12	
Intra-regional exports as (%) of SAARC exports to world	1%	4%	8%	61%	2%	5%		

Source: IMF Direction of Trade Statistics

Table 20.2 Share in intra-regional imports of South Asian countries in 2011 (US\$ million)

	Bangladesh	India	Maldives	Nepal	Pakistan	Sri Lanka	Total	Country-wise share(%) in intra-SAARC imports
Bangladesh								
India	584.64	2,710.11		16.26	388.13	15.48	3,129.98	22%
Maldives	0.90	134.00	19.92	549.97	401.19	720.89	2,276.61	16%
Nepal	10.05	1,646.95			5.00	74.00	213.90	1%
Pakistan	47.94	1,032.27			0.77		1,657.77	12%
Sri Lanka	17.00	3,126.00	15.00		241.00	46.39	1,126.60	8%
Total SAARC							3,399.00	24%
World	38,571.10	509,574.00	1,639.99	2,847.75	52,552.10	18,364.00	11,803.86	
Intra-regional exports as (%) of SAARC imports to world	8%	0.4%	13%	58%	2%	19%		

Source: IMF Direction of Trade Statistics

almost 10 per cent of its exports and imports transacted within the region. The question then is whether the vast dynamism in South Asia will allow its smallest member to further benefit from regional trade.

This chapter aims to look at what SAFTA means for regional trade integration for Maldives, as well as how Maldives trade should be further integrated to regional trade in order to reap the maximum benefit from potential South Asian growth.

20.2 Overview of the Maldivian economy

Maldives is a nation consisting of approximately 1,190 low-lying coral islands which form a chain that stretches over an area of 90,000 sq. km of the Indian Ocean, and is surrounded by an exclusive economic zone (EEZ) covering 859,000 sq. km. The nation's capital Malé, with around 2.5 sq. km of total land area, has over one-quarter of the entire population of 270,101, while approximately 71 per cent of the rest of the 200 inhabited islands have fewer than 1,000 inhabitants according to the 2000 census information. Maldives has a relatively young population with almost 41 per cent under 15 years of age and around 3 per cent over 65 years of age. With regard to human development trends, the country ranks high among Asia-Pacific countries.

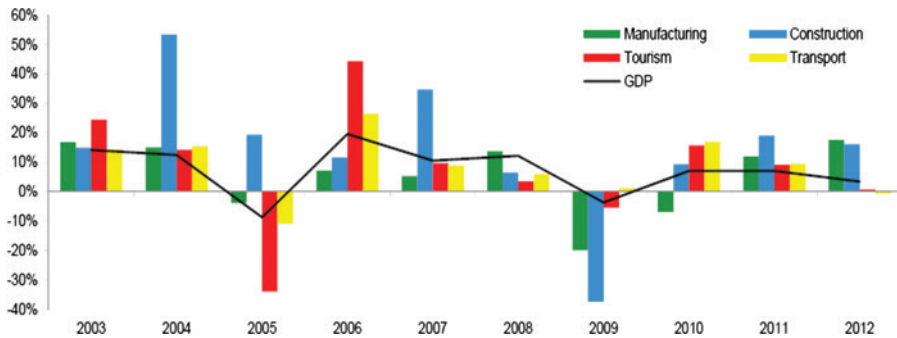
The Maldivian economy is very open. Trade in goods typically accounts for around 75–80 per cent of the gross domestic product (GDP). If services are taken into account, trade in goods and services account for approximately 150 per cent of GDP. Imports of goods typically outweigh exports of goods by a factor of between three and four. However, this large shortfall in foreign exchange earnings is, to a large extent, compensated by revenues from the export of services via the tourism sector.

There is currently very limited production activity in Maldives. This adversely affects the country's capacity to trade, both internationally and domestically. Factors contributing to the low productivity level include limited economic diversification, shortfalls in the supply-side and productive capacity, prevention of market linkages due to hurdles in the economic infrastructure, lack of an enabling business regulatory framework, weak institutional and limited technical capacity.

The Maldivian economy is heavily dependent on fisheries and tourism, which are the major sources of foreign exchange earnings and government revenue, and which together directly account for about 40 per cent of GDP, while indirectly accounting for a much larger proportion. In terms of employment, these two sectors alone account for more than one-third of total employment, according to the results of the 2000 census. The total labour force of the country is estimated at around 50 per cent of the working-age population, which, coupled with the low level of educated labour, has led to a high proportion of expatriate workforce in the country. Expatriate labour has, therefore, played a key role in the development of the Maldivian economy, and includes teachers, medical personnel and other professionals as well as a large number of lower-skilled workers such as domestic helpers and construction workers.

A slowdown in growth in the tourism sector led to a significant deceleration of economic growth in the country in 2012. Throughout 2012, the tourism sector

Figure 20.1 GDP growth by selected sectors, 2003–12 (growth in annual percentage change)



Source: Department of National Planning, Maldives

continued to be affected by weak economic conditions in Europe – the main tourism market for Maldives. In terms of growth rates, real GDP growth slowed from 7 per cent in the preceding two years to 3.4 per cent during 2012 (Figure 20.1), despite the improved performance of the construction, fishing and manufacturing sectors. The tourism sector slowed down significantly to 0.7 per cent during 2012 in contrast to the expected growth of 7.5 per cent. This marked slowdown was driven by the decline in tourist arrivals from Europe owing to weak economic conditions in the main European source markets, although it was partly offset by the robust growth in Chinese tourists. With the slowdown in the overall economic activity, especially in the tourism sector, the growth of the distribution sector (comprising the wholesale and retail trade) moderated to 5.0 per cent, following 8.2 per cent growth in 2011 (Maldives Monetary Authority 2013).

With effect from 11 April 2011, the Maldivian rufiyaa was allowed to fluctuate within a horizontal band of 20 per cent on either side of a central parity of MVR12.85 per US dollar. With the introduction of the exchange rate band, the exchange rate of the rufiyaa per US dollar moved towards the upper limit of the band, owing to persistent foreign exchange pressures in the economy.

By the end of December 2012, in annual terms, the rufiyaa appreciated by less than 1 per cent against the US dollar. As for the bilateral exchange rates, the rufiyaa depreciated against the Singapore dollar by 6 per cent, by 4 per cent against the pound sterling and against the euro by 2 per cent at the end of 2012. Conversely, the rufiyaa appreciated against the Japanese yen by 10 per cent, against the Sri Lankan rupee by 11 per cent and against the Indian rupee by 3 per cent (Maldives Monetary Authority 2013).

20.3 Trade policy framework

Maldives has undergone considerable political, constitutional and judicial change since the early 2000s. As a member of the WTO, Maldives accords most favoured nation (MFN) treatment to all members. Although Maldives graduated from LDC to middle-income country status on 1 January 2011, Maldives still benefits from

Table 20.3 Changes in the tariff structure effective from 1 January 2012

Duty rates	Tariff structure prior to 1 January 2012		Tariff structure since 1 January 2012	
	No. of tariff lines	% share of tariff structure	No. of tariff lines	% share of tariff structure
0%	16	0.29	2,247	40.43
5%	271	4.88	85	1.53
10%	503	9.05	396	7.12
15%	1,020	18.35	345	6.21
20%	780	14.03	1,941	34.92
25%	2,699	48.56	279	5.02
35%	154	2.77	183	3.29
50%	14	0.25	41	0.74
100%	92	1.66	19	0.34
150%			13	0.23
200%	9	0.16		
400%			9	0.16
Total lines	5,558		5,558	

Source: Maldives Customs Service

quota-free and duty-free access to the European Community (EC) and Japan, two of the main destinations for its exports of fish and fish products. The foreign investment regime is liberal, with 100 per cent foreign ownership permitted in all sectors.

In addition to SAPTA and SAFTA, Maldives has bilateral trade agreements with India, China and the USA. Up until 1 January 2012, import tariffs were Maldives' principal source of tax revenue, accounting for approximately two-thirds of tax receipts, as well as acting its main trade policy instrument. On 1 January 2012, goods and services tax was introduced for the first time, which was later followed by the introduction of business profit tax. This led to a subsequent reduction and reform in the tariff structure of the country.

Prior to reform in the import tariff structure, almost 49 per cent of tariff lines carried an applied rate of 25 per cent cost, insurance and freight (CIF), while after the reform 40 per cent of lines have an applied rate of zero per cent (Table 20.3). This subsequently led to a drastic revision of the sensitive list of Maldives under SAFTA where all food, clothing, cosmetics and domestic-use items now carry an applied rate duty of 0 per cent.

The export regime is relatively open, although exports of certain marine species are prohibited, exports of timber are controlled and ambergris exports are taxed.

20.4 Trade in merchandise

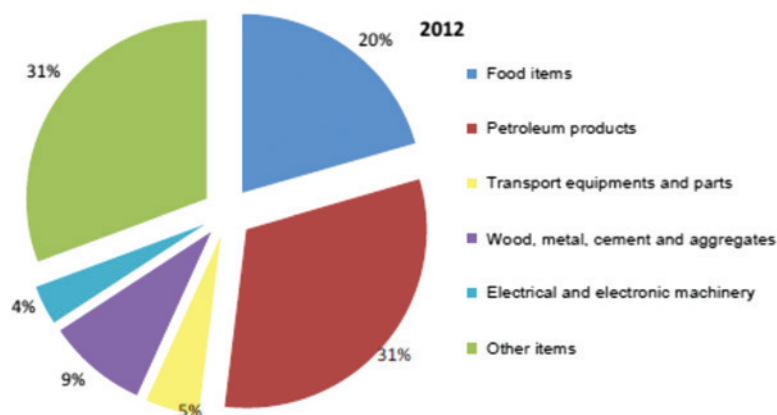
The merchandise trade deficit increased by 14 per cent in 2012 to a record US\$1,387.9 million (Table 20.4), reflecting the growth in imports. Merchandise exports, which are divided into domestic exports and re-exports, declined owing to a marked fall in re-exports despite the increase in domestic exports during the year. Domestic exports as a share of total exports rose to 40 per cent in 2012.

Table 20.4 Merchandise trade deficit (2008–12)

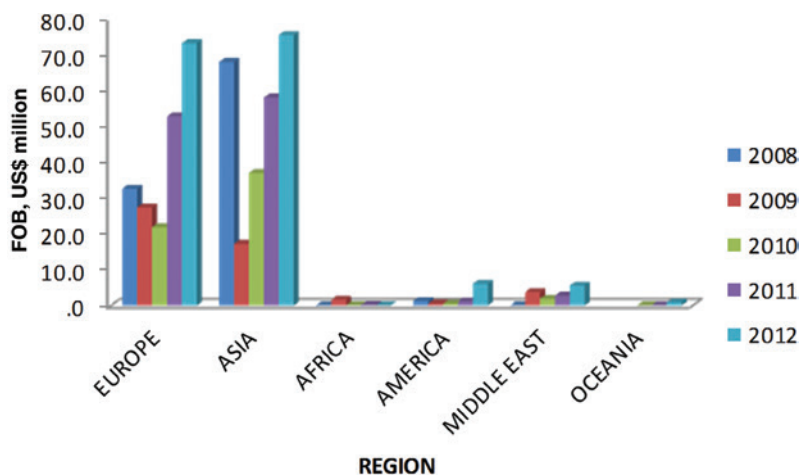
Year	Exports (free on board), US\$ million	Imports (cost, insurance and freight), US\$ million	Annual increase in exports	Annual increase in imports
2008	104.9	1,151.8		
2009	63.6	802.1	–39%	–30%
2010	61.6	909.0	–3%	13%
2011	114.8	1,328.5	86%	46%
2012	161.0	1,548.9	40%	17%

Domestic exports, which almost entirely comprise fish exports (97 per cent), registered a favourable growth of 12 per cent during 2012. The value of domestic exports rose from US\$114.4 million in 2011 to US\$161.6 million in 2012. The composition of fish exports was dominated by the fresh, chilled or frozen tuna category, which accounted for 82 per cent of the total value of fish.

Regarding the composition of imports, petroleum products accounted for the largest share (31 per cent) of total imports in 2012; followed by food items, which accounted for 21 per cent; and wood, metal, cement and aggregates, which accounted for 9 per cent (Figure 20.2). Expenditure on petroleum products rose by 33 per cent compared with 2011, with value adding up to US\$488.3 million in 2012, while imports of food items rose by 7 per cent during the year, in total by US\$318.9 million. The majority of Maldivian exports were traded with Asian countries (50 per cent) followed by Europe (45 per cent). Exports to Thailand accounted for more than half (54 per cent) of the total exports to Asia, while exports to Sri Lanka comprised 14 per cent of total exports to Asian countries. Other main export markets included France, Italy and the UK, which accounted for 36 per cent, 17 per cent and 16 per cent of the total exports to the region respectively (Figure 20.3).

Figure 20.2 Composition of imports (2011–12)

Source: Maldives Customs Service

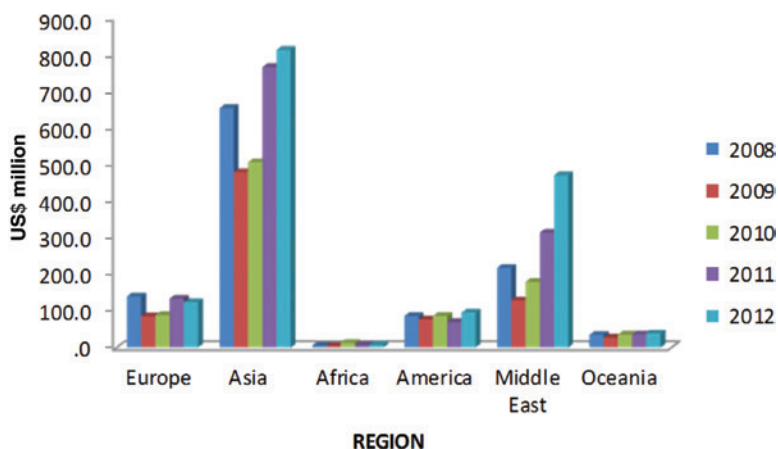
Figure 20.3 Export destinations by region (2008–12)

Source: Maldives Customs Service

With respect to the direction of imports, 83 per cent of imports came from Asian countries. As for the major source countries, 37 per cent of imports came from the UAE, followed by Singapore (22 per cent) and India (11 per cent). Meanwhile, imports from the European region accounted for 8 per cent of total imports (Figure 20.4).

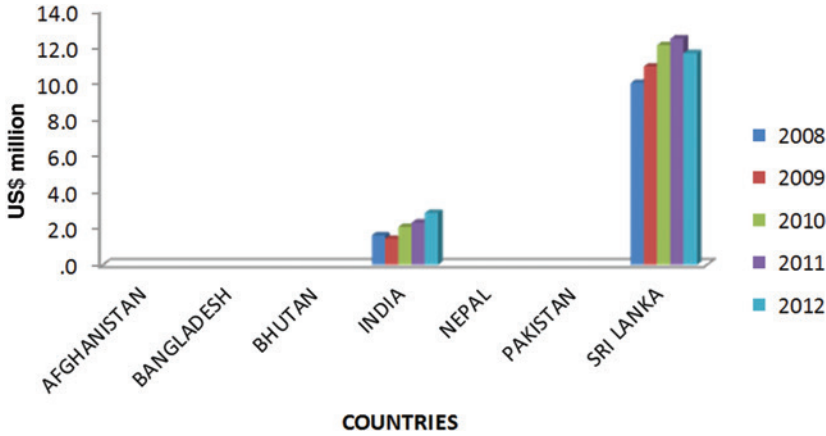
20.5 Trade with South Asia: Application of SAFTA

Both in terms of exports and import, Asia is one of the major trading regions. However, out of the total Asian trade, the South Asian share is 20 per cent and 30 per cent for exports and imports, respectively. For exports Sri Lanka is the main destination accounting for 10 per cent of export trade with the world, while the Indian share is around 3 per cent of total export trade of Maldives (Figure 20.5).

Figure 20.4 Import origins by region (2008–12)

Source: Maldives Customs Service

Figure 20.5 Export countries in South Asia (2008–12)

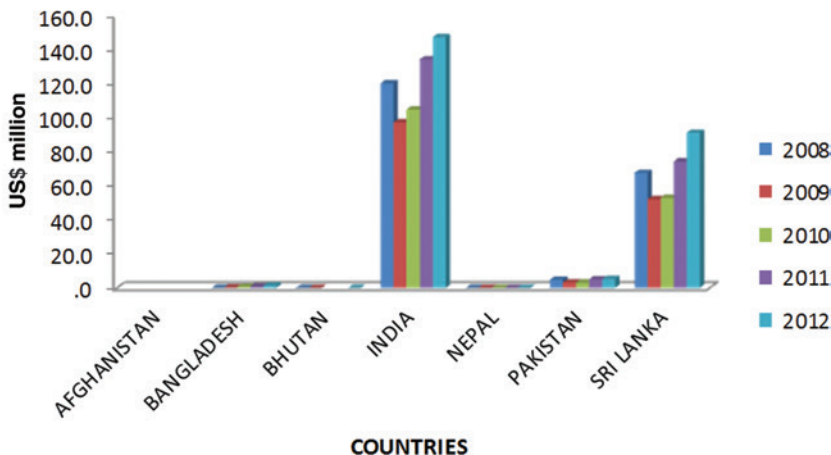


Source: Maldives Customs Service

Similarly in imports, India and Sri Lanka happen to be the main trading partners within South Asia. However, India's share in imports is higher with 10 per cent followed by Sri Lanka (5 per cent) while other countries in South Asia have abysmal values when compared with trade with the rest of the world (Figure 20.6).

The application of SAFTA is non-existent for Maldives because the main exporting destination, Sri Lanka, has fish and fish products included in the sensitive list under SAFTA. Almost 100 per cent of exports from Maldives to Sri Lanka are fish and fish products. On the other hand, almost 70 per cent of exports to India are scrapped iron, steel and aluminium, which are also negative items for India under SAFTA. However, a large share of trade with Sri Lanka accounting for around 70 per cent on average is done under SAPTA (Table 20.5).

Figure 20.6 Import countries in South Asia (2008–12)



Source: Maldives Customs Service

Table 20.5 Export trade with Sri Lanka (2008–12), (US\$ million)

DESCRIPTION	2008	2009	2010	2011	2012
Exports to Sri Lanka	10.0	10.9	12.0	12.4	11.6
Value traded under SAFTA					
Value traded under SAPTA	5.3	8.4	9.8	8.4	4.4
Share (%) traded under SAPTA	53%	77%	82%	68%	38%

Source: Maldives Customs Service

20.6 Barriers to effective application of free trade agreements

20.6.1 Sensitive list issues

It is obvious that a reduction in the size of sensitive lists is important to increase the quantum regional trade. Efforts are needed to take those products that are of export interest to the SAARC member states out of the sensitive lists for trade within South Asia.

In the absence of such revisions, the benefits and full potential of the intended trade liberalisation are effectively left unachieved.

20.6.2 Information gap

The Asian Development Bank (ADB) has an extensive database and numerous trend analyses on free trade agreements (FTAs) in Asia. According to research conducted by Dr Ganeshan Wignaraja, Principal Economist at ADB, firm size, ownership of firms, age of firms, and awareness of FTA provisions have a significant impact on effective applications.

These findings are very applicable to the trade environment of this region. It was found in this research that the firms that use FTAs are significantly larger than non-users. The trade environment of Maldives mainly consists of a large number of very small firms which at times lack the knowledge and expertise required for effective utilisation.

It was also found that firms that use FTAs are significantly older than non-users. One other important factor that came out in this research was that the extent of the awareness and the knowledge of the provisions in firms made a great impact on the utilisation of benefits.

In Maldives around 70 per cent of traders are not fully aware of the rules, benefits and implications of existing FTAs for Maldives trade.

This also highlights the issue of substantial informal trade in the region, given the large number of very small players in the market.

20.6.3 Rules of origin complications

Administrative complications of rules of origin (RoO) create restrictions at times, where dual restrictive criteria are required for both value of 40 per cent content and change of tariff classification to prove origin. Accumulation is allowed, but at

50 per cent regional value content (RVC) provided 20 per cent is domestic value. Lack of co-ordination and reporting mechanisms for certificates of origin (CO) among members, as well as the issuance of CO solely placed with government agencies creates other barriers for effective utilisation.

20.6.4 Slow progress in tariff reduction

Substantial reduction of tariffs has been a trend that the world has been following at a greater speed since the 1950s. South Asia to date has shown very slow momentum in this aspect. However, it has started to show signs in that direction.

Maldives tariff regime saw a tremendous reduction effective from 1 January 2012. Since 1 January 2012, out of 5,558 tariff lines almost 45 per cent now carry zero per cent duty rates whereas, before the revision, close to 50 per cent of lines carried a 25 per cent duty. This gigantic change is in support of the overall fiscal policy reform in Maldives, to transfer the burden of government revenue from import duty to more direct taxes.

20.6.5 Weak connectivity

It is noted that currently Maldives is trading with only India and Sri Lanka at a noteworthy level in the region. Given the demographics and the emerging markets in other countries, Maldives has the potential to enhance its trade with these other countries as well. However, this is impeded by barriers of transportation and infrastructure. Maldives being an island nation, all trade is conducted either by air or sea. Therefore, lack of proper transport connectivity both via sea and air is a prominent barrier when considering access to the markets of these countries. Therefore, development of infrastructure connectivity of the subregion could greatly enhance the potential for Maldives to develop its trade with other countries through transit arrangements.

20.7 Way forward: Greater trade facilitation through the elimination of non-tariff barriers

Trade facilitation is now being acknowledged and recognised to be the most crucial and significant aspect for international trade development. Tariffs will no longer be the main obstacle to trade with gradual reductions that will come into force. Yet, there remain significant costs to international trade mainly associated with unnecessarily complex customs and the at-the-border procedures, or with inefficient transit arrangements.

In the 'Doing Business 2012' publication by the World Bank and International Finance Corporation (IFC), South Asia has some of the lowest figures in comparison with other regions, especially in the 'Trading across borders' index. Among the 183 countries compared, the South Asian average is 125. After Eastern Europe and Central Asia, South Asia has the lowest figures.

In SAARC, a sub-group on customs co-operation is in operation under the objective to harmonise and simplify customs procedures and processes to promote and integrate trade in the region. The latest meeting of the sub-group, which was the

Table 20.6 Trading across borders index

Region	Regional average
Asia-Pacific Economic Cooperation	43
East Asia and Pacific	77
Eastern Europe and Central Asia	127
European Union	38
Latin America	97
Middle East and North Africa	79
South Asia	125

Source: World Bank (2012), 'Doing Business 2012: Doing Business in a More Transparent World'

ninth meeting, was held in Colombo, Sri Lanka, from 20 to 21 June 2013. During all the nine meetings of the sub-group, the themes of discussions and agreements made are similar. They include: building infrastructure including roads and railway networks near the land customs stations (LCSs); smoothing customs clearance procedures at LCSs; working with customs administrations to consider a system of customs facilitation in which export documentation of one member state could be considered by the customs administration in the importing country for the purposes of assessing and clearing the consignment; working towards developing an electronic data exchange system within the region; and the SAARC Secretariat is to develop a regional/subregional project to set up automated customs clearing mechanisms at the designated LCSs.

The focus of the discussions and the agreements made under the SAARC mechanism is in line with the modern trade facilitation and trade integration approaches and concepts practised across the globe. However, the speed of implementation or the levels of output generated through these agreements are abysmal. As such SAARC needs to transform into to a more result-focused entity rather than focussing on concepts and policy formulation.

20.8 Conclusion

Regional trade in South Asia has great potential for improvement. FTAs in the region can also be made more effective. Duplication of FTA agreements and exponential growth in the number of agreements is also a trend identified globally. A similar pattern is noticeable in South Asia where numerous bilateral trade agreements are made which effectively duplicate those that already exist at a regional level. Increases in number of FTAs that duplicate the provisions of existing ones complicate implementation and also minimise the effectiveness of such agreements.

Regional trade integration should be deepened, for instance, through revision of SAFTA sensitive lists and simplification of RoO, rather than initiating new agreements in the region. Also greater awareness is required on the merits of regional trade integration among key stakeholders in the private sector. Progress in regional integration will need to be supported by adequate connectivity mechanisms. As has been discussed and agreed at many SAARC summits, intra-regional transport connectivity is indispensable to further integrate trade in South Asia. The initiatives

for building supply capabilities and trade liberalisation in the South Asian region need to be complemented by a new approach towards connectivity and transit facilities for making the sub-continent interconnected and competitive.

Trade facilitation can be greatly improved by adhering to what has been very rightly agreed by the sub-group on customs co-operation, which is also in line with the current trade facilitation negotiations in the WTO. Efforts on trade facilitation should be aligned and integrated with the World Customs Organization (WCO) and South Asia Subregional Economic Cooperation (SASEC) activities that are ongoing in the region to further consolidate and streamline trade facilitation efforts carried out in different countries at an individual or bilateral level.

Note

1 This chapter has benefitted from research support provided by Ritwika Sen.

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PART IV. CASE STUDIES ON BILATERAL CO-OPERATION

Chapter 21

Indo-Bangla Trade: Composition, Trends and the Way Forward

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21.1 Introduction

Since the 1990s, South Asia has grown twice as fast as the rest of the world.² Most of the countries in the region have embarked upon more systematic and persistent trade liberalisation measures and, on the whole, such a policy stance has been maintained. This change in policy orientation has contributed to the improved trade performance of the region, coinciding with accelerated economic and per capita income growth. Enhanced outward orientation and improved growth performance also provide potential for increased regional trade and economic co-operation. In reality, however, South Asia is still one of the least-integrated regions of the world.

Like any other South Asian country, Bangladesh also needs to think about expanding regional trade as a source of economic growth. Policy-makers in Bangladesh and India are concerned about the meagre bilateral trade and are keen to bring dynamism to it, as reflected in their continued dialogues and efforts. The Sixth Five-Year Plan of Bangladesh attaches special importance to regional co-operation and the signing of the South Asian Free Trade Area (SAFTA) agreement by South Asian Association for Regional Cooperation (SAARC) member countries also indicates their shared objectives for closer economic integration.

According to trade theories, export potentials of any country are not omnipresent. Therefore, in its efforts to realise the above shared objectives, countries should look for the areas of their comparative advantage to maximise the gains from any policy-support measures. At the same time, it is important to recognise that the comparative advantage could change over time.

Against the above backdrop, this chapter examines the trade prospects between India and Bangladesh with emphasis on how the latter, faced with a growing bilateral trade-deficit, can expand its exports to the former. It reviews the trade policy of Bangladesh, composition and trends of bilateral trade between Bangladesh and India, and analyses trade data to ascertain the trade complementarities between the two countries. It also discusses the NTBs that hinder Bangladesh's export to India and provides some policy recommendations.

21.2 Bangladesh's trade policies and implications for Indo-Bangla trade

The gradual changes of Bangladesh's trade policies provide an opportunity for enhanced Indo-Bangla trade. Three distinct phases can be identified in Bangladesh's trade policy

regimes. The first phase (1972–75) was distinguished for heavy controls on export and import, and pervasive price control. The second phase (1976–90) was marked by a move towards a market-based economy, the beginning of de nationalisation, modest downward adjustment of tariffs, partial elimination of quantitative restrictions, and policy support to ready-made garments (RMG) export. The third phase (1990–to date) approached trade liberalisation in a more concerted manner. Major progress made so far includes substantial scaling down and rationalisation of tariffs, removal of trade-related quantitative restriction, unification of exchange rates and the move to a managed floating exchange rate regime. Despite frequently veering from its path, the trade liberalisation agenda continues to make progress over time.

The overall (trade-weighted) real exchange rate of the country also has moved within a fairly small band of about 8 per cent around its trend since the adoption of floating system. It showed a depreciating trend from fiscal year (FY) 04 to FY07, followed by a modest appreciation since then. The nominal rate of protection, measured as the unweighted sum of the average rate of tariffs and para-tariffs declined from 59.74 per cent in FY92 to 26.51 per cent in FY12.

The enhanced outward policy orientation is also reflected in the country's overall trade outcome, which is not matched by Indo-Bangla bilateral trade statistics. The openness of Bangladesh's economy, as measured by the ratio of export-plus-imports to GDP, increased from 16 per cent on average in the 1980s to 40 per cent in the 2000s (World Bank 2012). Exports as a share of gross domestic product (GDP) grew from 6.7 per cent in FY91 to 20.6 per cent in FY11. The impact the liberalised regime has on Indo-Bangla bilateral trade appears to be predominantly unidirectional, favouring Indian exports to Bangladesh. India as a destination market accounts for only about 2 per cent of Bangladesh's exports. In comparison, the European Union (EU) and USA together account for about two-thirds of Bangladesh's total export.

About four-fifths of the country's total export earnings are contributed by ready-made garments. With India changing to being an importer instead of exporter of some basic garments, Bangladesh's export of these items to the Indian market has been increasing. Therefore, such increase does not reflect any new dynamism of Bangladesh's export strength; rather it demonstrates that the increase was a dividend of being a neighbour of one of the fastest growing economies of the world. The South Asian Free Trade Area (SAFTA) agreement, which was signed by the member countries of SAARC in January 2004 to promote regional trade, is yet to make a notable impact on Indo-Bangla trade.³ A number of studies have evaluated the potential effects of the full implementation of SAFTA on bilateral trade flows and the findings are mixed.⁴

21.3 Composition and trend of Indo-Bangla trade

21.3.1 Some stylised facts and recent trends

The Bangladesh and Indian economies are different, perhaps not so much in terms of the overall level of development but more in terms of growth dynamics. The former has started off a slow but persistent acceleration of growth, whereas the latter has maintained one of the highest growth rates of GDP in the world for more than a

decade. In terms of composition of domestic outputs, there is no striking difference between these two economies. Both are dominated by the activities of the service sector, which contributes to about 53 and 50 per cent of total output in India and Bangladesh, respectively, followed by the industry sector, which contributes around 29 per cent of GDP in both economies.

As neighbours, the countries have established strong bilateral relations in political, economic, social and cultural areas since Bangladesh gained independence. Political relations have had their usual undulations but economic relations have always remained strong and have grown over time. Two-way trade flows between Bangladesh and India were nearly US\$5.07 billion in 2011, a notable increase from US\$1.12 billion in 2001, registering an average annual growth of about 26 per cent. However, India's exports to Bangladesh dominated and the resultant trade gap increased over time to about US\$2.78 billion in 2011 from about US\$1.01 billion in 2001.

Indo-Bangla bilateral trade flows demonstrate significant fluctuations. The growth of Bangladesh's export to India accelerated until 2005 and then started decelerating until 2009. During 2009, following the global economic and financial crisis of 2008, Bangladesh's export to India declined in absolute terms. It recovered strongly in 2010, resuming its earlier growth trajectory. The growth of imports from India had accelerated until it dipped in 2004, but recovered quickly. After a massive decline in 2009, it again recovered.

Despite the peaks and troughs, overall Indo-Bangla trade has increased over time, especially Bangladesh's imports from India. Bangladesh's export receipts from the Indian market increased from US\$0.005 billion in 1991 to US\$0.51 billion in 2011. The share of earnings from India in Bangladesh's overall exports fell from 0.33 per cent in 1991 to 0.31 in 2001, but then registered a rise to 1.88 per cent in 2011 (Table 21.1).

India's exports to Bangladesh increased from US\$0.2 billion in 1991 to US\$0.89 billion in 2001, and further to US\$4.56 billion in 2011. Nevertheless, the proportion of export receipts from Bangladesh in India's overall export earnings declined from 2.42 per cent in 2001 to 1.13 per cent in 2011, implying a faster growth of India's overall exports to the rest of the world.

Table 21.1 Trade between India and Bangladesh in different years

Year	BD's export to India (US\$ million)	BD's export to India as % of BD's total export	BD's export to India as % of India's total import	BD's import from India (US\$ million)	BD's import from India as % of BD's total import	BD's import from India as % of total export of India
1991	5.49	0.33	0.03	199.85	6.37	1.12
2001	16.51	0.31	0.03	889.59	11.06	2.03
2011	512.51	1.88	0.11	4,560.00	12.06	1.51

Source: UNCTADstat

Bangladesh's trade deficit is notably high with India compared with the rest of the world (Table 21.2). The overall trade deficit of the country accounted for about 24 per cent of its total imports and 32 per cent of total exports in 2001. These shares remained unchanged in 2011. But Bangladesh's trade deficit with India in 2001 was 95 per cent of its total import from and 1925 per cent of total export to India. These shares declined to 82 and 448 per cent respectively in 2011, yet these figures imply that India is predominantly a source country for imports rather than a destination market for the exports of Bangladesh. According to the latest information available from Bangladesh Bank, India is the second largest source of Bangladesh's overall imports and accounted for 15.1 per cent of the total imports of the country.

India's relative significance as a bilateral trade partner is second only to China, which was the source for about 21.5 per cent of Bangladesh's total imports. Other important import sources for Bangladesh are South Korea, Singapore, Japan, Malaysia, Indonesia, Brazil, Kuwait and Thailand with their shares in 2012 of 5.0, 4.7, 4.7, 4.4, 3.9, 3.8, 2.9 and 2.7 per cent, respectively.

Despite being the second largest source for imports, India is the only Asian country to emerge as one of the top ten export destinations of Bangladesh. The USA is by far the largest destination for Bangladesh's exports with a share of about one-fifth in the country's total export followed by Germany (16.4%), the UK (10.3%), France (6.6%), Spain (4.6%), Italy (4.4%), Canada (3.9%), the Netherlands (3.1%) and Belgium (2.9%). India's share in Bangladesh's overall exports was 2.7 per cent in 2012.

However, Bangladesh's exports to India and China have grown at an average annual rate of 28 per cent compared with 14 per cent for the USA and the EU. This suggests that the relative significance of India as well as China as Bangladesh's major export destinations is likely to grow in the future.

21.3.2 Dynamics of compositional change of export basket of Bangladesh to India

Contrasting with overall export structure of the country, Bangladesh's exports to India are dominated by primary *not* manufactured commodities. The shares of manufactured goods in Bangladesh's export to global markets were about 92 and 91 per cent in 2001 and 2011, respectively. During the same years, their shares in total export to India were about 51 and 45 per cent, respectively. Primary commodities

Table 21.2 Trade deficit of Bangladesh as percentage of total import and export

Year	With world		With India	
	Import	Export	Import	Export
2001	24.39	32.26	95.06	1925.23
2011	24.41	32.29	81.74	447.59

Source: Computed from UNCTADstat

accounted for about 35 per cent of Bangladesh's total exports to India in 2001, and 57 per cent in 2011. They accounted for only 7.41 and 8.24 per cent in Bangladesh's total export to global markets during the same years. Agricultural raw materials accounted for less than 2 per cent of the country's total exports to global markets both in 2001 and 2011. But they hovered around 27 per cent of the country's total export to India during the same years.

Bangladesh's exports of manufactured goods to India contain a puzzling feature. While labour-intensive commodities, with an 87 per cent share, dominated in Bangladesh's total export to global markets in 2011, they accounted for only about 22 per cent of total exports to India in the same year.⁵ Similarly, the share of high skill-intensive products accounted for 2.46 per cent of country's total exports to global markets as against of 21 per cent of country's total export to India.

Bangladesh succeeded in exporting new products to India while continuing to also export most the traditional ones (Figure 21.1). During 2001 and 2011, about 31 new products have been added to Bangladesh's global export basket. In contrast, as many as 103 new products were introduced to the export basket destined for the Indian market. Six items that were exported in 2001 but not in 2011 were pulp and waste paper (SITC 251), wool and other animal hair (SITC 268), cheese and curd (SITC 024), unmilled wheat (SITC 041), unmilled maize (SITC 044), and silk (SITC 261). The number of Bangladesh's export items to India with an export value of at least US\$1 million has increased from 4 in 2001 to 37 in 2011. At the same time, the comparable exports to the world market increased from 61 to 146 (Table 21.3).

Of the new export items to India, only a few were able to make a reasonable mark in terms of value of export. Exports of new commodities accounted for about 14.93 per cent of total export to India in 2011. Only ten of these accounted for about 12.55 per cent while the remaining 93 products accounted for only 2.38 per cent of total export to India. The relative contributions of the top ten new commodities are shown in Table 21.4. Petroleum oil or bituminous mineral (SITC 334) by far is the largest new export of Bangladesh to India in 2011.

Figure 21.1 Share (in %) of different product groups in Bangladesh's exports to India during 2001 and 2011

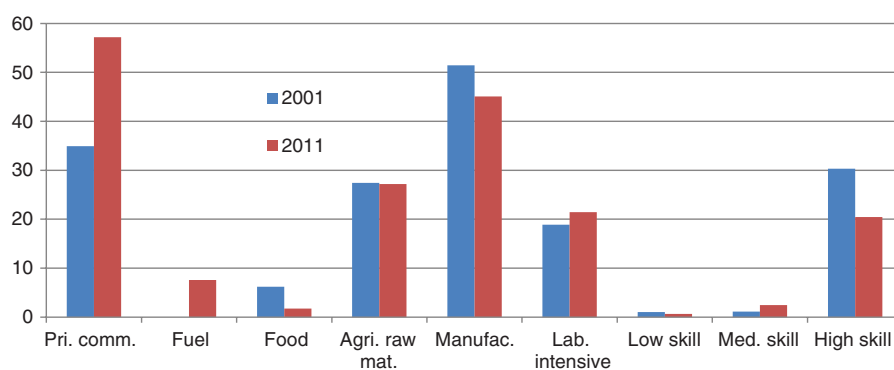


Table 21.3 Number of commodities exported from Bangladesh during 2001 and 2011

Year	Number of exports from Bangladesh		Number of exports with export value of at least US\$1 million	
	To World	To India	To World	To India
2001	214	90	61	4
2011	245	187	146	37

Source: UNCTADstat

Table 21.4 Top 10 new exports to India from Bangladesh in 2011

Commodities with [SITC] code	Value of export (in US\$ thousand)	Share in total export value of new commodities (%)	Share in total export value of all exports in 2011 (%)
[784] Parts and accessories of vehicles	1,165.9	1.3	0.2
[686] Zinc	1,316.2	1.4	0.2
[269] Worn clothing and other textile articles	1,873.5	2.0	0.3
[081] Feeding stuff for animals	2,296.0	2.5	0.4
[842] Women's clothing of textile fabrics	2,989.5	3.2	0.5
[571] Polymers of ethylene, in primary forms	3,180.6	3.4	0.5
[231] Natural rubber and similar gums, in primary forms	5,323.5	5.7	0.9
[422] Vegetable fats and oils, crude and refined	6,229.8	6.7	1.0
[273] Stone, sand and gravel	10,333.5	11.1	1.7
[334] Petroleum oils or bituminous minerals	43,316.9	46.7	7.0
Total	78,025.4	84.1	12.5

Source: UNCTADstat

Along with the inclusion of new commodities in the export basket, the relative share of different commodities in Bangladesh's total export to India has changed. Out of the top ten Bangladeshi exports to India in 2001, four failed to retain their position in 2011. They were copper [SITC 682], woven textile fabrics [SITC 654], special fabrics [SITC 657] and leather [SITC 611], which were replaced by non-ferrous base metal and scrap [SITC 288], fruits and nuts [SITC 057], petroleum oils or bituminous minerals [SITC 334], and cotton [SITC 263]. The top ten exports of 2001 accounted for 52.77 and 43.29 per cent of total Bangladeshi exports to India in 2001 and 2011, respectively. Similarly, the top ten commodities of 2011 accounted for 48.33 and 65.23 per cent of total exports in 2001 and 2011, respectively.

Being a developing country, the total imports of Bangladesh are understandably dominated by manufactured goods. However, Bangladesh's import from India is heavily dominated by primary commodities and food instead of manufactured goods (Table 21.5). This coupled with our earlier findings that Bangladesh's export to India is also dominated by primary commodities indicates the dominance of intra-industry trade in their bilateral economic relationship. The nature of the Indo-Bangla relationship is analysed in detail in Section 12.4. Bangladesh's reliance on India for primary commodities, food and agricultural raw materials is increasing over time (Figure 21.2).

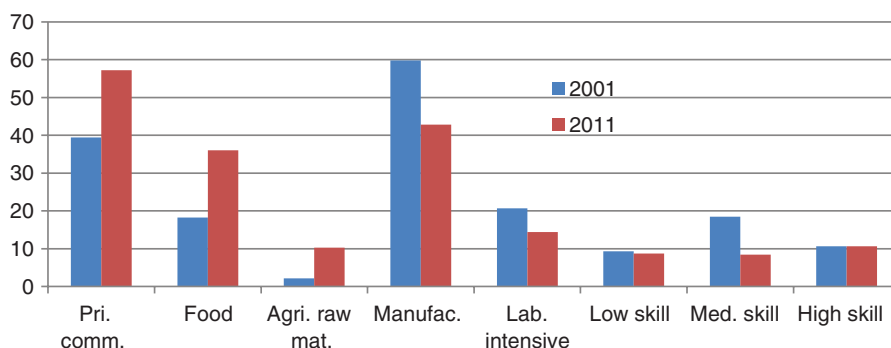
India's importance to Bangladesh as a source of imports has increased over time, not only in terms of value of imports but also in terms of number of imported commodities. Total number of commodities imported by Bangladesh from India increased from 212 in 2001 to 241 in 2011. Three commodities imported in 2001 but not in 2011 were wood particles and waste (SITC 246), meat of bovine animals (SITC 011) and fuel wood (SITC 245). The number of commodities with import value at least US\$1 million

Table 21.5 Percentage share of different imports by Bangladesh from India and world in 2011

Commodities	India	Global
Primary commodities	57.21	30.14
Food	36.02	20.42
Agricultural raw materials	10.30	6.48
Total manufacturing	42.79	60.93
Labour-intensive and resource-based manufacturing	14.43	21.53
Low skill- and technology-intensive manufacturing	8.74	7.94
Medium skill- and technology-intensive manufacturing	8.45	12.29
High skill- and technology-intensive manufacturing	10.64	18.10

Source: UNCTADstat

Figure 21.2 Share (in %) of different groups of commodities in total import from India by Bangladesh during 2001 and 2011



Source: UNCTADstat

has also increased from 98 in 2001 to 213 in 2011. To put them in context, the number of commodities imported from world markets increased from 235 in 2001 to 252 in 2011 and the number of imports from the same markets with an import value of at least US\$1 million increased from 139 to 239 during the same period.

The share of the new commodities added in Bangladesh's import basket from India in 2011 in total import (from India) was not significant and accounted for only about 0.23 per cent of total import from India. Only five commodities accounted for about 85 per cent of total value of all new imports. They are: natural gas (SITC 343), sulphur and unroasted iron pyrites (SITC 274), hides and skins (SITC 211), meat (SITC 017) and cereal meal and flour (SITC 047).

Although the new imports did not seem important in terms of their relative share, the relative importance of the existing imports changed during 2001–11. Out of the top ten imports of Bangladesh from India in 2001, four failed to retain their position in 2011. They were rice [SITC 042], cotton fabrics [SITC 652], parts and accessories of vehicles [SITC 784] and paper and paper board [SITC 641], which were replaced by cotton [SITC 263], maize [SITC 044], motorcycles and cycles [SITC 785], and fruits and nuts [SITC 057] in 2011. The top ten imports of 2001, accounted for 50.55 and 39.77 per cent of Bangladesh's total import from India in 2001 and 2011, respectively. Similarly, the top ten imports of 2011 accounted for 41.76 and 55.92 per cent of Bangladesh's total import from India in 2001 and 2011, respectively.

21.4 Explaining Indo-Bangla trade

The Indo-Bangla trade relationship appears to be concentrated in a few commodities, mostly in the domain of primary commodities. When viewed through a global lense, Bangladesh's export strength does not seem to lie in the area of primary commodities. Therefore, it raises a question about Bangladesh's export complementarity with India. Complementary trading partners, in many ways, are characterised by the differences in the goods and services produced and consumed. Economies that are structurally different from one another and produce a different basket of goods and services have greater potential for gains from trade. To assess the degree to which the Bangladesh and Indian economies can be considered as complementary rather competing, several indices as constructed in Basher (2013), using Standard International Trade Classification (SITC) three-level digit data, can be taken into consideration.⁶ They are: (i) the revealed symmetric comparative advantage (RSCA) index (ii) the trade specialisation index (TSI), (iii) the bilateral trade intensity index (BTII), (iv) the intra-industry trade index (IITI), and (v) the trade complementarity index (TCI). These indices are constructed using Standard International Trade Classification (SITC) three-digit level data as published by UNCTAD.

21.4.1 Different trade indices

Revealed symmetric comparative advantage (RSCA) index

The RSCA index is a modified specification of the share of a commodity group in a country's total exports as against the same for a partner country to indicate relative

advantage and disadvantage of the country in question as evidenced by trade flows. Basher (2013) presents the RSCA indices for the top 15 exports of Bangladesh and India in 2011 to assess their export competitiveness both bilaterally and globally. Nine commodities are part of the top fifteen exports of both countries, which to some extent provide primary indications that these two countries are competing on the same turf in the global market for their exports. The RSCA ranges from -1 to 1 , where a value greater than (less than) zero reveals a country's comparative advantage (disadvantage) in the export of a good. While it is possible for Bangladesh and India to each have comparative advantage (disadvantage) in one commodity relative to the world markets, only one of them will have comparative advantage relative to the other country in that particular commodity. The commodities, in which both countries have comparative advantage relative to the world markets, may not be suitable candidates for bilateral trade as both countries will be better off by exporting them to the world markets. The ideal candidates for Bangladesh to increase its export to India will be the commodities in which it has clear comparative advantage and India has comparative disadvantage – not only relative to Bangladesh but to world markets as well.

Out of the 21 commodities listed for which significant trade exists between the two countries, Bangladesh has comparative advantage relative to India in the case of 14 commodities. Most notable of these commodities are different categories of ready-made garments and leather products. However, out of these 14 commodities, India has comparative advantage relative to the world markets in 13 of them. The countries compete with each other in the case of these 13 commodities in the world market. The only commodity in which Bangladesh has clear advantage and can potentially increase its exports to India is fertilisers [SITC 562]. However, Bangladesh has limited installed production capacity in this commodity. Out of the 187 commodities exported to India in 2011, Bangladesh has clear advantage over India in only 16 (Bangladesh has comparative advantage over India and India has comparative disadvantage relative to world markets). The combined export value of these commodities accounted only for 2.5 per cent of Bangladesh's total export.

India has comparative advantage relative to Bangladesh in the export of seven commodities. Bangladesh has comparative disadvantage in the case of six of them relative to world market, giving India a clear advantage to increase the export of these six commodities to Bangladesh. They are petroleum oils and bituminous minerals [SITC 334], medicaments [SITC 542], rice [SITC 042], ships, boats and floating structure [SITC 793], telecommunication parts and equipment [SITC 764], and iron ore and concentrates [SITC 281]. Out of the 241 commodities exported by India to Bangladesh in 2011, India has clear advantage (India has comparative advantage over Bangladesh and Bangladesh has comparative disadvantage relative to world) in the case of 195 commodities. The total export value of these commodities accounted for about 85.1 per cent of India's total export.

Trade specialisation index (TSI)

The trade specialisation index (TSI) analyses the bilateral competitiveness by comparing the net flow of goods (exports minus imports) to the total flow (exports

plus imports) for Bangladesh and India. A positive value indicates that a country exports more than it imports of a commodity. The maximum value of this index could be 1, which would mean export specialisation, where the minimum value could be -1, which would mean import specialisation.

A total of 35 out of the 254 commodities that Bangladesh exports globally have a positive TSI, implying that Bangladesh specialises in their production and export. However, India also specialises in the production and export of 20 of these 35 commodities, thus implying that these two countries are more competitive with than complementary to each other. The correlation between Bangladesh's and India's TSI of all commodities is positive, reiterating the evidence of the competing nature of these two economies.

However, because of the concentration of Bangladesh's export around a number of commodities, indices estimated at a detailed disaggregated level may be misleading. Therefore, we evaluated the correlation between the TSI of Bangladesh and India for Bangladeshi exports overall export values of US\$5 million (Table 21.6). In the case of both groups of exports, classified on the basis of value of exports, the Bangladeshi and Indian economies appear to be competing with rather than complementary to each other.

Bilateral trade intensity index

Bilateral trade intensity is determined by comparing bilateral exports between Bangladesh and India to the exports of each country to the rest of the world. Bilateral export is deemed 'intense' if they trade with each other relatively more than they do with the rest of the world. Basher (2013) provides the results of the bilateral trade indices of commodities that have a bilateral export value of US\$5 million or more.

The results show that the degree of 'intense' bilateral trade relationship between India and Bangladesh is low, albeit increasing over time. Of the 19 SITC three-digit level products considered, Bangladesh had intense trade relationships with India only in the case of two commodities in 2001. This number has increased to six in 2011. However, India does not have an intense trade relationship for any commodity with Bangladesh. In fact, its trade intensity with Bangladesh is decreasing over time, implying its integration with the rest of the world at a faster rate than its integration with Bangladesh.

Table 21.6 Trade intensity indices of Bangladesh and India, 2011

Group of commodities	Number of commodities with positive TSI		Number of commodities with negative TSI		Correlation coefficient
	Bangladesh	India	Bangladesh	India	
All at SITC three-digit level	35	108	229	156	0.37
Export value ≥US\$5 million	34	71	112	15	0.43

Source: Estimated by using data from UNCTADstat

Intra-industry trade indices

The intra-industry trade index measures how much trade between the two economies occurs within the same industry. It is based on the premise that economies of scale provide an incentive to trade even when factor endowments and consumer preferences are identical between partner economies. Results reported in Basher (2013) show the intra-industry trade indices for commodities in which Bangladesh has an export value of US\$5 million or more in 2011. Bangladesh had significant relationship in the case of five in 2001. This number has increased to seven in 2011. India, on the other hand, had a significant trade relationship with Bangladesh in the case of six commodities in 2001. This number has decreased to four in 2011, implying the diminishing importance of Bangladesh as a trade partner.

Trade complementarity index

The trade complementarity index (TCI) assesses how well the export structure of one country matches the import structure of the other country. The critical value of TCI is 40, meaning any value less than this level indicates lack of trade complementarity. The trade complementarity indices, constructed for each year from 2001 to 2011 by using the bilateral trade information (export and import) of these two countries disaggregated at SITC three-digit level, show that India has had clear export complementarity with Bangladesh (Table 21.7). India being the second largest import source for Bangladesh, this result is quite expected. Bangladesh, on the other hand, clearly lacks export complementarity with India. Its export complementarity is less than ten for the period 2001–2011 and shows no sign of any improvement.

Impact of real exchange rate on exports of Bangladesh to India

It is difficult to identify any sizable complementarity between the economies of Bangladesh and India on the basis of different trade indices, which corroborates the findings of other studies, for example Sikdar (2003). Nevertheless, Bangladesh's export

Table 21.7 Export complementarity between Bangladesh and India in different years

Year	Bangladesh	India
2001	9.21	45.04
2002	8.66	45.99
2003	8.50	46.84
2004	8.34	45.29
2005	9.60	45.95
2006	8.24	44.60
2007	8.93	46.28
2008	9.85	48.48
2009	8.31	28.91
2010	9.50	43.16
2011	9.17	44.12

Source: Estimated by using data from UNCTADstat

to India is growing over time, even at a faster rate than its growth to traditional export markets such as the USA and EU. Therefore, it is important to see what explains this growth.

It is postulated that in an open economy, two main determinants of the exports of a country are the real exchange rate and foreign (destination country) income. In fact, the main target of exchange rate policy of the country is to foster exports and remittances. Although it introduced a 'floating' exchange rate policy in 2003, the de facto exchange rate regime in Bangladesh has been a managed one with a dominant role played by the central bank in determining the value of taka.

The real exchange rate of Bangladesh with India is estimated as:

$$q = \frac{e.P^I}{P^B}, \quad (21.1)$$

where P^I and P^B represent the price levels (measured in terms of the consumer price index) in India and Bangladesh, and e is the nominal exchange rate (equivalence of one Indian rupee in terms of Bangladeshi taka). Thus, this estimate of the real exchange rate shows to what extent Indian products are expensive vis-à-vis Bangladeshi products. Based on the above formulation, a rise in the real exchange rate would mean an increase of Bangladesh's competitiveness vis-à-vis India, and vice versa.

It emerges from our econometric exercises (including from Granger causality tests) that the real exchange rate and GDP of India affect the exports of Bangladesh to India. While statistically one can reject the hypothesis that real exchange rate does not cause exports of Bangladesh to India, the hypothesis that exports of Bangladesh to India does not affect the real exchange rate cannot be rejected. The real exchange rate is a useful summary of external competitiveness of a country vis-à-vis its export destination. Thus, the results of a Granger causality test imply that all else remaining unchanged, Bangladesh can increase its exports to India by improving its competitiveness, conforming the fundamental recipe for export promotion.

Similarly, the hypothesis that the GDP of India does not Granger cause Bangladesh's export to India can be rejected at the conventional levels of statistical significance, but it is not possible to reject that Bangladesh's export does not affect the economic activities (as reflected in GDP) of India. This implies, all else remaining unchanged, Bangladesh's exports to India will change with the growth of the Indian economy.

To analyse the direction of the relationship between the real exchange rate, GDP of India and Bangladesh's export to India, a linear specification as

$$XB = f(q, YI) \quad (21.2)$$

is empirically evaluated, where XB is Bangladesh's export to India, YI is GDP of India. In evaluating the above specification, we use the annual data for the period of 1990–2011. Keeping the analysis limited to this period is justified by the fact that the Bangladesh economy was more or less closed before the 1990s. Based on the results from the unit roots and co-integration analysis, it is possible to confirm a valid long-term relationship among these variables in equation (21.2).

The signs associated with all the estimated parameters of the long-term relationship turn out as expected. The empirical results also imply that Bangladesh's exports to India are highly responsive to changes in the competitiveness of the country as reflected in real exchange rate movements. All else remaining unchanged, a 1 per cent increase in competitiveness is likely to increase Bangladesh's export to India by about 8 per cent. A 1 per cent increase of Indian GDP is found to be associated with a 0.8 per cent rise in Bangladesh's exports to India. These results indicate that improved competitiveness matters for exports. While policy-induced measures such as exchange rate management can be a difficult option, enhanced external competitiveness can be achieved through tackling supply-side hindrances.

21.5 Non-tariff trade barriers between Bangladesh and India

As discussed in Section 21.4, both growth in the Indian economy and enhanced external competitiveness of Bangladesh are significant determinants of the country's exports to India. Since the Indian economy is expected to continue its growth momentum, opportunities for Bangladesh to increase its exports to India are likely to continue. One of the main hindrances to taking full advantage of the potential are the NTBs that hinder bilateral trade between India and Bangladesh.

It has been estimated that only about 30 per cent of Bangladesh's import needs are being sourced from the region despite the potential of the region's being able to supply all the import requirements of the country. In the case of the inputs of Bangladesh's main export sector – ready-made garments (RMG) – only US\$147 million (18.3 per cent of the total need of the country) was imported from the region, while the region's total exports of the same inputs were almost US\$2.7 billion in 2011 (Razzaque 2012). Intermediate inputs, when imported from a neighbouring country to produce the final export goods for the global market, can potentially reduce the lead time. However, a plethora of non-tariff measures severely constrain bilateral trade. The trade between these two countries also suffers from a poor state of trade facilitation and high transaction costs associated with cross-border exchanges.

An overwhelming majority of the NTBs faced by SAARC countries are related to sanitary and phytosanitary measures (SPS) and technical barriers to trade (TBT), which, according to an Asian Development Bank study (ADB 2008), accounts for about 86 per cent of all such constraints. Bangladesh also faces a number of SPS- and TBT-related trade barriers in promoting its export to India.

Lack of clarity and transparency about SPS standards of India affects Bangladeshi exports to its market. As discussed earlier, Bangladesh's exports to India are dominated by primary and agricultural products. India requires an approved risk analysis of agricultural imports in biosecurity and SPS categories in order to protect the human, animal and plant life. Nearly all livestock, agricultural and food imports require SPS certificates and import permits from India's Ministry of Agriculture. The process of getting these certificates and permits lacks transparency, which in turn affects Bangladesh's exports to India. Bangladesh's products are sent to Indian

standards testing laboratories (Bureau of Indian Standards) for certificates on quality, adding another layer of bureaucratic hassle and delay.

The Indian Prevention of Food Adulteration Act, 1954, requires the shelf life of processed foods to be not less than 60 per cent of the original shelf life at the time of import. While this objective is fine, the process of determining shelf life is often arbitrary and non-transparent. India's Prevention of Food Adulteration Rules, 1955 are complicated. Just one rule alone, number 32, has 30 provisions with further sub-provisions. It also cross-references other rules prescribing content, size and design of labels, display panel specifications, details of colours and flavours, trade names and so on. No certificate from the country of origin is accepted. The results of laboratory tests cannot be challenged. Separate regulations exist for various food types.

To export textiles and textile products to India, exporters must obtain a pre-shipment inspection certificate from a textile testing laboratory accredited to the National Accreditation Agency of the country of origin. In some cases, even certificates issued by EU-accredited laboratories are rejected by Indian customs authorities.

The Benapole land port is the main gateway for Indo-Bangla trade. The current traffic in this crossing is 300–500 loaded trucks entering Bangladesh each day and 100–200 loaded trucks exiting. The Indian trucks are allowed to proceed up to 500 yards of the zero point inside Bangladesh without checking, but the Bangladeshi trucks are allowed to go up to the border where the goods are transferred to an Indian truck using a back-to-back operation. This is a cumbersome procedure since the area is very small, only about 0.2 hectares.

Poor services at land ports and arbitrary decisions taken by custom officials are mentioned as a problem in promoting Bangladeshi exports to India. Poor logistic facilities of most of the Indian land ports, restrictions of commodities that can pass through land ports, cumbersome customs requirements, manual clearance, excessive inspection in the name of security, no customs co-operation or joint inspection, no harmonisation of standards, lack of warehouse facilities in most of the Indian land ports, no testing facilities in any Indian land port bordering Bangladesh, etc. are some of the major hurdles mentioned by the exporters of Bangladesh in the way of smooth movement of goods exported by Bangladesh to India.⁷

Lack of co-ordination between central and state government's rules and regulations also affects Bangladesh's export to India. The Directorate General of Foreign Trade (DGFT) of India is not the only authority to impose rules and regulations regarding exports from Bangladesh to India. Various state agencies even impose different barriers on their own. For example, the state customs departments (tariff agencies) sometimes ban different imports from Bangladesh. The customs authority of West Bengal at Kolkata once banned the import of soap from Bangladesh. DGFT claimed complete ignorance of the matter.

21.6 Conclusions and policy recommendations

South Asia is emerging as one of the most vibrant economic regions of the world. Within the region, India is by far the leading, as well as the fastest growing, economy.

Growth of Indian markets provides potential for increased intra-regional trade. Yet the intra-regional trade is very low in this region. In particular, bilateral trade between India and Bangladesh is not only low but also dominated by one-way traffic of commodities, from India to Bangladesh, making the former the second largest source for imports of the latter.

Bangladesh and India have an unusual trade profile compared with their overall trade with the rest of the world. While Bangladesh's export to rest of the world is dominated by labour-intensive manufactured commodities, its export to India is dominated by primary commodities and agricultural raw materials. A skill-puzzle is also observed in the case of whatever manufacturing commodities are exported to India by Bangladesh. The low-skill and labour-intensive commodities dominate in Bangladesh's overall exports but such dominance is not observed in the case of its export to India.

Bangladesh's import from India also represents a notable departure from its overall import structure. Being a developing country, total import of the country is understandably dominated by manufactured goods. But its import from India is heavily dominated by primary commodities and food, not by manufactured goods. This, coupled with the fact that Bangladesh's exports to India are also dominated by primary commodities, indicates the dominance of intra-industry trade in their bilateral economic relationship.

Trade between Bangladesh and India exhibited dynamism both in terms of consolidating the trade of the existing commodities and diversifying into new commodities. The composition of the top ten exports to Bangladesh has changed between 2001 and 2011. Similar compositional change is also observed in the case of imports from India.

Trade between Bangladesh and India cannot be explained by the trade complementarity between these two economies. An evaluation using five trade indices, namely revealed symmetric comparative advantage index, trade specialisation index, bilateral trade index, intra-industry trade index, and trade complementary index, shows that these two economies are more competing in nature. The lack of trade complementarity of these two economies is attributable to their similar economic and production structure, with both countries having a large service sector (about 53 and 50 per cent of GDP in India and Bangladesh, respectively), followed by the industry sector (with about 29 per cent of GDP in both countries). In many cases, both Bangladesh and India have comparative advantage in the same commodities in regard to the world export markets. Despite both countries being a story of service-led growth, services trade is conspicuously absent in their bilateral economic relationship.

Bangladesh's export to India can be explained by two factors: (i) increase of external competitiveness of Bangladesh vis-à-vis other countries including India and (ii) growth of Indian markets as represented by growth of Indian GDP. With growth of per capita income, India is moving up the value chain of a product or industrial ladder, favouring its neighbours, including Bangladesh, not only through lessening the intensity of competition but also by becoming a market for them. This is

why the World Bank (2011) argues that India and China 'are now changing from competitors to markets for Bangladeshi exports' (p8).

As long as the Indian economy continues to grow, the scope for Bangladesh to increase export to the Indian market will increase. In such a situation, it is imperative for Bangladesh to increase its competitiveness to take full advantage of the emerging opportunities. Bangladesh does not have to reinvent the wheel to do that: taking care of the usual suspects that limit country's manufacturing growth will suffice. A three-level intervention would be needed to eliminate the obstacles at the border, behind the border and over the border. Bangladesh needs to increase efficiency at the border in order to increase its export to India. About half of the bilateral trade between India and Bangladesh takes place through land ports. There are 16 land ports operating between these two countries.⁸ But Benapole is by far the most important land port of the country. Restructuring the Benapole crossing to allow cross-docking (unloading of materials from an incoming carrier directly onto outbound carriers, with little or no storage in between) and electronic processing of declarations at the border need to be introduced. The users of the Benapole port identified a number of actions to improve the efficiency of the port. They include: (a) construction of more sheds and a cold storage for perishables, (b) procurement of new cranes and forklifts, (c) expediting the completion of the bypass road to reduce traffic jams, and (d) construction of a new link road to be used exclusively by the passenger vehicles and passengers entering into and exiting from Bangladesh (World Bank 2011: 18).

A number of reports identified the main behind-the-border problems that reduce the external competitiveness of Bangladesh. The Sixth Five-Year Plan of Bangladesh also identified areas for improvements to increase the country's manufacturing as well as external competitiveness. The cross-cutting action areas are infrastructure, human development and the business regulatory environment.

- Infrastructure: infrastructure deficiencies have been a perennial problem in Bangladesh. The share of value-added infrastructure services in total GDP has remained mostly unchanged at around 11 per cent since the 1980s with very insignificant changes among different forms of infrastructure, while the economic structure has become more and more infrastructure service-intensive. As concluded in a World Bank report (2012), it is important to forge 'partnership with domestic and private investors to increase power generation, raise public spending on road maintenance, improve the management of Chittagong port'.
- Human development: according to World Bank (2012), skill shortages in Bangladesh have driven the real wages by 30 per cent, meaning the country can significantly improve its external competitiveness vis-à-vis the rest of the world including India by improving its skill situation. It is puzzling that the rising skill gaps and shortages have so far failed to incentivise the private sector to impart training, indicating a market failure in the provision of adequate skills. This warrants active public actions including trainee- and employer-targeted financing to impart training. In the first case, the government can introduce

‘training vouchers’ for interested trainees to finance part of their training cost. To minimise the moral hazard problem,⁹ the government can make the vouchers redeemable only after the trainee has found a suitable job. It emerged from the discussion with exporters and also from different anecdotes that job-hopping of skilled or trained workers is one of the reasons why employers are reluctant to impart on-the-job training in Bangladesh. To solve this problem, the Government of Bangladesh can undertake a levy scheme, as already undertaken by 30 different countries, under which employers pay a levy of a certain percentage of their wage bills and are eligible to claim a certain portion of allowable cost from this fund to train their employees. This can be topped up with government funding, at least until the time that sufficient funds are collected from the employers.

- Business regulatory environment: being a labour-abundant and capital-scarce country, Bangladesh should be an ideal candidate for global foreign direct investment (FDI). But the poor regulatory environment and difficulties in doing business are the major hindrance to FDI. According to the World Bank’s *Doing Business Report 2012*, Bangladesh ranks 122 out of 183 countries, with property registration typically taking 245 days, compared with 44 days in India, 57 days in Vietnam, 22 days in Indonesia and only 2 days in Thailand. The Government of Bangladesh needs to take measures to improve its poor governance and property rights.

The Government of Bangladesh should work closely with its Indian counterpart to overcome the over-the-border problems. The main over-the-border problems that seriously affect Bangladesh’s export to India were discussed in Section 21.5 of this chapter. A joint effort by the Bangladeshi and Indian governments would be required to solve these problems and promote bilateral trade between these two countries.

Notes

- 1 The author has benefitted immensely from the insightful comments of Mohammad Razzaque and other anonymous referee(s). Excellent data and research support was provided by Jahangir Alam.
- 2 South Asia comprises eight economies – Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. Seven of them, excluding Afghanistan, formed the South Asian Association for Regional Cooperation (SAARC).
- 3 According to the Trade Liberalization Programme (TLP), one of the core elements of SAFTA, all non-LDC member countries of SAARC – India, Pakistan and Sri Lanka – shall reduce their existing tariffs to 20 per cent in two years from the date of coming into the force of the treaty, and thereafter to 0–5 per cent over a five-year period (i.e. by 2013). However, Sri Lanka, because of its smaller size compared with India and Pakistan, has been allowed an extended period of six years to achieve such levels (i.e. by 2014). The LDC member countries – Bangladesh, Bhutan, Maldives and Nepal – shall reduce the existing tariffs to 30 per cent within the first two years from the date of coming into force of the treaty, and thereafter 0–5 per cent in eight years (i.e. by 2016).
- 4 The findings of these studies are mixed. Rodriguez-Delgado (2007) predicted that SAFTA will have ‘minor effect’ on regional trade flow. Raihan and Razzaque (2007) found that if all SAARC countries eliminate their intra-regional tariffs while keeping them intact for the rest of the world, Bangladesh will gain a positive effect from trade creation which surpasses the negative effect of trade diversion. Raihan (2008) found that under SAFTA Bangladesh’s export to India will increase

to US\$78 million. Raihan (2008), observes that ‘... there are some special and differential provisions for the LDC members in the SAFTA Agreement. However,... most of these provisions are rather “vague” in nature and thus require substantial clarification and revision so that Bangladesh and other LDC members can effectively take advantage of these provisions.’ Bandara and Yu (2003) found that unilateral liberalisation would benefit South Asian countries more than preferential liberalisation.

- 5 According to UNCTAD’s classification, labour-intensive commodities include clothing, fabrics, yarn, apparel and clothing accessories, etc. High skill-intensive commodities include leather products, footwear, textile fibre, chemical products, fertilisers, machineries and transport equipment, etc.
- 6 One has to bear in mind that each of these indices contains certain limitations. The indices themselves cannot explain why trade takes place in the first place. They also fail to identify the problems that constrain exports.
- 7 One exporter of fruit juice from Bangladesh to India claims that the customs authorities of India frequently change their positions about where to print the expiry date of the juice, on the bottom of the bottle or on the label of the bottle. Such changed rules increase the cost of production. He further claims that he needed 40–50 days to get the results of testing of the products from the Indian authority.
- 8 They are: 1. Benapole, Jessore, 2. Banglabandha, Panchaghar, 3. Bhurimari, Lalmonirhat, 4. Hilli, Dinajpur, 5. Sonamasjid, Chapai Nawabgonj, 6. Tamabil, Sylhet, 7. Akhaura, Bhahmanbaria, 8. Nakugaon, Sherpur, 9. Haluaghat, Mymensingh, 10. Darshana, Chuadanga, 11. Birol, Dinajpur, 12. Bhomra, Satkhira, 13. Teknaf, Cox’sbazar, 14. Bibirbazar, Comilla, 15. Bilonia, Feni, and 16. Gobrakura and Karaitoli, Mymensingh.
- 9 Introduction of training vouchers may encourage the private training institutions to enroll fake students to redeem their vouchers and share a portion of the money with them, with the students leaving the programme before completion.

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Chapter 22

India–Pakistan Economic Co-operation: Implications for Regional Integration in South Asia

Selim Raihan and Prabir De

22.1 Introduction

One of the most significant recent developments in India–Pakistan bilateral economic co-operation is the revival of trade talks in 2011. Since then, the two countries have built closer economic relations with a shared vision of enhancing peace and stability in the South Asia region. There have been several initiatives taken by both countries to strengthen bilateral relations, of which Pakistan's decision to offer most favoured nation (MFN) status to India is remarkable.

After partition in 1947, India accounted for about 70 per cent of Pakistan's official trade. However, discordant political relations brought a halt to the bilateral official trade between the two countries. Between 1965 and 1973, bilateral trade dropped to zero. In 1971, India and Pakistan signed a first trade agreement, which did not last long. In 1989 Pakistan introduced a first positive list of tradeable items (for four products originally), and it kept increasing the number of items almost every year. Soon after establishment of the World Trade Organization (WTO) in 1995, India granted MFN status to Pakistan. From end of 1990s until the mid-2000s, political issues affected bilateral economic relations. When the leaders of the two countries felt the need for stronger bilateral economic relations, they came forward with measures to enhance economic exchanges. The Musharraf–Singh Composite Dialogue in 2004 is an example where 'trade' alone was the subject of four treaties between the two countries. Later in 2004, Pakistan announced a positive list of 757 trade items, and rail and air routes were re-opened in the same year. Pakistan announced another positive list of 1,075 items in 2006, and more trade incentives were introduced, such as for cross-border truck movement, among others. Bilateral trade declined sharply in the aftermath of the 2008 global financial crisis, and Pakistan had to announce another positive list of 1,934 items in 2009 with the aim of bringing back momentum to the growth in bilateral trade.¹ As the region recovers from the global financial crisis, India and Pakistan have agreed to deepen their bilateral relations. Pakistan decided to extend MFN status to India in 2012 and replaced the restricted positive list with a negative list in February 2012. India reciprocated by allowing Foreign Direct Investment (FDI) from Pakistan. There have been many such initiatives initiated by both the countries; have agreed to simplify customs procedures, facilitate the process of goods certification, and liberalise the issuing of visas. Undoubtedly, the environment for bilateral trade has greatly improved.

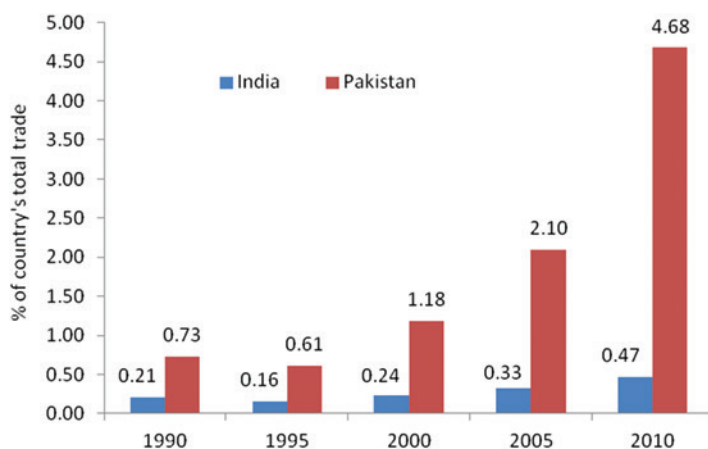
Against this backdrop, this chapter presents a comprehensive overview of the trade relations between India and Pakistan, analyses the modalities of co-operation, and assesses the potential economic benefits for both countries and the South Asia region. It examines the trade potential between India and Pakistan and maps the major trade barriers affecting both bilateral and regional trade, and also makes an attempt to quantify the gains for India and Pakistan and the South Asia region from the MFN scenario.

22.2 Bilateral trade: Trends and bottlenecks

South Asia remains one of the least-integrated regions in the world. Pakistan and India account for almost 92 per cent of South Asia's gross domestic product (GDP), 85 per cent of South Asia's population and 80 per cent of South Asia's surface area, whereas only 20 per cent of the regional trade is India–Pakistan trade.² South Asia's two largest economies barely trade with each other (Figure 22.1). Despite the fact that trade between the two countries has increased over the years, India's trade with Pakistan has remained negligible. By 2010, trade with Pakistan accounted for less than half a per cent of India's total trade, whereas Pakistan's trade with India was 4.7 per cent of her total trade.

The bilateral trade between the two neighbours witnessed an upward trend in the second half of the 2000s, owing much to the India–Pakistan Composite Dialogue in 2004. India's trade with Pakistan trebled in 2010 and reached an all time record of US\$2.56 billion (Table 22.1). India's exports to Pakistan increased much faster than imports, thereby making India's trade surplus with Pakistan increase from less than US\$100 million at the beginning of 2000 to US\$1.94 billion in 2010 (Table 22.1). Therefore, the increasing trade between India and Pakistan has also been accompanied by a sharp rise in the bilateral trade deficit in Pakistan.³ Nevertheless, compared with their economic strength, trade between India and Pakistan is negligible and much below its potential.

Figure 22.1 Bilateral trade as a percentage of each country's total trade



Source: Calculated based on IMF Direction of Trade Statistics (DOTS)

Table 22.1 India's trade with Pakistan

	Exports	Imports	Total trade	Trade balance
	(US\$ million)			
1990	43.49	44.86	88.35	-1.37
1995	70.4	37.37	107.77	33.03
2000	163.33	65.05	228.38	98.28
2005	647.19	158.42	805.61	488.77
2010	2,252.89	310.44	2,563.33	1,942.45
Compound annual growth rate (CAGR) (%)				
1990–99	9.22	9.88	9.56	
2000–09	27.45	17.32	25.18	

Source: UN Comtrade database

An analysis by sector reveals that the composition of exports from India to Pakistan was primarily limited to about 14 commodities defined by the HS four-digit level in 2010–11, which on average accounted for around 78 per cent of the total exports. These commodities include sugar, raw cotton, synthetic fabrics, tea, petroleum products and chemicals. The shares of both raw cotton and woven fabrics in India's exports to Pakistan increased from almost zero in 2000 to more than 13 per cent in 2010, whereas the share of oil-cake and other solid residues declined from about 16 per cent to 3 per cent during the same period. Official major imports from Pakistan to India have been limited to 18 commodities, namely fruits and vegetables, wool and wool products, petroleum products, chemicals, lead, and, more recently, cement. These products together form about 88 per cent of India's total imports from Pakistan. In 2010, the sectors with large shares of the exports from Pakistan to India were fruits (19%), followed by petroleum products (12%) and cement (11%). In short, the trade volume between India and Pakistan has never expanded in the way it would have in a normal trade environment. Why? First and foremost are political disturbances. Bilateral trade and commerce were held hostage to the resolution of political disputes. Second is protectionism. For years, domestic industry in Pakistan has feared it would be swamped by imports from India. Third are restrictive trade policies in both countries, which are embedded in a variety of trade barriers targeted at each other's markets.

Pakistan places 1,209 items on the negative tradeable item list, which was supposed to be phased out by end of 2012, but this did not happen. The remaining 6,800 can now be imported from India, while the previous positive list had only 2,000 items. The South Asian Free Trade Area (SAFTA), which both India and Pakistan have signed up to, will gradually phase out all tariffs on traded goods, with zero tariffs by 2016.

India and Pakistan have 3,323 km of land border that demarcates the Indian states of Punjab, Rajasthan and Gujarat and the Pakistani provinces of Punjab and Sindh. In addition to the Attari–Wagah land border, which is the major road and rail crossing between India and Pakistan, three more land routes, namely, Khokrapar–Munabao, Muzaffrabad–Srinagar and Poonch–Rawalakot, have been used for bilateral trade. Three land customs stations handle the overland trade between the two countries.

India and Pakistan also have one direct sea route (Mumbai–Karachi) and three air routes (Delhi–Lahore, Delhi–Karachi and Mumbai–Karachi). Needless to say, restrictions imposed by the two countries on trade across the border have opened many indirect trade routes through neighbouring countries, some of which, Mumbai–Dubai–Karachi and Mumbai–Dubai–Bandar Abbas–Afghanistan–Pakistan act, as major trade axes between the two countries

Bilateral barriers to trade are very complex in nature and appear to be ‘thick’ at the land border. This results in a large informal trade, because of restrictive trade policies and transport bottlenecks, which varies in value from US\$500 million to about US\$1 billion (Khan et al. 2007). At present, a great deal of trade goes via Dubai, a trade process which is inefficient and fraught with illegalities, effectively functioning as behind-the-border barriers to trade.

The composition of informal trade between the two countries shows that a range of products are avoiding official tariff and non-tariff barriers through a third country, reflecting the potential to expand official trade. The South Asian Association for Regional Cooperation (SAARC) Chamber of Commerce and Industry (SCCI) and several other business groups in Pakistan have listed a variety of goods and services traded informally or through a third country, which could offer considerable potential for trade between the two countries (SCCI 2011). Indian products that arrive in Pakistan through this process include tyres, auto components, pharmaceuticals, engineering products, betel leaf, chemicals and some textiles. These industries in India will, therefore, benefit immediately from the changing environment. Moreover, consumers in Pakistan will benefit from reduced prices for these products. As far as Pakistan’s exports to India are concerned, cement, fruit and vegetables, cotton, some specialised textiles, and sports items – also currently arriving via Dubai – are expected to experience a rapid increase. And these are only the existing sectors; there are possibilities for emergence of trade in new products between the two countries in the new environment. It should, however, be mentioned that India and Pakistan perform poorly compared with their global peers in terms of improvement in trade logistics. Non-price barriers, such as costs of documentation and transportation, surpass the price barriers to trade in South Asia.⁴ Trade becomes uncompetitive when channeled through Dubai due to the increased transportation costs and time taken, since the normal/MFN trade at the land border between India and Pakistan is still not permitted.⁵ While both countries have adopted a negative list of tradeable items, Pakistan still maintains a positive list for imports from India at the Attari–Wagah land border. Incidentally, both the lists are inconsistent with the General Agreement on Tariffs and Trade (GATT) principles.

It should also be mentioned that tariffs between India and Pakistan have come down much faster than NTBs. Despite the fall in average tariffs, the trade restrictiveness of both India and Pakistan has been heavily influenced by the large volume of NTBs.⁶

Some notable anti-trade measures are as follows:

- Only a limited number of items are allowed to be transported via rail/road; there are specific timings for the opening of these routes and, in most cases, there

are no proper warehousing/storage facilities available. The quality of the road network is low with few regional road linkages, while rail networks between ports and markets are often missing, putting unnecessary burdens on already inadequate road networks. Unavailability of railway wagons and locomotives at the border, fixed times of loading and unloading of goods and inter-changing goods trains between the two countries add to the high transaction time and cost of trade.

- The imposition and application of standards in India is often perceived as a non-tariff barrier by Pakistan. More importantly, information flow for trade-related matters between the two countries is particularly weak, thereby generating enormous problems for exporters and importers.
- India and Pakistan still follow restrictive visa regimes. Granting city-specific visas, visas for a limited number of cities, limits on the number of entries and for limited periods of stay, requirements to report to police on arrival and before departure, requirements to exit from the port of entry, lack of criteria for rejection of visas, granting mode-specific visas, disregarding the requested date of entry, and delays in granting visas are some of the restrictions known to us.
- There is a mismatch between the Harmonized System (HS) classifications of goods. The Indian HS eight-digit classification is sometimes used for the Pakistani HS six-digit classification of items on the positive list, giving customs officials room to allow entry based on discretion.
- Most bilateral payments are made through the Asian Clearing Union and businessmen and women in both countries have complained about the inefficiency of this procedure. Since banks are not allowed freely to open branches across the border, this leads to significant delays, especially when letters of credit need to be confirmed, which can take up to a month.
- Mechanisms for redress of grievances do not exist, which prevents some mutually beneficial exchanges from taking place.

Both India and Pakistan have announced several NTBs under SAFTA and later under the bilateral trade negotiations. As mentioned in Taneja (2012), some of these NTMs did not offer any barriers, as they were compatible with WTO rules; some NTMs were also applicable to domestic manufacturers in India but were perceived as NTMs by Pakistan (e.g. inter-state taxes); and in some cases corrective action had been taken but they were still notified as NTMs (e.g. for jute bags). On the other hand, some NTMs imposed by India were found to be trade restrictive. For example, some of the technical barriers to trade (TBT) and sanitary and phytosanitary measures (SPS) measures in India involved cumbersome procedures. Also, the lack of transparency in the regulations is a problem (e.g. regulations related to woollen products and other textiles and jute products). The measure related to labelling requirements for processed foods qualifies as a barrier because it violates the principle of national treatment.⁷ Lack of information about regulatory regimes (e.g. pest risk assessments) is another NTM. Absence of systems for recognition of standards for products (e.g. textiles for the domestic market) is also a NTM faced

by traders between India and Pakistan. To facilitate bilateral trade, these are the immediate challenges that need to be addressed through appropriate policy measures.

Another barrier is the use of dual lists for bilateral trade by both India and Pakistan, which is inconsistent with General Agreement on Tariffs and Trade (GATT) principles. Pakistan has 1,209 items on the negative list for trade with India. Contrary to popular belief, these items are not allowed to be traded through land routes. For trade through land routes (mainly Attari–Wagah), Pakistan maintains a positive list of 137 items, most of which belong to commodity groups such as vegetables, cotton, and iron and steel. This clearly suggests goods should move by ocean and/or air routes despite there being land border crossings between the two countries. With the Integrated Check Post (ICP) in Attari, handling goods across the land border may not always be cost effective but is certainly faster than ocean routes. Once the infrastructure at the land border has been improved, India and Pakistan should not impose any restriction on movement of goods across the land border.

Finally, India and Pakistan compare poorly with their global peers in terms of logistics. Trade procedures are lengthy and flow of goods is constrained by the poor condition of infrastructure, congestion, high costs and lengthy delays.⁸ These problems are particularly severe at India–Pakistan border crossings, many of which pose significant barriers to trade.

22.3 Trade complementarity between India and Pakistan

To what extent are India and Pakistan competitors in the world market? Do they show any complementarities in trade? Answering these questions gives an idea of the prospects for trade between them. At first, the export similarity index (ESI) for the two economies at a disaggregated level is constructed.⁹ The results in Table 22.2 suggest the export profiles of these two economies are not very similar. In large part this reflects the major shift by India into exports in the high-skilled and technology-intensive categories, a move that is yet to be matched by Pakistan (Table 22.3). A quarter of India's global exports are contributed by manufacturers having medium to high skill and technology intensity, whereas almost two-thirds of Pakistan's global exports come from labour-intensive and resource-based manufactures. Trade complementarity between the two countries may be seen in this perspective.

One can construct a trade complementarity index (TCI) to measure the degree to which the export pattern of one country matches the import pattern of another.¹⁰

Table 22.2 Export similarity index (%)

Trade classification	Trade partner	2005	2010
HS six-digit (at H2)	India–Pakistan	21.027	22.496
HS six-digit (at H3)	India–Pakistan		23.158

Source: Calculated based on UN Comtrade database

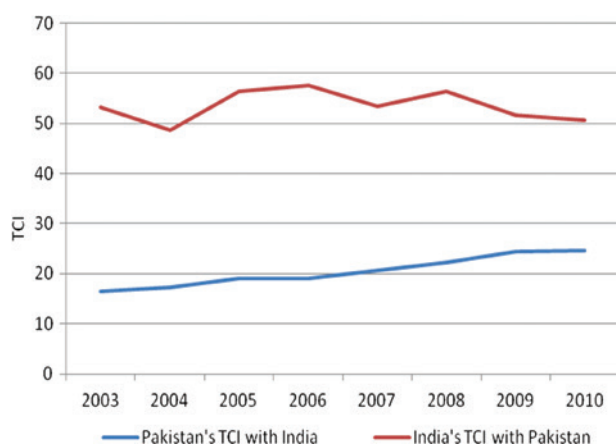
Table 22.3 Structural change in merchandise trade: Share in the country's exports

	Pakistan			
	1995	2000	2005	2010
Labour-intensive and resource-based manufactures	79.18	78.74	73.15	62.03
Manufactures with low skill and technology intensity	0.41	0.66	1.39	1.84
Manufactures with medium skill and technology intensity	0.53	0.98	1.79	2.39
Manufactures with high skill and technology intensity	2.08	3.17	4.80	5.18

	India			
	1995	2000	2005	2010
Labour-intensive and resource-based manufactures	32.90	32.74	21.45	15.09
Manufactures with low skill and technology intensity	6.16	6.77	9.29	9.88
Manufactures with medium skill and technology intensity	6.59	6.67	9.68	9.90
Manufactures with high skill and technology intensity	9.97	11.87	12.90	13.84

Source: Calculated based on UNCTAD Stat database

TCI trends in Figure 22.2 indicate that both countries have witnessed a rise in trade complementarity between 2003 and 2010. However, as noted in Lopez-Calix (2012), major gains would come from diversifying exports since a 'Complementarity Index' as low as 24 per cent between Pakistan's exports and India's imports shows

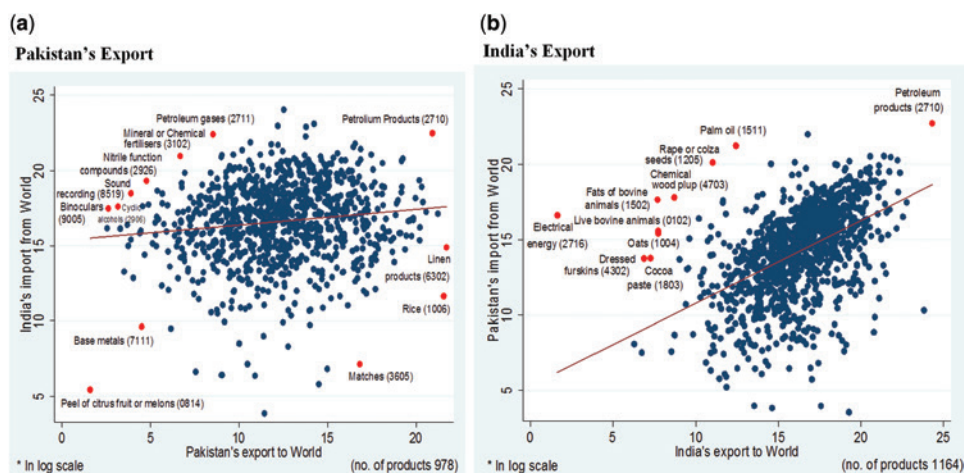
Figure 22.2 Trends in complementarity between India and Pakistan

Source: Calculated based on UN Comtrade database

clearly that the opportunities for Pakistan are not large at the ‘intensive margin’ (to export more of the same to new Indian markets).¹¹ Hence, developing exports at the ‘extensive margin’ (diversifying the exports basket to India) is fundamental to tapping larger benefits from accessing this large and growing neighbouring market. In short, it can be said that an increase in trade competitiveness of India and Pakistan has been accompanied by a rise in trade complementarities. However, almost 90 per cent of the goods on the Pakistan’s negative list belong to manufacturing items for which India has gained competitiveness (e.g. automobiles, iron and steel, etc.). Therefore, Pakistan would lose welfare gains by trading with India if the negative list continues in operation. Improving trade complementarities would thus hold promise for encouraging intra-industry trade across borders. Apparently, the potential for intra-industry trade between the two countries is not limited to a few products (Figure 22.3).

Raihan and De (2014) provide the number of the common set of traded goods between India and Pakistan and compute the intra-industry trade (IIT) scores for these products. Over 32 per cent of total traded products are found to have scored IIT scores greater 0.50 in the case of India; for Pakistan the comparable figure is 15 per cent. The IIT index scores also indicate that there is large potential for about 30 products, with varying capacity. The range of such potential varies from textiles and clothing, iron and steel, electrical machinery and equipment, to mechanical appliances, etc. This indicates potential to integrate their production structures in many sectors and improve their global competitiveness. This can lead to regional and/or global value chains, if supported by improved logistics and lower NTBs. In order to realise the potential, both countries have to undertake further trade liberalisation, such as reducing tariffs and removing NTBs, and also take effective action to reduce trade costs by improving trade facilitation both ‘at-the-border’ and ‘behind-the-border’.

Figure 22.3 Potential trade sectors



Source: Authors

22.4 Pakistan's granting most favoured nation status to India and its impact on bilateral and regional trade

How much would be the bilateral gains from the two countries trading on the basis of the MFN principle? Do other South Asian countries benefit from India–Pakistan MFN trade? To what extent would MFN trade between India and Pakistan increase regional trade in South Asia? These are the questions we often face with changes in the trade environment between India and Pakistan. To answer these questions, we use the help of a computable general equilibrium (CGE) modelling exercise, the details of which are provided in Raihan and De (2014).

First, we identified 561 products for Pakistan at the HS six-digit level from the World Bank's World Integrated Trade Solution (WITS) database, where the unit costs of imports if they were sourced from India would be lower than the unit costs of imports if they were sourced from other countries. The percentage differences in these unit import costs were then calculated. The percentage differences in unit prices for these 561 products at the HS six-digit code were then aggregated into Global Trade Analysis Project (GTAP) sectors matching the concordance and weights for each product.

Since Pakistan would only enjoy a fall in unit import prices for these products if the import source were India, in the GTAP model a scenario ('MFN' scenario) is considered, where there would be a fall in import prices for Pakistan while importing from India. This simulation is done by shocking on the transaction cost of the import from India to Pakistan. In brief, the MFN scenario incorporates a reduction in import prices for Pakistan because of the increased potential to source imports from India at cheaper prices. In addition, it is assumed that there would be some 'peace dividends' for all the South Asian countries because of the improved trade relations between India and Pakistan. In the GTAP framework, such a 'peace dividend' is assumed to lower transaction costs in bilateral trade among the South Asian countries by 0.5 per cent.

The results of the MFN scenario are presented in Table 22.4. The simulation indicates that the welfare effects of MFN will be positive for both India and Pakistan. The results

Table 22.4 Welfare effects of MFN: equivalent variation in US\$ million at 2007 prices

Country	Welfare effects of MFN
Bangladesh	21.08
India	160.71
Nepal	18.01
Pakistan	99.21
Sri Lanka	34.92
Rest of South Asia	15.72
China	−10.52
USA	−18.39
EU25	−29.55
Rest of the World	−66.71

Source: GTAP simulation

also suggest some positive welfare effects on other South Asian countries out of the ‘peace dividends’ generated by improved economic co-operation between India and Pakistan. There will, however, be some negative welfare effects for countries outside of South Asia, since Pakistan, after giving MFN status to India, would change the source of some of its imports from other countries to India.

According to the MFN scenario, Pakistan’s imports from India would rise by 32 per cent. Also, there would be some marginal rise in imports from Bangladesh, Nepal and rest of South Asia. However, imports from China, the USA, EU25 and the rest of the world would decline by some margin.¹² This suggests that a rise in imports from India would lead to a fall in imports from other major sources. Pakistan’s total imports would, however, increase by only 0.28 per cent. This apparently indicates that the MFN scenario on its own would not have a major impact on Pakistan’s total imports. A number of sectors in India would benefit in terms of increases in exports to Pakistan due to MFN status. Such rises in exports from India would happen because of India’s unit cost advantage compared with Pakistan’s other trading partners. Under this scenario, the change in exports from India to Pakistan would vary from meat (348%) to vegetables, fruits and nuts (0.2%). Furthermore, India’s exports to Pakistan would rise for chemical, rubber and plastics, food processing, mineral fuels (petroleum, coal products), metals, machinery and equipment, textiles, leather products, dairy products, fishing, etc.

The impact of the MFN scenario on Pakistan’s total exports would also be minimal. Pakistan’s total exports might rise by only 0.17 per cent and the exports to India in particular might rise by 0.4 per cent. MFN status for India would thus have negligible impact on Pakistan’s sectoral exports to India. There would, however, be some rise in the exports of plant-based fibres, animal products and metals from Pakistan to India. Pakistan would experience some rise in exports to Bangladesh, Nepal, Sri Lanka, the rest of South Asia and China. At the same time, Pakistan would experience some marginal fall in exports to its major export destinations, such as the USA and EU25. This suggests that the MFN scenario would lead Pakistan to re-orient some of its exports to the South Asia region.

The above analysis points to the possibility that, though the MFN scenario would generate some welfare and export gains for both India and Pakistan, such gains would appear to be small. This is because MFN alone would not be enough; and to reap larger benefits extended economic co-operation between India and Pakistan might be needed. In order to explore such possibilities we look at several other scenarios in the GTAP framework. These scenarios include a bilateral free trade agreement (FTA) between India and Pakistan, a bilateral FTA plus increased bilateral trade facilitation, a SAFTA scenario (where all South Asian countries reduce their bilateral tariffs on the goods trade to zero) and a SAFTA scenario plus regional trade facilitation scenario. All these scenarios incorporate the MFN scenario.

Table 22.5 presents the welfare effects of different scenarios. Under a bilateral FTA scenario, both India and Pakistan gain, and the gain for Pakistan would be larger than that for India. Other countries would, however, experience some welfare losses

Table 22.5 Comparison of welfare effects: Equivalent variation in US\$ million at 2007 prices)

Country	MFN	MFN plus India– Pakistan FTA	MFN plus India–Pakistan FTA with bilateral trade facilitation	MFN plus SAFTA	MFN plus SAFTA with regional trade facilitation
Bangladesh	21.08	–2.58	–14.59	–111.77	1,479.56
India	160.71	376.43	2,288.46	1,810.73	5,452.03
Nepal	18.01	–0.65	–6.85	485.03	1,654.21
Pakistan	99.21	443.96	1,964.11	1,121.67	2,618.38
Sri Lanka	34.92	–4.28	–15.56	71.88	2,173.12
Rest of South Asia	15.72	–20.27	–41.22	298.21	1,265.02
China	–10.52	–4.81	–128.04	–216.19	–760.12
USA	–18.39	–62.13	–223.79	–270.47	–985.54
EU25	–29.55	–38.32	–262.74	–348.32	–1,394.91
Rest of the world	–66.71	–185.81	–861.13	–681.72	–3,020.78

Source: GTAP simulations

due to exclusion from the FTA. The gains from the bilateral FTA would be much larger for both countries when associated with enhanced bilateral trade facilitation.¹³ Under this scenario, however, the size of the welfare gain for India would be larger than that for Pakistan. It should be mentioned here that deeper bilateral economic co-operation between India and Pakistan may give rise to some concerns about the prospect of deepening economic co-operation among other countries of South Asia. Therefore, effective implementation of the SAFTA would be more desirable for the South Asian countries. Thus, a scenario of SAFTA was also run and the simulation results suggest larger welfare gains for both India and Pakistan. In terms of gains in both allocative efficiency and of trade, a full SAFTA would generate much larger welfare gains for India and Pakistan than those under a simple bilateral FTA between the two countries. There would be welfare loss for Bangladesh due to the possibility of a larger trade-diversion than trade-creation effect Raihan (2012). However, when the SAFTA scenario is run with a regional trade facilitation scenario, welfare gains for all South Asian countries would increase dramatically, and Bangladesh's welfare loss would be more than compensated by the resulting large welfare gain.¹⁴ Under this scenario, the welfare gains for India and Pakistan would be much higher than those under any other scenarios.

The scenarios with enhanced trade facilitation would result in much larger rises in Pakistan's overall imports and exports. Under the bilateral FTA scenario with trade facilitation, Pakistan's total imports would rise by 7.35 per cent which would be 4.95 percentage points higher than under the bilateral FTA scenario. Similarly, the rise in total exports would be 5.4 percentage points higher under the former scenario than under the latter scenario. Similar observations can also be made for the SAFTA scenarios. The rises in imports and exports would be the highest under the scenario of SAFTA with enhanced regional trade facilitation. It should also be mentioned that

the MFN scenario on its own would result in the least increases in imports and exports for Pakistan. Although the magnitudes are lower, similar results are observed as far as the impacts of different scenarios on India's imports and exports are concerned.

To conclude, Pakistan granting MFN status to India would generate larger benefits if supported by improved connectivity and trade facilitation.¹⁵ The net economic impacts of SAFTA along with trade facilitation are beneficial to both Pakistan and India, and eventually would lead to stronger economic growth of the entire South Asian region. With Pakistan granting MFN status to India, the full implementation of SAFTA is, therefore, not beyond reach. Both countries should go beyond MFN and embrace a second generation FTA that would open the door to other regional co-operation initiatives. At the same time, investment from India could provide a major boost to Pakistan's export industry, which in turn would reduce its trade gaps with India and other countries in the world.

22.5 Role of foreign direct investment in narrowing Pakistan's trade gap with India

Despite the huge inflow of FDI towards developing countries, particularly in China and India, the inflow of FDI in Pakistan has not been impressive. During the 2000s, Pakistan accounted for 0.16 per cent of world FDI, increasing marginally over the next two decades, but always remaining lower than the South Asia average (Table 22.6). India, on the other hand, successfully increased its share in global FDI inflows to over 1 per cent in the 2000s from a meagre 0.11 per cent in the 1980s. The size of FDI inflows to Pakistan was not significant until the beginning of the 2000s, when the FDI inflow increased sharply (Table 22.7). However, the 1980s was a good decade for Pakistan in which it outperformed neighbouring India in attracting FDI. On average, 149 per cent of India's total FDI inflow went to Pakistan, but this reduced in later periods (Figure 22.4). In 2009, FDI inflow contributed to about 1.78 per cent of GDP in Pakistan and 1.54 per cent in India, but remained consistently lower than

Table 22.6 FDI inflows from 1980–2009

	1980–89		1990–99		2000–09	
	Inward FDI	Share in world FDI inflow	Inward FDI	Share in world FDI inflow	Inward FDI	Share in world FDI inflow
	(% of GDP)	(%)	(% of GDP)	(%)	(% of GDP)	(%)
China	0.63	1.83	3.91	6.24	3.09	6.26
India	0.02	0.11	0.39	0.35	1.54	1.13
Pakistan	0.33	0.12	0.88	0.15	1.78	0.16
South Asia	0.08	0.29	0.45	0.55	1.52	1.37
World	0.67	100	1.48	100	2.85	100

Note: FDI inflows counts net inflows, and its share in world FDI inflow.

Source: Calculated based on UNCTAD Stat database

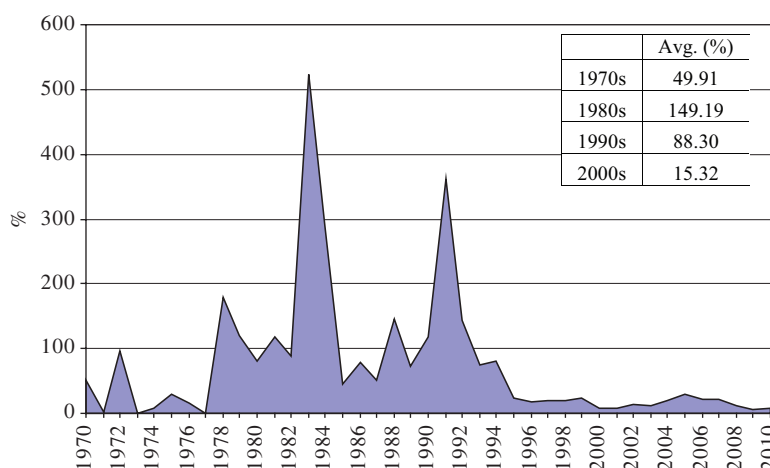
Table 22.7 FDI inflows and outflows (US\$ billion)

	Inward FDI		Outward FDI	
	India	Pakistan	India	Pakistan
2000	3.588	0.309	0.514	0.011
2001	5.478	0.383	1.397	0.031
2002	5.630	0.823	1.678	0.028
2003	4.321	0.534	1.876	0.019
2004	5.778	1.118	2.175	0.056
2005	7.622	2.201	2.985	0.045
2006	20.328	4.273	14.285	0.109
2007	25.350	5.590	17.234	0.098
2008	42.546	5.438	19.397	0.049
2009	35.649	2.338	15.929	0.071
2010	24.640	2.016	14.626	0.046

Source: Calculated based on UNCTAD Stat database

the Chinese and world averages (Table 22.6). On the positive side, India and Pakistan have witnessed sharp rises in FDI inflow since 2000. Table 22.7 shows that FDI inflow to India increased from US\$3.59 billion in 2000 to US\$24.64 billion with a peak of US\$42.55 billion in 2008, whereas a little over US\$2 billion FDI had gone to Pakistan in 2010, increased from less than US\$500 million in 2000. However, FDI to both the countries has shown a declining trend since 2008.

The inflow of FDI into Pakistan is small and concentrated in only a few sectors, mostly in communications, financial services and power (Table 22.8). Broadly, manufacturing industries, mining and quarrying, and the financial sector are the major sectors dominating FDI inflow into Pakistan. On the other hand, a large number of sectors have been attracting FDI in India. The sectoral compositions

Figure 22.4 Pakistan's FDI inflow as a percentage of India's FDI inflow

Source: Calculated based on UNCTAD Stat database

Table 22.8 Top 10 sectors attracting FDI during 2000–10 (US\$ million)

Pakistan		India	
Sectors	Volume	Sectors	Volume
Communication (IT and telecommunications)	7,375.80	Telecommunications	12,546.09
Financial business	4,929.30	Computer software and hardware	10,997.13
Others	4,666.90	Housing and real estate	10,932.53
Oil and gas	4,452.30	Construction activities	10,239.18
Trade	976.80	Drugs and pharmaceuticals	9,196.54
Power	918.40	Power	7,136.46
Construction	709.00	Automobile industry	6,601.12
Transport	626.00	Metallurgical industries	5,761.36
Chemical	588.50	Hotel and tourism	3,195.70
Textiles	350.10	Petroleum and natural gas	3,334.83

Sources: Department of Industrial Policy and Promotion (DIPP), Government of India and State Bank of Pakistan, various years

of FDI in Pakistan and India have also changed over time.¹⁶ Although FDI inflow to India and Pakistan shows wide variations in levels, both have some similarities. First, the communications sector occupies the top position in both the countries. While Pakistan attracted US\$7.36 billion FDI in the communications sector during 2000–10, about US\$12.55 billion went to India in the telecommunications sector in the same period. Power, oil and gas, and construction are other common sectors receiving FDI in India and Pakistan. The services, automobile, metallurgical, drugs and pharmaceuticals, and computer software and hardware sectors in India have also attracted modest FDI in the last decade. Incidentally, these are India's prime export sectors. Mauritius and the USA have been the largest direct investors in India and Pakistan, respectively. The USA, UAE, Switzerland, Japan and Germany are major common investors in both the countries.

South Asian economies have great potential to attract FDI. However, except for India, all other countries actually attract very low amounts of FDI. A number of policy and regulatory measures have been taken to improve the investment climate and attract foreign investment in most of the South Asian countries. For example, restrictions on capital inflows and outflows have been gradually lifted across the South Asian countries. In spite of the liberalisation of their formerly inward-looking FDI regimes and the tempering or removing of obstacles to foreign investors, the performance of most of the South Asian countries, barring perhaps India, in attracting FDI has been lackluster, volatile and unpredictable. Many believe that major barriers to investment in South Asia are widespread corruption, poor governance, and weak political and institutional structures, which are creating gaps between policies and their implementation in these economies.

In recent years, emerging market economies such as the BRICS countries are increasingly becoming a source of foreign investment for rest of the world. It is not only a sign of their increasing participation in the global economy but also

of their increasing competence. More importantly, a growing impetus for change is today coming from developing countries and economies in transition, where a number of enterprises are increasingly undertaking outward expansion through FDI. Companies are expanding their business operations by investing overseas with a view to acquiring a regional and global reach. For example, India has emerged as one of the key investors in the world. Outward FDI from India increased from half a billion US\$ in 2000 to US\$14.63 billion in 2010 with a peak of US\$19.40 billion in 2009, with most of the outflow being in the form of guarantees to offshore investment companies. Indian firms have continued to invest aggressively in foreign countries to explore new markets and also increase their global footprint, while taking advantage of the attractive valuations of assets overseas. However, not one Indian firm has any commercial presence in Pakistan. There is no denying that Indian FDI is important for Pakistan for many reasons, and one reason would certainly be to narrow Pakistan's trade gap with India.¹⁷

(a) Barriers to and constraints on bilateral FDI

While India and Pakistan have succeeded in attracting FDI from the rest of the world, there is hardly any investment between the two neighbours. Pakistan has long complained about the Indian government's policy that bars Pakistani industry from making investments in India. India did not allow FDI from Pakistan until recently.¹⁸ There has been demand from Pakistan to allow investments in India but the proposal did not find many takers within the government due mainly to security concerns. On the other hand, Pakistan does not place any major restrictions on Indian investments. However, Indian companies have not made any investments in Pakistan. In the cases of services trade and FDI, prior government approval has to be obtained, and it is clear that such approvals have been granted very sparingly by both countries.

At the time of writing, there are no joint ventures between India and Pakistan. Institutional mechanisms for bilateral investment guarantees are yet to be established. There is considerable lack of information and awareness in India about Pakistan's trade regime, commercial policies, and business and regulatory procedures. Indian companies have shown interest in floating joint ventures in Pakistan and have asked the two governments to set up an institutional mechanism that would guarantee protection of each other's investments. Companies from Pakistan are also showing interest in investment in India. As several companies are showing interest in investing in each other's countries, it is imperative to understand the nature of such investment and provide timely facilitation.

(b) Measures to strengthen bilateral FDI

There is a complementary (joint) impact of institutions and openness on FDI.¹⁹ Several empirical studies support the view that institutional quality is an important determinant of FDI and believe a healthy institutional environment (i.e. efficient bureaucracy, low corruption, better law and order conditions and secure property rights) is important to enhance FDI in developing economies.²⁰ When rising protectionism is slowing down

openness amid a global financial crisis, strengthening institutions and governance would perhaps help the South Asian countries increase FDI inflow.

Improving the investment environment and political relations are the most important measures for bilateral FDI between India and Pakistan. Physical and technological infrastructures also need to be developed, most importantly at the border check-posts. The poor state of infrastructure acts as a serious bottleneck not only for exports but also for foreign investment.²¹ Improving labour market conditions and administrative capabilities are also important to induce higher levels of foreign investment. Easier travel rules for business people should be enacted. There should be a pro active policy of promoting investment through joint ventures in both countries, market access for banks in each other's market, etc. At the same time, institutions to deal with investment-related grievances along with transparent rules and regulations should be set up. Improving the border trade infrastructure and mutual recognition agreements (MRAs) to facilitate movement of goods are also very important. In September 2012, India and Pakistan took steps to ease visa restrictions and increase travel between the two countries. Both countries have agreed to allow one-year multiple entry visas for business visitors and entry and exit through different cities. The central banks – the State Bank of Pakistan and Reserve Bank of India – had finalised a deal to open up banking outlets in each other's country which would reduce the transaction cost of trade and facilitate FDI.²² These steps are perceived as fruitful ways and means to boost business sentiments and bilateral relations.

(c) Industries to benefit from enhanced FDI

As India and Pakistan compete to sell their goods in the global market, there are many areas in which both the countries can complement each other's needs and hence produce cost-effective quality goods. According to the SCCI, investment possibilities in Pakistan exist in sectors such as food processing, chemicals and pharmaceuticals, automobile components, and information technology. Previously, a number of potential sectors for mutual co-operation between India and Pakistan were identified, including agricultural products, the textile machinery industry, the automobile industry, the petrochemical industry, minerals, chemicals, pharmaceuticals, leather, telecommunications, etc.

India and Pakistan could also establish joint ventures to harness and transmit the region's hydropower resources. With higher energy demands, there is potential for co-operation between India and Pakistan in electricity generation using coal or wind energy. There is potential for tapping wind energy in the Sindh province of Pakistan, which could make use of wind power in co-operation with India. Co-operation in water management and power projects might help in increasing irrigation benefits, decreasing risks of floods, and establishing an India–Pakistan electricity grid system for intra-country transmission of electricity. Both countries require large volumes of natural gas imports to meet their future domestic needs. A single, joint natural gas pipeline extending overland from Pakistan to India would be economically more viable for both countries than constructing their pipelines independently.

(d) Recent progress in FDI

Both governments plan to restart investment flows, and have made notable progress in reinstating a favorable climate. With political and economic stability, India and Pakistan can expect fresh foreign investment coming into them. An atmosphere of co-operation and amicability is apparent between India and Pakistan, and both countries are trying to improve their bilateral trade relations, which would improve the security climate for investment. As a part of the broader process of regional integration, an economy with larger access to regional markets becomes more attractive to foreign investors. Greater inflow of FDI, in turn, may lead to increased technology transfers and productivity. These steps would greatly expand the scope of integration, with potentially large efficiency gains for both sides.

The Indian government has amended the Foreign Exchange Management Act (FEMA), which has paved the way for investment from Pakistan. Subsequently, FEMA rules have also been amended. Investment from Pakistan is now allowed except in the defence, space and atomic energy sectors. However, proposals for investment in India by companies from Pakistan must be routed only through the Foreign Investment Promotion Board (FIPB) and not through other channels. It is expected that FDI from Pakistan to India will be slow since companies may wait and watch overall political progress before making any commercial decisions. However, this is not to deny that compared with the past, current progress in FDI has been very healthy.

India and Pakistan have agreed to develop mechanisms to address trade and investment issues. The 5th Round of Commerce Secretary Level Talks held on 27–28 April 2011 discussed trade promotion options. The discussion progressed further at the 6th and 7th Rounds of Commerce Secretary Level Talks, held on 14–16 November 2011 and 20–21 September 2012, respectively. The concerned authorities, trade bodies and associations have suggested that the Pakistani government should consciously relax conditions on Indian investment. It was also clarified that there would be no harm to indigenous industry if an industry was established by Pakistani and Indian companies, each party having a 50 per cent share. The opening of investment would not result in a deluge of money flowing both ways across the border. Nonetheless, closer economic co-operation will lead to positive political gains.

22.6 Ways to facilitate bilateral trade and policy options: Some recommendations

Normal trade between India and Pakistan will place peace on a fast track. This is not to deny that there were disruptions in the past, but they have become shorter-lived. Some recent studies show that trade between the two countries may touch US\$12 billion by 2015, if trade and investment barriers are removed.²³ To achieve this, we have to strengthen the peace process and continue interactions. ‘Peace dividends’ is yet another effort to nudge the two countries into keeping the economy high on the agenda. Undoubtedly, normal relations between the two countries offer huge peace dividends. They offer great opportunities for a new era of integration.

While the foregoing is good, both governments must be much more ambitious. Pakistan needs to focus on improving customs and scrapping the remaining negative list of trade

items. But India, which stands to gain disproportionately from burgeoning trade, must take bigger responsibilities. Stable relations with Pakistan are a prize in itself for India. Immense hurdles remain, not least the quest for peace in Afghanistan, but the longer-term dream is of land trade through Pakistan to Central Asia, with its oil and gas, and even to European markets. Given all that, India should dare to be generous, removing NTBs, cutting duties on Pakistani imports and making it easier to invest in India. Important steps at the border today will bring great rewards in the future.

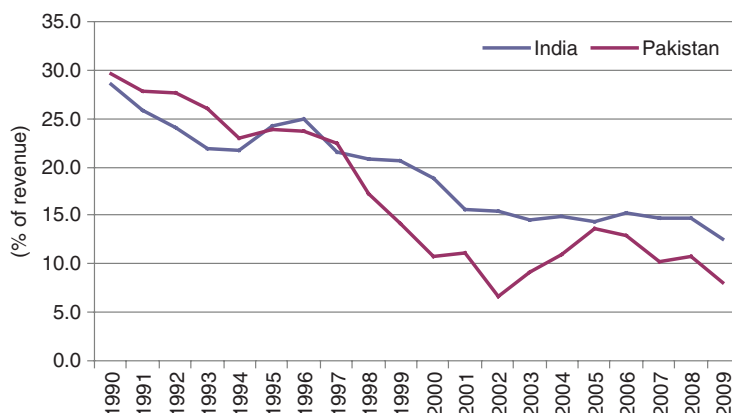
A battery of recent studies indicate that India and Pakistan should further liberalise trade by cutting lists of sensitive products and removing NTMs, along with improvements in trade facilitation, and in transit of goods and services.²⁴ So far, by replacing the positive lists with negative lists of trade items, India and Pakistan have come relatively closer to reinstating a non-discriminatory trade regime. With MFN status, Pakistan will provide equal treatment to India in terms of tariffs and trade regulations to that it offers to other WTO members. This will obviously encourage formal trade to grow, and informal and third country trade is expected to disappear gradually. At the same time, MFN treatment does not necessarily mean that the trade regime becomes preferential, open or accessible. As trade flows between India and Pakistan increase, there would be a greater demand for transparency, faster movement of goods and services across borders and increased market access. New solutions need to be worked out to ease NTBs. A step forward in this direction could mark the beginning of greater trade and economic co-operation between the two countries through the MFN regime. A lot more needs to be accomplished before free trade would give each country a stake in the other's success.

What makes a MFN work is the trade facilitation that surrounds it. The results of the general equilibrium simulations indicate Pakistan's granting MFN to India would generate larger benefits if supported by improved connectivity and trade facilitation. In other words, gains to Pakistan would be limited in the absence of improved connectivity and trade facilitation. The net economic impacts of SAFTA along with trade facilitation are beneficial to both Pakistan and India, and eventually would lead to stronger economic growth of the region. With Pakistan's granting MFN to India, the full implementation of SAFTA is, therefore, inevitable.

In general, three policy options are recommended. First, further deepening of trade liberalisation (e.g. removal of NTBs, cleaning the sensitive lists, duty-free, quota-free (DFQF) access to products where marginal return from trade is very high, removal of quantitative restrictions). Second, supporting trade facilitation to complement trade liberalisation (e.g. removing the delay in payment between exporter and importer by introducing internet banking, allowing more banks to operate). Third, making the FDI flow move freely between the two nations (e.g. building the institutional mechanism for bilateral investment guarantees).

Option 1. Tariff rationalisation and removal of NTBs

Both countries' trade liberalisation initiatives since the 1990s have been deep as well as broad. Government's dependence on import duties has declined in both India and Pakistan (Figure 22.5). Given that import tariffs introduce a bias against exporting, the large reductions in tariffs have played a role in improving export competitiveness

Figure 22.5 Taxes on international trade

Source: Calculated based on World Bank Doing Business database

in India and Pakistan. Thus, customs duties are still the principal instrument of trade policy, particularly in the context of India and Pakistan trade.

Average tariffs between India and Pakistan have come down much faster than NTBs. But both countries feature large variations between – and within – statutory tariffs (Lopez-Calix 2012). For example, India's distribution is skewed more to lower tariffs. Although the average tariff has come down to 10–15 per cent in both countries, high tariffs still persist for some major products. For example, Pakistan's import tariff of 35 per cent on Indian exports of granite (contributing about 55 per cent of Pakistan's total granite imports from the world) or 20 per cent on condensers for steam or other vapour power units (contributing about 100 per cent of Pakistan's condenser imports from the world) have been penalising the growth of bilateral trade. On the other hand, India's import tariffs of 24 per cent on Pakistani exports of dates (edible fruits and nuts) appears to be on the high side. India imported about US\$35 million of dates from Pakistan in 2009. India's tariffs are also relatively high on imports of textiles and agricultural products from Pakistan. India imposes both an *ad valorem* rate and a specific duty, whichever is higher, on the import of textiles and clothing and agricultural goods. Generally, the specific duties appear to be higher in India and, in some cases, exceed 100 per cent, especially on value-added textiles. Compared with the specific duty, *ad valorem* rates are much lower. Quick gains could be obtained by reducing Indian tariffs on Pakistani cotton yarn, fruits and vegetables and removing NTBs. Similarly, freeing imports of newsprint from India would help Pakistan to manage its huge shortfall in demand for newsprint. Therefore, pruning the sensitive lists and normalisation of import tariffs may enhance bilateral trade.

In addition to rationalising import duties, quantitative restrictions, regulatory duties and other para-tariffs, several other measures that have restricted trade in the past should be eliminated. Despite the fall in average tariffs, trade restrictiveness of both India and Pakistan has been heavily triggered by the large number of NTBs. In promoting trade between India and Pakistan, the major stumbling block is the

presence of such NTBs.²⁵ Deeper co-operation between India and Pakistan can potentially result in significant reductions of these barriers.

Trade liberalisation has long been seen as an important element of sound economic policy, and trade facilitation is a necessary step to achieve it. Trading more efficiently between India and Pakistan would probably increase average incomes, providing more resources with which to tackle poverty.

Option 2. Trade facilitation and improvement in connectivity

Trade facilitation is aimed at ensuring the movement and clearance of goods across borders within the shortest time at the minimum cost.²⁶ Thus, the two elements which form the crux of the issue are time and cost. Trade facilitation would mean addressing these issues and attempting ways and means to minimise the cost and time taken for movement of import and export cargo.

Trade facilitation in South Asia is unimpressive when we consider behind-the-border issues. India and Pakistan compare poorly with their global peers in improving logistics. South Asian countries suffer from excessive direct costs and excessive time taken to cross borders and from inefficiency in cross-border transactions, which ultimately affect trade negatively. Trade in the region is also constrained by the poor condition of infrastructure, congestion, high costs and lengthy delays. These problems are particularly acute at the India–Pakistan border crossings, many of which pose significant barriers to trade. Among the major causes of high trade transaction costs is the number of cumbersome and complex cross-border trading practices, which also increase the possibility of corruption. Goods carried by road are largely subject to transshipment and manual checking at the border, which creates serious impediments to regional and multilateral trade. The problem is further compounded by lack of harmonisation of technical standards.

The GTAP simulations show that improved trade facilitation (e.g. removal of behind-the-border barriers) would increase the volume of trade between India and Pakistan, by reducing the transaction costs of trade, making exports more competitive and imports less expensive. However, in reality, the South Asian countries are far behind their global peers in trade facilitation. India has an edge over Pakistan in all dimensions of the World Bank's Logistics Performance Index.²⁷ While larger economies such as India have successfully reduced the time taken to export, exporting a consignment in Pakistan still takes about 21 days. On the positive side, Pakistan beats India and the other South Asian countries with lowest cost of exports in the region. In terms of export time, preparation of documents takes most of the time needed for exports in South Asia, except for Maldives and Nepal where the time needed for customs and ports, and inland transit, respectively, outweigh document preparation time (World Bank Doing Business Database). Therefore, reduction of transaction time through simplification of documentation and paperless trade should be the priority.²⁸ Pakistan has the advantage of the lowest costs of trading across the border in South Asia. However, other South Asian countries have relatively higher costs of exporting and importing. Therefore, significant reductions in transaction costs in South Asia will be critical to the effectiveness of bilateral trade co-operation. To

reduce trade-related transaction costs, governments must collaborate on a trade facilitation agenda that encompasses procedures, regulations and processes that impose costs on cross-border commercial transactions (e.g. customs, standards, movement of people, etc.).²⁹

India and Pakistan do not have much cross-border infrastructure between them and, therefore, circumvent this by transporting much of their bilateral trade through unofficial routes. Thus, development of cross-border infrastructure, especially transportation linkages and energy pipelines, should be given the utmost priority, since completion of this will contribute to bilateral as well as regional integration by reducing transportation costs and facilitating trade and services. With MFN status in trade, India and Pakistan should consider a strategy that will not only eliminate the barriers to cross-border infrastructure development but will also encourage investment flows in the region. Given that most cross-border projects are associated with several risks, India and Pakistan have to play a larger role in creating an enabling environment for the private sector to invest in regional infrastructure projects.

Improved transit in South Asia is long overdue. SAFTA may give Afghanistan increased access to South Asian market. Similarly, the MFN agreement offers the potential for India and Pakistan to improve their connectivity with South West Asia, Central Asia and beyond. If goods are permitted to transit freely in South Asia, the whole region will benefit. Better trade relations with Pakistan can provide transit access for Indian goods to Afghanistan and Central Asia, on the one hand, and to Iran and Turkey, on the other. Pakistan has a bilateral transit agreement with Afghanistan, which was renewed in 2010. In addition, Pakistan is an integral part of the trade and transit arrangement in the Economic Cooperation Organization (ECO), which has helped Pakistan to run container trains between Islamabad and Turkey via Tehran. In November 2006, Pakistan signed an FTA with China, and in November 2008, fast-track clearance for cross-border transit between China, Pakistan, Kazakhstan and Kyrgyzstan commenced after 13 years of negotiations. Transit between Pakistan and Afghanistan will facilitate the market for goods and energy trade (power and gas pipelines) between India and the energy rich Central Asia, South West Asia and the Gulf. The advent of MFN status may perhaps help complete the implementation of the Turkmenistan–Afghanistan–Pakistan–India (TAPI) gas pipeline, as a new environment of trust and co-operation prevails. At the same time, subregional transit between Afghanistan, India and Pakistan would help build regional transit, thereby moving towards a Customs Union in 2015 and an Economic Union in 2020 in South Asia. In addition, India and Pakistan should work to harmonise trade and tariff policies, customs procedures, exchange of customs information, and establish linkages between trade associations in the trade transport and transit areas and prepare a trade guide and website giving information on trade, transport, transit and customs facilitation institutions and activities.

Option 3. Allowing FDI to narrow the trade gap

The GTAP simulations indicate the winning sectors in terms of rise in exports from India to Pakistan, such as chemical, rubber and plastics, food processing, mineral fuels (petroleum, coal products), metals, machinery and equipment,

textiles, leather products, sugar, etc. SAFTA with enhanced trade facilitation will help firms in India and Pakistan exploit economies of scale through access to an enlarged market. Indian FDI (and also from other countries) would help Pakistan to narrow the trade deficit with India. In view of the larger market size, Pakistan's MFN status for India would attract Indian FDI in Pakistan in these sectors, thereby facilitating intra-industry trade between the two countries.³⁰ For example, the export of petroleum products from India to Pakistan is one aspect of trade relations which will benefit from the new arrangement.³¹ Undoubtedly, there would be a huge expansion in the number of new opportunities for trade and commercial enterprise in the region.

FDI becomes relevant as economic engagement between the two countries deepens. A greater degree of bilateral investment could strengthen bilateral exports between India and Pakistan. Exports in sectors such as agricultural produce, chemicals, textiles and auto components could be enhanced through bilateral investment.

Can a Pakistani enterprise invest in India? Yes.³² Pakistan was the only country from which investment was barred until 1 August 2012. Indian investors have shown willingness to invest US\$20–50 billion in Pakistan's mining, petroleum, energy, power and infrastructure projects.³³ The Indian private sector has also shown eagerness to export electricity and petroleum products to Pakistan.³⁴ After enhancement of trade ties, opportunities will further increase for big projects like the gas pipeline project between Turkmenistan, Afghanistan, Pakistan and India.

India has amended the FEMA to allow FDI from Pakistan and made an appropriate change in the Consolidated FDI Policy. Subsequently, FEMA rules were also amended, the overall FDI policy would also apply to Pakistan and proposals for investment in India by companies from Pakistan would be routed through the Foreign Investment Promotion Board (FIPB).

Pakistan has lifted restrictions on investment but no Indian has been able to invest in the country. India is a large market and Pakistanis have great opportunities to set up manufacturing bases, besides exporting their products. Therefore, there is an urgent need for both governments to set up an institutional mechanism that would guarantee protection to each other's investments. As of yet, Pakistan and India do not have a bilateral investment protection agreement (BIPA). Both countries should sign a BIPA at the earliest opportunity. This would enable financial institutions to protect investments by extending insurance cover at the market rate.

There should be a proactive policy to promote investment through joint ventures in both countries, access for banks in each other's markets, etc. There is ample scope for joint ventures across borders. Linking the capital and financial markets of both countries would give a boost to economic activities. An integrated network of multi-commodity markets in the South Asian Association for Regional Cooperation (SAARC) countries would help in providing the maximum benefit from the region's potential.³⁵ The Karachi Stock Exchange (KSE) and Bombay Stock Exchange (BSE) are about to sign a memorandum of understanding, which would enable the KSE to be listed at the BSE.³⁶

Improving border trade infrastructure and mutual recognition agreements to facilitate movement of goods and services is also important. Facilitating visas for increased business travel is needed. Business travellers, medical patients and students from both countries should be exempted from any sort of visa restrictions. On-arrival visas at selected air and land ports should be extended to patients, investors and selected services professionals. Improved frequency of transport services (i.e. bus, rail, air) would provide increased flexibility for businessmen and the population as a whole. These steps are perceived as fruitful ways and means to boost business attitudes and bilateral relations. Finally, besides withdrawing bans on investment in both countries, a change in the mindset on both sides of border is a key to bridging the trust deficit and building a lasting partnership.

22.7 Concluding remarks

Trade is a key component of international co-operation and sustainable development. While the world has changed in fundamental ways since the global financial crisis erupted in 2008, and faces challenges both old and new, furthering South–South co-operation remains vital. Merchandise exports from developed economies have turned ominously downward. On the other hand, trade flows of developing economies have mostly remained strong. Thus, it appears that the trade slowdown is mostly confined to developed economies, especially in Europe. This suggests that South–South trade may be one of the best ways to avoid a more serious trade slump. Countries in the South will continue to have higher trade in the southern region. India and Pakistan from South Asia, and China from East Asia, for example, have the added responsibility to drive this.

India and Pakistan have come a long way in rebuilding their economic and political relations. A liberalised India–Pakistan trade regime would strengthen the economic relationship and regional integration. We need to undertake projects on priority basis, not only to rebuild bilateral relations (starting with MFN status) but also to strengthen South Asian regional co-operation.

Notes

- 1 Interestingly, the cumulative list of tradeable items in Pakistan's positive list saw a modest rise from 600 in 2000 to 4,376 in 2009.
- 2 Data refer to the year 2010, sourced from WDI Online Database of the World Bank.
- 3 The widening trade balance is in favour of India, but it should not be a major concern. A bilateral trade deficit has to be seen in the light of a country's total trade balance.
- 4 See De (2011), for a general discussion on the cost of trade in South Asia.
- 5 More because of Pakistan's trade with India, since Pakistan has a positive list of 137 items that can be imported from India through the Attari–Wagah land border.
- 6 India still has significant NTBs. For example, the NTB frequency/trade coverage ratio is as high as 51 per cent in India. In the literature we find NTBs that have protectionist intent such as quotas, tariff-rate quotas, licensing regimes, price bands and NTMs. NTMs are policy measures, other than ordinary customs tariffs, that can potentially have an economic effect on international trade in goods, changing the quantities traded, or prices, or both. Some of these measures may constitute NTBs.
- 7 The measure requires imported processed food items to have a shelf life of at least 60 per cent of its original shelf life at the time of import. There is no such stipulation for domestic goods.

- 8 See, for example, Roy and Banerjee (2010).
 9 ESI can be calculated based on following formula:

$$\sum_i \min \left(\frac{\sum_w x_{isw}}{\sum_w X_{sw}}, \frac{\sum_w x_{idw}}{\sum_w X_{dw}} \right) \times 100,$$

where d and s are the countries of interest, w is the set of all countries in the world, i is the set of industries, x is the commodity export flow and X is the total export flow. In words, the smaller of the sectoral export shares (as a percentage) in each product category are taken and added together.

- 10 TCI can be calculated based on following formula:

$$\left[1 - \left(\sum_i \left| \frac{\sum_w m_{iwd}}{\sum_w M_{wd}} - \frac{\sum_w x_{isw}}{\sum_w X_{sw}} \right| \right) \div 2 \right] \times 100,$$

where d is the importing country of interest, s is the exporting country of interest, w is the set of all countries in the world, i is the set of industries, x is the commodity export flow, X is the total export flow, m the commodity import flow and M the total import flow.

- 11 Hummels–Klenow (Products) intensive margin refers to the share of Country A's exports in world exports of only those goods that Country A exports, whereas Hummels–Klenow (Products) extensive margin refers to the share of world exports only in goods that Country A exports in total world exports of all goods. Pakistan's intensive margin (products) is found to be only 0.17 per cent in 2010 at HS four-digit (at H3) trade classification, whereas the same for India is 1.57 per cent (calculated based on WITS).
- 12 Here, EU25 means the 25 member countries of the EU.
- 13 Under the bilateral trade facilitation scenario, the transaction costs in the bilateral trade between India and Pakistan are reduced by 25 per cent. In this regard, the 'ams' – import-augmenting 'technical change' in the Armington nest in the GTAP model (which can be used to lower the effective price of imported products) – is shocked.
- 14 Under the regional trade facilitation scenario, the transaction costs in the regional trade among the South Asian countries are reduced by 25 per cent. In this regard, the 'ams' – import-augmenting 'technical change' in the Armington nest in the GTAP model (which can be used to lower the effective price of imported products) – is shocked.
- 15 In an another study, Hertel and Mirza (2009) observed that trade facilitation plays an important role in determining patterns of global trade flows, where the relative effect on bilateral trade of improving an exporter's border logistics is larger than that of improving an importer's trade facilitation. The study also revealed that proportionate increases in intra-South Asia trade are larger in all countries for textiles and clothing, automobiles and their parts, and other manufacturing goods.
- 16 In India, foreign investments are currently permitted through financial collaborations, through private equity or preferential allotments and in joint ventures. FDI is not permitted in the arms, nuclear, railway, coal or mining industries.
- 17 See a joint press conference (on 15 February 2012) with his Pakistan counterpart, by Indian Commerce, Industry and Textiles Minister Anand Sharma. (Sharma is the first Indian commerce minister to visit Pakistan since independence. He arrived through the Attari–Wagah border, accompanied by a 150-strong business delegation.) Sharma told reporters "The question of investment becomes relevant as economic engagement between the two countries deepens. The concerns expressed (by Pakistan) on investment have been seriously taken on board and would take an appropriate and correct view soon".
- 18 There used to be a negative list of countries under the Foreign Exchange Management Act (FEMA) in India. The government removed Sri Lanka in 2006, Bangladesh in 2007 and Pakistan in 2012 from the list.
- 19 See, for example, Dollar and Kraay (2003).

- 20 However, many studies have failed to establish significant relationships between institutions and FDI. The literature revealing evidence of significant associations between institutions' quality and FDI remains mixed. See, for example, Lim (2001), Blonigen (2005).
- 21 Refer to, for example, Amjad et al. (2012), which evaluated Pakistani exporters' perceptions of the problems they face in exploiting their full competitive potential in the international market. Using firm-level survey data, they found that a shortage of skilled labour, the energy crisis, institutional rigidities, market imperfections, and weaknesses in physical infrastructure have been the key impediments to achieving export competitiveness.
- 22 From India, the Bank of India and the State Bank of India and from Pakistan, the National Bank of Pakistan and the United Bank are likely to open branches in Pakistan and India, respectively.
- 23 See, for example, De et al. (2012).
- 24 Gains for South Asian intraregional trade accruing from improvements in regulatory and logistical issues are huge. See Taneja (2012), Kochhar (2012), Lopez-Calix (2012), Khan (2011), De et al. (2012), Pasha and Imran (2012), etc.
- 25 This has been well recognised at the ministerial level. Refer to the Joint Declaration of 7th Ministerial Meeting, 20–21 September 2012.
- 26 The broader definition of trade facilitation goes beyond what has been noted in the WTO. In the literature, trade facilitation has been identified as the means of moving trade across borders and is not restricted to a country's customs authority.
- 27 This refers to the year 2010. Source: World Bank Logistics Performance Index (LPI).
- 28 To support the trade flows between the two countries, India's Integrated Check Post (ICP) at the Attari border, inaugurated on 13 April 2012, is a step forward. The setting up of the ICP is significant as it will naturally boost bilateral trade between the two countries. Built at a cost of nearly INR15 billion and spread over about 130 acres, the ICP has passenger and cargo terminals, security and scanning equipment, and passenger amenities, in addition to waiting areas, restaurants, restrooms, duty-free shops, banks and other financial services. The ICP can handle about 600 trucks at a time. As a consequence of this enhanced infrastructure, trade, previously conducted only between 8 am and 4 pm can now be conducted for 12 hours – between 7 am and 7 pm. Thus, more trucks can drive to India and cross over to Pakistan each day. However, the physical infrastructure facilities at the Wagah border-control facilities must be expanded. Specifically, sophisticated X-ray machines through which trucks can pass quickly should be a top priority, warehousing is needed at Attari, and several new train stations need to be built.
- 29 Seeking to give a big push to opening up of borders for trade and commerce, both the countries have set up several Joint Working Groups (JWGs), such as the JWG on electricity, petroleum and banking, the JWG for visas, the JWG for border trade on the Munabao–Khokharapar route, the JWG for trade in petroleum, the JWG for electricity trade, etc.
- 30 In an article, one of India's largest business chambers commented: 'Intra-industry trade should increase as the MFN agreement takes effect, and a large number of multinational corporations will likely set up their plants to serve both markets' (Kumar 2012).
- 31 Lakshmi Mittal, an Indian steel tycoon, is currently constructing a new oil refinery in the border city of Bhatinda in India's Punjab state in association with India's Hindustan Petroleum Corporation. It will eventually have the capacity to supply large amounts of petroleum products to northern Pakistan. India's Essar Oil has entered into an agreement with Pakistan's Maple Leaf, a major cement manufacturer, to supply petcoke.
- 32 But India did not allow FDI from Pakistan until recently. The Indian FDI Policy used to state: 'A non-resident entity (other than a citizen of Pakistan or an entity incorporated in Pakistan) can invest in India, subject to the FDI Policy. A citizen of Bangladesh or an entity incorporated in Bangladesh can invest only under the Government route.' Refer to Chapter 3, General Conditions of FDI, Consolidated FDI Policy (effective from 12 April 2012), Department of Industrial Policy and Promotion (DIPP), Government of India.
- 33 According to Pakistan–India Business Council (PIBC) Chairman, Noor Muhammad Kasuri.
- 34 There is a proposal to export surplus diesel from Bhatinda refinery in India to Pakistan through a 200km pipeline.
- 35 Refer to Mr Joseph Massey, Managing Director of the Multi Commodity Exchange, Mumbai.
- 36 Refer to Mr Muneer Kamal, Chairman, Karachi Stock Exchange (KSE), Karachi.

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Chapter 23

India–Sri Lanka Free Trade Agreement and the Proposed Comprehensive Economic Partnership Agreement: A Closer Look

*Saman Kelegama*¹

23.1 Introduction

In pre-colonial times there were strong economic relations between India and Sri Lanka, but these relations diluted during nearly four and a half centuries of colonial rule. Soon after independence in both countries, economic relations strengthened, but not significantly, as a result of inward-looking economic policies dominating in both economies until about the mid-1980s. The economic links began to pick up in the 1990s with the liberal economic regimes consolidating in both economies, and received a boost in 1998 when the two countries signed a bilateral India–Sri Lanka Free Trade Agreement (ISLFTA), which came into operation in March 2000. This was a pioneering attempt in the direction of trade liberalisation in the South Asian region and involved the liberalisation of trade in goods. Sri Lanka's economic objectives were to increase trade ties with South Asia's dominant economic power, to induce the transformation of Sri Lanka's exports from low-value-added goods to high-value-added goods aimed at niche markets and to provide low-income groups with cheap consumer imports from India (Kelegama 1999).

The ISLFTA was formulated based on the 'negative list' approach; each country extending tariff concessions/preferences to all commodities except those indicated in its negative list.² The two countries agreed for preferential treatment on 5,112 tariff lines.

Over the years much research has been done on how to design a free trade agreement (FTA) between a small and large country to work as a 'win-win' situation. This is done by taking the asymmetry between the two countries into account and building special and differential treatment (SDT) for the smaller country into the FTA, with the large country not insisting on reciprocity by the smaller country. SDT was built into the ISLFTA in favour of Sri Lanka with a longer negative list, longer trade liberalisation schedule, favourable rules of origin, and so on.³

This chapter provides a broad brush Sri Lankan perspective of the current situation vis-à-vis India–Sri Lanka trade and investment, while highlighting some of the findings of in-depth studies done on the FTA so far. The chapter goes on to highlight the impediments faced and various constraints that have prevented the FTA moving to the higher stage of a Comprehensive Economic Partnership Agreement (CEPA). It also highlights the opportunities of a CEPA through which Sri Lanka can gain, especially at a time when its traditional export markets are undergoing a recession.

23.2 Experience of the ISLFTA: Recent trends

23.2.1 Trade in foods

Sri Lanka's trade with India changed dramatically following the implementation of the FTA. In the period 1995–2000 immediately preceding the agreement, average annual exports from Sri Lanka to India were US\$39 million (close to 1 per cent of Sri Lanka's overall exports) while average imports were US\$509 million (close to 10 per cent of Sri Lanka's overall imports). While India was an important source of imports even prior to the FTA, it was not a major export market, and in 2000 it ranked 14th in terms of India's export destinations. By 2005, Sri Lanka's exports to India reached US\$566.4, a ten-fold increase compared with 2000, and stood at US\$567 million in 2012 (see Table 23.1). India was the fifth largest destination for Sri Lanka's exports in 2008 and by 2012 India has become the third largest export destination after the EU and the USA.

The number of products exported by Sri Lanka to India also increased substantially during this time. While in 1999 Sri Lanka exported 505 tariff lines to India, by 2005 this had increased to 1,062, and by 2012 had further increased to 2,100. In the early years of the FTA there had been trade creation with a number of new products exported from both countries (Mukerjhi et al. 2003). The ISLFTA did not become a discriminatory trading framework for the rest of the world and according to Joshi (2010) it had a trade-creation effect on the rest of the world.

Sri Lanka gradually began to export higher-value-added products as the FTA progressed. In 1999, Sri Lanka's main exports to India included pepper, waste and scrap steel, areca nuts, dried fruit, cloves and waste paper. By 2008, there were still

Table 23.1 India–Sri Lanka merchandise trade: 2000–12

Year	Sri Lanka				
	Exports to India (US\$ million)	Imports from India (US\$ million)	Share of total exports (%)	Share of total imports (%)	Import:export ratio
2000	58	600	1.0	9.0	10.3:1
2001	72	601	1.5	10.5	8.4:1
2002	170	832	3.6	13.8	5.0:1
2003	245	1076	4.6	16.1	4.4:1
2004	391	1439	6.8	18.0	3.7:1
2005	566	1835	8.9	20.7	3.2:1
2006	489	2173	7.1	21.2	4.4:1
2007	515	2610	6.7	23.1	5.1:1
2008	418	3447	5.2	24.5	8.2:1
2009	322	1820	4.5	17.8	5.7:1
2010	474	2570	5.6	19.0	5.4:1
2011	519	4431	4.9	21.9	8.5:1
2012	567	3640	5.8	19.0	6.4:1

Source: Central Bank of Sri Lanka, (2008), *Annual Report*, various issues

a number of primary products exported to India; however, several value-added products such as insulated wires and cables, pneumatic tyres, ceramics, vegetable fats and oils, refined copper products and furniture were among the top exports to India.⁴ Imports too grew at a rapid rate following the implementation of the FTA. Imports from India, which amounted to US\$600.1 million in 2000, reached US\$3.64 billion in 2012, six-fold growth. India has been Sri Lanka's main source of imports since 1997.

An aggregate view of trade between India and Sri Lanka since the FTA came into being suggests a positive picture with overall trade growing close to six-fold and exports from Sri Lanka growing ten-fold. Furthermore, the increased diversity and greater value addition in exports from Sri Lanka was a positive development.

There were, however, some unfavourable trends in Sri Lanka's exports to India during 2005–07. Although exports from Sri Lanka to India reached a high value of US\$566.4 million in 2005, these exports were largely concentrated in two products – copper and vanaspathi (a vegetable oil) – with 49.66 per cent of Sri Lanka's export to India being from the export of these two tariff lines. If vanaspathi and copper were excluded from the trade figures, Sri Lanka's exports to India would have increased from US\$58 million in 2000 to just US\$278 million in 2005, an increase of five-fold compared with the ten-fold increase with vanaspathi and copper. Why did these two industries dominate during a brief period in the mid-2000s?

23.2.2 Vanaspathi and copper boom

The rise in exports of these items was not due to any distinct comparative advantage that Sri Lanka held, but rather due to short-term tariff arbitration by Indian manufacturers investing in Sri Lanka.⁵ The vanaspathi industry was viable only as long as there was a difference between the Indian and Sri Lankan tariffs on palm oil imports – the main input ingredient of vanaspathi. In Sri Lanka there was a duty-free importation facility for palm oil for industrialists listed under the Board of Investment, in addition to a duty-free exporting facility to India, while in India a tariff close to 60 per cent was applied to the importation of palm oil. In response to the increase in global commodity prices in 2007/2008, India cut import tariffs on various food imports including palm oil, making vanaspathi exports from Sri Lanka unviable. Unsurprisingly, vanaspathi exports in 2008 were LKR 4.5 billion, a fall of 72 per cent from exports in 2007 which amounted to LKR 16 billion. Vanaspathi exports had completely disappeared by 2009.

Copper exports from Sri Lanka were also subject to much scrutiny from India, based on their low domestic value addition, arguing that copper exports from Sri Lanka were under invoiced and violated the rules of origin criteria. India insisted that pricing of iron ore inputs for copper should be carried out based on the London Metal Exchange Prices, and since adhering to this rule a large proportion of Sri Lankan copper exports were deemed ineligible to the Indian market (IPS 2008). With the change in invoicing measures, copper exports from Sri Lanka were the first to be affected, with exports falling from US\$145 million in 2005 to US\$13 million in 2008.

With the collapse of vanaspathi and copper exports in 2008, Sri Lanka's total exports to India in 2008 declined substantially to US\$418 million, the lowest since 2004 (US\$391 million) and a 26 per cent fall in export value since the peak in 2005. In 2009, due to the global financial crisis, exports to India further fell to US\$322 million and then recovered gradually until they reached closer to the 2005 level of exports by 2012. In short, the vansapathi/copper episode and the global financial crisis dipped Sri Lankan exports to India for nearly seven years from 2005.

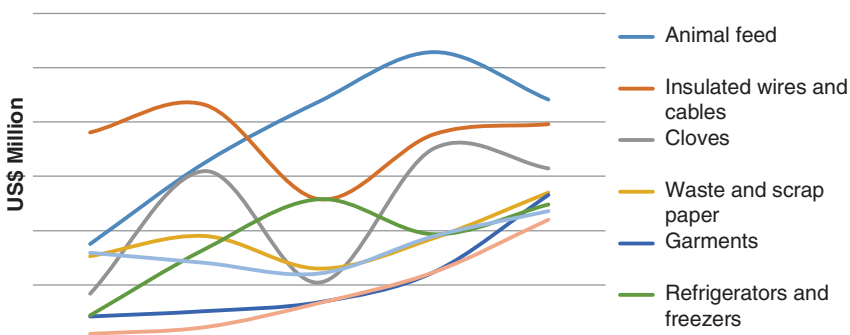
23.2.3 Increased value-added exports

As stated, since 2008 there has been rapid growth in exports of high-value-added manufacturing goods to India, and by 2011 insulated wires and cables, garments, animal feed, refrigerators and freezers were prominent exports (Figure 23.1). Moreover, value-added tea, furniture, tableware, machinery, rubber gloves and refined copper products were able to capture niches in the Indian market. Over 70 per cent of Sri Lankan exports to India went under the FTA during the post-2007 period, and in 2011 the share was 83 per cent.

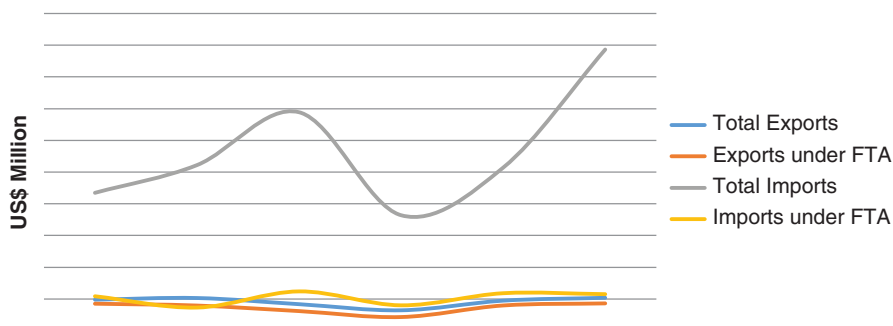
At the same time, imports from India have increased considerably. In 2008, imports from India reached US\$3.44 billion, a growth of 37 per cent compared with 2007. However, the major cause for the increase in imports was the increased cost of petroleum products in global markets.⁶ The import of petroleum products from India is not influenced by the FTA, as petroleum imports are in Sri Lanka's negative list. In fact, the bulk of Indian imports into Sri Lanka (petroleum, vehicles, sugar, cotton, iron and steel, pharmaceutical products) are not subject to reduced tariffs through the FTA, as over 70 per cent of Sri Lanka's import value from India is from products that are either in the negative list or are exempt from MFN duty. According to the Department of Commerce, Sri Lanka's imports under the FTA were only about 14 per cent of the country's total imports from India in 2007 and 13 per cent in 2011.

These observations suggest that the growth of the trade deficit between India and Sri Lanka is not largely a result of the FTA between the two countries, since most of the major traded items are not subject to the FTA. Figure 23.2 clearly shows that that

Figure 23.1 Top exports from Sri Lanka to India, 2007–2011



Source: Export Development Board of Sri Lanka, Export Performance Indicators

Figure 23.2 Sri Lanka's Trade under the FTA with India, 2006–11

Sources: Central Bank of Sri Lanka, Annual Report, various issues and Department of Commerce of Sri Lanka, 2012

there is hardly a deficit between the two countries for actual goods moving under the FTA. Normal trade patterns between the two countries are likely to have resulted in an even wider trade deficit, since the FTA has provided some scope for Sri Lankan exports to India.

The trade deficit between the two countries could be viewed from the import–export ratio and, as clearly seen in Table 23.1, this ratio improved from 10.3:1 in 2000 to 6.4:1 in 2012, indicating that the overall deficit too has improved in favour of Sri Lanka. In fact, if the exceptional year of the vanaspathi and copper boom of 2005 is examined, the table clearly shows that the ratio had reached a peak level in favour of Sri Lanka to 3.2:1.

It must be noted that a country need not be overly concerned about bilateral trade deficits. Given the nature of globalisation and international division of labour, it is impossible to maintain trade surpluses with all trading partners, and these are simply a reflection of the industrial specialisation that is associated with trading economies. Sri Lanka imports largely from countries such as India and China (and has large trade deficits with these countries) and exports to Europe and the US (and has large trade surpluses with these countries). Even if the trade deficit has expanded in the current account, this has been largely balanced by investment flows from India to Sri Lanka on the capital account.

23.2.4 Investment

There have been three waves of Indian investments in Sri Lanka after the opening up of the Sri Lankan economy in 1977. The first wave saw companies such as Ashok Leyland coming in 1982 to manufacture buses for the domestic market. After the 1983 political turbulence there was hardly any Indian investment. The second wave of investment started in the mid-1990s after India became the largest source of imports to Sri Lanka. Investments were seen in areas such as steel, cement, roofing sheets, and paint manufacturing. The third wave was seen after the FTA in 2000 and many of the popular companies, such as ICICI bank, Bharat Airtel, IOC, Apollo Hospitals, etc., starting to come to Sri Lanka. Indian investment amounted to 14 per cent of total FDI

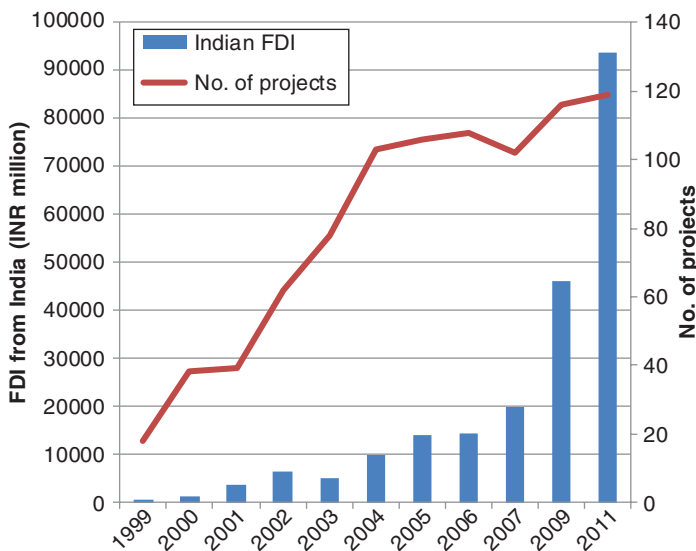
flows to Sri Lanka in 2008. India is now the second biggest investor in the country, exceeded only by Malaysia.

Indian cumulative investment in Sri Lanka is above US\$1 billion and Indian companies have committed to nearly US\$2 billion of investments in Sri Lanka for five years. Figure 23.3 shows the increasing Indian investment in Sri Lanka. The bulk of the existing Indian investment in Sri Lanka is in services such as telecommunications – Bharat Airtel, energy – Indian Oil Corporation, banking – ICICI Bank, tourism – Taj Hotels, etc., amounting to nearly 60 per cent of Indian investment. India is the main destination for Sri Lankan foreign investment and companies such as Carson Cumberbatch, Brandix (US\$1 billion worth of textiles and apparel city in Vizag), MAS Holdings, John Keells, Hayleys, Aitken Spence, Damro, Dankotuwa Porcelain, Ceylon Biscuits and Atlas Stationery are some of the companies that already have investments in India.

In the mid-2000s, much of the investment that came into Sri Lanka was associated with products such as vanaspathi and copper, as foreign investors from India and third parties saw an opportunity to break into India's market through Sri Lanka. Employment creation was also limited. According to the Board of Investment, by 2008, 5,900 jobs were created as a result of Indian investment. But this includes 1,500 employees in the Indian Oil Company retail outlets, which entailed rehiring staff from the Ceylon Petroleum Corporation-owned outlets rather than the creation of new jobs.

While the dominance of services suggests that the impact of the FTA (which only deals with trade in goods) on the investment decision (Indian firms investing in Sri Lanka to take advantage of the FTA to export products to India) is limited, it could be argued that the surge of investment between 2000 and 2012 was influenced by the increased profile of economic ties between the two countries and increased investor confidence as a result of the FTA.

Figure 23.3 Cumulative FDI from India to Sri Lanka: 1999–2011



Source: Board of Investment of Sri Lanka, 2012

23.2.5 Services

Monetary measurement of trade in services is very limited (due to the intangible nature of services) and, therefore, exact figures for trade in services are difficult to calculate. However, the extent of commercial services exchange between the two countries has increased as demonstrated by the following examples. Many Sri Lankan students and patients travel to India to purchase education and health services each year, approximately 70 per cent of the Colombo port's income is from transshipment earnings from India, and approximately 40 per cent of Sri Lanka Airlines' revenue is from the Indian market, while Indian airlines, Jet and Spicejet (and sometime back Kingfisher) have operations in Sri Lanka. Sri Lankan information technology firms have provided technical solutions to Indian companies.

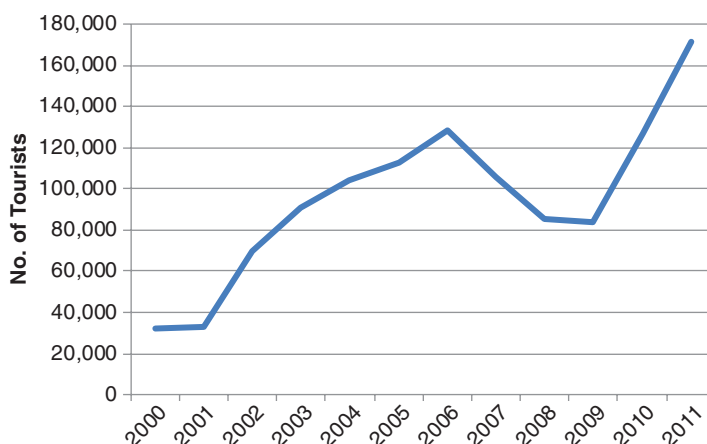
Sri Lankan tourist sector firms such as Aitken Spence and Jetwing have also ventured into the Indian market. India has become the largest source of tourists to Sri Lanka. India now accounts for 20 per cent of tourist arrivals to Sri Lanka. Figure 23.4 shows the increasing trend of Indian tourist flows to Sri Lanka. Improved bilateral relations, including unilateral visa liberalisation by Sri Lanka contributed to the rapid growth of Indian arrivals. Meanwhile, Sri Lanka is among the top five countries that supply tourists to India. Buddhist pilgrims' travel to India has increased due to better connectivity and the availability of a budget airline in Sri Lanka.

23.2.6 Problematic areas

While the aggregate figures resulting from the ISLFTA are impressive, the full potential of the FTA has not been reaped by Sri Lanka. The key question, in terms of moving forward and lessons for the future is: why hasn't there been a greater positive impact on the Sri Lankan economy as a result of the ISLFTA? Several reasons have been identified.

First, intra-industry trade between the two countries did not grow significantly enough to stimulate overall trade. Abeyratne (2013) finds that Sri Lankan

Figure 23.4 Tourist arrivals from India to Sri Lanka: 2000–11



Source: Central Bank of Sri Lanka, Annual Report, various issues

manufacturers have not been successful in linking up with Indian supply chains and this supports the earlier findings of de Mel and Jayaratne (2012) that vertical integration of Sri Lankan industries with Indian industries is at a very low level. The explanation for this could be found in the level of industrialisation in India compared with that of the ASEAN region. Abeyratne (2013) argues that the level of industrialisation is not sufficiently sophisticated to encourage large-scale supply chains to develop with regional suppliers. It may be noted in this context that India made a shift from agriculture to industrialisation, but before the level of industrialisation deepened, India made a rapid shift towards the service sector, surpassing the shift to services of many other developing countries.

Second, there were a number of impediments for market access in the Indian market. Some of them are highlighted here.

- Tariff rate quotas on major exports

Tea, and ready-made garments and textiles, which make up 50 per cent of Sri Lanka's total exports, were placed under quotas in the ISLFTA. Also, quota utilisation has been minimal due to stringent RoO requirements and port restrictions. Quota utilisation has somewhat improved following a degree of relaxation of RoO and port restrictions in 2007.⁷

Sri Lankan ready-made garment exports to India were negligible even after the FTA. Ready-made garments were granted preferential market access of 50 per cent for 8 million pieces per year, while textiles were granted a preferential margin of 25 per cent with no quantitative restrictions. Out of the 8 million pieces, 3 million were required to have Indian fabrics as per the rules of origin. While this condition remained till the end of 2012, the 8 million pieces were made duty-free in 2006. The quota utilisation for the 5 million pieces was 10 per cent to 15 per cent, while for the 3 million pieces it was 100 per cent, as Sri Lankan ready-made garment exports with Indian fabrics were not competitive in the Indian market. In 2013, the Indian fabrics usage conditionality was completely removed.

- Non-tariff barriers

Many Sri Lankan exporters have faced difficulties in entering the Indian market due to the maintenance of non-tariff barriers (NTBs) such as state taxes, quality requirements and administrative procedures, which are outside the scope of tariff reduction under the FTA. One example is state taxes charged by Tamil Nadu, where Sri Lankan exporters are taxed at 21 per cent while local products are taxed at 10.5 per cent on sales (Kelegama and Mukherji 2007).

- Rules of origin

Besides the stringent rules of origin within the tariff rate quotas (TRQs) for ready-made garments, the more general case of requiring a change in tariff heading (CTH) at the Harmonized System (HS) four-digit level has been burdensome for certain Sri Lankan exports. This rule has had a detrimental effect on Sri Lanka's blended tea exports where a CTH at the HS four-digit level is difficult to achieve even when blended with Indian tea.

- Unilateral imposition of quotas

Following the surge of vanaspathi imports from Sri Lanka to India, the two countries entered into negotiations in 2006 to apply a quota on vanaspathi exports as a result of the disruptions caused to the Indian domestic industry. The two countries initially agreed to a quota of 250,000 metric tonnes per year. However, in 2006 India unilaterally reduced this quota to 100,000 metric tonnes and canalised all vanaspathi imports from Sri Lanka through national procurement agency.⁸ Further negotiations took place and the quota was reverted to 250,000 metric tonnes. Similar problems have occurred in exports such as bakery shortenings, pepper and copper. More than the disruptions to the industries as a result of such quantitative restrictions, what is of concern is the undermining of confidence in the FTA as a whole due to strong unilateral measures.

A ‘back of the envelope’ calculation shows that if all exports of Sri Lanka go to India it would have amounted to 2 per cent of India’s overall imports; and in this context, India removing more of the NTBs to Sri Lankan exports should not be an issue. However, given the concentration of production and the federal state structure in India, the issue of restriction removal becomes more complicated. For instance, the state of Kerala accounts for 92 per cent of Indian pepper exports, 74 per cent of cardamom and 63 per cent of ginger, among others; it also accounts for 67.5 per cent of total spice exports from India (Ahmed and Jena 2012). It is reported that ISLFTA contributed to the depression of pepper prices in the Kerala market that led to a lot of ‘hue and cry’ among local producers in Kerala. In 2006, the Indian Pepper Spices Trade Association pressured the central government to impose quota restrictions on Sri Lankan pepper imports.⁹ Accordingly, the central government imposed an annual import cap of 2,500 tonnes on Sri Lankan pepper imports and designated one port – Kochi – for such imports in order to monitor quantity and quality of such imports as there were allegations that third country pepper was coming to India via Sri Lanka through the FTA.

23.3 The comprehensive economic partnership agreement: Way forward towards increased integration

Given the early success of the FTA, both parties were aware of the importance and benefits of broader economic integration and, thus, were keen on deepening and broadening the FTA, and based on the recommendations of the Joint Study Group (JSG) of 2003 report, it was decided to include trade in services, investment and economic co-operation, along with further liberalisation of the goods sector, under the ambit of a Comprehensive Economic Partnership Agreement (CEPA) (JSG 2003). Negotiations for the CEPA began in 2005, and after three years of negotiations the CEPA framework agreement was scheduled for signature by the respective head of states of the two countries in parallel to the Fifteenth SAARC Summit in Colombo in July 2008. However, owing to the reservations expressed by a group of local industrialists with strong connections with the government and a left-oriented political party, the CEPA was not signed during the Summit and it has remained in limbo since then.

The reservations expressed by critics of the CEPA were based on two broad concerns; the first, about the nature of the CEPA itself, and the second that the drawbacks in

the FTA should be dealt with first, prior to embarking on a CEPA. The first concern was largely related to the inclusion of trade in services, specifically the movement of natural persons (General Agreement on Tariffs and Trade (GATT) Mode 4) which was understood as a move towards free movement of labour between the two countries. But critics failed to take into account the fact that, like the FTA, the CEPA also made room for the economic asymmetry between the two countries, and therefore accorded special and differential treatment to Sri Lanka – Sri Lanka was not expected to fully reciprocate India's commitments. Furthermore, the CEPA services agreement was based on a positive list framework, where the two countries exchange request lists for the liberalisation of a specific sector and each country can choose to make an offer which is in line with their comfort levels and developmental interests. Moreover, GATT Mode 4 was linked to GATT Mode 3 and there was no standalone GATT Mode 4 liberalisation unless there was a special request by a particular sector in Sri Lanka. In the stakeholder consultations, such requests were made for ship repairing and the IT sector in Sri Lanka. Given such flexibility, concerns about a flood of Indian labour into the Sri Lankan market were completely misplaced.

The second concern, that the shortcomings in the FTA should be addressed before CEPA, is made with very little understanding of the Agreement. At the onset of discussions on CEPA, it was recognised that in the modern world trade in goods and services are inter-related and also closely linked to investment. Given these inter-linkages, the negotiation teams of both countries were of the view that all barriers for economic integration between the countries should be addressed in a broader framework that consisted of trade in goods, services and investment. Both mutual recognition agreements and memorandums of understanding (MoUs) were to be signed covering broad subject areas. Thus CEPA was negotiated with the very objective of addressing the shortcomings in the FTA, such as the removal of port restrictions, NTBs, RoO requirements in ready-made garments, and so on.¹⁰

Also, increasing exports to India requires a general change in the perceptions and preferences of Sri Lankan exporters – a process that will take time. Despite the geographic and cultural proximity between the two countries, India was not a major export market of Sri Lanka since independence, with exporters preferring developed markets in the Western world. The current limitations on established export items due to the global economic crisis mean that new export products have to be developed from scratch – economies of scale need to be achieved, brand development must be carried out, and marketing-buyer relations must be developed. This process becomes more challenging given the large and competitive market of India. Furthermore, supply capacities in developing economies like Sri Lanka take time to develop. With the improvement of the security situation in the country, it is hoped that foreign investment in the country would gradually build up.

There are many successful Sri Lankan exporters to India, as was clearly seen from the increase in the number of products exported from Sri Lanka to India. However, many of these successful exporters are reluctant to come out in support of the CEPA for a number of reasons. For example, a successful strawberry exporter from Sri Lanka to

India says that his main problem is inadequate domestic supplies and not NTBs in the Indian market, and that he would not like to come out and openly support the CEPA as he fears that his rivals will eat into his market share in the Indian market.

In the entire CEPA criticisms in Sri Lanka, the NTBs in the Indian market have been highlighted time and again. However, it would not be prudent to over emphasise NTBs in the Indian market without looking at the overall bigger picture. The question could be posed as to how Chinese exports to India increased from a mere US\$1.5 billion in 2001 to over US\$50 billion by 2011 despite the existence of these same NTBs in the Indian market and without the benefit of an FTA? While this question needs detailed study, it is clear that NTBs alone do not explain the problem facing Sri Lankan exporters in capturing a bigger share of the Indian market. A factor that clearly stands out from this example is that Sri Lanka does not possess the supply capacity of China to fully exploit the growing Indian market. One way of addressing this issue is by promoting joint investment ventures with Indian companies with buy-back arrangements like, for example, CEAT–Kelani tyres which exports tyres produced in Sri Lanka to India among other countries.

For large Indian companies to be engaged in such ventures, Board of Investment incentives alone would not be adequate. There is a need to create a ruled-based investment regime with renewed double taxation agreements, investment protection agreements, pre-establishment national treatment, and so on. The FTA matured enough for these to be built-in as Sri Lankan investors have been moving increasingly to the Indian market and these investors will be more secured under a rule-based system.

With the CEPA negotiations being stopped, the only forum for addressing shortcomings of the FTA has been closed. Delaying CEPA until all the issues in the FTA are addressed would result in the hijacking the potential national gains by vested interests and hold up the benefits of liberalisation of these sectors.

Given the fact of geographic proximity and socio-political and historical relations between the two countries, economic exchange is inevitable. Furthermore, in the context of Sri Lanka continuing to have a concentrated export basket, both in terms of destination (the USA and the EU) and products (ready-made garments and tea), diversification becomes essential. This necessity has been highlighted in the 2008 global economic crisis, as Sri Lanka became particularly vulnerable given the concentration of exports to the most adversely affected markets. Whilst the USA and EU markets have faced a recession, emerging markets such as India and China have managed to sustain some degree of economic growth despite the global downturn. The Indian economy has been growing at an average of around 7 per cent during 2009–2012. Had Sri Lanka maintained a more diverse export basket, the country would have been less vulnerable to external shocks by exploiting the neighbourhood markets, in particular, India.

The ISLFTA has somewhat helped in shifting Sri Lanka's trade towards alternative emerging markets by encouraging exporters to move beyond their traditional buyers. This strategy will be essential in the medium to long term given the fact that world trade can no longer rely on unsustainable credit-based consumption booms,

particularly in the USA. The global imbalances (production and savings by East Asia and the Middle East along with credit-based consumption in developed markets) that had shaped the world economy will no longer be viable, and increased domestic consumption in Asia and the Middle East will be required to re-balance the system. Given Sri Lanka's proximity with India, the country is in an ideal position to take advantage of this shift in global economic powers towards the East.

The CEPA should be seen as an attempt to manage Sri Lanka's trading relationship with India. The Agreement provides a legal framework which defines the rules and regulations under which trade and investment occur between the two countries. The lack of a rule-based regime to manage bilateral relations is a problem, especially for small states. While a rule-based regime that is entered into on the basis of principles of fairness by parties that are equally endowed with knowledge and power are definitely the best option, even when there is substantial asymmetry of power among the parties and the rules are not perfect, rule-based systems are superior to anarchy. Given these conditions, the continued failure to proceed with the CEPA is unfortunate and detrimental to Sri Lanka's trade policy.

While countries continue to move ahead with negotiations at various levels, the multiple and overlapping agreements of such negotiations can involve considerable transaction costs. For example, Sri Lanka has entered into bilateral and multilateral negotiations in the South Asian region such as the ISLFTA, PSLFTA (Pakistan-Sri Lanka FTA), SAFTA (South Asia FTA) and APTA (Asia Pacific Trade Agreement), each involving different rules of origins, tariff preferences, etc. In the absence of progress in regional frameworks such as APTA and SAFTA, the best option available to Sri Lanka is a bilateral framework within a rule-based disciplinary framework. Also, given the fact that India is currently engaged in negotiating a number of bilateral trade agreements with much larger economies, such as Japan and the EU, it would be unwise to delay the already-negotiated CEPA.

Given the slow progress of the WTO services negotiations, Sri Lanka stands to benefit from early access to the large and growing Indian services sector by engaging in the CEPA. As upper-middle-class individuals' incomes increase by almost double digits annually, the demand for services will continue to expand in India. Furthermore, with economic growth, wages in India have increased relative to those in Sri Lanka, and coupled with the effect of an appreciating Indian rupee, services offered by Sri Lanka have become relatively competitive in the Indian market (de Mel 2008). It is also possible that access to the Indian market may attract investment from third parties into Sri Lanka, looking to export services to Indians through joint ventures with Sri Lankan firms. While India's regime is quite liberal – it is not a guaranteed position over time. The CEPA will provide legally binding market access to India – over and above what is available to other countries. Given Sri Lanka's limited domestic market, the required economies of scale can never be achieved without sufficient international integration. There is no better opportunity than the Indian market.

The experience of the 2008 global economic crisis has stressed the need for more inclusive and equitable trade and growth policies. The CEPA is important in this context, as an increased importing of services such as health and education from

India at a reasonably low cost through service sector liberalisation is beneficial to the lower- and middle-income Sri Lankans who face domestic supply constraints. While wealthy Sri Lankans can obtain these services from Singapore, Europe and the USA, India is the only option for the poorer population.

23.4 Concluding remarks

The ISLFTA has now been in operation for 12 years. It has many achievements to its credit but is not free of problems. The potential of the FTA is yet to be fully exploited by Sri Lanka and, in this context, deepening and broadening the FTA is the way forward. Policy tools under the command of the respective governments need to be put into action to give more dynamism to the FTA and the trade–investment nexus is a very powerful component that could be used for this purpose. The causality from trade leading to investment is commonly seen, but the casualty the other way round of investment leading to trade, needs strengthening and this is what will stimulate intra-industry trade, supply chains, production networks, etc., and will further stimulate trade. This is what Sri Lanka must aim for beyond the FTA and where both countries could enhance the overall trading between the two countries from US\$5 billion to the target of US\$10 billion by 2016 as agreed by both governments in January 2013.¹¹

In conclusion, the key opportunity is to tap into the large and dynamic Indian market, by moving beyond the ISLFTA towards broader economic integration. The CEPA, implemented with proper regulatory mechanisms in order to accommodate the disparity between the countries, provides an opportunity for Sri Lanka to integrate more closely with the Indian economy and accrue some of the benefits that would undoubtedly be enjoyed by India. As an economic crisis grips Sri Lanka's traditional export markets and the global economy is experiencing a slow recovery, Sri Lanka should view India as an opportunity and not a threat, and strive towards more meaningful co-operation in facilitating sustainable development.

Notes

- 1 Research assistance from Ashani Abeysekera, Research Officer, IPS, Colombo, in preparing this chapter is gratefully acknowledged.
- 2 Sri Lanka's negative list comprises mainly agricultural products, key revenue items such as motor vehicles and items of significant domestic production such as ceramics and footwear.
- 3 The immediate duty-free list (319 items) and 50 per cent preferential duty list (889 items) were considerably smaller than those offered by India (1,351 items and 2,799 items respectively), while the Sri Lankan negative list (1,180 items) was considerably larger than India's (196 items) (Kelegama and Mukherji 2007).
- 4 Department of Commerce, Sri Lanka website: www.doc.gov.lk
- 5 India maintained high tariffs on imports of crude palm oil from countries such as Malaysia, while Sri Lanka maintained relatively low tariffs on imports of these products. Thus Indian manufacturers set up vanaspathi manufacturing plants in Sri Lanka, imported crude palm oil, processed it in Sri Lanka to form vanaspathi and exported it to India free of duty under the FTA.
- 6 Crude oil reached US\$148 a barrel in June 2008.
- 7 India removed the port restrictions on tea imports from Sri Lanka within a quota of 12.5 million kg, (de Mel 2008).

- 8 See: www.lankabusinessonline.com/news/Sri_Lanka-India_trade_talks_to_resume_control_vanaspati_exports_inconclusive/1450011840
- 9 In 1999, prior to the ISLFTA, India exported US\$69.025 worth of pepper (HS 0904.11) to Sri Lanka and with the FTA in place in 2005 pepper exports declined to US\$9,203 while pepper imports from Sri Lanka kept on rising.
- 10 Many of the misconceptions on CEPA have been addressed in Analyst (2008).
- 11 Target set at the meeting of the two external affairs ministers of both countries in January 2013.

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Chapter 24

The Promise and Potential of Trade Between Pakistan and India

Arif Zaman

24.1 Background

There have been significant developments in Pakistan–India trade relations since the beginning of 2011, as both countries have moved determinedly to remove some of the key barriers impeding bilateral trade. In April 2011, the two countries announced a roadmap to boost trade relations; April 2012 saw the formal opening of the trade gate at the Wagah–Attari border and New Delhi making the surprise announcement that it would allow direct Pakistani investment in India. While India promised to resolve the issue of non-tariff barriers (NTBs) that constrain Pakistani exports to its neighbour, Islamabad pledged to grant most favoured nation (MFN) status to India. More important in the near-term is Pakistan's decision to relax the constraints on Indian imports by switching to a 'negative list' approach to import controls.

With the two countries now considering relaxing visa regimes, especially for business people, and allowing one another's banks to open branches, there is much optimism and hope that the current volumes of bilateral trade – US\$2.7 billion – will double soon. Since 2008, there have been a number of breakthroughs in various areas of co-operation. Pakistan with the decision by Pakistan's Parliamentary Committee on Culture decided to lift a four-decade ban on Hindi films; the Securities and Exchange Board of India (SEBI) and the Securities and Exchange Commission of Pakistan (SECP) signed an memorandum of understanding (MoU) to encourage greater co-operation in promoting and developing their respective capital markets; and India and Pakistan's two leading security think tanks – India's Institute of Defence Studies and Analysis (IDSA) and Pakistan's state-run Institute for Strategic Studies (ISS) – signed an agreement to exchange security information – a landmark given that, except for contacts at international forums, there has never before been a mechanism for open discussions on security issues. Of perhaps the greatest impact, both countries agreed to double the number of weekly passenger flights with direct flights commencing between Delhi and Islamabad and significantly extend the air services agreement between the countries after four years of negotiations. The implementation and impetus of these and other initiatives was thwarted after the Mumbai attacks in November 2008, which resulted in a strained relationship and significantly reduced contacts among business people and policy-makers from both countries.

In a changing global environment where the economic centre of gravity continues to move towards Asia, and as both countries move towards the resumption of the dialogue and progress made in bilateral discussions between 2004 and 2008, it is time

to look afresh at the promise, performance and potential of trade between Pakistan and India.

24.2 Drivers and rationale

There are three key reasons why trade between India and Pakistan needs to be enhanced. First, viewed in a larger regional context, South Asia is the least-integrated region and stronger economic relations between India and Pakistan are a key element of regional integration and stability in South Asia. Second, there are vast untapped trade and investment possibilities between the two countries, which can be gainfully exploited with significant welfare gains and opportunities to alleviate poverty and strengthen human security – South Asia is home to 24 per cent of the world's population but 42 per cent of its poorest people. Third, as natural trading partners with a common border, trade could be substantially higher: the potential is estimated to be ten times the current level.

There are several advantages of normalising trade between the two countries. To begin with, there is the advantage of geographical proximity – in cheaper transportation costs (which will, to exploit the full potential of bilateral trade, require investment in the infrastructure of roads, railway and permission for each other's merchant ships to call at each other's ports) – and trade complementarity in goods in which either country has a comparative advantage are overwhelming. The shorter distances will render it unnecessary for industry to carry high levels of inventories of raw material, intermediate goods and parts, thereby reducing the cost of operations and the country's overall trade deficit while also improving allocation of scarce resources.

According to the Indian Council for Research on International Economics (ICRIER) (Taneja 2006), Pakistan can benefit from India in strengthening a number of economic sectors, especially in textile design. The ICRIER study also highlights that the costs related to trade between the two countries through indirect routes are nearly three times than if the goods were transferred directly. The presence of such high costs should be considered when the informal trade between the two countries was revealed to amount to US\$3 billion a year by the Peterson Institute of International Economics (Khan 2009). This certainly points to the fact that even under increased transportation costs there is still huge potential for the two countries.

Co-operation in the agriculture sector could turn out to be beneficial to Pakistani farmers. The success achieved by India in raising yields per acre¹ through improvements in extension services and research and in seed, irrigation and mechanical technologies offers opportunities that Pakistani agriculturists can exploit gainfully. The Pakistan textiles sector (cotton-based fabrics and short-staple fibre yarn/fabric) should be expected to benefit (through increased production and higher productivity owing to a more modern technological base and equipment) from improved access to the huge Indian market, with the latter having a distinct advantage in polyester fibres and related fabrics. Similarly, Pakistan's leather products (manufactured from the more durable cow skin) will be well-received in the Indian market where leather products are essentially made from goat skin.

Opening up trade with India will also have a salutary effect on prices. By depressing inflation rates it will also ease the inflationary burden in Pakistan. The Indian machine tool and capital good producing industries are regarded as highly developed and efficient. Therefore, access to cheaper capital goods, technology and skills should, by reducing the cost of investment, also improve the productivity and efficiency of Pakistani industry, thereby strengthening global competitiveness.

As the Final Report of the Panel of Economists on Medium-Term Development Imperatives and Strategy for Pakistan from the Planning Commission, Government of Pakistan (2010: 52) made clear, 'the fear of the Pakistani manufacturing sector being swamped and rendered uncompetitive by Indian goods is highly exaggerated.' The Panel Report identified several reasons for this. The average Pakistani consumer has tended to be more quality conscious and the industry has, for a long time, had to compete against both smuggled goods and official imports under the highly generous baggage schemes (for resident and overseas Pakistanis travelling or returning to Pakistan). The business enterprises have, therefore, learnt to survive against the heavy competition that it has had to face on account of rather porous borders. Pakistan also followed fairly liberal import policies in respect of capital goods, technology imports and production processes. Import tariffs have been substantially lowered and industry is standing up to the threat from cheap imports, especially Chinese products. Moreover, if Pakistani exports can compete with Indian exports in international markets they can compete with Indian products in Pakistan's domestic market. Pakistani industry will, therefore, be able to withstand the competition from India. While there may be a restructuring of industry as it adjusts to competitive forces resulting in the development of a structure based on comparative advantage, WTO regulations can be harnessed into providing adequate safeguards against dumping.

24.3 Trade potentials

Due to the size of their economies, India and Pakistan, with a combined population of 1.15 billion people, have the greatest potential for economic integration in the South Asia region. Although bilateral trade between Pakistan and India represents approximately 2 per cent and 5 per cent of Pakistan's total exports and imports respectively (State Bank of Pakistan 2006), a more comprehensive analysis of trade data reveals that the two countries are important partners in trade. Pakistan's exports to India are almost half of its exports to South Asia, while its imports from India are in excess of 70 per cent of its imports from South Asia, which in value terms is more than its imports from France, Canada, Netherlands, Turkey, Iran and Thailand. Nevertheless, trade between the countries is lower than its potential.

Available estimates on trade potential suggest that trade could be in the range of US\$3 to US\$10 billion compared with the annual official trade flows over the last six years of less than US\$400 million; in other words only 4–13 per cent of the potential bilateral trade is being exploited. Since Pakistan and India account for almost 90 per cent of South Asia's gross domestic product (GDP), low bilateral trade is an important constraint for growth of South Asian exports to the rest of the world, as well as for an expansion of intraregional trade (Naqvi and Schuler 2007).

Due to restrictions on official trade, unofficial trade through third countries is thought to be substantial. The various routes used for this trade include circuitous routes via Afghanistan, Dubai and Iran. Much of the informal trade takes place in goods that are either not on Pakistan's positive list (e.g. pharmaceuticals, cosmetics, jewellery), have high tariffs in Pakistan (e.g. betel leaves, tractor tyres), or face high tariffs through specific taxes in India (e.g. Pakistani textile products).

24.4 Barriers and constraints

A USAID report in 2005 identified the major constraints to trade, which are still largely in place. Many of the trade cost sources were as a result of lack of trade facilitation and lack of availability of physical infrastructure in South Asia (Banik and Gilbert 2008). Five factors accounted for the high transaction costs of trading between Pakistan and India: (i) limited transportation routes; (ii) the shipping protocol between the two countries; (iii) restrictions on the number of items permitted into Pakistan from India; (iv) non-availability of rail wagons; and (v) procedural clearances.

Constraints on bilateral trade include high tariff and non-tariff barriers, inadequate infrastructure, bureaucratic inertia, excessive red tape and direct political opposition. Pakistan until recently did not reciprocate MFN status for India and maintained a fairly narrow positive list on goods that India could export to Pakistan. At the same time, India's tariff rates remained high, especially for goods of particular interest to Pakistan, such as textiles, leather and onyx, and NTBs are substantial. Poor transportation linkages make trade costly, with railway and road connections inadequate and sea shipments constrained by both limited port facilities and bureaucratic regulations and restrictions. Moreover, constraints on visas and cumbersome payments and customs procedures further limit scope for trade. Finally, although there are no specific restrictions, there is virtually no trade in services or foreign direct investment (FDI) flow between the two countries. In the cases of services and FDI, prior government approval has to be obtained, and it is clear that such approvals have been granted very sparingly by either country.

The most feasible and cost-effective way of moving goods between the two countries is through the land route. However, the only operational rail route is through the Wagah border. The Wagah border post between Amritsar in India and Lahore in Pakistan is routinely blocked by scores of trucks transporting agricultural produce. Their progress is slow in the heat. Papers are checked and rechecked under the watchful eye of military and customs officials on both sides of a hostile divide. Fewer than 20 civilians cross the major crossing point between two of the world's most populous countries. In the interim, goods from Kolkata are being shipped to Karachi via Singapore.

A large number of textile mills are located around Lahore but cotton has to be imported through a circuitous route where goods are first transported to Mumbai; here they are moved to Karachi by sea and further on to Lahore by road.

Transportation links between India and Pakistan are inadequate and weak. Until very recently the restrictive bilateral maritime agreement led to high costs along the sea

route. There are several bottlenecks on the road and rail routes. The road route is open for exports of a limited number of commodities from India. In addition, there are problems such as absence of warehousing facilities and cold storage facilities for perishables, a single gate for exports and imports, trading for a limited number of hours only, etc. Similarly, some of the problems on the rail route include, availability of wagons, requirement of wagon balancing, non-containerised rail wagons, and inadequate handling capacity at Lahore and insufficient infrastructure facilities at the rail cargo station. As a result, transaction costs for trading across the borders are very high. Addressing barriers to the flow of goods across borders will smoothen the movement of goods, lower transaction costs and enhance trade flows.

ICRIER (Taneja 2007) found that the imposition and application of standards in India are often perceived as NTBs by Pakistan. An effective Consumer Protection Act in India ensures the application of rigorous standards to domestic produce and to imports. However, in the application of these standards Pakistani traders do face problems. Notable among these are the multiplicity in Indian standards, rules, regulations and enforcement agencies. Since information flows on trade-related matters between the two countries are particularly weak, the problems are compounded. Lack of testing facilities at the land border causes unnecessary delays in trade transactions.

Both the Indian and Pakistani authorities require that visa applicants should have invitations from sponsors in each city intended to be visited. This is a major impediment for traders as they are unable to visit cities where they cannot locate sponsors. It also inhibits traders from entering into new partnerships. For instance, several soybean meal importers in Pakistan have their trading partners located in Delhi simply because they can get visas to Delhi. Most of the soybean meal is produced in the Madhya Pradesh belt but the Pakistani traders cannot visit these areas unless they can identify sponsors. Similarly, Indian importers would like to visit the Sialkot belt in Pakistan where most of the manufacturers of surgical instruments are located. Currently, imports of surgical instruments from Pakistan into India are miniscule but have the potential to increase if traders and manufacturers are allowed to travel freely.

24.5 Opportunities and openings

It is generally recognised that there are vast untapped trade and investment possibilities between the two countries in both goods and services. The private sector has been proactive in identifying areas of trade interest, possible joint ventures and other forms of co-operation between the two countries. Potential sectors for mutual co-operation have been identified to include some agricultural products, tyres, auto spare parts, minerals, chemicals, pharmaceuticals, leather, textiles, telecommunications, electricity generation using coal and wind energy, etc. Studies undertaken by the private sector also see a large scope for trade in several service sectors such as health, entertainment services, information technology, energy and tourism.

India and Pakistan have mostly common multinational corporations (MNCs) operating in their respective countries (such as Standard Chartered, Unilever,

GSK, BAT and British Airways), which are a force to be harnessed, as they can act as meaningful conduits for trade and investment if they source raw material from each other. MNCs operating in the South Asian region can greatly influence regional economic integration by building a supply chain for their requirements of raw materials and finished goods in the regional countries. Vast opportunities exist in the area of consumer goods. This potential needs to be explored through sector-wise studies and research.

The two countries have considerable interest in collaboration, the transfer of technology and the sharing of knowledge in such sectors as: R&D for crop productivity; seed development and processing; food processing and preservation; storage and warehousing; auto components production; automation in the government and private sectors; and harmonisation of systems (trade, customs, and taxation). They should also have an interest in: co-operation for technical services and networking among institutions to build indigenous capacities in quality and productivity management; energy conservation; environment management; technical education and training; and entrepreneurship development. While it is possible to provide a long list of areas of potential co-operation, some specific areas under both goods and services trade have drawn interest of many business enterprises. These are summarised below.

Textiles and clothing. The textiles and apparel sector continues to be a driving force for economic growth in both India and Pakistan. The two countries exhibit different degrees of specialisation in the sector. India is regarded as a major source for apparel and made-up textiles products while Pakistan is considered to be a competitive supplier of a certain range of products including men's apparel, home textiles such as bed linen and fabrics. The two countries can trade with each other to improve the supply of different varieties of cotton yarn. India produces good-quality short staple yarn whereas Pakistan produces medium and long staple yarn. Also, the short-term shortages in cotton, created by crop fluctuation in both countries, can be overcome through trade. Products that have a huge potential market in India are raw wool for the carpet industry, clothing accessories, cotton fabric, and hand- and machine-made carpets. There are huge opportunities for a two-way trade in ready-made garments, particularly ethnic garments such as shawls, salwar kameez and saris.

Agricultural commodities. Trade in agricultural commodities between the two countries could bridge the short-term supply shortages caused by seasonal crop fluctuations. Items of potential export from India are tea, coffee, wheat, oil meals and fresh vegetables. Items of potential import from Pakistan are molasses, dry fruits and fresh fruits. India and Pakistan are both exporters of processed fish. Bilateral trade could be useful for managing deficits in either country, particularly in Pakistan, which is more dependent on agricultural imports compared to India. Where there are concerns about agricultural subsidies in India, they can be pursued as part of SAFTA negotiations. Both countries have adequate marine resources that could be gainfully tapped for mutual benefits. Joint ventures could be set up for the export of value-added fish products.

Chemicals and pharmaceuticals. The demand for petrochemicals in Pakistan is growing steadily and so is its import. Pakistan lacks basic manufacturing facilities and relies heavily on high-priced imports of raw materials. It could import several of these raw materials from India and reduce its cost of production. India and Pakistan can enter into joint ventures for the bulk production of drugs. The knowledge chemicals industry – comprising of agrochemicals, pharmaceuticals and biotechnology companies – is among the fastest-growing segments of the chemical industry in India. Several Indian companies have built strong manufacturing capabilities in this segment and offer potential for joint venture prospects in Pakistan.

Petroleum. Pakistan imports petroleum products, including diesel, while India has large exporting capacity for diesel. Due to their proximity and associated economics, diesel imports from India to Pakistan could be a win-win situation for the two countries. India is the only country in the South Asian region that has naphtha cracking facilities. Pakistan exports naphtha and can put up a naphtha cracker plant in collaboration with Indian investors.

Light engineering. Ceiling fans, pedestal fans and standard bicycles hold great potential for regional trade. Based on price comparisons, Pakistani producers would have a comparative advantage in exporting fans to India. Both Pakistan and India are large producers and exporters of fans to the rest of the world. In contrast, Indian bicycle producers are likely to displace Pakistani producers but would benefit Pakistani consumers. There could be possibilities for intra-industry trade in parts and components for the bicycle and fans industries in the two countries.

Machinery, equipment and components. Although Pakistan is a major producer and exporter of textile products, it meets its requirements of textile machinery and spares through imports from Europe and the Far East. Pakistan's industry could consider importing textiles and other machinery from India, which are of reasonable quality and comparatively cheaper in price. In India, a large portion of the needs of textile mills are met by indigenous machinery, which gives them a major advantage over Pakistan. There is a vast scope for import of certain components from India that could facilitate the emergence of technology-intensive industries in Pakistan, such as components for autos, bicycles, machine tools, textile machinery, and electrical and electronic machinery.

Automotive components and spares. The automobile industry of India has developed immensely. Due to a good engineering base and a huge population whose purchasing power has considerably increased over the last decade, India is able to produce a wide range of passenger and commercial vehicles and spare parts. Pakistan imports automobiles, components and spare parts from different countries. Pakistan could benefit considerably in importing cheaper automotive components from India as an additional source of supply, thereby reducing its cost of locally-produced vehicles and spare parts.

Energy. There is immense potential for co-operation in the energy sector. India has a large demand for energy. Pakistan's could be a potential transit route for energy from the Middle East and Central Asia to India. It is estimated that Pakistan would gain between US\$600 and US\$800 million per year in transit fees. India has a strong manufacturing base for the production of liquefied petroleum gas (LPG) cylinders. India and Pakistan could enter into a joint venture for the manufacturing of these cylinders.

Banking and capital markets. To facilitate payments for bilateral trade and commerce, banks in India and Pakistan should be allowed to open branches in major cities in the other country. Similarly, the stock exchanges of the two countries should permit the listing and trading of stocks of both countries, which would provide financial depth and diversification to the investors and stockbrokers. The Dow Jones SAFE 100 Index measures the performance of 100 blue-chip companies in five of the eight member states of the South Asian Federation of Exchanges (SAFE), which includes India and Pakistan, who jointly provide the largest number of constituent companies.

Information Technology (IT). In India, the IT industry has made tremendous progress and has emerged as one of the fastest-growing sectors. Pakistan has lagged behind other regional countries in exploiting IT as a catalyst for economic revival. This is one of the potential areas that could be exploited. India, with its wider software industry, could extend help to Pakistan to promote IT through the establishment of joint ventures. The software industry in Pakistan is still in its nascent stages, although it has the potential to emerge as a major software-exporting and training centre. India and Pakistan could enter into joint ventures to tap the global market for software. Pakistan has launched an aggressive effort to woo global corporations to farm out technology tasks. India and Pakistan could jointly tap the global market. The Indian IT training market has also grown significantly. Several Indian institutions have set up training centres in many countries, including in South Asia. India and Pakistan could enter into collaborative arrangements to set up training institutes in Pakistan, which would enlarge its technical workforce.

Entertainment services. India and Pakistan share a common culture, meaning there is scope for trade and co-operation in the film, television and music sectors. India is the second largest producer of films, while Pakistan produces very few movies. However, Indian films are not allowed to be screened in Pakistani theatres and vice versa. There is an interest in India and Pakistan in each other's music and there is also a demand for live Pakistani and Indian music performances. The trade potential in the entertainment industry, particularly in films, television and music, can be tapped by encouraging joint productions. Removing the ban on screening movies would benefit both countries. Exchanging broadcasting rights to telecast each other's programmes on television is yet another trade opportunity for the two countries. Removal of visa restrictions would encourage individuals to participate in each other's entertainment industries.

Tourism and aviation. Tourism holds immense potential for the two countries, due to their shared cultural heritage and with the emergence of new, more dynamic and less risk-averse airlines. However, movement of people is limited due to visa restrictions. The existing meagre tourism trade can be easily expanded with the liberalisation of visas and the improved provision of inter-country transportation facilities. In 2008, Pakistan and India signed an MoU for increasing air services co-operation. They agreed to double the number of weekly passenger flights between the two countries, to expand the number of destinations served by the flights and to allow more airlines to operate the routes. This remains an area for deeper co-operation.

24.6 Recommendations and way forward

To achieve successful regional integration and effective economic co-operation between Pakistan and India, three crucial steps need to be taken:

- deepening of trade by reducing both tariff and non-tariff barriers and by addressing trade facilitation issues;
- expanding the scope to include trade in services and investment and stimulate structural change in the region; and
- focusing reform and policies initially on a limited number of key industries to demonstrate the process and benefits of policy measures.

In terms of the sequence of policy implementation, priority consideration should be given to building a normalised trading relationship between the India and Pakistan. Subsequently, problems related to information exchange, trade facilitation, banking, NTBs, visas and communication should be addressed. For business and private sector enterprises, an enabling environment for investment has to be created with one of the key objectives being promoting joint ventures between the two countries. In this context, to conclude this chapter, a few key recommendations are provided.

- Ease restrictions on visas. In particular, allow multiple-entry visas for business executives, eliminate requirements to report arrival to the police at each place of stay, eliminate city-specific visas and speed up approval processes.
- Eliminate the reciprocal requirement that rail wagons carrying goods across the border return empty, increase the frequency of rail traffic, and improve co-ordination between railway authorities.
- Create adequate testing facilities at land borders so that no trade restrictions are imposed on the grounds that testing facilities are not available.
- Extend transport routes. As there are only two operational routes, the Mumbai–Karachi sea route and the Attari/Wagah rail link on the land border, new routes should be explored and opened up. Opening the Attari–Wagah border to allow the transportation of goods by road should be done at the earliest time possible, as the road link for movement of passengers is already operational. New rail and road links for example, the Khokrapar–Munabao link and the Srinigar–Muzaffarabad

link (for goods transportation) should be opened. Opening additional border crossings, increasing traffic frequency on the road route through the Wagah border (connecting the major cities of Amritsar and Lahore) and the Khokhrapar–Munabao route, and allowing increased traffic through the Srinagar–Muzzafarabad route, which is currently restricted, should also be carried out. Bus routes and air links should be enhanced to promote regional tourism.

- Address transport bottlenecks. Abandoning the positive list approach would allow goods to move freely on the direct routes, thereby lowering transaction costs. The rail protocol should be amended, such that restrictions on wagon balancing are removed and wagon availability is improved. Measures such as simplified border procedures should be introduced at the land borders. The shipping protocol should be amended so that third country and non-national flagships can ply on the Mumbai–Dubai sea route and the reciprocal requirement that ships touch a third country port before bringing in imports should be eliminated. This would help in lowering shipping costs. The third country port restriction particularly affects trade of high-bulk, low-value goods, such as coal, tar and cement, making their transportation via sea commercially unviable. Increasing the number of customs posts where ‘sensitive’ items can be cleared and eliminating requirements for 100 per cent verification. Sea shipments should be allowed in addition to the current Mumbai–Karachi route.
- Allow branches of Indian and Pakistani banks to operate in the other country and allow banks in one country to hold accounts in the currency of the other. As there is evidence of anonymous transactions between trading partners, payments through formal channels assume a greater role. The existing payments system, formalised through the Asian Clearing Union, is widely considered to be inefficient and payments are often delayed. The two countries need to have an institutional arrangement so that state, private and foreign banks can participate freely in banking transactions. Greater transparency is needed to address problems related to confirmation of letters of credit and to payments.
- Dealing with NTBs. There is a need to quickly reduce NTBs, which are more pernicious on Pakistani exports to India. Moreover, there is also a need for a simplified and harmonised system of TBT and SPS standards. For the latter, protocols will have to be negotiated under SAFTA.
- Both countries should harmonise their customs procedures, including more standardised and transparent documents and inspection procedures and product standards. Also, sanitary and safety laboratory inspections in one country should be accepted in the other.
- Establish India–Pakistan joint ventures. As several Indian companies have shown interest in setting up joint ventures in Pakistan, it is important to understand the nature of such investments and provide timely facilitation. Companies in each country should be allowed to float shares in the securities markets of the other, and double taxation on corporate and individual incomes should be removed.
- Energy trade between the two countries should be facilitated.

It is widely acknowledged that past Pakistan–India relations have been a major impediment for regional co-operation in South Asia. Enhanced trading and investment relations and political commitments are critical for promoting effective regional integration in South Asia, from which both Pakistan and India along with other members can benefit enormously.

Note

- 1 These differentials have, however, narrowed significantly over time.

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