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Abstract

Recent developments in South Asian countries, especially the re-emergence of democratic governments, new growth momentum despite the global economic downturn and greater openness, warrant a fresh look at the region's prospects for economic integration. On the basis of a thorough review of the literature on potential and prospects of regional integration in South Asia and after examining the trends in intra-SAARC trade and investment flows, this paper finds that the progress in regional cooperation has been far short of potential. The paper, therefore, focuses on the 'real impediments' to regional integration and on that basis makes a set of policy oriented recommendations for furthering deeper regional integration in South Asia. It also emphasizes that given its dominant size, human resources, and aspirations for a global role, India will have to take on a disproportionately larger responsibility for promoting regional cooperation in South Asia. However, regional integration will not be achieved by India's unilateral actions alone. Neighboring governments will have to respond positively to Indian initiatives for successful regional integration in South Asia.

Keywords: South Asia, economic integration, regional trade, foreign direct investment

JEL Classification: F15

1. Introduction

There is perhaps no other historical example like South Asia of a geographically and historically contiguous region with widely shared social, cultural, linguistic and spiritual practices, experiencing a continuous fragmentation of its once reasonably integrated economic space. Intra-regional trade in the South Asian region (broadly from Kabul to Chittagong) was as high as 19% in 1948, soon after the countries achieved independence from British rule. But this declined to a mere 2% by 1967. Intra-regional trade has perked up a bit in recent years but still remains below 6% of South Asia's total trade with the world. This is far below levels of intra-regional trade in other regions such as East Asia and the Pacific (about 52%), Latin America and Caribbean (about 17%) and even Sub-Saharan Africa (at nearly 11%).[1] According to the World Bank (2007), only 7% of all telephone calls in South Asia are intra-regional as compared with 71% in East Asia.[2] Cross-border investment is also negligible with none being permitted between India and Pakistan. Informal or border trade and movement of personnel are perhaps larger than normal trade flows and intra-regional tourism, knowledge sharing or technology transfer across countries is well below its potential. Given this rather dismal picture of the progress of regional cooperation nearly 25 years after the formation of the South Asian Association for Regional Cooperation (SAARC) would justify anyone in treating SAARC as a failed experiment. But as we argue below, this conclusion may not be fully justified.

South Asia has the dubious distinction of having an even larger number of poor people living below $1 per day than sub-Saharan Africa. Border regions—where central policy making in any country is peripheral and where this poverty is largely concentrated—will benefit significantly from greater regional economic cooperation because it opens up these borders and converts peripheries to new poles of economic activity. Historically, the best example is the development of Northern Italy and Southern Switzerland. Greater cross border flows became possible with the opening of the Mont Blanc tunnel under the Alps that drastically reduced travel times and opened up the border regions on both sides.[3] A similar growth-generating impact can be expected in the Eastern regions of South Asia, where Bangladesh, Bhutan, India and Nepal are in close proximity to each other, through greater regional cooperation. This would make existing national borders, which arbitrarily divided organically integrated communities, once again irrelevant. However, as section 2 shows, these and other intuitive arguments in support of regional integration are not unambiguously endorsed by empirical studies attempting to quantify the benefits of regional economic cooperation in South Asia.

Section 3 then re-examines the structure and direction of trade flows in South Asia and concludes that in a region characterized by low per capita incomes, poorly developed infrastructure, and high transaction costs, trade liberalization can be expected to yield

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1 World Bank (2007, 4) Regional formations like the EU and ASEAN also have a high share of intra-regional trade, at nearly 65% and 24% respectively.

2 Ibid p. 4.

3 As a complete contrast the case of the Ferghana Valley in Central Asia can be cited, where new borders created after 1991 resulted in massive economic dislocation and steep fall in living standards, apart from leading to widespread unrest and growth of Islamic fundamentalism in the valley.

only modest gains. Deeper integration that encourages cross border investment by improving the business environment and reducing uncertainty is perhaps a necessary condition for successful regional integration. This requires greater investment in regional public goods and expansion of productive capacities in the framework of regional production networks that will facilitate the growth of intra-industry trade. In this regard, we look at the experience of regional cooperation in East and Southeast Asia to draw relevant lessons for advancing the process in South Asia. The primacy of developing physical infrastructure and improving connectivity to foster intra-regional trade has been pointed out by several authors (Muchkund Dubey 2007, Wilson and Otsuki, 2007, and others) but so far has been not carried forward.

Section 4 therefore reviews the policy developments in the region to identify factors that are holding up needed investment in regional public goods, physical infrastructure, and intra-regional connectivity. We also review the private sector's experience in cross border investment within South Asia to be able to suggest public policy measures for encouraging it further.

Section 5 takes a forward looking stance and discusses the possible role that India can and should play in this regard. The two central arguments that are made in this section are that first, there is little value addition in proliferating regional trade and economic cooperation agreements as these simply confuse both the private entrepreneur and public authorities, and distract from efforts to strengthen existing formations. Second, that it is in India's national interest to take a proactive role in promoting regional trade and investment integration and that India should take on the principal responsibility in this regard. However, regional integration will not be achieved by India acting alone, and other governments will have to respond positively to India's efforts. Finally, the last section makes specific recommendations for the various stakeholders in the South Asia regional economic cooperation process.

The paper makes three central arguments: first, that regional economic integration in South Asia that implies a greater share of intra-regional trade and cross border investment is not only desirable but necessary if South Asian countries are to realize their development objectives of reducing poverty by sustaining rapid and spatially equitable economic growth. Therefore, governments in the region must continue these cooperative efforts despite the provocations and setbacks from extremist violence or factional and fractious politics. Second, all South Asia countries will have to view the process positively and play their role in advancing the process. However, given its dominant size, human resources, and aspirations for a global role, India will have to take on a disproportionately larger responsibility and ensure that regional cooperation in South Asia is successful. Third, as a result of widespread and increasing civil society support in all South Asian countries, the process of regional cooperation could well be near a tipping point. A coordinated and sustained effort could push it into a virtuous cycle that will yield significant gains for all concerned with tangible externalities for the entire global community. Therefore, major countries and multilateral agencies and existing SAARC institutions would do well to provide the necessary impetus to push it beyond the tipping point and at least make it invulnerable to sudden random shocks. At present, however, random negative events such as a major terrorist attack can push the entire process backwards. Multilateral institutions and the private sector, domestic and foreign, can play an important role in strengthening regional cooperation and making the process less vulnerable to such shocks.

2. The Case for Trade and Investment Integration in South Asia

Recent developments in the region, especially new growth momentum and greater openness in all South Asian economies, warrant a fresh look at enhancing regional integration. Gross Domestic Product (GDP) in the South Asian economies has grown strongly at about 6% since the 1990s, and almost 7% in the last five years, starting in 2002–03. This higher growth trajectory is directly attributable to the opening up of the economies and adoption of stabilizing macroeconomic policies. Growth rates of these magnitudes have helped South Asia to reduce poverty rates and raise living standards. However, the incidence of poverty is still very high and the absolute number of people living below the poverty line has actually increased. The biggest challenge for the region is poverty reduction through robust and sustained growth.

A recent growth accounting exercise for the region (Collins 2007) reveals that though both capital accumulation and increased efficiency of factor usage have contributed to higher growth in South Asia, these countries have not been characterized by high rates of investment, especially in comparison with East Asian economies.[4] Greater regional integration will help improve the investment climate in the region and encourage more cross border investment. Reducing poverty also requires faster growth in the manufacturing sector, which can absorb the labor displaced from the agriculture sector. The manufacturing sector in the region suffers from under utilization of technology, inappropriate scales, and poor infrastructure. Most of these factors will benefit from greater regional integration. The role of manufacturing in generating inclusive, employment-intensive growth has been under estimated in South Asia, perhaps because of the greater dynamism shown by the services sectors in all the countries in the region (Table 1). However, services are often a residual sector for national statistics and could disguise very low levels of productivity in a very large segment of this sector. Manufacturing has to be encouraged in South Asia and this will benefit directly from greater regional cooperation and integration.

That regional cooperation benefits the manufacturing sector through trade expansion and economies of scale can be seen in the European Union (EU), Association of Southeast Asian Nations (ASEAN), and others. Removal of barriers to trade can stimulate competition which can help boost allocative and productive efficiency by facilitating industrial restructuring that is less difficult in the context of larger and growing markets that will be made possible by regional cooperation.

[4] Collins (2007) 'Economic Growth in South Asia, A Growth Accounting Perspective' in South Asia: Growth and Regional Integration, World Bank.

Table 1: Value Added (% GDP)

Country Name	Agriculture		Industry		Manufacturing		Services	
	1990s	2000s	1990s	2000s	1990s	2000s	1990s	2000s
Bangladesh	27.1	22.5	23.9	26.3	14.9	15.9	49.2	51.2
Afghanistan	n.a	42.9	n.a	22.6	n.a	15.2	n.a	34.5
Bhutan	33.8	26.7	31.8	37.5	9.6	7.8	36.4	35.8
India	29.3	20.9	26.9	26.5	16.5	15.5	50.5	52.6
Nepal	42.8	38.9	20.6	21.2	8.6	8.3	38.9	40.0
Pakistan	26.1	23.6	24.4	23.6	16.4	16.4	51.2	52.8
Sri Lanka	23.6	19.0	26.4	26.6	15.7	15.7	52.8	54.4

Source: WDI.

Table 2: Share in Total Export to the World

SITC	South Asia (minus India)		SITC	South Asia with India	
84	Apparel/clothing/access	41.4	84	Apparel/clothing/access	14.4
65	Textile yarn/fabric/art.	25.8	33	Petroleum and products	12.4
4	Cereals/cereal preparation	4.1	65	Textile yarn/fabric/art.	10.9
7	Coffee/tea/cocoa/spices	3.0	66	Non-metal mineral manufactures	8.2
33	Petroleum and products	2.7	89	Misc manufactures nes	5.1
3	Fish/shellfish/etc.	2.6	67	Iron and steel	4.5
89	Misc manufactures nes	2.3	51	Organic chemicals	3.5
61	Leather manufactures	1.9	28	Metal ores/metal scrap	3.5
66	Non-metal mineral manufacture	1.7	68	Non-ferrous metals	2.8
5	Vegetables and fruit	1.0	54	Pharmaceutical products	2.4

Notes: Bhutan has not been included. Data for Bangladesh is for 2004, Nepal 2003, and Sri Lanka 2005. For India, Pakistan and Maldives data pertains to 2006.

Source: Estimated from WITS Database.

Because the manufacturing sector is restricted by limited capacity to generate exportable surpluses and lacks product diversity, the region's share in global exports remains negligible at 1.3%. Exports remain concentrated in low technology products such as textiles and garments, leather products, and agricultural products (Table 2). A regionally integrated South Asia will attract globally leading firms to establish capacities within the region to meet demand from South Asia's burgeoning middle class. An immediate and almost certain spillover effect is for these large foreign firms to use the newly created capacities to supply their global requirements. This will help South Asian countries to increase their shares in global markets, generate employment and reduce poverty.

An integrated market can be especially important for small economies in South Asia by acting as a launching pad for integrating with extra-regional markets and providing an opportunity to diversify into export goods with higher value added to the sub regions. Greater trade between the countries also gives impetus to infrastructure development. The flow of information and technology and knowledge spill-over, increased foreign direct investments, and regulatory cooperation and harmonization can make economies more dynamic. Therefore, to maximize the benefits of higher growth regional cooperation needs to be strengthened.

Intuitive arguments in support of greater regional integration are also backed up by quantitative exercises, a number of which are reported in the literature. Studies conducted for South Asia show that dismantling tariff and non tariff barriers will increase trade and welfare in the region. One of the earliest studies conducted, T.N.Srinivasan (1994), using a gravity model, showed that a Free Trade Agreement (FTA) in South Asia would lead to an increase in trade of 8.9 times in Bangladesh, 9.5 in Pakistan, 12.8 in India, 10.3 in Sri Lanka and 17.2 in Nepal. Given initial trade patterns, Nepal and Bangladesh stand to gain most significantly from such an arrangement. The simulation showed that the effect of removing all tariffs would be to increase total trade from 3% of GDP for India to 59% of GDP in Nepal, and something in between for the other countries. Hassan (2001), using a gravity model, looked at whether trade in the region was small because of normal outcomes or because of unexplored trade opportunities and found that SAARC member countries were yet to achieve trade-creating benefits. SAARC countries should liberalize trade as these offered significant gains for all the economies in the region. Further effort was needed to liberalize border trade and remove tariff and non-tariff barriers in the general framework of South Asian Preferential Trading Arrangements. Hirantha (2004) also used the gravity model to evaluate the progress of South Asian Preferential Trade Agreement (SAPTA) and the prospects for South Asia Free Trade Agreement (SAFTA) using trade data for 1996–2002. Both panel data and cross sectional data analysis were used. The gravity model results showed that there was a significant trade creation effect under SAPTA and found no evidence of trade diversion effect with the rest of the world. Pitigala Nihal (2005) using the natural trading partners hypothesis as the empirical criterion to assess the potential success of a South Asian trading bloc showed that South Asian countries could be characterized only as moderate natural trading partners. But this characterization was largely a consequence of previous impediments to trade among regional members. The author also used additional statistical measures—revealed comparative advantage indices, trade concentration, and trade competition profiles—and demonstrated that the trade structures that have evolved among the South Asian countries may not facilitate a rapid increase in intra-regional trade. But there was evidence that previous unilateral trade liberalization efforts in the South Asian countries have already had a positive impact in boosting both intra- and extra-regional trade. He therefore recommended continuation of the process of unilateral liberalization, in parallel with regional integration, to help the South Asian countries to continue diversifying still narrow export bases and potentially evolve new comparative advantages and complementarities that could facilitate the successful implementation of SAFTA. The most recent study, (UNCTAD and ADB 2008) used general equilibrium analysis to estimate the impact of SAFTA on the welfare of member nations. It concluded that SAFTA will be trade creating, with India serving as the growth pole for the region, and found that all the participating countries will gain. Gains will be greater for smaller, least-developed countries.

Studies have also been conducted at a micro level from a one-country perspective. Kemal et al. (2000) found that the South Asian region was characterized by an almost identical pattern of comparative advantage in a relatively narrow range of products and that there was a lack of strong complementarity in the bilateral trade structures of South Asian countries .This may have played a role in constraining intra regional trade growth in South Asia. They also looked at the Grubel-Lloyd indices of intra-industry trade, based on industry-wise exports and imports of Bangladesh to and from India, Nepal, Pakistan and Sri Lanka. According to them the low intensity of intra-industry trade in the region indicated the potential for widening its scope. But since intra-industry trade was largely driven by product differentiation and increasing returns to scale, increasing it could only be achieved if these countries would develop technological capacity to produce different product varieties at declining average cost. This also required that firms operating in South Asia were able to exploit economies of scale, which would be possible if the markets were more integrated. Batra (2004), using an augmented gravity model, estimated the trade potential for India with its trading partners in the world and specifically within regional groupings like the SAARC. Though the estimates indicated positive trade potential for the SAARC region as a whole, the positive trade potential was mainly on account of potential trade between India and Pakistan, which was estimated at $6.5 billion more than the actual trade between these economies. On the basis of the trend and structure of trade between India and Bangladesh Rahman (2005) believes that bilateral trade between India and Bangladesh was not as high as it should be. And there was scope for mutual trade expansion. If Bangladesh's exports were increased, this would induce higher imports of raw materials and intermediate goods from India. The demand for the Indian consumer goods exports would also increase in Bangladesh due to higher income from increased exports.

Among those who have not been optimistic about the benefits from greater trade and investment integration in South Asia region are Bandara and Yu (2003).They have used trade data and a global computable general equilibrium (CGE) model to address the desirability of SAFTA and perform simulations using two policy scenarios namely, unilateral liberalization and preferential liberalization. Results from the two scenarios confirm the pessimistic view by showing that unilateral liberalization would benefit South Asia countries much more than preferential liberalization. This is because it would be difficult to achieve meaningful regional cooperation in economic and social matters in the SAARC region without proper resolution of political conflicts between member countries, particularly between India and Pakistan. They therefore recommend that it would be better for policy makers in the region to put more effort into liberalizing their own trade regimes, rather than wasting energy on forming SAFTA with a lot of economic and political constraints. According to Panagariya (2003), trade diversion will probably swamp the beneficial trade creation effects. Krueger et al (2004) suggest that although potential gains from SAFTA exist, the region does not meet most of the theory-based criteria for successful trade agreements. Both Panagariya and Krueger feel that unilateral and bilateral liberalization may be more efficient ways to achieve welfare and economic improvements. According to them the welfare benefits of SAFTA could be significantly higher for all countries if an agreement could be forged between NAFTA and SAFTA and not by promoting SAFTA by itself.

Kumar and Saini (2007) look at the Pareto optimality of SAFTA as well as the welfare optimality of alternative sets of coordinated trade policies that go beyond SAFTA using the standard static GTAP model. These policies include (i) extended preferential trading between SAFTA and three other major trading blocs (ASEAN), the North American Free Trade Area (NAFTA) and the EU27; (ii) coordinated full trade liberalization (carried out unilaterally or as part of a multilateral agreement) by South Asian countries, and (iii) SAFTA plus a customs union (two variants with 5% and 10% Common External Tariff). Their analysis shows that the welfare basis for establishing SAFTA or for deeper trade policy coordination in South Asia was not very strong. Nor was it obvious that cooperation in South Asia would be forthcoming given the rather meager anticipated welfare impacts.

Though there have been hardly any studies into the impact of an FTA on foreign direct investment (FDI) in the South Asian region due to lack of data on bilateral FDI, Jayasuriya and Weekrakoon (2002) looked at the nature of intra-SAARC investment flows and emerging trade and investment links within the region. They explored the evidence on the trade-investment links in South Asia by focusing on the textile and garment sectors as well as on some firm-level evidence from Sri Lanka. On the basis of this preliminary analysis, they believed that though the extent of these trade-investment links in the SAARC region were still rather limited, they indicated the potential. ADB-UNCTAD (2008) has shown that the lowering of tariffs following SAFTA will attract FDI from outside the region into South Asia. SAFTA may not only increase intra-regional trade but also attract more vertically integrated FDI into the region.

Evidently, the above review of quantitative estimates does not unambiguously support the intuitive case for greater regional integration. The results from exercises based on gravity and CGE models apparently yield different results. These could well be due to the former being able to take into account some of the non-economic factors which CGE models cannot. Thus, it is not surprising to see that in general gravity models yield higher welfare gains. Moreover, all these studies, whether based on gravity type or CGE models, are undertaken at a reasonably high level of aggregation. If we could use more disaggregated (for example six digit) data, these exercises would yield higher welfare gains as some of the substitution effects across sectors are avoided. For example both Pakistan and India are seen as textile and handicraft exporting economies with limited complementarities. However, when data at the six-digit level are considered, it emerges that there are only four over-lapping items between India and Pakistan in their top ten exports. This is possibly another area for useful future research.

Quantitative estimates of welfare gains from regional integration are essentially based on a static understanding of economic processes in South Asia. As Taneja and others point out, informal border trade is nearly twice as large as the formal trade within South Asia. There is also enough anecdotal evidence on fairly large cross border movement of personnel. Trade flows in the services sectors is also underestimated. If all these magnitudes are put together, there would be in our view a significant increase in the net welfare impact of greater trade integration in South Asia.

Even more important perhaps is to realize that trade flows critically depend upon the state of infrastructure—especially cross border infrastructure—the level of transaction costs that remain unacceptably high because of poor trade facilitation and other bureaucratic procedural delays, and the large number of often opaque and arbitrarily applied non-tariff barriers. It has been estimated (Hertel and Mertel 2008) that gains from improving trade facilitation are significantly larger than those which accrue from a reduction in tariffs. Procedural delays and regulatory requirements create a regime of great uncertainty, as different from risks that can be estimated in probabilistic terms, in intra-regional trade. This uncertainty is compounded by the presence of similar factors on both sides of the border and acts as a strong deterrent to trade and investment. The quantitative models do not and, by their nature, cannot take into account the impact of these factors, which are both non-tradable and non-estimable in their nature. Their inclusion, while estimating net welfare impact of enhanced trade flows, could be the agenda for future research.

Further motivation for greater economic cooperation in the South Asian region emerges from four important factors: First, pure economic efficiency gains through efficient use of capital and labor that result from a freer cross-border movement of goods and services. These gains will be significantly higher once cross border production networks expand in South Asia as they have done in South East Asia, resulting in a significant expansion of intra-industry trade, the most dynamic aspect of intra-regional trade. This necessitates improvement in the regional business environment and connectivity, which should therefore be the highest priority for South Asian governments. Second, there are other, non-traditional gains from greater regional integration, such as increased FDI as regional markets become more accessible to outside investors. Third, there are strategic benefits for South Asian countries negotiating as a unified group in a multilateral forum. Fourth, there are developmental and environmental efficiency gains arising from adopting a regionally integrated approach towards provision of regional public goods such as environment, water conservation, infrastructure and other natural resources including the regional ecosystem and related biodiversity. These regional issues cannot be effectively addressed individually and are best addressed in a cooperative framework. The quantitative, model-based exercises cannot take these welfare-raising effects of greater regional trade and investment integration, for obvious reasons.

While the economic gains (including the less traditional) that arise from intra-industry trade and investment flows are well discussed in the literature, it is useful to point to the political and security motivations for regional cooperation in South Asia. These considerations are often the main driving force behind the emergence of regional blocs (Crawford and Fiorentino 2005, 16). For example, it was the fear of the People's Republic of China dominance that drove the Southeast Asian economies to form ASEAN, and even the EU was seen as a response to the post-war emergence of the United States and the East European bloc under the USSR. In this context it is useful to note that the terrorist threat to India and Pakistan is prompting the government establishments in the two countries to improve their relationship and support political dialogue to ensure political stability and social harmony. This has resulted in the

'Composite Dialogue' process, which denotes a real advance over the earlier position under which no forward movement was possible without addressing the so-called core issue of Kashmir. Greater regional and bilateral cooperation within emerging economies can also be seen as a response to the slow progress in multilateral trade regimes and increasing recourse to regionalism within developed economies.[5]

The other main driver of economic integration in South Asia is the need for greater energy security. All these countries are heavily dependent on energy imports and even more specifically on hydrocarbon imports from West Asia. At the greater Asian regional level the SAARC economies can be seen to offer a unified market for hydrocarbon imports from Central and West Asian gas and oil fields by overland pipelines. Energy trade in the region can also be seen as a confidence-building measure and a lock-in mechanism for irreversible economic interdependence (Pandian 2005). With Afghanistan's membership in the SAARC, the region can expect further potential gains through alliance with Central Asian countries, with immediate and significant benefits for Afghanistan.

In our view, therefore, there is a strong case, based on economic and strategic grounds, for greater regional trade and investment integration in South Asia. The important question, of course, is that if this is known to policy makers in the region, then why has there been so little progress over the last two and a half decades in promoting regional economic cooperation in this part of the world? This merits a serious enquiry for identifying those elements or categories of economic and political agents whose interests could be harmed by greater regional economic cooperation and who are in sufficiently strong positions to be able to thwart attempts at promoting regional integration among SAARC members.

3. Trade and Investment Patterns in South Asia

As mentioned earlier, intra-regional trade in South Asian countries, at 19% of total trade in 1948, decreased to 2% by 1967 as governments adopted inward-looking and import-substituting policies, backed up by high tariff and non-tariff import barriers. The low share began to increase only during the 1990s, with the adoption of unilateral trade policy liberalization in the individual countries (World Bank, 2004). During 1996–2006, the volume of trade among the member countries quadrupled from $2.214 billion to $9.778 billion and has been growing at a rate faster than the region's trade with the world. Intra-regional trade rose from 4.2% in 1995, then stagnated at around 5% until 2005, and is presently 5.5%.[6] The stagnation in intra-regional trade could indicate that trade expansion impulses from mutual tariff reduction have perhaps played out and have no further potential. This would also point to the need now for identifying the non-tariff

[5] A total of 211 regional trade agreements for goods and services are in force today. While 124 regional trade agreements for goods were notified in the GATT (some no longer in force) during 1948–94, more than 130 agreements covering trade in goods and services, as of September 15, 2006, had been notified since 1995 under the World Trade Organization, (WTO website www.wto.org/english/tratop_e/region_e/summary_e.xls, accessed December 6, 2006).

[6] Wijesinghe S.' Economic and Political Utility of the SAARC Summit to Sri Lanka', Daily News, July 23, 2008.

barriers to trade, as is being attempted under the agreement reached at the Delhi SAARC summit, and to improve the trade infrastructure and facilitation process.

With intra-regional trade accounting for a mere 5% of the region's total trade, South Asia is considered the least integrated region among regional trade arrangements such as NAFTA (42%), EU (65%), and ASEAN (24%). However, the position changes if India, which clearly overshadows all estimates, is dropped. This is also brought out in Table 3, which shows that India sources less than 1% of its imports from the region and only exports 5.5% of its total exports to countries in South Asia. But the commonly held perception that the low level of imports by India is due to its highly protected economy may not necessarily be true.[7] A recent World Bank study shows that though the number of tariff preferences for Bangladesh has increased steadily since 2001, its exports to India have stagnated. The study suggests that the reason for low imports from Bangladesh could be due to supply-side factors in Bangladesh not due to a lack of demand or protection in India (World Bank 2006).

Today the MFN tariff for Indian manufacturing is 10% on average, effectively eroding the advantage SAARC members have in the Indian market both relative to imports from other sources and also from domestic enterprises now competing successfully with relatively low tariff protection. This implies that the tariff arbitrage enjoyed by South Asian firms has been eroded. This comes out rather sharply in the case of Sri Lankan exports of hydrogenated edible oils, copper and copper-based products and aluminum and aluminum-based products, exports of which have declined since 2005 with the lowering of import tariffs on these products by India. Unilateral liberalization practiced by all countries in South Asia has effectively eroded the advantages of mere tariff liberalization under SAFTA.

Given the relatively slow rate of expansion of intra-regional trade, despite the recent decline in tariff levels, attention has been directed to the prevalence of non-tariff barriers to trade in the region. At the Delhi Summit, it was agreed that all SAARC member countries will undertake detailed studies of non-tariff barriers that impede imports from neighboring countries. The removal of these non-tariff barriers would surely contribute to a rapid expansion of intra-regional trade. At the same time, given that intra-industry trade is generated to a large extent from investment in cross border production capacities, the region should now aim at deeper regional integration that would generate much larger volumes of cross border investment and expansion of intra-industry trade.

But it is worth pointing out that with India's exclusion, estimates of the share of intra-regional trade in the region's total trade rises from about 5% to 11% in 2006–07. This is a significant increase in the share of intra-regional trade and shows that businesses in other South Asian countries are more regionally oriented than in India. Indian firms clearly find non-regional export markets and import sources more attractive. It would therefore be a strong policy suggestion that both India and its regional partners take the steps necessary to make regional markets and supply sources more attractive for Indian firms. Some Indian, as well as Sri Lankan and Pakistani, firms are developing sector or

[7] If we look at SADC, the exports of South Africa (the largest country in SADC) to member countries, were 10.1% but it sourced merely 2.2% of its imports from the region in 2006.

even sub-sectoral specializations which make them more technologically advanced and more intensively connected to global markets than firms operating in the same sector in other countries. This increasing specialization can become the basis for expanding intra-firm trade within South Asia.[8] But it requires the urgent improvement of investment conditions in all SAARC countries.

Though most trade of the countries in the region has always been extra-regional, the most important trading partners being the United States and EU, in recent times, the South Asian market has become important, especially for smaller countries such as Afghanistan and Nepal. For Bangladesh and Sri Lanka, the region is an important source of imports.

Table 3: Intra Regional Trade for SAARC Region (Average over 2002–06)

Country	Intra Regional Exports			Intra Regional Imports		
	Average Value ($ million)	Share in Region	Share in Own Total Exports	Average Value ($ million)	Share in Region	Share in Own Total Imports
Afghanistan	83	1.2	41.9	896	13.2	39.8
Bangladesh	145	2.1	1.8	1836	27.1	15.2
India	4474	66.2	5.5	984	14.5	0.9
Maldives	17	0.2	13.9	127	1.9	20.0
Nepal	319	4.7	51.9	762	11.2	45.9
Pakistan	1209	17.9	8.9	573	8.5	2.8
Sri Lanka	508	7.5	8.7	1598	23.6	19.4
SAARC Region	6754	100.0	6.2	6776	100.0	4.4

Source: Estimated from Direction of Trade Statistics Data.

India naturally dominates the region's trade as it has common borders with all the countries of South Asia (except Afghanistan). Table 4 reveals that India's trade with all countries increased from 1995 to 2006, with a large proportion of total exports to the region going to India. There have also been changes in the direction of the region's trade. In 1995, 61.5% of India's exports to the region went to Bangladesh, but this decreased to 30.7% in 2006. On the other hand, Bangladesh's export share to India increased from 42.3% in 1995 to 63.5 % in 2006.

[8] As Das (2007) suggests, despite the problems facing these countries they should continue to regionalize because as they move up their respective growth trajectories, they are likely to gain in welfare terms even if they succeed only in shallow regional integration.

India-Sri Lanka trade too has increased tremendously and India has become the most important trading partner for Sri Lanka in the region. Some 86% of Sri Lanka's exports to the region go to India and 35.5% of India's exports to the region go to Sri Lanka. This could be due to the FTA between the two countries which became operational in 2000. There has also been an increase in India's trade with Nepal and Pakistan in recent years, despite the trade with the latter being conducted still on the basis of a positive list and India not having been granted MFN status by Pakistan, in violation of World Trade Organization (WTO) norms and practices.

Table 4: Direction of Intra-regional Trade
(% of Total Exports of a Country in the Region)

1995 **From/to**	**Afghanistan**	**Bangladesh**	**India**	**Nepal**	**Pakistan**	**Sri Lanka**	**Maldives**	**Bhutan**
Afghanistan	…	3.4	32.2	0.0	64.4	0.0	n.a	n.a
Bangladesh	0.6	…	42.3	11.8	31.4	13.6	0.0	0.3
India	0.9	61.5	…	6.9	4.5	24.6	0.8	0.8
Nepal	0.0	11.9	83.6	…	1.5	3.0	0.0	n.a
Pakistan	7.3	56.3	14.2	1.1	…	20.2	0.5	0.4
Sri Lanka	1.0	11.8	31.4	0.0	42.2	…	13.7	n.a
Maldives	n.a	0.0	1.0	0.0	0.0	99.0		n.a
2006								
From/to	**Afghanistan**	**Bangladesh**	**India**	**Nepal**	**Pakistan**	**Sri Lanka**	**Maldives**	**Bhutan**
Afghanistan	…	2.2	50.0	0.0	47.7	0.1	n.a	n.a
Bangladesh	0.5	…	63.5	1.9	27.8	4.7	0.0	1.8
India	2.7	30.7	…	15.8	12.2	35.5	1.2	1.8
Nepal	0.0	0.8	98.3	…	0.9	0.0	0.0	n.a
Pakistan	60.0	12.0	19.0	0.2	…	8.7	0.2	0.0
Sri Lanka	0.3	2.2	86.6	0.1	6.7	…	4.2	n.a
Maldives	n.a	0.0	5.9	0.0	0.0	94.1	…	n.a

… = Data not available.
Source: Estimated from Direction of Trade Statistics Data.

If we look at the composition of intra-regional trade (Appendix I), both imports and exports seem to be concentrated in a few commodities, such as textile fibers, minerals and agricultural products. Though imports of the countries from the region are diversified, the top five exports comprise more that 60% of their total intra-regional exports. This relatively high level of product concentration in intra-regional exports makes these economies vulnerable to protective action by the importing country. Greater diversification of their export basket can reduce this vulnerability, but this has to be balanced against the need to fully exploit the country's comparative and competitive advantage, which will be the basis for securing greater market shares globally.

3.1 Regional Trade Orientation

UNCTAD-ADB (2008) has shown that in South Asia the number of products in which each country has a comparative advantage has increased. It also shows that the complementarity index has improved considerably overtime for Bangladesh, India and Sri Lanka, though it has declined for Pakistan. The Grubel Lloyd index, which measures intra-industry trade, shows that intra industry trade has increased in sectors such as agricultural raw materials, chemicals and textiles. The study also shows that intra-industry trade has increased in some sub-sectors within textiles, indicating that countries are beginning to specialize in products at different stages of production which is the basis for intra-industry trade and as a result, manufactured goods now make up a larger share of overall trade in the region.

This paper looks at a different aspect of intra-regional trade. Since complementarities in trade seem to be increasing we identify the products that have experienced large increases in regional trade orientation.[9] Data has been obtained from UNCTAD's Personal Computer Trade Analysis System (PC-TAS). To evaluate the orientation of trade, two time periods have been used.[10] Table 5 presents the list of 33 HS Code two-digit products that have met two criteria. As suggested by Yeats, in order to eliminate marginal products, only those products have been considered whose two year average (1995–96) was greater than $5,000 in intra-regional trade and, second, these products registered the highest growth rate between 1995–96 and 2003–04.

The results presented in the table show that regional orientation has increased despite the fact that a reduction in trade costs and global trade liberalization has made distant markets more accessible. There are some products for which regional orientation was less than one in 1995–96, indicating that the countries imported these products from outside the region. But the higher ROI index in 2003–04 implies that imports are being sourced from the region itself. As many of the products with increased regional

9 The methodology of the Regional Orientation Index (ROI) as suggested by Yeats (1997) has been used. ROI measures the relative importance of intra-regional exports for a product. Yeats used the index to study regional orientation of trade flows within MERCOSUR. Though his aim was to find out if regional integration had led to trade diversion, no attempt has been made to see if the reorientation of trade in South Asia has led to trade creation or trade diversion. Though regional integration is considered to be advantageous when trade diversion is less than trade creation, this is a static gain. We believe that even if the integration is trade diverting it is beneficial if the overall benefits are greater than the costs. For example, regional integration may enable member countries to export successfully and have a sustained high rate of growth, enjoy the benefits of economies of scale due to the increased size of the market.

10 As the export data is volatile, an average for two years 1995–1996 and 2003–2004 has been used. Because data is unavailable the countries that have been included are India, Bangladesh, Sri Lanka and Pakistan. Export data for Pakistan is not available for the years 1995 and 1996, and has therefore been estimated from the imports of various countries. Regional orientation has been studied at two digit HS Code level.

The Index (ROI) is defined as, $ROI_j = (x_{ij}/X_r) / (x_{oj}/X_o)$ where, (x_{ij}/X_r) is the share of product j in intra-regional exports and (x_{oj}/X_o) is its share in exports to the world. An index value above unity indicates a concentration of exports to the regional markets. While the index does not provide much useful information when observed at a single point in time, its development over time may reveal interesting information about changes in trade patterns.

orientation exhibit RCA[11] less than one, regional integration has helped South Asian firms to expand production in sectors where they would otherwise have been unable to compete in the world. Resource-based or agricultural products appear to have increased their regional orientation, with some manufacturing products also showing higher regional concentration. Though there is some increase in textiles, regional orientation has not increased in very many products in the category, namely in HS Code 50 to 63. This could be because of their inclusion in the sensitive lists of all the member countries. The increase in chemicals could be because in the first three rounds of negotiations under SAPTA most of the concessions offered were in chemicals, textiles, machinery and chemical appliances. Increasing regional orientation in at least some sectors demonstrates that SAFTA, despite its several limitations discussed below, is beginning to change firms' behavior and making them gradually more oriented towards regional markets. With greater flow of cross border investment and improvement in conditions affecting regional trade, this regional orientation is bound to increase in future.

Table 5: Regional Orientation and Revealed Comparative Advantage Indexes

HS Code	Description	ROI_95	ROI_04	RCA_95
27	Mineral fuels, oils, distillation products, etc	1.25	2.16	0.24
15	Animal, vegetable fats and oils, cleavage products, etc	0.60	4.69	1.03
29	Organic chemicals	0.54	1.10	0.72
73	Articles of iron or steel	0.84	1.38	0.61
39	Plastics and articles thereof	0.94	1.30	0.34
33	Essential oils, perfumes, cosmetics, toiletries	0.78	1.81	0.58
54	Manmade filaments	0.58	1.02	2.13
7	Edible vegetables and certain roots and tubers	4.79	7.14	0.85
38	Miscellaneous chemical products	0.71	0.78	0.51
23	Residues, wastes of food industry, animal fodder	0.92	3.10	3.67
28	Inorganic chemicals, precious metal compound, isotopes	1.65	1.86	0.65
85	Electrical, electronic equipment	1.12	1.18	0.14
26	Ores, slag and ash	0.26	0.16	2.99
76	Aluminum and articles thereof	2.52	2.20	0.31
19	Cereal, flour, starch, milk preparations and products	4.37	3.60	0.24
72	Iron and steel	2.23	1.22	0.71
30	Pharmaceutical products	1.71	1.26	1.08
12	Oil seed, fruits, grain, seed, fruit, etc, nes	1.10	1.29	1.43
55	Manmade staple fibers	0.70	1.16	3.05
49	Printed books, newspapers, pictures etc	3.43	2.37	0.19
63	Other made textile articles, sets, worn clothing etc	0.13	0.08	11.86

[11] Revealed Comparative Advantage (RCA) has been calculated for 1995. (RCA) measures a country's/region's comparative advantage in a product and is estimated by, RCAi = (Xi, S. Asia/ΣX S. Asia) / (Xi, World/ΣX World). Where: RCAi = Revealed Comparative Advantage for good i. Xi, S. Asia= exports of good i by S. Asia ΣX S. Asia = total exports by S. Asia Xi, World = world exports of good i ΣX World = total world exports If RCAi > 1, then S. Asia has a comparative advantage in good i. If RCAi < 1, then S. Asia has a comparative disadvantage in good i.

Table 5 *continued*

HS Code	Description	ROI_95	ROI_04	RCA_95
25	Salt, sulphur, earth, stone, plaster, lime and cement	4.46	3.11	2.00
69	Ceramic products	1.54	1.60	0.60
84	Nuclear reactors, boilers, machinery, etc	1.91	1.08	0.14
70	Glass and glassware	2.80	1.54	0.34
10	Cereals	4.28	3.65	3.91
87	Vehicles other than railway, tramway	3.92	2.61	0.21
9	Coffee, tea, mate and spices	0.82	1.14	9.68
34	Soaps, lubricants, waxes, candles, modeling pastes	4.87	3.69	0.32
53	Vegetable textile fibres nes, paper yarn, woven fabric	1.41	1.84	14.96
48	Paper & paperboard, articles of pulp, paper and board	7.01	3.49	0.12
99	Commodities not elsewhere specified	0.73	0.81	0.51
8	Edible fruit, nuts, peel of citrus fruit, melons	1.81	1.64	2.12
32	Tanning, dyeing extracts, tannins, pigments etc	1.72	1.29	1.22
71	Pearls, precious stones, metals, coins, etc	0.02	0.01	6.95
40	Rubber and articles thereof	2.40	1.59	1.10

Source: Calculated from PCTAS data.

3.2 Trends in FDI

World FDI flows have grown at an annual average rate of 21.2%.[12] South Asian governments recognize the benefits from FDI and all of them have liberalized the conditions governing FDI inflows. This is reflected in FDI inflows to South Asia which increased by nearly 8 times between 1996 and 2006 (Table 6).

However, the effect of regional integration of South Asian countries seems to have been insignificant on FDI, with the share of South Asia in world FDI remaining less than 2% of world FDI inflows, despite doubling in 2006. Moreover, there does not appear to be any significant increase in intra-regional FDI flows despite the emergence of a number of multinational corporations (MNC) from within the region, especially from India.

Table 7 presents the inflow of FDI by country over the period 1996–2006. India saw an increase in cross border mergers and acquisitions in the telecommunications, business process outsourcing, and pharmaceutical industries, while the improved investment environment and the privatization of assets in Pakistan and Bangladesh contributed to increased FDI inflows to those countries. However there have been variations. All the countries in the South Asian region except India have received very negligible FDI inflows. The dominance of India in FDI in South Asia is largely due to the size of its economy. But if we look at per capita FDI, then even if India accounted for 75% of the South Asia's inflows (2006), it fares no better than Bangladesh, while Pakistan and Sri Lanka have done better.

[12] FDI flows to developed countries have typically been much higher. The top two FDI destination regions have been the European Union and the US, with shares of world total FDI flows of 41% and 13% respectively.

One of the reasons behind poor FDI flow in South Asia, it has been argued, is the relatively small size of individual country markets and the relative failure of regional integration efforts in unifying these markets by removing border and behind-the-border impediments and weaknesses. Studies have also shown that a country's business environment and institutional quality are equally if not more important for FDI than low wages or concessions for investments etc. However, the countries of South Asia are considered among the least competitive in the world. The global competitiveness index which ranks countries on a broad range of indicators such as institutions, macroeconomics, infrastructure, business sophistication and innovations ranked these countries, except India (50), near the bottom in the set of 137 countries that were considered. Bangladesh is at 111, Nepal at 126, Pakistan 104, and Sri Lanka 80. Political interference and corruption combine to make this a high risk region for potential investors. Other problems include, FDI regimes not matching international best practices, trade regimes still biased against exports, high transaction costs, and the presence of non-transparent procedures and bureaucratic delays (Irwin 2003).

Table 6: Share in World FDI of Selected Regions and South Asia

Year	EU	USA	PRC	ASEAN	S. Asia	World	EU	USA	PRC	ASEAN	S. Asia
	$ million						Share in World FDI (%)				
1996	124811	84455	41726	30490	3359	392743	31.78	21.50	10.62	7.76	0.86
1997	142400	103398	45257	34307	5371	489243	29.11	21.13	9.25	7.01	1.10
1998	281000	174434	45463	22276	3889	709303	39.62	24.59	6.41	3.14	0.55
1999	502636	283376	40319	28766	3234	1098896	45.74	25.79	3.67	2.62	0.29
2000	695277	314007	40715	23540	4658	1411366	49.26	22.25	2.88	1.67	0.33
2001	381558	159461	46878	20729	6415	832567	45.83	19.15	5.63	2.49	0.77
2002	307345	74457	52743	18024	6984	621995	49.41	11.97	8.48	2.90	1.12
2003	256707	53146	53505	24491	5469	564078	45.51	9.42	9.49	4.34	0.97
2004	204245	135826	60630	35245	7601	742143	27.52	18.30	8.17	4.75	1.02
2005	486409	101025	72406	41071	9866	945795	51.43	10.68	7.66	4.34	1.04
2006	530976	175394	69468	51483	22274	1305852	40.66	13.43	5.32	3.94	1.71

PRC = People's Republic of China.
Source: UNCTAD.

The manufacturing sector in Pakistan, especially the all-important textile sector, has received hardly any FDI inflows. In Bangladesh too, non-tradable sectors such as transport, and the telecommunication sector have attracted the largest share of FDI (see Appendix II).[13] It is clear that these countries have to make an effort to attract FDI in their

[13] See www.iptu.co.uk/content/srilanka_investment.asp#FDI

export sectors and these efforts could be profitably focused on emerging MNCs from within the region. This will increase the competitiveness of the region, step up overall FDI, and increase the share of the region in world FDI flows.

Table 7: FDI Inflows in South Asia ($ Million)

Year	S. Asia	Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
1996	3359	1	232	1	2525	9	19	439	133
1997	5371	-1	575	-1	3619	11	23	711	433
1998	3889	0	576	-	2633	12	12	506	150
1999	3234	6	309	1	2168	12	4	532	201
2000	4658	0	579	0	3585	13	0	309	173
2001	6415	1	355	0	5472	12	21	383	172
2002	6984	1	328	2	5627	12	-6	823	197
2003	5469	2	350	3	4323	14	15	534	229
2004	7601	1	460	3	5771	15	0	1118	233
2005	9866	4	692	9	6676	9	2	2201	272
2006	22274	2	625	6	16881	14	-7	4273	480
Cumulative	79119	15	5082	25	59280	133	83	11829	2672

Source: UNCTAD.

While extra regional FDI has been far greater than intra-regional investments, intra-regional investments seem to be increasing. Most intra-regional FDI flows are from Indian firms (Table 8). However these flows are insignificant, accounting for only 1.5% of India's total outward FDI. Apart from a few resource-rich countries, Indian outward FDI has been generally directed towards developed economies and has been motivated by the market size as well as access to frontier and strategically needed technologies that will improve global competitiveness.

In Nepal and Bhutan, India is the predominant source of FDI. It has also emerged as the largest investor in Sri Lanka.[14]

Not only have the countries failed to attract ample FDI, they have also failed to attract FDI in their export sectors. This can be seen from the fact that the sectors receiving the most FDI in India are transport and electrical equipment rather than export-oriented

[14] The principal sectors in Sri Lanka which have attracted Indian investment are steel, cement, rubber products, tourism, computer software, IT-training and other professional services. Some of the Indian investments are Lanka Indian Oil Corporation, TATAs (Taj Hotels, VSNL, Watawala tea plantations) Apollo Hospitals, LIC , L & T (now Aditya Birla Group), Ambujas, Rediffusion, Ceat, Nicholas Piramal, Jet Airways, Sahara, Indian Airlines and Ashok Leyland. Indian Human Resources and Education Companies like ICFAI have also started entering the Sri Lankan market.

sectors such as gems and jewelry, pharmaceuticals, textiles, etc. Financial services, telecommunications and the energy sector have received the bulk of FDI in Pakistan.

Table 8: Intra-Regional FDI in South Asia (% of Country Total)

	India		Bangladesh		Pakistan		Nepal		Sri Lanka
	2001-03	2006-07	1995-96	2005-06	2001-05	2006-08	Up to2006	2006-07	2005
India			0.62	0.54	0.00	0.00	40.71	46.60	6.20
Bangladesh	…	…			0.05	0.10	0.75	…	0.18*
Pakistan	…	…	1.40	1.87			0.47	…	0.60*
Nepal	…	…	…	…	…	…			…
Sri Lanka	0.01	0.01	0.23	0.41	…	…	0.13	…	
Bhutan	…	…	0.01	…	…	…	0.01	…	…
Maldives	0.01	0.01	0.00	…	…	…	0.00	…	n.a.
Share of South Asia	0.02	0.02	2.25	2.82	0.06	0.10	41.80	46.60	7.00

Source: As in Aggarwal (2008).
… = Data not available. * pertain to the year 2000.

Indian investments in Bangladesh include the state-of-the-art modern hospital in Dhaka in collaboration with India's Apollo Group. Many Indian companies are also involved in the information technology and ready-made garments sector in Bangladesh. In what could be a trend setter, a French-owned cement project in northeast Bangladesh will source its limestone from across the border in Meghalaya. Over 100 Indian joint ventures currently operate in Nepal, accounting for 36-40% of its total FDI.[15]

There is great potential for intra-regional investment, especially in infrastructure. India, for instance, has invested in hydro projects in Bhutan and buys back the electricity, and has played an important role in infrastructure development in Nepal.[16] There is huge scope for further infrastructure investment in South Asia, both in cross-border and national projects. The countries will benefit immensely from development of a cross border highway network, which apparently used to exist even in the pre-British period and facilitated movement of goods and personnel all across the region from Kabul to Dhaka. This is now in severe disrepair and needs rehabilitation and expansion. Similarly, the creation of a regional transmission grid for electricity will promote the development of

[15] These joint ventures are in tourism, infrastructure, consumer durables and non-durables and export-oriented industries such as garments and carpets. A number of Indian companies, including Dabur, Hindustan Lever, Colgate, etc., have established their manufacturing base in Nepal with the objective to export their finished products to India.

[16] The Tribhuvan Airport at Kathmandu, roads from Kathmandu to Dakshinkali, Trishuli, Balaju, Godavari and Raxaul were built with Indian assistance. With the construction of bridges by Gammon India Ltd on the Kohalpur Mahakali sector of East West Highway, the Mahendra Raj Marg in Far Western Nepal has become operational even during monsoons and has opened up this part of Nepal bordering India to new possibilities in trade, investment and economic growth.

hydro-power in the North East and could even facilitate the transfer of surplus energy from Central Asian economies to South Asia. The benefits of greater transport, communication and energy connectivity cannot be captured in any quantitative exercise but are estimated to be very significant. The resource requirements for infrastructure development in South Asia are gigantic. In India alone, Planning Commission estimates put the resource requirement at $500 billion for the next five years to meet the needs of growing population and rapid urbanization. Regional cooperation can offer multilateral agencies and the private sector attractive investment opportunities in developing the physical infrastructure in the region.

However, the regional investment climate is far from satisfactory. At present, Pakistan and India do not permit cross border investments, ostensibly on security grounds. But this could change with the recent liberalization announced by the new Pakistan government, which has also enlarged the positive list for Indo-Pakistan trade. Some investment, like exports, from India nevertheless manages to reach Pakistan, as in the case of Dabur establishing facilities in Pakistan by 2008 from its subsidiary registered in Dubai. It is time that both countries remove restrictions on mutual investment as this will have significant, positive economy-wide impacts.

Though small, other members of the region are also finding bilateral investment opportunities. Bangladesh increased its investment in Pakistan in the last two years (Aggarwal, 2008). Sri Lanka is the largest investor in India from the region (Table 9). While Indian investment in the region goes to the manufacturing sector, Sri Lankan investment is concentrated mainly in the service sector.

Table 9: Country-wise Distribution of FDI Projects from SAARC Region in India

	SAARC countries	Sri Lanka	Bangladesh	Maldives	Nepal
1998-00	17	10	4	3	0
2001	7	7	-	-	0
2002	4	3	1	-	0
2003	3	3	-	-	0
2005	11	9	1	1	0
2006	7	7	0	0	0
2007	6	6	0	0	0

Source: Aggarwal (2008).

Political considerations have become an important factor holding back investment flows, not only between India and Pakistan but also between India and Bangladesh and India and Nepal. Tatas is a well-known example: it proposed an investment of $2 billion in Bangladesh in steel, fertilizer and power plants at terms that looked highly favorable to the host economy. But this has not moved forward despite the Bangladesh government being reportedly inclined favorably towards it. The bid by Indian construction and power project developer GMR Group to develop Nepal's 300 MW Upper Karnali hydropower plant through a joint venture with the state-owned utility, Nepal Electricity Authority, has also run into public and legal opposition. The important question on which further primary research needs to be undertaken is to understand the underlying causes for this political opposition to investment from Indian firms in neighboring countries and for examining if the security concerns that presently prevent cross border investments between India and Pakistan are justified. This would yield significant benefits because, as we have argued, in South Asia, as in other regions, trade expansion could well be premised upon higher investment activity.

4. Progress in Policy-Led Initiatives and Challenges for South Asia Trade and Investment Integration

SAARC was established in 1985 but it took a long time for the heads of its member governments to include a core area like trade in the organization's ambit. This happened when SAPTA was signed, which became operational in December 1995. The basic objective of SAPTA was to strengthen intra-regional economic cooperation and the development of South Asian economies. But once again the progress in trade liberalization and integration in South Asia was slow. The many reasons given for the low impact made by SAPTA in increasing intra-regional trade included long sensitive lists, low trade coverage, exclusion of most of the traded commodities, limited depth of tariff cuts, failure to deal with non-tariff issues and complex product specific rules of origin. The inability of the two largest economies in the region, India and Pakistan, to resolve their political tensions has also been a major stumbling block in achieving effective regional cooperation.

In 2004 SAFTA replaced SAPTA. The idea of creating SAFTA was first mooted in 1995. The Ninth SAARC Summit in 1997 created a twelve-member Group of Eminent Persons (GEP), which at the Tenth SAARC Summit in Colombo in 1998 submitted the report SAARC: Vision Beyond the Year 2000 envisioning economic union by 2020 in three stages. These included SAARC becoming a Free Trade Area by the year 2010, a Customs Union by 2015 and an Economic Union by 2020, with a Regional Investment Agreement to be concluded prior to the region becoming a free trade area. But due to the rapid deterioration in Indo-Pakistan relations (the Kargil War) the process was delayed. A commitment was made at the Eleventh SAARC Summit at Kathmandu in 2002 for the creation of a South Asian Economic Union (SAEU). Finally, at the Twelfth Summit at Islamabad in 2004, the Framework Agreement for a South Asia Free Trade Area was signed.

SAARC members ratified SAFTA with the objective of reducing tariffs for intraregional trade in goods among the SAARC member countries. SAFTA became operational in 2006. Under Article 7 of SAFTA, a phased tariff liberalization program is envisaged. In the first two years, non-LDCs are expected to bring down tariffs to 20%, while LDCs will bring them down to 30%. Non-LDCs will then bring down tariffs from 20% to 0–5% in the next five years, Sri Lanka (a non-LDC) in six years and LDCs (from 30% to 0–5%) in eight years. Moreover, non-LDCs will reduce their tariffs for LDC products to 0–5% in three years. Thus, SAFTA has provided for a ten-year time frame for phasing out tariffs beginning January 2006.[17]

Products that can qualify for SAFTA preferences are also subject to rules of origin, sensitive lists, balance of payments, and safeguard measures. As discussed above, the agreement also has provisions for special and differential treatment of LDCs such as longer time periods for tariff reduction, consideration for applying antidumping and/or countervailing measures, and others. The SAARC agreement refers to some additional measures that can be considered in future negotiations. These include harmonization of standards, reciprocal recognition of tests and accreditation of testing laboratories, simplification and harmonization of customs clearance, import licensing, registration and banking procedures and removal of barriers to intra-SAARC investment. With its scope principally on import tariffs and having left the non-tariff barriers and 'behind the border measures' to be negotiated in future, SAFTA represents a case of 'shallow integration' and commensurately low ambition. This is particularly so because SAFTA excluded services which constitute more than half of GDP in almost all member countries. This major omission is, however, being rectified with a decision at the last summit to explore the possibility of including services under SAFTA. As we have argued above, a shallow form of regional integration will not deliver the desired results in South Asia because an expansion in trade flows is premised upon the development of regional infrastructure and lowering of transactions costs and elimination of non-transparent procedures. SAARC must, in our view, create the conditions for a deeper form of integration that promotes cross border investment and encourages greater transactional transparency by simplifying the procedures and harmonizing standards, qualifications etc.

More recently, there has been agreement on establishing a South Asian university in Delhi and the project has already been initiated. The 2008 Colombo Summit saw progress also in other areas and, more importantly, a stronger overall recognition of the importance of regional cooperation and a greater degree of commitment for achieving it. This has been to some extent overshadowed by the tragic attacks in Mumbai in November 2008, but this further reinforces our earlier argument that regional cooperation needs to be pushed beyond the point where random shocks can derail the process.

SAFTA in its present form and with its long timelines, therefore, represents an unsatisfactory agreement.[18] We also expect that without a concerted and sustained push from all member countries, SAFTA goals will not be achieved. There are several reasons for which SAFTA's implementation is not simply a routine affair and requires on-going commitment from all concerned including the SAARC secretariat:

- Pakistan has ratified SAFTA but needs to shift to a negative list for its trade with India. The sooner it can afford MFN treatment to India the better, as this is an

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[17] Prior to the Fourteenth SAARC Summit in New Delhi in April 2007, India announced its decision to allow duty free access from all LDCs including from South Asia. This became effective from January 2008 and represents a significant unilateral action.

[18] Please also see Dubey Muchkund (2008) where he argues on similar lines and calls for a revision of the agreement so that it better represents the goals set by the Group of Eminent Persons and also has timelines that will keep the momentum and not allow vested interests to derail the process of regional integration in the long-term between different stages.

unnecessary irritation in the relations between the two countries. It is also ineffective as Indian exports find their way into Pakistan in any case, but their prices are higher as they have to be routed through other transit destinations such as Dubai.[19] Under SAFTA trade between non-LDC member countries should be liberalized by 2013, but judging by the present situation, this will not happen between India and Pakistan, to the detriment of regional cooperation in South Asia. This anomalous position between the two largest economies in South Asia not only reduces the value of any trade agreement in the region, but also vitiates the overall environment for pushing cooperation forward. In addition, it gives all those opposed to regional integration the best reason for not moving ahead and to cite this as the basis for continuing to distrust Pakistan's commitment to regional integration. Civil society within Pakistan and all those seriously supportive of South Asian regional integration should now work to change Pakistan's ill conceived stand. This puts it not only in opposition to the spirit of SAFTA but also violates its commitments under the WTO. Such blatant disregard for regional and international commitments should not be allowed to continue.

• The time frame (by the year 2016) to reduce the tariffs to 0% is too long as by then tariff reduction to even lower level may have come about from multilateral trade negotiations and under bilateral free trade agreements between South Asian countries.[20]

• The sensitive lists are too large.[21] In Bangladesh it includes 1,249 items for least developed countries (LDCs) and 1,254 for non-LDCs, while India's includes 763 items on its sensitive lists for imports from LDCs and 884 for non-LDCs. Similarly Pakistan's sensitive list includes 1,183 products, Nepal 1,210 products, Sri Lanka 1,065 items, Bhutan 157 and the Maldives includes 671 items. These sensitive lists apply to nearly 53% of current intra-SAARC imports.[22] India's negative list covers even a larger proportion of its imports from these countries and is larger than what India has offered under the India Sri Lanka FTA and around three times larger than its latest offer under the FTA with ASEAN, which is in an advanced stage of negotiations.[23]

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[19] So while Pakistan has notified tariff concessions on imports of 4,872 items from other member countries, imports from India remain restricted to the items on their positive list of 773 items, recently enlarged to 1,075 products.

[20] For example under the India-Sri Lanka Free Trade Agreement (ISLFTA) India is expected to eliminate tariffs by 2003 and Sri Lanka by 2008. India already completed its tariff liberalization program on March 18, 2003, thereby granting duty free status on 81% of all items. On the other hand, Sri Lanka is expected to complete its trade liberalization program by 2008, which would result in duty-free status to India on 77% of all items.

[21] These lists include products at six digit HS line, sub sectors.

[22] SAFTA has been notified under Article XXIV of GATT which allows countries to grant special treatment to one another by establishing a free trade association provided that duties and other trade restrictions would be "eliminated on substantially all the trade" among the participants.

[23] For example, less than 14% of Sri Lanka's exports are covered by the Indian sensitive list under the Indo-Sri Lanka FTA, but nearly 42% of Sri Lanka's exports are covered in the Indian sensitive list under the SAFTA Agreement (Dubey 2007, 2008). India's sensitive list includes Chapters 61 & 62 of garments

• There is no binding commitment to reduce or remove the lists, though the agreement does talk about review of the sensitive list every four years.

• Members are free to have bilateral agreements that include deeper tariff cuts and cover larger number of sectors, including sometimes service sectors. The non-application clause in SAFTA allows that concessions negotiated bilaterally or multilaterally need not be extended to other SAARC members. While these provisions are welcome, they pose the danger of making SAFTA redundant. Members should consider a region wide MFN which will make bilateral concessions applicable to all SAARC members.

• Technical assistance in SAFTA, designed to assist LDCs in building their negotiating and trading capacities, is in the nature of 'best endeavor clause' without any binding commitments. Members may reconsider this clause and at least encourage special technical assistance programs with assistance from multilateral institutions.

• There is no time frame under SAFTA for removing Non Tariff Barriers (NTBs). However, the recent agreement at the Delhi Summit to identify NTBs and hopefully reduce and eventually remove them is a welcome step forward. So is the establishment of the SAARC Standards Coordination Board, which would function as a precursor to the SAARC Regional Standards Body for achieving uniform quality standardization within the region.[24]

• Poor trade facilitation procedures and the consequent high transactions costs also add to NTBs. According to a World Bank study the costs of trading across borders in South Asia are among the highest in the world. Land border crossings, the main gateways to countries in the region, introduce significant delays and costs and, worse still, introduce unreliability of supply chains that pass through them. Das and Pohit (2005) estimate that the delay in a single shipment from India to Bangladesh is four days.[25] Efforts to improve their performance generally require changes in procedures rather than additional infrastructure (Arnold 2007). In a more recent paper Roy (2008) provides a comprehensive list of measures to improve trade facilitation and reduce the cost of cross border trade in the region. These should be on the agenda for joint action by SAARC member countries and by India in particular as the only country with common borders with all SAARC members.

SAFTA's weaknesses make it clear that SAARC could benefit from looking at the relatively successful East and Southeast Asian experiences in regional cooperation.

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and hence blocks a large proportion of Bangladeshi exports to India, while Bangladesh's sensitive list has yarn and blocks Indian exporters of these goods. Pakistan has placed the principal export items of Bangladesh namely, jute, fabrics, woven and knitted garments, special woven fabrics, footwear and textiles on their sensitive list. Pakistan's sensitive list for India includes automobiles, auto-parts, and textile machinery etc.

[24] The main focus of the Board will be industries related to food, textile and chemicals.

[25] The maximum loss of time occurs in parking, customs clearances, and crossing the border (78 hours), followed by unloading at Benapole (nine hours). Therefore on average an Indian exporter incurs an auxiliary transaction cost of about 10 per cent of shipment value.

These countries were also at a similar level of economic development when they initiated their regional integration efforts. So their experience can have relevance for South Asian economies. In a recent paper Chandra and Kumar (2007) address this issue and list a number of lessons that can be drawn from the East Asian experience. Briefly summarizing them, these are:

(i) Most importantly, South Asian leadership should give primacy to economic issues and not allow political differences to stand in the way of regional cooperation;[26]

(ii) South Asia would do well to adopt the open regional approach followed in East Asia. South Asia followed inward-looking policies for a long time, and has been a latecomer to the concept of regional cooperation. And this inward-looking mind-set is still visible in the region's approach to regionalism. As discussed above, the SAFTA accord is characterized by large negative lists, a limited number of products for tariff concessions, restrictive rules of origin, exclusion of services, and exclusion of issues such as para-tariffs and non-tariff barriers. This should change in favor of greater openness. East Asian economies have shown that bilateral and regional trade arrangements do not act as stumbling blocs for promoting multilateral trading negotiations. Therefore, South Asian governments should not view the process of bilateral or regional FTAs as inimical to the process of multilateral trade liberalization. However, Plummer's ten point agenda should guide the design of any bilateral or regional FTAs so that these are of high quality and remain consistent with open regionalism. (Plummer 2006a);[27]

(iii) In the literature, interstate distribution of power is identified as critical to the process of regional integration (Webber and Fort 2006). For example, some authors give a key role to hegemonic or dominant powers in providing a focal point around which policy coordination can take place and financial resources for more equitable distribution of gains could be provided (for example,,Maatli 1999). In the case of Europe, France and Germany have provided this focal point. As Taneja and Sawhney (2007) and Kumar (2008) suggest, India should now take the lead in revitalizing SAARC. Sawhney and Kumar (2006) discuss at length the reasons for

[26] Within the ASEAN and in the larger ASBAN + 3 arrangements, there have been periods of significant political differences between member countries. These differences for example, between Malaysia and Singapore, Thailand and Myanmar, China and Japan, etc. have not been allowed by political leadership in East Asia to stall the process of economic cooperation.

[27] Plummer's ten point blue print includes: (1) Comprehensive coverage of goods within a reasonable period of 10 years; (2) Comprehensive coverage of services within a reasonable period; (3) Rules of origin should be symmetrical and as low as possible; (4) To the extent possible, customs procedures should follow global best practices and WTO consistent protocols; (5) Intellectual Property Rights guidelines should be non-discriminatory and consistent with Trade-Related Aspects of Intellectual Property Rights (TRIPS) and other international conventions; (6) FDI related provisions should embrace national treatment, non-discrimination, shun performance requirements, and have a highly-inclusive negative list, as well as provide the usual protection necessary for foreign investors; (7) Anti-dumping procedures and dispute resolution need to be transparent and fair, and the process needs to be well specified and effective; (8) Government procurement should be open and as non-discriminatory as possible, and procedures should be clear and as open as possible; (9) Policies related to competition should create a "level playing field" for residents and partners, and they should not put non-partner competition at a disadvantage; (10) Technical barriers to trade should be kept to a minimum, with clear and transparent mechanisms for determination of standards.

which India should more proactively support SAARC and economic cooperation in the region;[28]

(iv) SAARC should adopt ASEAN pragmatism and not let domestic issues interfere with the progress of regional cooperation. This stance has facilitated the entry of former communist states like, Cambodia, the Lao People's Democratic Republic, and Viet Nam, as well as Myanmar (Nesadurai 2006).

(v) Like ASEAN, but at an informal level, a South Asian Finance Ministers' (FM) process has been established with help from the ADB. This should be formalized under the SAARC framework and further strengthened. This will contribute to a better appreciation of existing macroeconomic inter-linkages and initiate some coordination of these policies.

(vi) A South Asian Commerce Ministers' forum could also be established with the aim of fostering greater trade integration and ensuring the follow up of decision taken in SAARC summits;

(vii) SAARC members could also think of establishing a regional liquidity arrangement to guard against any future liquidity crisis, with India taking the lead with its large foreign exchange reserves. In this regard, a SAARC+4[29] FMs process, similar to ASEAN+3 FMs process, can be established. This will become the starting point of an interaction between South Asia and East Asia that will contribute to the movement towards an Asian Economic Community. It may be worth mentioning that the process of regional integration in South Asia will be facilitated if it is undertaken as a part of a broader project of pan-Asian cooperation;

(viii) Finally, it is important to note that ASEAN members did not try to establish competing or overlapping regional formations even during times when progress in ASEAN was slow. Formations like Asia-Pacific Economic Cooperation (APEC) which had a much larger membership and broader objectives were allowed to come up but without diluting the commitment to take ASEAN forward. In South Asia, this is not the case. Several alternative and overlapping and competing regional formations have emerged to which SAARC member countries are often seen to be giving greater precedence. BIMSTEC (Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation) and the Indian Ocean Rim have very similar membership, though in both cases the membership goes beyond South Asia. Moreover, Afghanistan is a member of CAREC (Central Asia Regional Economic Cooperation) and both Afghanistan and Pakistan are members of the ECO (Economic Cooperation

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28 Some important measures that India could take in this regard are: (i) reducing its negative list to a maximum of 5% of total imports of buy value; (ii) removing specific duties on textile, fabrics and readymade garments; (iii) rationalizing tariffs that include domestic central taxes and levies and interstate taxes on imports; (iv) reducing transaction costs at the borders; (v) removing ports specific entry conditions; and (vi) improving and simplifying regulatory conditions and testing facilities for technical barriers to trade and sanitary and phytosanitary standards.

29 The "plus 4" here can be the People's Republic of China, Japan and the Republic of Korea and ASEAN which would be represented by the country that may be holding the Chairmanship of ASEAN in that year.

Organization) initiative that bring them together with other Central Asian republics. There is also the SASEC (South Asia Sub-regional Economic Cooperation). Two of these formations, BIMSTEC and SASEC were established quite clearly to circumvent the lack any progress in relations between India and Pakistan that held back any progress in SAARC projects. The underlying premise for both BIMSTEC and SASEC was that regional cooperation among countries without Pakistan will make more rapid progress. The results so far do not seem to endorse this assumption. But more research needs to be done before the inevitable conclusion is reached that it is not merely the state of Indo-Pakistan relations which holds back regional cooperation in South Asia.

Our view is that proliferation of regional formations confuses members and dissipates the rather limited capacity that these countries have for such regional efforts. It is quite clear that very limited if any progress can be made in regional integration in South Asia without the two largest economies coming together and recognizing the benefits from such cooperation. It is therefore suggested that much greater attention and resources be directed by all concerned to making SAARC a success and not trying to bypass the issue of the centrality of improving Indo-Pakistan relations in any effort to take regional integration forward in South Asia.

5. Prospects and Strategic Direction in South Asian Regional Integration

It is clear from the discussion above that initiatives taken so far on expanding trade flows within SAARC have not been so successful. Intra-SAARC trade remains a small proportion of the region's total trade. Institutions remain weak and not able to push regional integration forward to a level commensurate with potential. Regional agreements like SAFTA are beset with problems and have the danger of lagging behind ground realities that can change quite rapidly. There is no doubt that some progress was made in the last three summits, but it can hardly be argued that this has taken the region much further in either building trust-based relationships or putting up institutions or structures which have the necessary incentives or motivation to push regional integration forward. If, as we have argued above, regional integration in South Asia has the potential to generate significant benefits for its member economies, some conditions need to be fulfilled and priorities established. We address these issues in this section.

The first condition is for India to further reaffirm its commitment to SAARC and take a far more proactive role in ensuring its progress. This stance has to be maintained despite the periodic strong provocations that happen in the form of attacks by extremists of different hues like the one that occurred in Mumbai in November 2008. There appears to be a pattern to these attacks as they are timed to disrupt the progress in bilateral relations and in regional cooperation. It is important to repeat this because there is still not unanimity in the policy making and policy influencing circles in India on this issue. Moreover, any forward movement towards a greater appreciation of the benefits of regional cooperation receives a severe setback from random shocks and makes it important to reiterate this central message of persisting with efforts for cooperation.

There are several reasons for the lack of unanimity among Indian policy makers on the need to promote regional cooperation in South Asia. These are, first, a perception that a more regionally integrated space with effectively open borders will exacerbate security problems. This sentiment has become stronger in recent years with increasing evidence of anti-Indian and extremist elements finding succor and support in some neighboring countries. Second, there is also a perception that the region is simply too small for India to spend its political and economic negotiating capital, particularly in view of the somewhat intransigent stance in some countries, such as Pakistan, which refuse to afford India even the WTO-mandated MFN status. Thus, all effort in promoting SAARC seems to be wasted. However, India cannot also be seen to support a breakdown of SAARC. Thus, the grouping was, until recently, treated as a case of an 'unavoidable sunk cost.' Third, with the trend toward bilateral agreements that are deeper and broader in their coverage now gaining ground, combined with the slow progress of regional agreements, there is clear incentive to put more resources in finalizing the bilateral agreements. India already has bilateral FTAs with Bhutan, Nepal and Sri Lanka. With Pakistan in any case not playing the SAFTA game, and Maldives being relatively unconnected with South Asia in both geographic and economic terms, there is a case to be made for not pushing SAARC and its related agencies and institutions too actively and waiting for it to take its own meandering course.

There is no doubt some merit in each of these arguments. But as it has been argued, the benefits for India from actively taking the SAARC process forward far outweigh any costs or potential negative outcomes.[30] The most compelling reasons for India to take a pro-active role in support of SAARC are: first, India can hardly expect to play its due role on the global stage with a neighborhood that is unstable, insecure and a locus of militant and extremist activity. It will be also good for India's international role to ensure that it is seen to lead a regionally integrated and prosperous South Asia where its neighbors pull together with it on regional and global issues. Second, some of the most crucial issues, such as climate change, HIV/AIDS, migration, hydropower and water management, cannot simply be addressed on bilateral terms and have to be tackled regionally. Third, India's lagging regions are concentrated on its borders and are today concentrations of poverty and militancy. The situation in these lagging border regions can be changed only with regional cooperation. Finally, India's ethnically diverse, pluralistic, and heterogeneous social structure will be better sustained in tandem and collaboration with its counterparts across the borders rather than in forced isolation from them. This is true of several nationalities that straddle the present borders such as the Kashmiris, Punjabis, Sindhis, Tamils, Bengalis, Madhesis, including the Tharus (which are found in the Terai region on both sides of the Indo-Nepal border), and several groups which have their compatriots across borders in either Bangladesh or Myanmar. For these reasons and others that are detailed in Kumar (2008), a successful SAARC emerges to be an imperative for India's own sustainable and inclusive development.

The second necessary condition for pushing forward regional integration in South Asia is for India to press ahead and further strengthen its evolving stance of unilateral concessions and pro-active pursuit of tangible objectives. A number of working and sector groups have been established under the SAARC framework. But there is not

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[30] See (see Sawhney and Kumar 2007) and Kumar (2008) for a detailed discussion on this issue.

much to show in terms of achievements and successes from these efforts. This can change if India decides to pursue a select set of initiatives so that the stated objectives and goals are achieved. Thus, for example, the issue of lower tariff rates for telecommunication services within the SAARC area has been on the agenda for almost a decade, as has been the proposal for establishing direct links among all SAARC capitals. There is merit in both these proposals as they will generate positive externalities in support of regional integration. India, along with other willing partners, that could include observers to SAARC, can decide to pursue these initiatives and also bear any financial costs for compensating potential losers. India has to play a similar role in South Asian regional integration as was done by Germany in Europe, the US in NAFTA and the PRC in the Greater Mekong Subregion and CAREC. As the large and dominant partner, it can expect to reap the maximum benefits and so should also be prepared to shoulder the efforts and costs of achieving an integrated economic space in South Asia.

Third, the SAARC secretariat needs significant reinforcement and professionalization. A beginning in this direction is reportedly being made after all these years. This is important because a central organization can design new initiatives that follow up others that have been started. One of SAARC's weaknesses is its lack of 'champions' for its work program. Thus, a number of good ideas and projects remain on the drawing board. Ideally of course these champions would come from member country governments. In the absence of such a group, however, the SAARC secretariat would have to play this role. Therefore, it is important that the senior staff of the secretariat is composed of specially selected professionals who have the commitment and motivation to push regional integration forward. Their effort is crucial to better appreciation in the region of the benefits of regional integration and to identifying the 'low hanging fruits' which will demonstrate the tangible benefits from regional cooperation.

Fourth, SAARC member countries must agree to focus attention now on improving trade facilitation at the borders. As Roy and Banerjee(2008) point out, this is eminently doable and yields significant benefits to all concerned. This is reinforced by Wilson and Otsuki (2007), who estimate that if South Asia acts collectively to raise capacity in trade facilitation, the total estimated gain from capacity building would be about $2.6 billion, a 60% rise in total formal intra-regional trade in South Asia.

Fifth, the poor state of infrastructure in South Asia is a major constraint on the expansion of intra-regional trade flows. It has been estimated that capacity building in information technology and services infrastructure, reflected in expanded internet access and use, would lead to the greatest gains to intra-regional trade, while capacity building in port (air and maritime) efficiency would achieve the second largest trade gains. Not only this, unilateral capacity building in the region would increase trade with the rest of the world by about $27 billion. This represents about 32% of the region's trade with the rest of the world. Also, 87% of the total gains to South Asia will be generated from South Asia's own moves to upgrade infrastructure in ports and information technology, harmonize regulations, and improve customs. Infrastructure development, within individual countries but preferably in projects that improve regional connectivity, will enhance prospects for regional cooperation. The continued emphasis on infrastructure developments by bilateral and multilateral agencies is therefore welcome.

Sixth, the lack of progress in SAARC can also be attributed to exaggerated perceptions of security threats. This has worsened since the 9/11 attacks in the US. This is especially relevant for India, which has been the target of extremist activity both by religious fundamentalists and other forms of militancy. The immediate and direct consequence of this security perception is a rise in mutual mistrust and lack of progress in liberalizing cross border movement of people and goods. Given that security is essentially a national issue, individual countries will have to determine their own level of comfort. For India, which understandably has the highest threat perception and potential, it is perhaps time to undertake a thorough review of its security threats that emerge from its neighboring countries and present the results to other SAARC members. The neighbors must understand that India's perception of security threats is based on experience and intelligence and is real. They would do well to cooperate with India in containing them. It is quite clear from recent experience within the region and outside that it is in every country's interest to not encourage, either explicitly or implicitly, any form of militancy and extremist behavior. This is like riding a tiger and militancy comes back to haunt even the supporter at a later date. Therefore, it is of utmost importance that the SAARC Convention on Terrorism is operationalized and given the resources needed for region-wide steps to give it teeth and a clear mandate.

Seventh, with Bangladesh, Nepal, and Pakistan having recently joined the ranks of democratic polities, all SAARC member countries will have democratically elected governments. This is an important characteristic for selecting the modalities for pushing forward the agenda for regional integration. Progress can hardly be expected to come 'top down' as in the case of a majority of ASEAN member countries. Instead progress, if any, will happen if there is popular support for regional integration at the ground level and this is communicated effectively to the leadership in each country. In fact recent experience perhaps demonstrates that 'political and executive establishments' in all SAARC member countries are prone to capture by sectional interests and are therefore unable to take the bigger view of the benefits of regional cooperation. More worrisome is the often heard argument in civil society forums in several capitals in South Asian countries that bureaucracies in some may be implicitly opposed to greater regional cooperation and intra-regional liberalization because they see it as eroding their power and in some cases also their capacity to capture rents. This makes them willing partners of the local industry (especially the manufacturing and trading classes) who see intra-regional liberalization as resulting in an encroachment on their protected economic space. Thus, in every SAARC member country there can exist a nexus of interests against further progress in regional cooperation. The somewhat tardy progress in SAARC can be seen as being due to this nexus, which most often is referred to in the literature as 'lack of political will' in these countries for regional integration.

This can be changed only by a concerted and coordinated action on part of the other stakeholders who either expect to gain from regional integration or those who recognize the significant benefits emerging from it. These would include consumers, competitive industry, policy think tanks and the media. Major countries external to the region that have recently joined as observers in SAARC would support regional integration as the most effective means to sustain rapid and inclusive growth, make the region less unstable, and reduce the potential for militancy. The multilateral development banks will promote regional integration in their attempt to develop the lagging regions, a number of which are in the border areas and to improve the state of regional public goods. Thus, the effort should be to bring together a coalition of these stakeholders in support of regional integration. In a democratic framework there is no other short cut but to establish such a coalition and give the widest publicity to its work and arguments.

The eighth recommendation is to give greater attention to and make more resources available to state/provincial governments in India that have borders with other countries. These will include some of India's most advanced states, such as the Punjab and Tamil Nadu bordering Pakistan and Sri Lanka respectively, and also some of the least developed states like those in the northeast bordering Bangladesh, Bhutan and Nepal, including provinces such as Uttar Pradesh and Bihar, which border Nepal. Others, such as Gujarat and Rajasthan are middle income states which border the Sind and the Punjab provinces of Pakistan. There are several reasons for which the border states may be more active and effective partners for regional cooperation in South Asia. First, in several cases the population in these border states share features with populations across borders drawn somewhat arbitrarily and, in some cases, divided populations that have a long common history and traditions. Second, in India's northeast, its landlocked nature will be transformed if regional cooperation allowed access to Bangladeshi ports. This will also benefit both Bhutan and Nepal because although these countries are allowed transit rights through India for goods destined to Bangladesh, the overall environment is not conducive to cooperative action. The rapid development of India's northeast and that of Nepal, Bhutan and the northern regions of Bangladesh can be facilitated through cross border cooperation between the Indian border states and their neighbors.

Finally, it is clear from a review of trade flows and also from extensive interviews of industrialists and experts that in South Asia, as also in East and Southeast Asia, greater of intra-regional trade volume will most likely follow greater cross-border investment flows. This effectively implies that real growth in intra-regional trade can be expected to come as intra-industry trade, which all over the world arises from the emergence of global or, in this case, regional production networks. This is premised directly upon an improvement in the investment climate in individual countries in the region and also as discussed above, by addressing infrastructure constraints at the border and for improving regional connectivity. Therefore, multilateral development banks and bilateral partners from outside the region should further emphasize the need for improving the investment climate in individual countries. Successful regional projects will themselves contribute to the improvement in the regional investment climate.

Conclusion

This paper has comprehensively reviewed the literature on the potential and prospects of regional integration in South Asia. This review, as an examination of the intra-SAARC trade and investment flows, also reveals that the progress in regional cooperation has been far short of potential. Yet the prospects for greater integration remain intact and these are recognized by external observers and also significant sections of people within South Asia.

The paper therefore tries to focus on the ‘real impediments’ to regional integration and on that basis makes a set of policy oriented recommendations for furthering regional cooperation in South Asia. These nine recommendations, in the previous section are directed towards not only the member countries in SAARC but also to the ‘observers’ in SAARC and the multilateral development agencies, both of which, in collaboration with civil society institutions and think tanks, can make an effective contribution to taking the process forward.

The three central arguments in the paper, as mentioned at the beginning, are: first, increased intra-regional trade will follow higher flows of cross-border investment and so greater effort should be directed to achieve the latter. Second, as the dominant partner in SAARC, India will have to accept disproportionately greater responsibilities in pushing forward the SAARC process. This will include a continuation and strengthening of the process of unilateral concessions that India has recently initiated in a clear admission that it will not demand reciprocity from its neighbors. However, we also argue that India’s unilateral approach cannot be continued indefinitely and its neighbors, particularly Pakistan and Bangladesh, will have to show some minimal progress in changing their current positions, which cannot be justified either on the basis of international agreements or bilateral benefits that visibly accrue from regional cooperation. Third, given the widespread support for regional cooperation in the civil society, academics, and sections of industry in each member country in SAARC, this is an opportune time for putting together a concerted and coordinated effort to overcome the remaining impediments to regional integration. Such an effort will surely take the process beyond the tipping point. The benefits that are subsequently generated will ensure that the virtuous cycle of increasing levels of regional cooperation in South Asia is then set in motion.

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Appendix I

Intra-regional Exports and Imports

Bangladesh

SITC	Exports	SITC	Imports
26	Textile fibres	65	Textile yarn/fabric/art
52	Inorganic chemicals	04	Cereals/cereal preparatn
65	Textile yarn/fabric/art	26	Textile fibres
07	Coffee/tea/cocoa/spices	78	Road vehicles
56	Manufactured fertilizers	67	Iron and steel

Source: Estimated from WITS Data. Notes: Data is for 2004.

India

SITC	Exports	SITC	Imports
33	Petroleum and products	65	Textile yarn/fabric/art
65	Textile yarn/fabric/art	68	Non-ferrous metals
06	Sugar/sugar prep/honey	33	Petroleum and products
78	Road vehicles	05	Vegetables and fruit
51	Organic chemicals	43	Animal/vegetable oils processed

Source: Estimated from WITS Data Notes: Data is for 2006.

Maldives

SITC	Exports	SITC	Imports
03	Fish/shellfish/etc.	27	Crude fertilizer/mineral
08	Animal feed excluding unmilled cereal	05	Vegetables and fruit
28	Metal ores/metal scrap	04	Cereals/cereal preparation
41	Animal oil/fat	89	Misc manufactures
57	Plastics in primary form	66	Non-metal mineral manufacture

Source: Estimated from WITS Data Notes: Data is for 2006.

Nepal

SITC	Exports	SITC	Imports
65	Textile yarn/fabric/art	33	Petroleum and products
43	Animal/veg oils processed	67	Iron and steel
55	Perfume/cosmetic/cleanser	65	Textile yarn/fabric/articles
67	Iron and steel	66	Non-metal mineral manufacture
84	Apparel/clothing/access	78	Road vehicles

Source: Estimated from WITS Data Notes: Data is for 2003.

Pakistan

SITC	Exports	SITC	Imports
33	Petroleum and products	06	Sugar/sugar prep/honey
65	Textile yarn/fabric/art	51	Organic chemicals
04	Cereals/cereal preparation	26	Textile fibres
43	Animal/vegetable oils processed	08	Animal feed ex unml cer.
66	Non-metal mineral manufacture	57	Plastics in primary form

Source: Estimated from WITS Data Notes: Data is for 2006.

Sri Lanka

SITC	Exports	SITC	Imports
68	Non-ferrous metals	78	Road vehicles
43	Animal/vegetable oils processed	33	Petroleum and products
07	Coffee/tea/cocoa/spices	65	Textile yarn/fabric/art
77	Electrical equipment	67	Iron and steel
69	Metal manufactures nes	68	Non-ferrous metals

Source: Estimated from WITS Data Notes: Data is for 2005.

Appendix II

FDI Inflow by Sectors

($ Million)

India	**2004**	**2005**	**2006**
Cement and Gypsum Products	0	452	243
Chemicals	198	447	206
Construction	152	151	985
Drugs and Pharmaceuticals	292	172	215
Electrical Equipment	721	1,451	2,733
Fuel	166	94	250
Food Processing	38	42	98
Services Sector	469	581	4,749
Telecommunications	129	680	521
Transportation	179	222	466

Source: South Asia Economic Report: FDI in South Asia. ADB, December 2007.

($ Million)

Pakistan	**2005**	**2006**	**2007**
Communications	518	1,938	1,899
Financial Business	269	329	930
Oil and Gas Explorations	194	313	545
Tobacco and Cigarettes	7	3	390
Power	73	321	205
Trade	52	118	173
Construction	43	90	157
Petroleum Refining	24	31	155
Beverages	6	6	89
Personal Services	24	62	84

Source: South Asia Economic Report: FDI in South Asia. ADB, December 2007.

($ Million)

Bangladesh	**2004**	**2005**	**2006**
Transport Storage & Comm.	127.5	279.9	347
Telecommunication	127.5	278.8	346.5
Power, Gas & Petroleum	124	208.3	208.2
Gas & Petroleum	93.7	181.1	187.2
Trade & Commerce	66.6	130.5	130.2
Banking	n.a.	117.8	117.7
Manufacturing	139.4	219.3	104.9
Textile & Wearing	37.7	96.5	70.1
Power	30.3	27.2	21.2
Cement	59.3	45.3	2.6
Agriculture & Fishing	1.7	1.7	1.3
Services	1.1	3	0.2

Source: Bangladesh Bank Enterprise Survey, 2006 and 2007.

($ Million)

Sri Lanka	**2003**	**2004**	**2005**	**2006**
1. Food Beverages & Tobacco	10.39	23.01	29.38	34.1
2. Textile, Wearing Apparel & Leather	22.1	26.82	47.28	103.48
3. Wood & Wood Products	6.35	0.35	0.92	4.39
4. Paper & Paper Prod., Printing & Publishing	0.79	0.09	8.16	0.76
5. Chemicals, Petroleum, Coal, Rubber & Plastics	14.8	8.85	20.14	43.15
6. Non-Metallic Mineral Products	8.63	51.74	5.9	5.27
7. Fabricated Metal, Machinery & Transport	10.51	3.6	15.34	14.08
8. Manufactured Products (N.E.S.)	6.89	8.14	8.22	29.54
9. Agriculture	-	-	0.47	0.67
10. Services/ Infrastructure	130.14	111.68	151.41	368.24

Source: www.unescap.org/tid/artnet/mtg/tipc_slnotes.pdf

Approved FDI Projects by Sub-sector (As of April 2007)

(in Rupees Million)

Nepal	No. of Projects	Total Project Cost	Foreign Investment
Manufacturing	522	39,513.60	13,815.30
Tourism	304	16,299.60	4,874.10
Service	331	18,323.20	9,104.60
Agro-based	15	440.1	101.8
Energy-based	19	19,814.30	3,432.50
Construction	23	1,186.90	691
Mineral	4	1,163.10	56
Total	1218	96,741.10	32,075.30

Source: www.unescap.org/tid/artnet/mtg/tipc_nepalnotes.pdf

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