

# Chapter 1

## Regional Integration in South Asia: An Overview

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### 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.<sup>1</sup> 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.<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup> 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.<sup>5</sup>

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 slowdown 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 his 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.*<sup>6</sup> 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.