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Core IV-B, Fourth Floor, India Habitat Centre, Lodhi Road, New Delhi-110 003, India.
Ph. 91-11-2468 2177-80, Fax: 91-11-2468 2173-74-75, Email: publication@ris.org.in
Website: <http://www.ris.org.in>, <http://www.newasiaforum.org>



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Ram Upendra Das

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Core IV-B, Fourth Floor, India Habitat Centre
Lodhi Road, New Delhi – 110 003 (India)

Tel: +91-11-2468 2177/2180; Fax: +91-11-2468 2173/74

Email: publication@ris.org.in

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Regional Economic Integration in South Asia: Prospects and Challenges

Ram Upendra Das*

Abstract: Realizing its importance, the South Asian region has also embarked upon various processes of regional economic integration. However, the South Asian regional integration process is fraught with difficulties, especially due to a lack of understanding about the very economics of regional economic integration. Thus, this paper dwells upon some of the conceptual issues pertaining to regional economic cooperation in general and specific to the South Asian region. It also documents the progress made in SAARC, the SAFTA trade liberalization and associated mechanisms alongside the nature of safeguards provided for. In this respect, developmental perspectives of safeguards are put forth. Some fresh insights on the status of SAARC trade integration process in a dynamic setting are also brought out. The paper also highlights the potentials for deeper economic integration in the region. The paper further illustrates some of the areas wherein project-based cooperation is feasible in the region. Finally, the paper makes an objective assessment of the regional integration process and identifies certain policy-induced and structural constraints that have important policy-implications.

I. INTRODUCTION

I.1 The Context

Recent global trends have been characterized by an increasing tendency to trade on preferential basis in a bilateral or regional grouping rather than on an MFN basis. Realizing the importance of intra-regional trade, the South Asian region has also embarked upon various processes of regional economic integration. This is evident from their increased economic engagements, bilaterally and regionally both with countries within the region and outside.

* Senior Fellow, RIS. Email: upendra@ris.org.in

However, the South Asian regional integration process is fraught with difficulties. Firstly, some difficulties arise because of a lack of clarity at the conceptual level regarding the prospects of economic integration in the region. Secondly, some policy-induced constraints limit the realization of fuller benefits of economic integration. Finally, these are compounded by some of the structural economic weaknesses within the region. In order to augment the level and scope of South Asian economic cooperation, all these need to be approached in an objective manner. Ultimately, such an exercise would help articulating adequate policy-responses to address these different levels of difficulties.

I.2 Structure of the Paper

Against this background, Section II dwells upon some of the conceptual issues pertaining to regional economic cooperation in general and specific to the South Asian region. To provide for the progress made in SAARC, the SAFTA trade liberalization and associated mechanisms are documented in Section II alongside the nature of safeguards provided for. In this respect a developmental perspectives of safeguards are put forth. Some fresh insights on the status of SAARC trade integration process in a dynamic setting are brought out in Section IV, along with highlighting the potentials for deeper economic integration in the region. However, an objective assessment of the regional integration process suggests that the progress has been less than desired. Consequently, policy-induced and structural constraints are laid down in Section V.

II. THE CONCEPTUAL BASIS

There is a sense of skepticism which prevails with respect to economic integration in the South Asian region. This emanates on account of various reasons that include a general apprehension about the concept of regionalism *per se* as opposed to ‘first-best’ solution of multilateral liberalization; perception about integration as one which would be trade-diverting and hence welfare-reducing; a lack of trade complementarities in the South Asian region due to similarities in production structures; asymmetric gains from integration with relatively bigger countries gaining more than the lesser developed ones, and lack of investible resources limiting any possibilities of investment cooperation, among others.

While some concerns could be valid in some specific respects, largely these apprehensions could be set aside by bringing about an element of conceptual clarity on them as aimed at in this Section in the paragraphs that follow. In so doing, some of the genuine and more pressing challenges confronting the region are not lost sight of and they have been dealt with in Section V.

II.1 Regionalism and Multilateralism

This has been a much-debated aspect in the present era of economic policy making and the debate had to some extent influenced adversely the will to deepen the South Asian economic integration process.

It has been contended that while ‘absolute’ protectionism is reduced as a result of the economic integration process, the ‘relative’ protectionism against the rest of the world increases and thus the processes of regionalism and multilateralism should not be considered as complementary (Elena et al 1999). Such an argument needs to be assessed from an alternative viewpoint for a clearer understanding.

It is suggested that as absolute protectionism is reduced in a regional framework, *ceteris paribus* the overall protectionism in the entire world (including the region under consideration) would have got reduced. Thus, reduction in protection in a particular region would contribute to the globalization and multilateral liberalization process in the sense of a ‘building block’. It is for this reason any argument about the effects of regional liberalization on multilateral liberalization, by excluding the region and comparing it with the rest of the world could be essentially flawed and misleading (see also RIS, 2002).

In addition, the experience gained by member countries from any regional economic integration process could help them to participate more effectively in the multilateral liberalization process. Regional economic integration provides them with the opportunities to experiment with negotiations pertaining to different dimensions of tariff cuts, sensitive lists etc. at a smaller scale and magnitude within the region. Therefore, their

preparedness to the multilateral liberalization process at a much larger scale is expected to get enhanced.

What is more, not only that the negotiating capacities increase due to experience gained at the regional level, the economies also gain in terms raised efficiency levels and competitiveness profiles achieved through regional cooperation. This may also be true of any adverse impacts that any member would have experienced due to regional trade liberalization, offering useful insights for their similar multilateral engagements.

Such a view-point suggests that regional economic integration could be complementary to the globalization and multilateral liberalization process and the South Asian economic integration needs to be approached with a rather balanced perspective. In this context, there are two additional arguments in favour of South Asian economic integration, as put forth below.

II.1.1 Adjustment Cost vs. Efficiency Concerns

In the South Asian context, there was a stage of development when trade liberalization was considered crucial for enhancing domestic efficiency-levels through import-competition. However, this posed the risk of a deindustrialization process in the country, as the domestic stakeholders needed some time for adjustment for withstanding import-competition. Thus, economic integration, especially in the region, provides for an avenue for balancing these seemingly conflicting objectives of addressing efficiency-concerns on one hand and providing a level playing field to stakeholders on the other - ensured through a phased transition towards a more competitive economic environment with some time for adjustment (Das, 2006 a). It is particularly important for the lesser developed countries in South Asia.

This is possible due to the very nature of regional economic integration initiatives. Any import liberalization is calibrated in terms of the choice of a country (or countries), sectors (sectoral coverage), timeframe for liberalization and depth of tariff-cuts. In this sense, it does not open up all sectors to all the countries at the same time. Moreover, import liberalization is done with reciprocity; hence on balance exports also get market access.

Moreover, such initiatives have in-built safeguards against any sudden deluge of imports.

II.1.2 Growth Convergence in RTAs

An important merit of RTAs that is being increasingly recognized is in terms of its impact on reducing growth divergences among members (Berthelon 2004). In the case of the EU it has been found that regional integration and financial support may have succeeded in reducing gap in economic growth trajectories between relatively more advanced and poorer members (Cappelen et al., 2000). One of the explanations to this effect is offered in terms of trade integration leading to a higher growth rate in the integrated area due to the spatial agglomeration of economic activities (Martin and Ottaviano, 1996). Further, owing to the concept of ‘economic geography’ (Krugman, 1991) the relation, between geography and the factors that affect it, is considered to be non-linear. One of the ways in which this comes about is due to the strong emphasis put by regional policies on the financing of public infrastructure in the region, which works through an effect on reducing transaction costs (Martin, 1997). In the South Asian context, a presence of growth convergence has been found by Das and Sambamurty (2006b), though it is difficult to give credit to the regional integration process alone for the entire effect.

II.2 Analyzing Trade Diversion

Mostly the debate on the net effects of RTAs has focused on whether a particular RTA is trade-creating or diverting. A broad conclusion that is emerging is that the numerous estimates from the gravity model generally support the contention that RTAs create trade (for a survey see Ghosh and Yamarik, 2004). However, trade diversion is largely viewed with a negative connotation.

The phenomenon of trade diversion occurs when it is assumed that the members of a regional grouping are not the lowest-cost producers. Due to preferential tariff concessions the members of a regional grouping acquire an advantage over the non-members in terms of lower product prices. A member country thus switches its imports from the more efficient rest of

the world producers to the lesser efficient and higher cost partner member countries, taking advantage of the liberalized tariff treatment. This results in resource misallocation and amounts to trade diversion. In this sense, the grouping may be an efficiency-reducing arrangement. This has remained as one of the most cited arguments against regional groupings since the work of Viner (1950) and subsequently Meade (1955) and Lipsey (1970).

There are various counter-arguments that need to be taken into account for any balanced understanding the issue. Firstly, whether a particular regional grouping would be efficiency/welfare-reducing or not, is essentially an empirical question. Members of a regional grouping cannot be simply assumed away as inefficient producers vis-à-vis the rest of the world. Second, a related issue is that it is the net effects of trade creation and diversion that need to be estimated for concluding whether the grouping would be welfare-enhancing or welfare-reducing.

Third, trade diversion need not necessarily be welfare-reducing in all circumstances, especially in a dynamic setting; hence there is nothing sacrosanct about its perceived negative impact. It is often missed out from the analytical debate on the subject that trade diversion in some products could itself lead to trade creation in other products over a period of time. Illustratively, if an intermediate product is cheaper in a member country as compared to the importing member country and it is imported by the latter on preferential terms, it may become further cheaper in the importing country as compared to the landed price of the similar product when imported from efficient rest of the world but on MFN tariff. This makes the final product highly competitive in the importing country for the production of which the imported input is used. The possibilities of trade creation in the final product increase, generating the forward linkage effect. Similarly, backward linkage effect in the country producing the intermediate product could also be present. Thus, through their backward and forward linkage effects, trade diversion could lead to trade creation in a dynamic setting (Das, 2006 a).

Finally, in certain cases, the phenomenon could be one of 'reverse trade diversion'. However, for instance, within the South Asian region there

are several lower unit value export items already present and are not being imported by the South Asian countries from within the region. They are actually being imported from outside the region. By not importing those by other South Asian countries results in welfare loss. Such *costs of non-cooperation* have been estimated to be substantial for different South Asian countries. It may be said that the South Asian region has been thus characterized by some sort of reverse trade diversion.

II.3 Trade Complementarities

It may be argued as to why the South Asian trade integration needs to be pursued with a greater degree of conviction as trade complementarities exist in both trade in goods and services.

II.3.1 Trade in Goods: Focusing on Intra-industry Trade

There can be various ways of assessing the existence or a lack of trade complementarities, especially in the South Asian region. Firstly, the fact that products are being exported by a country to the rest of the world but not to another country in the region, despite the fact that the same product is being imported by the latter from the rest of the world but not by the former, elucidates the existence of trade complementarities. Second, reportedly the South Asian region is characterized by informal trade flows that do not get recorded and do not get reflected in official statistics. This is nothing but a manifestation of ‘natural trade complementarities’ not only existing in the region but also being tapped. Third, similarity in production structures in the region across countries could also offer opportunities for intra-industry trade which is taking place globally as well as in the region. These together help in arguing that the region has trade complementarities and innovative policy mechanisms are needed to tap them and further augment intra-South Asian trade.

The scope of trade in goods complementarities get widened if the constraint of similarity in production structures among the South Asian countries is converted into an opportunity by focusing on intra-industry trade. There are various sectors amenable to this kind of trade such as processed food, rubber products, plastics, pharmaceuticals, textiles, apparel,

and light engineering goods. Augmenting intra-industry trade could be made possible by helping countries in reaping economies of scale, undertaking product differentiation – based on different raw materials, skills and technology – and creating industrial clusters.

Building Trade Capacities

In turn, this would help creating export supply capacities if investment that enhances intra-industry trade is facilitated. This is particularly important in the South Asian context as one of the limiting factors on intra-regional trade is as much a set of trade barriers as a lack of trade capabilities. Imports get limited due to limitation on the size of the importing country-market, whereas exports face a supply-capacity constraint. Strengthening trade-investment linkages in the realm of intra-industry trade thus assumes a greater importance. Efforts geared towards intra-regional intra-industry trade with the help of investment cooperation hence hold the key in South Asia as such a measure would help relieve both the size of the market constraint as well as export supply constraint.

II.3.2 Trade in Services

Given the very nature of services' trade, immense complementarities exist in the region primarily due to similarity in levels of development, geographical proximity and cultural ties. Since trade in services often require a simultaneous presence of service consumers and providers, the economics of neighborhood assumes greater relevance. As a matter of illustration, sectors like health, education, tourism, etc. are amenable to be traded much more efficiently regionally due to least-cost but high quality options available in proximate locations (see Box 1).

Box 1: Gains from Regional Trade in Services

International trade and investment in services are an increasingly important part of global commerce. Advances in information and telecommunication technologies have expanded the scope of services that can be traded cross-border. Many countries now allow foreign investment in newly privatized and competitive markets for key infrastructure services, such as energy, telecommunications, and transport. More and more people are travelling

Box 1 continued

abroad for tourism, education, and medical services, and to supply services ranging from construction to software development. In fact, services are the fastest growing components of the global economy, and trade and foreign direct investment (FDI) in services have grown faster than in goods over the past decade and a half (Mattoo et al., 2007).

Services liberalization with proper regulation can be a powerful driver of economic growth and poverty reduction. At the sectoral level, removing barriers to competition can lower prices, improve quality, and add variety. Because of the linkage effects—the fact that producers require telephones, use finance, need adequate transportation services, and benefit from business services—improving service sector performance can generate huge economic gains.

The motivations for RTAs in term of possible advantages includes the following: (a) existing literature suggests significant welfare gains; (b) services agreements can be more easily negotiated between limited set of participants with similar levels of development, geographical proximity and cultural ties; (c) allows for regional specificity; (d) provides a greater degree of reciprocity; (e) potential to foster greater liberalization of temporary movement of services suppliers; (f) include cooperative mechanisms for capacity building; (g) enable regions to attract higher levels of FDI; and (h) a facilitative transition to multilateral liberalization and helps strengthen indigenous supply capacities and regulatory effectiveness (Puri, 2007) .

Mattoo et al (2001) show that countries with fully liberalized financial and telecommunications sectors grew annually on average about 1.5 percentage points faster than other countries, controlling for other factors. These gains are not automatic—they require adequate regulation and a supportive investment climate—but the potential gains are large (World Bank 2001). Realizing these gains requires allowing foreign investors greater *market access*, and this is the most important provision in a preferential arrangement. Countries can open previously closed sectors to RTA partners as part of an agreement. Since today most countries accept, indeed clamour for, foreign investment in manufacturing and natural resources, RTA-driven reductions in entry barriers affect mainly services. Moreover, services now play a larger role in investment flows, and for some countries, such as Mexico, they have dwarfed investments in manufacturing. The great bulk of services' investment is market-seeking and horizontal investments. These cover a vast range of large multinationals: Deutsche Bank, WalMart, Starbucks, Microsoft, and so on. These “mode 3” services require the

commercial presence of affiliates, branches, or franchises to deliver the service.

To be sure, some countries (such as India) have experienced substantial flows associated with call centers and data processing, and this new investment accompanies these cross-border supply (“mode 1”) activities, though these activities remain small in comparison to trade through commercial presence. Because preferential arrangements permit more suppliers to compete in the market, a country is almost certain to gain from preferential liberalization of the services trade, irrespective of the supplier. In services, barriers to entry usually take non-monetary forms such as regulatory restrictions on entry, foreign equity limitations, quotas on outputs and foreign service workers, and requirements on legal form of establishment. Moreover, the scope for increased competition and exploitation of scale economies, as well as the possibility of inducing knowledge spillovers, strengthens the presumption that a country would gain from a preferential agreement in services.

Overall, the existing literature suggests a greater likelihood of static and dynamic gains from preferential liberalization of services than would be the case with preferential liberalization in the goods area. The potential of RTAs in promoting liberalization of the temporary movement of services suppliers is particularly significant. Regulatory cooperation on mutual recognition or harmonization of professional qualifications and licensing certification and technical standards, competition, and provisions for labour mobility, could further improve welfare. Furthermore, regional services trade offers a supportive environment for national firms by accelerating learning curves, building supply capacities and enhancing international competitiveness. Regional services trade also plays a catalytic role in generating employment and furthering the development of growing regional services industries and firms. By allowing for economies of scale in the production of services, RTAs may support the development of regional infrastructure in key sectors such as transportation, communications and energy (UNCTAD, 2007).

Source: RIS.

At the more operational level too, trade complementarities can be exploited much more easily at the regional level as compared to similar attempts at a forum with a large number of countries. It may be suggested that similarities among countries in a region help regulatory cooperation on mutual recognition or harmonization of professional qualifications, licensing

certification, technical standards, competition laws and provisions for labour mobility.

II.4 Asymmetric Distribution of Trade Gains

It is often argued that due to tariff liberalization in the region, the relatively bigger countries would gain more in terms of their exports and would be able to capture the markets of the smaller and lesser developed countries. This may not be true at least due to two reasons. Firstly, the bigger countries are already having larger presence in terms of exports to the smaller countries. Thus, with regional trade integration, the bigger countries would not be able to expand their exports due to limits on the size of the markets in the smaller countries. Second, smaller and lesser developed economies would gain much more than relatively bigger economies on account of enhanced market access for the former in the latter under any meaningful tariff concessions on tradables.

It has been argued that the formation of large blocs creates incentives to join for smaller countries that trade heavily with members—what has been termed “domino regionalism” (Baldwin 1993). The EU is the best example of this phenomenon: EFTA countries that were not in favour of the EU integration model ultimately concluded that the costs of staying out were too high (World Bank, 2005).

II.5 Investment Cooperation for Building Supply Capabilities: Horizontal Specialization and Vertical Integration

It is further acknowledged in regional economic integration that the strengthening of trade-investment linkages is a pre-requisite for achieving economic successes because of the fact that trade deficits between bigger and smaller countries need to be compensated by capital account surpluses wherein outward-FDI from bigger to smaller countries takes place (RIS, 2004). It also helps building export supply capabilities in the smaller countries which enables them to take fuller advantage of any regional trade liberalization initiatives like SAFTA.

Thus, the real gains from regional economic integration result from efficiency-seeking industrial restructuring, which also builds productive

capacities in relatively lesser-developed economies (Box 2). This is particularly important in the context of empirical findings that countries participating in regional trading blocs attract export-oriented production (Kumar, 1998).

Box 2: Efficiency-seeking Industrial Restructuring: Facilitating Product Mandate

Rationale

A number of quantitative studies conducted in inter-country contexts have also found strong association between membership in RTAs and FDI inflows. However, market extending (or enlargement) effect is only one and a relatively minor effect of RTAs. It is argued here that a more important effect of RTAs is strengthening of overall competitiveness of the region forming it through extensive industrial restructuring or rationalization across the region. This process of efficiency seeking industrial restructuring is accomplished by intra-regional FDI. The efficiency-seeking industrial restructuring is facilitated by liberalization of trade and investment regimes as a part of regional trading arrangements that enables free movement of goods across borders facilitating internal restructuring by removing the need to maintain horizontal national operations for multinational enterprises (MNEs). Therefore, MNEs restructure their operations by assigning the responsibility for serving specific regional or even global markets in particular product lines to certain affiliates. This strategy is sometimes called product mandating and results from the efficiency seeking restructuring or specialization within the MNE. The EU integration as also facilitated industrial restructuring of European businesses by adopting a statute of a European Company (*Societas Europaea*, S.E.) and through another legal instrument called the European Economic Cooperation Agreement (EECA). The latter is a form of cooperation between two or more firms which become a single body corporate with the aim of furthering the business activities of the participating firms.

Global Experiences

IBM has reorganized its operations in pan-European basis with IBM UK looking after PCs, IBM Germany, mainframe computers and manufacturing industry; IBM France, telecommunications, and IBM Italy, mid-range machines. Thus, this type of restructuring enables the enterprise to exploit the economies of scale and specialization. The location for specific product mandates is chosen on the basis of the advantages a particular country has

Box 2 continued

for the particular activity. These could include factor availability and their prices, agglomeration economies and other locational advantages. Quantitative studies conducted in the inter-country contexts have also found strong evidence of the role of RTAs in shaping the patterns of export-oriented investments made by US and Japanese MNEs across countries to exploit the potential of efficiency-seeking industrial restructuring. The studies on the existing RTAs have shown that in the deeper type of integration, the biggest beneficiaries are relatively poorer or lesser developed economies because of migration of industry to them helping their economy converge with those of more developed ones. It is evident that poorest economies of EU, viz. Spain, Portugal, Greece and Ireland have rapidly converged with more developed economies of the region such as Germany, France or the UK. Although resource transfers have also played a role, investment restructuring (such as relocation of production to low wage locations within the EU) has played an important role bringing about this convergence. It is also clear that investment liberalization becomes a key to facilitate the process of industrial restructuring. The barriers to investment flows may not allow the full benefits to be reaped from the regional trade liberalization.

Source: Kumar (2007).

The trade-investment linkages run in both the directions. While a free trade agreement can spur investment flows in terms of efficiency-seeking regional restructuring, it is the trade-creating joint ventures that ultimately have a decisive impact on regional trade flows. The trade-creating joint ventures are in a position to take advantage of the regional freer trade agreement. In this context, in a dynamic scenario, vertical integration and horizontal specialization could be focused upon with the help of cross-country investment flows that strengthen trade-investment linkages. This may essentially mean distribution of different stages of production in a particular industry regionally in an integrated manner, viz. the vertical integration coupled with specialization (in the same stage of production) with the help of product differentiation across the region, viz. the horizontal specialization (Das, 2004).

To elaborate this further, it may be mentioned that a shirt bought in America could have been Made in Sri Lanka, from the fibre imported from

Pakistan, woven into fabric in Nepal, cut in Bangladesh with computer-aided designing done in India (see also *The Economist*, 2004). Such a splitting of the final product into several intermediate products and components helps TNCs maximize their returns on investments and has helped production network assume strategic importance, especially in the context of regional integration (see Box 3).

Box 3: Relevance of Production Chains in a Regional Context

Advantages of Production Chains

In distributing the production chains, TNCs are able to arbitrage various variables such as wage, skill and knowledge. The manufacturing of parts and components is located in countries that have comparative advantage in producing them. These are sent for assembly into final products and shipment to customers all over the globe. As argued by Winters (2004), production chains and finer division of the production processes across countries allow producers to exploit potential gains from (i) local increasing returns to scale in the production of intermediate inputs, (ii) regional differences in factor costs for different production processes, (iii) increasing competition arising from widening market and (iv) technology transfer embedded in intermediate inputs and backward linkages through exports. This is most evident in the emergence of production chains, with trade in intermediate products becoming more important, encouraged by economies of scale, specialization and scope. These production chains have been instrumental in surges in intraregional trade (Nathan, 2004).

Effects of Production Chains

This approach emphasizes on the global coordination system that integrates the organization of international production networks (Gereffi, 1995). In this context, commodity chains are considered as networks of business units involved from the stage of supplying raw materials to production, exporting, and finally marketing and retailing - including both forward as well as backward linkages. In this framework, the importance of building brand names is also highlighted.

The importance of production networks especially in a regional integration framework has been further corroborated by World Bank (2005). According to which, the differential in trade and growth performance reflects the fact that certain regions have been better placed—in part through the policies

Box 3 continued

they adopted—to take advantage of new technologies and changes in the nature of world trade. Not only has the volume of international trade expanded in the postwar period, but also its structure has changed in fundamental ways. Exports of manufactured products from developing countries, and trade in manufactures among them, have become increasingly important for all regions. Moreover, trade integration has allowed developing countries to specialize (most evident in the emergence of production chains), with trade in intermediates becoming more important. This trend is also evident in the role that new products play in production.

Role of FDI

Foreign direct investment is playing an ever-increasing role in the integration process. These developments have facilitated the integration of countries that have adopted relatively open trade policies, and have increased the disadvantages facing countries that have segmented themselves from global markets. In a way, foreign investment has been a driver of integration, increased trade in manufactures, and vertical specialization. As tariff barriers have come down in manufactures, market-seeking, horizontal FDI that once led the way in the import-substitution process has faded in importance relative to efficiency-seeking, vertical FDI that looks to locate segments of production in the lowest-cost site. This form of investment is associated with the rise in production chains and trade in components and parts.

Source: RIS based on different studies.

Experience from East Asian Countries

East Asian countries have become major suppliers of parts and components that make up final products produced in this dispersed system. This is the reason why China now runs a sizeable trade deficit with the countries of East Asia and has a large surplus with the US. The East Asians have specialized in the production of parts and components while the US is the largest consumer of final products (Nathan, 2004).

II.6 Need for Safeguards

The preceding analysis presents a brief overview of the conceptual basis for regional economic engagements. However, such integration attempts are not bereft of certain deleterious implications for the domestic stakeholders.

Thus, as in most cases, regional economic integration initiatives also have detailed provisions of safeguard measures, addressing different economic concerns. A brief profile of such measures is presented in the section that follows.

III LIBERALIZATION AND THE NEED FOR SAFEGUARD MECHANISMS

Safeguard measures are often confused with protectionist devices. While protection may mean not committing to trade liberalization at all, safeguards are meant essentially to tackle any possible import threat to the domestic industries on account of import liberalization commitments. Often, there is an overemphasis on either the liberalization commitments or the safeguards. It must be highlighted that to reap the full benefits of a regional integration initiative, it is imperative to balance the liberalization commitments with adequate safeguard measures. In such integration initiatives, different objectives are sought to be addressed by setting in place different safeguard measures.

Within the provisions of tariff-liberalization there are various dimensions that provide for safeguards. These include time-frame over which tariff is scheduled to be reduced/eliminated. The extent of tariff reduction/elimination also helps calibrating market opening to a trade partner. Similarly, the extent of product-coverage is yet another avenue to safeguard domestic sensitivities. Country-specific treatment in these respects too, provides flexibilities.

There are the provisions of sensitive lists to address domestic concerns depending on the developmental imperatives of different countries. In this context, given the stages of development a special and differential treatment if accorded to smaller and least developed members, a facet which is crucial in the South Asian context. Furthermore, Tariff Rate Quotas (TRQs) provide for safeguarding domestic sensitivities that are not taken care of by the above-mentioned measures (See Box 4 in the case of India-Sri Lanka FTA and Box 5 in the case of India- Nepal Trade Treaty).

While rules of origin check against trade deflection and play a developmental role, there are trade remedial measures, viz. anti-dumping duty (checking price-discrimination) and countervailing duty (tackling foreign export subsidy) for checking any unfair trade practices by a trading partner in a regional trade grouping. Over and above these, there is a provision captioned as 'Safeguards' which is aimed at checking sudden import surge of a product even if it occurs through fair trade practice.

Box 4: Tariff-Rate Quota in India-Sri Lanka FTA

Apparel

Pursuant to the FTA, a meeting between the two sides (India and Sri Lanka) was held in February, (2000) to operationalise the Agreement, wherein, amongst other things, it was decided that Sri Lanka could export into India in any one calendar year 8 million pieces (pcs.) of apparel articles falling under chapters 61 and 62 of the Harmonized System of Nomenclature (HSN), on the payment of preferential import duty. It was also agreed that for the manufacture in Sri Lanka of 6 million pcs. out of these 8 million pcs. of apparel articles, the sourcing of fabrics will be done from India. It was further agreed that not more than 1.5 million pcs. will be of any one product category. The above preferential tariff quota for the calendar year 2000 is capped at a total of 6.67 million pcs, of which a minimum of 5 million pcs. will be manufactured in Sri Lanka out of the fabrics of Indian origin. The other condition to the effect that the quantum of export of such apparel articles by Sri Lanka into India shall not exceed 1.5 million pcs. in respect of a single product category stands. In terms of the FTA, the import of apparel articles from Sri Lanka into India is allowed through the designated ports of Chennai and Mumbai. The latter will also include the Jawahar Lal Nehru Port (JNP) in Nhava Sheva. For the purpose of these arrangements, such imports will include imports through the sea and air modes in Chennai and Mumbai.

Tea

Pursuant to the signing of the Free Trade Agreement, a meeting between the two sides was held on 2 February, 2000 to operationalise the Agreement. In that meeting it was decided, *inter alia* that the import of tea into India from Sri Lanka under the Tariff Rate Quota Arrangement would be through Calcutta and Cochin Ports. Since the exports were to commence with effect from April, 2000, the quota for year 2000 for tea was kept at 11.25 m.kgs. If

Box 4 continued

the tea is off-loaded at a port or airport other than the designated port or airport, the Customs shall be at liberty to levy the duty at the normal tariff rate without allowing 50 per cent concession

Removal of Port Restrictions

The Finance Ministry has done away with port restrictions on imports of quota tea from Sri Lanka at a concessional rate under the Indo-Sri Lanka FTA (June, 2007). India and Sri Lanka have signed an MoU to finalise the procedural arrangements for operationalisation of tariff rate quota for import of three million pieces of apparel articles covered under the India-Sri Lanka free trade agreement (FTA). In pursuance of the FTA that came into force on 1 March 2000 it was decided that Sri Lanka could export to India, in one calendar year, three million pieces of apparel articles covered on duty-free basis and without any restriction on entry points and sourcing of fabrics (October 2007).

Source: Ministry of Commerce and Industry, GOI (http://commerce.nic.in/trade/international_ta_indsl_3c.asp), <http://www.thehindubusinessline.com/2007/06/08/stories/2007060803681200.htm> and <http://www.thehindubusinessline.com/blnus/01061631.htm>)

Having argued a case for regional economic integration in the South Asian context along with highlighting the need for adopting a balanced perspective on the imperatives of liberalisation and safeguard mechanisms, the Section which follows presents some evidence on the potential for South Asian economic integration.

Box 5: TRQ and ROO in India-Nepal Trade Treaty

The India-Nepal Trade Treaty was renewed on March 2, 2002 after incorporating suitable modifications to the protocol to the Treaty without changing the basic spirit and framework of the Treaty. Nepal would continue to enjoy non-reciprocal duty free access for its manufactures in the Indian market. The 1996 Trade Treaty contained no value addition norm (Rules of origin) for duty free entry of articles manufactured in Nepal into India. This had resulted in a surge in imports of some products from Nepal with little or no value addition such as acrylic yarn, zinc oxide, vanaspati and copper

products. Representations were received from Indian Industry regarding the surge in imports of these commodities from Nepal into India, and its adverse impact on our domestic industry.

TRQ In the revised Trade Treaty, ceilings have been fixed for duty-free import of Vanaspati, acrylic yarn, copper products and zinc oxide, in such a manner as to avoid disrupting Nepal's existing exports to India while simultaneously addressing the concerns of the Indian industry. There is no ceiling on exports of these commodities on MFN basis. The quota figures for the four sensitive items for duty-free import are: Vegetable fats (Vanaspati) 100,000 MT Per Year, Acrylic Yarn 10,000 MT Per Year, Copper Products 7,500 MT Per year, Zinc Oxide 2,500 MT Per Year. Government of India has subsequently agreed to the request from Government of Nepal for increasing the quota for import of copper products from Nepal by 2500 MT per year.

Rules of origin

A very reasonable value addition norm of 25 per cent in the first year and 30 per cent in the subsequent years for Zero duty access has now been built into the Protocol to the Treaty along with change in tariff heading to ensure that the provisions of the Treaty facilitate the accrual of benefits to genuine industries of Nepal and are not used as a conduit for third country exports to the detriment of Indian Industry.

The problem of third-country imports has since been tackled.

Source: GOI, Parliament Proceedings to Unstarred Question No 2479, 2002.

IV. POTENTIALS FOR SOUTH ASIAN ECONOMIC INTEGRATION THROUGH DEEPER INTEGRATION

At present, alongside the various bilateral initiatives, the most significant progress in the regional economic cooperation in South Asia has been in the realm of implementation of the SAFTA Treaty (see Annexure for details on the Treaty). However, while the fuller and effective functioning of the SAFTA Treaty might be a necessary condition, it may not be a sufficient condition for tapping the regional economic synergies.

In this sense, the regional economic integration in South Asia needs to be pursued by deepening the ongoing efforts under the SAFTA Treaty.

For this, cooperation in the areas of services and investment would be crucial. It may be highlighted that there is a strong rationale for deepening the regional economic cooperation efforts (see Box 6) and potential for trade expansion in goods and services as well as investment integration needs to be tapped simultaneously. This is particularly important for building export supply capacities in the relatively smaller economies in the region which in turn helps them to take advantage of the greater market access on account of preferential market access under SAFTA Treaty.

Box 6: On Deepening RTAs

On the product/policy coverage issue, the conventional wisdom appears to be that agreements should first focus on trade liberalization and then move on to behind-the-border areas—that is, go from shallow to deeper integration. There is no theoretical justification for this, however, and there is a well-documented history that, in the case of the EEC, many policymakers were of the view that the two needed to be pursued in tandem. The rhetoric of policymakers and their advisors often suggests that deeper integration is necessary to attain free trade. During the period leading to the creation of the EEC, Jelle Zijlstra, the Dutch Minister of Economic Affairs argued that credible tariff removal required common policies on taxes, wages, prices, and employment policy. Similarly, the Belgian government felt that policy harmonization was required to equalize costs, and that without it, a customs union would not be feasible because countries would impose new forms of protectionist policies. French officials persistently demanded harmonization in social policies—equal pay for both sexes, a uniform work week—as a precondition for trade liberalization—French standards in this area were higher than in other countries (Milward, 1992).

Recent research on the effects of, and interplay between, efforts to liberalize trade and investment in services (and FDI more generally) suggests that countries may be better off pursuing both shallow and deeper forms of liberalization in tandem. Hoekman and Konan (2001) and Konan and Maskus (2003), for example, note that not only can this generate much greater welfare gains, it can also reduce aggregate adjustment costs over time—through avoiding outcomes in which factors of production must move repeatedly across sectors (as will, by definition, occur if goods are liberalized first and then services/investment, or vice versa). They also note that because many services continue to be less tradable than goods, there is greater scope for

Box 6 continued

employment opportunities to be created as a result of allowing greater competition in services markets, thus helping to absorb labour from other sectors as prices change due to trade reform.

An important implication of such deepening is the fact that regional cooperation in the areas of trade in goods and services coupled with investment integration helps smaller countries in a region like South Asia to take advantage of larger market access available through preferential trade liberalisation under SAFTA. This happens through the effects of investment in building export supply capabilities.

Source: RIS and World Bank (2005).

IV.1 Intra-South Asian Trade in Goods Linkages

It is a common knowledge that intra-South Asia trade has remained at modest levels and somewhat stagnant. However, the present scenario of intra-regional trade needs to be analysed to understand fully the initial conditions that exist as of now for stepping up intra-regional trade in future. This would also help us identify the potential for future trade cooperation in the region.

Table 1: Trade Integration of South Asia within and Without (%)

Intra-regional Trade Ratios		1986	1996	2006
R1	$(X_s+M_s)/(X_{sw}+M_{sw})$	3.12	4.50	4.91
R2	$(X_s+M_s)/(X_{sw}+M_{sw}-M_s)$	3.17	4.61	5.04
R3	$(X_{sw}+M_{sw}-M_s)/(X_{ww}+M_{ww}-X_{sw}+M_{sw})$	0.97	1.03	1.70
R4	R1/R3	3.23	4.37	2.89

Source: Calculated from IMF, Direction of Trade Statistics, 2007.

Notes: X_s = Intra-South Asia Exports, M_s = Intra- South Asia Imports, X_{sw} = Total South Asia Exports to ROW, M_{sw} = Total South Asia Imports from ROW, X_{ww} = Total World Exports, M_{ww} = Total World Imports.

Intra-regional trade: a Relativity Test

The present level of intra-South Asia trade has been subjected to some relativity tests. There are two kinds of such tests that have been performed: (i) Intra-South Asia trade relative to South Asian countries' global trade and (ii) Disaggregated country-wise intra-South Asian trade relative to country-

wise global trade. Both the tests have been further analysed on different dimensions. Moreover, the tests have been analysed in a dynamic context.

Test I: Intra-South Asia Trade vs. South Asia's Global Trade

The first set of relativity tests (Table 1) focus on objectively analyzing the intra-South Asia trade from four angles. Intra- South Asia trade expressed as a percentage of their global trade (R1) shows an increase from 3.12 per cent (1986) to 4.50 per cent (1996) with a further increase to 4.91 per cent (2006). Such an increase since SAARC's inception up to recent times needs to be viewed with a positive perspective. Two points need to be raised at this stage: (i) Any serious attempt to integrate SAARC in trade in goods by implementing the SAFTA Treaty is only a more recent phenomenon (it got implemented in 2006), as recent that its effect on intra-regional trade cannot be captured (see Annex for details on SAFTA). Hence, the importance of intra-regional trade relative to their global trade can at best be considered as independent of any regional policy-making process, so far. If at all, some of the bilateral trade agreements in the region might have contributed to intra-regional trade. (ii) The level of intra-regional has remained at low levels and has increased with modest trade dynamism, primarily due to limited export supply capabilities of the lesser developed countries. However, if viewed along with the reported magnitudes of informal trade, the intra-regional trade figures would be at higher levels. Coming back to R1, what is positive in this is that the ratio has increased over time, suggesting that South Asian countries have been integrating on an intra-regional basis at a faster pace than their global trade integration. This is even more pronounced when intra-regional imports are deducted from their total imports from world, as R2 suggests. It may be mentioned that in aggregate intra-regional exports would be equal to intra-regional imports but for the cif/fob factor. This is why either of the two can be deducted from the denominator of R2.

Interestingly, as evident from R3, the importance of South Asian countries in the global trade landscape has increased from 0.97 (1986) to 1.03 (1996) to 1.70 (2006). This relativity test has positive implications for the export supply capacities of the South Asian countries. However, when the importance of intra-South Asian trade with respect to their total global trade is juxtaposed vis-à-vis their importance in global trade space, this

relativity test (R4) suggests that while R4 increased between 1986 and 1996, it has declined in the subsequent decade of 1996-2006. This has important implications. On one hand, it means that the South Asian countries have been improving their importance in the world trade arena at a much faster pace than the speed with which the region has increased its importance for the South Asian countries in their trade profiles. This may have a negative implication for the intra-regional trade, however, on the other hand, this has a positive connotation inasmuch as it depicts the potential for greater intra-regional trade in South Asia.

Since the aggregate analysis of intra-regional trade may hide country-specific trends and patterns, it has been put to the relativity tests for an analysis at a disaggregated country level intra-regional trade with respect to each country's global trade.

Table 2: Country-wise Intra-South Asia Export Linkages

(Value: US \$ Million)
(Share: per cent)

	1986	1996	2006	Percentage change (1996-2006)
Afghanistan				
1 Exports to South Asia	77.04	30.19	125.23	314.80
2 Exports to World	166.31	128.05	282.84	120.88
3 Share of 1 in 2	46	24	44	83.33
Bangladesh				
1 Exports to South Asia	55.31	65.93	231.51	251.14
2 Exports to World	888.91	3297.16	12630	283.05
3 Share of 1 in 2	6	2	2	0
India				
1 Exports to South Asia	289.69	1619.9	6390.63	294.50
2 Exports to World	9135.28	32325.6	120289	272.11
3 Share of 1 in 2	3	5	5	0
Maldives				
1 Exports to South Asia	4.73	10.99	21.21	92.99

Table 2 continued

Table 2 continued

2 Exports to World	24.54	59.3	172.25	190.47
3 Share of 1 in 2	19	19	12	- 36.84
Nepal				
1 Exports to South Asia	51.18	74.1	424.71	473.15
2 Exports to World	134.29	360.11	703.89	95.46
3 Share of 1 in 2	38	21	60	185.71
Pakistan				
1 Exports to South Asia	135.01	252.39	2193.45	769.07
2 Exports to World	3383.15	9301.21	17038.20	83.18
3 Share of 1 in 2	4	3	13	333.33
Sri Lanka				
1 Exports to South Asia	59.56	110.00	808.49	634.9
2 Exports to World	1162.66	4089.00	7486.01	83.07
3 Share of 1 in 2	5	3	11	266.67
SAARC				
1 Intra- South Asia Trade	672.52	2163.50	10195.23	371.23
2 Total Exports of South Asia to World	14895.14	49560.43	158602.19	220.017
3 Share of 1 in 2	5	4	6	50

Source: Calculated from IMF, *Direction of Trade Statistics*, 2007.

Test II: Country-wise Intra-South Asia Trade vs. Country-wise Global Trade

The country-wise disaggregated analysis is further disaggregated and analysed for intra-regional exports and imports separately. Some important insights emerge when either of the exports and imports is analysed in terms of country-wise importance of intra-regional linkages on four dimensions, viz. (i) Absolute Volume (ii) Growth Dynamism (iii) Attractiveness Relative to world and (iv) Increase in Attractiveness. It is noticed that intra-regional trade is quite important for each country albeit for varying reasons as captured in the above-mentioned four dimensions that are presented below.

Absolute Volume: In terms of absolute volume of intra- South Asia exports (Table 2), the region is important for the non-LDCs with India exporting

US \$ 6 bn. Pakistan US \$ 2 bn. and Sri Lanka US \$ 1 bn. out of a total of US \$ 10 bn. of intra-regional exports in 2006.

As for the absolute volume of intra-regional imports (Table 3), out of the total US \$ 10 bn. in 2006 interestingly, the importance of the region is quite high for Sri Lanka (US \$ 2.4 bn.), Bangladesh (US \$ 2.4 bn.), Afghanistan (US \$ 1.6 bn.), India (US \$ 1.6 bn.) and Nepal (US \$ 1.1 bn.).

Growth Dynamism: In terms of growth in exports to the region between 1996 and 2006, the region has emerged as an important export destination for Pakistan registering 769 per cent growth followed by Sri Lanka (635 per cent) and Nepal (473 per cent) – all above the average growth for South Asia as a whole which registered 371 per cent export growth on an intra-regional basis.

Growth in imports also registered massive increases; however, only few countries registered higher growth than the average for South Asia which was 262 per cent over 1996-2006. Countries for which the region was an important source of imports include Afghanistan (3685 per cent), India (694 per cent) and Sri Lanka (278 per cent). However, these figures need to be interpreted with caution since some of the growth dynamism is on a low base (Tables 2 and 3).

Attractiveness of South Asian Region Relative to World: The South Asian region has remained attractive to individual South Asian countries as an export destination vis-à-vis the rest of the world. As evident from Table 2 the share of intra-South Asia exports in total exports to world in 2006 was 60 per cent in the case of Nepal, 44 per cent for Afghanistan, 13 per cent for Pakistan, 12 per cent for Maldives and 11 per cent for Sri Lanka, way above 6 per cent for the South Asian region as a whole.

Similar figures in terms of South Asia's importance as an import source (Table 3) are Nepal (50 per cent), Afghanistan (44 per cent), Sri Lanka (21 per cent), Maldives (17 per cent) and Bangladesh (14 per cent).

Increase in Attractiveness vis-à-vis World: The region's attractiveness has increased by phenomenal proportions with respect to world for individual countries during 1996-2006. On the front of exports it increased by 333 per cent for Pakistan, Sri Lanka (267 per cent), Nepal (186 per cent) and Afghanistan (83 per cent). For India and Bangladesh it remained constant and for Maldives it declined. For the region as a whole the attractiveness with regard to world increased by 50 per cent.

On the front of imports, positive trends are observed in the case of Afghanistan, India, Nepal, Pakistan and Sri Lanka and declining trends in the case of Bangladesh, Maldives and the region as a whole.

Summing up, it may be highlighted that the South Asian region has remained important for different reasons for different countries of the region. A country-wise disaggregated analysis suggests that both the importance of the region as a market for exports of South Asian countries as well as a source of imports for them has increased for some countries tremendously. For instance, in terms of attractiveness of the region for the exports of Nepal it is as important a destination as it is for a member of EU or NAFTA for its respective regional grouping. For Maldives and Sri Lanka too it is quite important. Some of the not-so-healthy trends in trade profiles of individual countries reflect the limits of both export supply capacities as well as size of the markets to absorb imports.

Table 3: Country-Wise Intra-SAARC Import Linkages

	(Value: US \$ Million)			
	(Share: per cent)			
	1986	1996	2006	Percentage change (1996-2006)
Afghanistan				
1 Imports from South Asia	48.07	43.52	1647.54	3685.83
2 Imports from ROW	596.98	660.80	3733.80	465.05
3 Share of 1 in 2	8.05	6.59	44.13	570.00
Bangladesh				
1 Imports from South Asia	91.10	1128.49	2431.58	115.47

Table 3 continued

Table 3 continued

2 Imports from ROW	2550.35	6934.93	17629.20	154.21
3 Share of 1 in 2	3.57	16.27	13.79	-15.24
India				
1 Imports from South Asia	92.31	201.57	1601.30	694.41
2 Imports from ROW	15051.40	36054.80	189438.00	425.42
3 Share of 1 in 2	0.61	0.56	0.85	51.20
Maldives				
1 Imports from South Asia	8.68	60.59	159.82	163.75
2 Imports from ROW	78.42	300.14	930.23	209.94
3 Share of 1 in 2	11.07	20.19	17.18	-14.90
Nepal				
1 Imports from South Asia	101.87	457.00	1139.04	149.24
2 Imports from ROW	313.98	1348.30	2304.82	70.94
3 Share of 1 in 2	32.45	33.89	49.42	45.81
Pakistan				
1 Imports from South Asia	110.98	320.95	946.02	194.75
2 Imports from ROW	5367.24	12149.90	34080.40	180.50
3 Share of 1 in 2	2.07	2.64	2.78	5.08
Sri Lanka				
1 Imports from South Asia	144.28	647.00	2448.70	278.47
2 Imports from ROW	1829.43	4740.00	11813.70	149.23
3 Share of 1 in 2	7.89	13.65	20.73	51.85
SAARC				
1 Intra- South Asia Imports	597.30	2859.13	10374.00	262.84
2 Imports of South Asia from ROW	25787.80	62188.86	259930.15	317.97
3 Share of 1 in 2	2.32	4.60	3.99	-13.19

Source: Calculated from IMF, *Direction of Trade Statistics*, 2007.

The disaggregated analysis of intra-regional trade in the South Asian region presented above presents an optimistic picture for the potentials of future trade and deeper economic integration and somewhat dispels the myth that the region lacks trade complementarities and thus, intra-regional trade have remained low. It also points to the fact that the smaller countries have been integrating within the region and taking advantage of geographical proximities for exports and sourcing efficiently produced imports. These

augur well for the potentials of trade-augmentation on a regional basis in South Asia, further evidence to which is presented in subsequent sub-sections.

IV.2 Trade Complementarities

South Asia as a region with geographical contiguity, cultural, social and historical ties has good potential for emerging as a strong, efficient and dynamic region. Important policy initiative in this respect has been the implementation of the SAFTA Treaty (see for an analysis, RIS and IPS, 2006). However, economic cooperation in the region lacks in progress, even with regard to fuller implementation of SAFTA, due to a lack in awareness of potential for cooperation and costs of non-cooperation. It is often argued that the region is characterized by low trade complementarities; however, much of the RIS studies have demonstrated evidence otherwise, based on both economic logic and empirical estimates. These studies have been further validated by various other studies.

RIS (1999) carried out a detailed quantitative assessment of costs of non-cooperation in the SAARC region. The empirical exercise revealed that in 1994 Sri Lanka and Pakistan imported many items at higher unit values than that would have prevailed if they imported from within the SAARC region. On this account Sri Lanka lost US \$ 266 million and Pakistan lost US \$ 511 million. For Sri Lanka the unit values of imports from outside the region were on an average twice the unit values associated with regional import of same items. Illustrative examples of the price comparison of Kawasaki- Bajaj two-wheelers imported from India by Sri Lanka with its original Japanese Kawaskai brand can be highlighted (see also Kelegama, 1999 and RIS, 2004).

Similar studies of two-way trade complementarities between India and Pakistan also confirm existence of trade complementarities (SBP, 2005). It predicts that Pakistan would benefit more, with imports mopping up net savings ranging from US\$ 400 to 900 million. The study estimates that if Pakistan-India trade were to open up, bilateral trade volume could cross US\$ 5.2 billion. The study also reveals that both countries had achieved only two per cent of their total bilateral trade potential during the past 25 years.

According to the study, 32 per cent of Pakistan's export products are currently bought by India from other countries and constitute one third of

India's total imports. The report notes that about 1,181 items worth US\$ 3.9 billion, covering 45 per cent of the total items exported by Pakistan, were at par with India's imports during 2004. It indicates that about 70.3 per cent of the common items exported from Pakistan have unit values less than or equal to Indian imports' unit values, and there is a large scope for the export of those items simply by producing the quality required by India. The SBP study (2005) also shows that India currently earns US\$ 15 billion in export revenue from 2,646 items being imported by Pakistan from other countries and notes that in 2004 the unit value for Pakistan's imports was higher than the unit value of Indian exports for 48.7 per cent of these items. Forty five per cent of those common imports were not included in the Pakistan positive list and hence their import from India was not allowed. Pakistan was losing US\$400 million to 900 million dollars by importing those items from other sources.

Some recent studies have revalidated the economic logic of existence of trade complementarities in the region. A recent study by UNCTAD and ADB (2008) concludes that the number of products that each country has a competitive edge in the region has increased overtime. This indicates the possibility of increased intra-regional trade. The shift of these economies from agriculture to manufacturing and from manufacturing to services in some has led to higher trade potential. The results show that complementarity index has improved considerably over time for different South Asian countries. This implies that for these countries, the products that they export are to a greater extent now being imported by the region as a whole. The improved complementarity indices indicate strong possibilities of higher intra-regional trade with SAFTA.

IV.3 Potential for Regional Trade Expansion and its Distribution

Some estimates worked out by RIS and IPS (2006) of the potential of SAFTA in a partial equilibrium framework of trade creation and trade diversion effects suggest the following: Firstly, the total trade gains from trade in manufacturing goods (other sectors excluded since they are not covered by SAFTA presently) are about US \$ 8 billion under a full tariff liberalisation scenario in a static setting. However, if due to SAFTA unofficial trade is also included in the realm of official trade flows, RIS estimates suggest that

there would be trade gains to the extent of three times the present level of regional trade (Kumar, 2005).

Earlier, Mehta and Bhattacharya (1999), using a gravity model, estimated 1.6 times increase in intra-regional trade due to tariff liberalisation under SAFTA. The gains in a dynamic setting were estimated to be much higher especially on account of economies of scale and smaller countries' market access to bigger economies in the region (Das 2003).

Recent RIS estimates suggest that the formal trade can grow in the range of US \$ 25 bn by 2010 to US \$ 36 bn by 2020. In terms of distribution of trade gains estimates suggest that smaller and least developed economies like Bangladesh, Nepal and Sri Lanka would gain more than relatively bigger economies like India and Pakistan due to access to larger markets. The experience with India-Sri Lanka FTA provides for counterfactual trends to this effect.

These results are revalidated by UNCTAD and ADB (2008). The prime inference is that not only South Asian countries would gain through trade integration but also the distribution of trade gains would not be as asymmetric as often apprehended (see Box 7). Pitigala (2005) also finds that if the South Asian countries continue the process of unilateral liberalisation in parallel with regional integration it would help them to diversify their export bases and help evolve potentially new comparative advantages and complementarities that could facilitate a successful implementation of SAFTA.

Studies have also examined the scope of tapping intra-industry trade in South Asia, the importance of which was highlighted earlier. It has been found that there are various sectors that have rich potential for intra-regional intra-industry trade in chemicals, clothing, paper manufactures, leather goods, rubber products, pharma, electronics, ceramics, among others (RIS, 1999; Kemal, 2000; UNCTAD and ADB, 2008).

Box 7: Potential for Trade Expansion in South Asia

I. Using general equilibrium analysis, impact of SAFTA on production, employment, trade and welfare for each of the SAFTA member country has

Box 7 continued

been estimated. The total output of Bangladesh does not show any significant change, but SAFTA induces a relocalization of output, with major production increases seen in Wearing Apparel (5.5 per cent) and Leather Sectors (3 per cent). This is a positive result since these sectors tend to be highly employment intensive. In fact, it appears that the gains of Bangladesh are so significant that all other South Asian countries see a decline in their output and global exports. Its output in chemicals, rubber and plastics also rises by about 2 per cent, while global exports go up by 10 per cent - this is a validation of indications that Bangladesh is an emerging competitive producer in chemicals like pharma, plastics and ceramics.

% Change	Output	Effect on Unskilled Employment	Exports to South Asia	Global Exports	Global Imports
Bangladesh					
2008-09	-0.01	0.0001	38.08	0.19	0.27
2016	-0.03	0.0001	14.43	4.31	5.47
India					
2008-09	0	-0.00001	3.41	0.09	0.11
2016	0.08	0.00002	90.44	1.19	1.68
Pakistan					
2008-09	0.01	0	5.52	0.17	0.19
2016	0.02	-0.0001	102.41	0.77	1.54
Sri Lanka					
2008-09	0.1	0	2.52	0.05	0.14
2016	0.55	-0.000107	58.78	0.72	1.98
Afghanistan, Bhutan, Maldives & Nepal, (ABMN)					
2008-09	0.03	-0.0004	20.82	0.74	1.96
2016	0.26	0.0002	60.32	7.89	11.99

Contrary to popular intuition, India and Pakistan are not the most important markets vis-à-vis each other. More than 60 per cent of the increase in exports to the region for both India and Pakistan are directed towards Bangladesh. This seems to indicate the relative lack of complementarities between India and Pakistan, but the existence of complementarities of between India and Bangladesh, and Pakistan and Bangladesh. A detailed look at disaggregated data reveals that more than 50 per cent of Pakistan's gains from SAFTA, are from increased exports to Bangladesh in textiles alone.

Sri Lanka's gains are more improved in the second phase, when all countries participate fully (and remove their negative lists). The increase in output in vegetable oils corroborates empirical evidence of duty structures that favor manufacture of edible oils. The textiles sector which contributes to about 5 per cent of total output in Sri Lanka sees a growth of about 4 per cent. There are gains in primary commodities with complete liberalization in 2016. With the removal of sensitive lists in a full liberalization scenario, ABMN groups see good export growth in agriculture products and primary commodities. Given that the agriculture and forestry sector in ABMN accounts for over 50 per cent of domestic output, and given that these sectors are employment intensive, a full SAFTA is beneficial to ABMN.

II. A gravity model is estimated using bilateral trade flows between SAFTA members and factors that may explain trade with respect to gravity. The estimates show that the potential trade between the SAFTA member countries as predicted by the gravity model is 120 per cent more than the actual trade.

Source: RIS excerpted from UNCTAD and ADB (2008).

IV.4 Trade Creation and Trade Diversion: Implications of Afghanistan's Membership

An attempt was made to examine the trade creation and diversion effects of Afghanistan's membership of SAFTA (Das, 2007). With the inclusion of Afghanistan as a member of SAFTA the total trade gains for SAFTA as a whole is estimated to be increasing from US \$ 8.6 billion to US\$ 10.6 billion (Table 4). Out of this, it is estimated that the trade gains accruing to Afghanistan would be to the extent of US\$ 606 million due to its SAFTA membership.

Table 4: Simulating Trade Creation and Trade Diversion Effects in Individual SAARC-7 Import Markets under SAFTA for Manufacturing Sector (US\$ '000)

Country	SAARC – 7				SAARC – 8			
	Total Trade Effect	Trade Diversion Effect	Trade Creation Effect	Price Effect	Total Trade Effect	Trade Diversion Effect	Trade Creation Effect	Price Effect
Afghanistan	-	-	-	-	606102.81	236328.42	334948.94	34825.45
Bangladesh	2644755.20	725498.90	1867398.20	51858.00	2912781.30	812583.99	2025436.90	74760.43
Bhutan	151758.00	0.00	148782.30	2975.60	177561.13	50112.10	115146.17	12302.86

Table 4 continued

Table 4 continued

India	1387464.20	404036.60	983427.60	0.00	1530725.10	444884.90	1085840.20	0.00
Maldives	368708.00	91230.00	270248.70	7229.40	426858.87	95771.44	303894.40	27193.03
Nepal	1612211.90	172905.90	1407694.30	31611.70	2276612.40	232195.71	2002914.80	41501.93
Pakistan	1013845.40	306464.10	707381.70	0.00	1229305.00	354934.52	874370.45	0.00
Sri Lanka	1461906.40	294343.20	1167563.20	0.00	2061165.90	393847.74	1667318.20	0.00
Total	8640649.00	1994479.00	6552496.00	93674.50	10615010.00	2384330.00	8074921.00	155758.30

Source: Das (2007) *Notes:* (i) Only positive trade diversion effects considered (ii) Analysis done at HS 6- digit Level (iii) Tariffs set at zero level for measuring the effects.

IV.5 Trade in Services

Services have emerged as the engine of growth in the SAARC economies explaining the dynamism displayed by them over the past decade. Service sector is also emerging an important source of employment. Some SAARC countries have also begun to exploit the potential of services in trade. However, the trade potential of services remains to be exploited by the region. South Asian countries need to take steps to specialize in services sectors which have potential for expansion in domestic markets and build their export capacity. Regional cooperation and integration of the service markets in the SAARC region may also assist in specialization and strengthening the competitiveness of services industries in the South Asian countries. Realizing this, concerted policy-efforts have been directed to step-up regional integration in trade in services, especially under SAARC (Box 8).

Box 8: Policy-formulation to Enhance Trade in Services in SAARC

The SAARC Heads of State or Government at their Thirteenth SAARC Summit (Dhaka, 12-13 November 2005) recognized the potential of trade in services and had called for a study to see how services could be integrated into the SAFTA process. At their Fourteenth Summit (New Delhi, 3-4 April 2007) also, the Leaders stressed that to realize its full potential, SAFTA should integrate trade in services and called for finalisation of an Agreement in the services sector at the earliest.

Accordingly, a study on *Potential for Trade in Services under SAFTA Agreement* was launched within the framework of the SAARC Network of Researchers on Global Financial and Economic Issues with Research and Information System for Developing Countries (RIS), New Delhi as the

Box 8 continued

Coordinator, on the basis of national studies prepared by each national focal point (Kumar, Das and De, 2008). The Inception Workshop for the Study organized by RIS in New Delhi on 10-11 May 2007, discussed terms of reference, outline of the study, national inputs to be included in the Study, operational approach and time lines to be adopted for the Study. National studies covered these issues in the context of each SAARC member country. Subsequently, a regional synthesis based on the national studies for consideration of the SAARC policy makers was discussed at the Regional Consultation Meeting organized by RIS for the SAARC Secretariat in New Delhi on 6-7 February 2007 by country delegations from all the SAARC countries.

The Regional Study was considered by the Third Meeting of SAFTA Committee of Experts (COE) in New Delhi on 1-2 March 2008 which while adopting the study recommended that RIS may be requested to draft a Draft SAARC Framework Agreement on Trade in Services (SAFAS) by 30 June 2008. Further, this recommendation was endorsed by the Third Meeting of SAFTA Ministerial Council held on 3 March 2008 and thus, RIS was given this policy-mandate by the SAARC Governments.

The study (Kumar, Das and De, 2008) found evidence of vibrant intra-regional trade in services taking place within the SAARC region overall and in a number of sectors even though the data gaps do not allow a fuller appreciation of its extent. It also suggests that the trade in services within the region is more balanced with smaller and poorer economies generally enjoying surpluses with larger economies thus helping to bridge the asymmetries that exist in the trade in goods in the region. The analysis also suggests complementarities in general between the SAARC countries in terms of their specializations and competitive strengths as demonstrated by an analysis of their trade patterns (for an illustration see Box 9).

Box 9: India-Sri Lanka Trade in Services

The natural linkages between goods and services opened up a number of service sectors to bilateral trade in the aftermath of increased goods flows resulting from the India-Sri Lanka Bilateral FTA. Unilateral liberalization of FDI in various services have opened the door for various Indian services to invest in Sri Lanka such as Apollo Hospital, Escorts Heart Centre at Durdans Hospital; Taj Hotels, Barista (fast food/coffee outlets), Amaravathi (restaurant) in hospitality sector; Jet Airways and Air Sahara in air transport.

Retailing and distribution – although a “sensitive” area that neither India nor Sri Lanka liberalized under the GATS during the Uruguay Round of WTO talks – now makes up a significant component of services trade between the two countries, mainly through franchise arrangements. Such franchise led retail services are Titan, Usha, Godrej, Bajaj, etc. from India and Damro (pre-fabricated furniture), Noritake porcelain and Dankotuwa porcelain, etc., from Sri Lanka. Although FDI in retailing is not permitted in India, initiatives by the Export Development Board of Sri Lanka (EDB) with Reserve Bank of India (RBI) made way for Sri Lankan firms to engage in exhibition-cum-retail sale for a brief period during 2004-2005.

In early 2002, the tourism sector was given a boost when Sri Lanka took the unilateral measure of granting visas upon arrival to Indian tourists. Since then, the largest number of tourist arrivals to the country has been from India (sometimes coming a close second to UK or Germany). In a reciprocal gesture, India granted 4 additional destinations to Sri Lankan Airlines. Now with a total of 10 destinations, viz. New Delhi, Mumbai, Buddh Gaya, Chennai, Bangalore, Hyderabad, Trichy, Trivandrum, Cochin, and Goa, tourist flows from Sri Lanka to India have also risen significantly. With 94 weekly flights to India, Sri Lankan Airline is today the largest foreign airline operating into India and 42 per cent of the Airline’s revenue comes from Indian operations.

Source: Saman Kelegama and I.N. Mukherjee (2007).

Complementarities in Trade in Services

The study found a compelling case for liberalization of trade in services in the regional SAARC context for mutually beneficial cooperation for development. The study identified the opportunities that exist in select sectors like Tourism, IT, Telecommunication, Energy, Education, Health, Financial Services, Business Services, Audio-visual, sports, environment and transport.

Table 5: Countries with Revealed Comparative Advantage¹

Category of Services	Sector	Countries with Revealed Comparative Advantage (RCA>1)
Labour and resource intensive	Transport	Sri Lanka, Pakistan
Labour and resource intensive	Travel	Maldives, Nepal
Labour intensive	Construction	Sri Lanka

Table 5 continued

Table 5 continued

Skill and technology intensive	Communications	Bangladesh, India, Nepal, Pakistan, Sri Lanka
Skill and technology intensive	Computer and information services	India, Sri Lanka
Skill and technology intensive	Financial and insurance services	Sri Lanka

Source: Kumar, Das and De (2008).

Notes: (i) Considers average RCA ($e^* > 1$) for the period 2000 to 2006. (ii) The RCA method of capturing a country's comparative advantage suffers from conceptual problems further compounded by the lack of reliable and detailed statistics in the case of services.

As summarized in Table 5, there is a pattern of revealed comparative advantage emerging from the RCA computations in recent years in various services sectors in South Asia. Notwithstanding the limitations of the RCA computations, it is apparent that all the South Asian countries have comparative advantage in one or many services trade sectors. However, none yet has attained comparative advantage in all the sectors, and at the same time, there are some countries (Bangladesh in communication services; Maldives in exporting travel services) which have gained comparative advantages in single sector. While India has gaining comparative advantages in skill- and technology-based services such as communication and computer and information services due to its relatively rich IT sector and vibrant service sector, most of South Asian countries are showing relative advantage in labour-intensive services exports thus showing rich potentials in intra-regional services trade in South Asia. In general, South Asian countries seem to be relatively specialized in labour and natural resource intensive. What emerges is that there are two distinct groups of countries in South Asia – one has comparative advantages in skill-based and technology-intensive services trade (such as India), and the other group offers labour-intensive services trade (virtually all the South Asian countries except India).

This clearly shows future potentials in services trade appears immense in South Asia provided countries have adequate capacity to export such services and match the trade demand correctly and the barriers to their trade are addressed (see also (Chanda, 2006). That the distribution of gains from services trade integration would be for each South Asian country in various sectors is also corroborated by the study by UNCTAD and ADB (2008).

IV.6 Investment Complementarities

IV.6.1 Location-specific Developmental Cooperation

Since investments are often location-specific, they can serve as important instruments for evolving cooperation in the South Asian region for development projects. There is also a growing realization that on certain dimensions of development-oriented economic cooperation like in the areas of energy, food, environment and water, policy responses might be needed at the subregional and bilateral levels for outcomes to be effective in the real sense in the region. Such a realization comes about on account of various factors and these necessitate tapping on the investment complementarities.

Firstly, due to the fact that some projects are essentially location-specific in nature, only a sub-set of South Asian countries may need to cooperate without necessarily involving the entire region. Secondly, in terms of its economic viability too, certain projects may necessitate involvement of only a few countries. Thirdly, the timeliness of a project may be ensured at times when the number of participating countries is as less as possible.

Moreover, subregional cooperation has an economics of its own. The economics of neighbourhood become more pronounced within the framework of a 'Growth Zone Approach'. In this kind of a localized arrangement, successful policies, projects, and programmes within the zone can be extended to the rest of the economy in the respective participating economies while any adverse consequences can be contained and confined within the zone. Due to involvement of three or more countries, growth zones help reaping economies of scale and exploiting resource endowments of many countries together. Especially for some South Asian countries, subregional cooperation becomes imperative given their supply-side potentials in excess of limited demand in particular areas. Growth zones have also been found quite amenable to public-private partnerships in specific projects.

Launching of projects in areas like energy, food, environment and water is often more feasible and effective in a subregional context; hence, the South Asian region needs to explore such possibilities in future. Against this backdrop, some initiatives on each of these areas are enlisted below.

A. Energy

In the energy sector there exists tremendous potential at the subregional level. Subregional cooperation would enable countries to optimize the use of scarce energy resources. These might include hydropower, thermal power and coal, natural gas as well as other non-conventional energy sources. Some of them are mentioned below.

• Bangladesh-Bhutan-India-Nepal (BBIN) Hydro-Power Project

The mountainous terrain in the Himalayan regions of India, Bhutan and Nepal has immense hydropower generation potentials. The estimated hydropower potential of Bhutan is 30000 MW and Nepal 43000 MW. Hydropower resources of Bhutan and Nepal can be exploited and exported to Bangladesh and India. However, a very small proportion of this potential has been exploited so far. On the other hand, these countries have been facing serious shortfall in energy supply both because of the multi-fold increase in demand as well as the high cost of energy from sources other than hydropower.

Complementarity and Gains

The exploitation of available potential requires joint efforts on the part of these countries. A common hydropower project can be undertaken by tapping the complementarities in financial and natural resources of these countries. It is argued that average cost of power project at the subregional level will be less than the cost incurred by each country for a national power project to enhance the security of supply, promote sustainable development and improve energy efficiency.

Revenue gains from power exports for Bhutan is estimated to be US \$ 200.50 million per annum, including exports from Chukha, Kurichu and Tala projects accounting for US \$ 44 million, US \$ 6.50 million and US \$ 150.00 million per annum, respectively. For Nepal, revenue gains from power exports are estimated to be US \$ 194.87 million per annum from West Seti project on completion.

It is estimated that each 10 MW hydropower project creates about 1200 unskilled jobs for about three years of construction period. It is possible

that hydropower-supported 8 per cent GDP growth will create about 352000 new jobs in Nepal. For Bangladesh, availability of additional 150 MW power could provide employment to 55,000 persons in agriculture; 49,000 persons in industry; and 42,000 in retail and wholesale shops.

Given the hydroelectric potential of the region, future generation and expected demand, interconnecting the regional electricity grid is of paramount importance. The success of India-Bhutan and India-Nepal power exchange need to be replicated in other countries case, especially in Bangladesh.

The mutual benefits for linking the Indian and Bangladeshi power grids to facilitate cross-border power exchanges are considerable. Although India's eastern and northeastern regional grids have periods of surplus power, various parts of Tripura, Mizoram, and other northeastern Indian states could be served more economically by power imports from eastern Bangladesh. In turn, western Bangladesh has only 755 MW of installed capacity, well below actual demand. Instead of adding new generation capacity locally to meet this demand, western Bangladesh could be better served by importing power from India.

Today, while India-Nepal and India-Bhutan have interconnected their power systems at various points, the Bangladeshi grid remains isolated from its neighbours. Interconnecting the Bangladeshi and Indian grids is an important prerequisite for subregional energy trading. It would also substantially enhance the energy security supply for both Bangladesh and India. Selective interconnection of the power grids along the India-Bangladesh border helps both countries avoid investment in new capacity additions. Moreover, the small power exchanges needed to meet demand in the border areas builds mutual confidence to facilitate power-trading mechanisms.

• **India-Pakistan Wind Energy Technology Sharing Project**

There is tremendous potential for wind energy across South Asia that has hardly been explored. India is the fifth largest wind power producer in the

world after Germany, the USA, Denmark and the UK, with a wind power capacity of 1,870 MW.

On the other hand, with funding from the Asian Development Bank, Pakistan's government has set a target of generating 10 per cent of its electricity needs using renewable energy resources (approximately 2,700 MW) by 2015, including wind energy. The government has established an Alternative Energy Development Board (AEDB) and will launch a Renewable Energy Project that will invest in developing electricity sources for rural areas.

Complementarity and Gains

The complementarity between the two countries lies in the sphere of technology-collaboration. State-of-the-art wind power technologies are now indigenously available in India and introduction of higher capacity WEGs (Wind Electric Generators) enable more cost-effective harnessing of wind energy. However, Pakistan does not give permission for payment of technology fees to India and Pakistanis are importing high-cost technologies from the western world.

This sets the stage for a bilateral Wind Energy Technology Sharing project and its feasibility needs to be explored.

• Sri Lanka-India Bio-Diesel Production Cooperation

Biofuels have come to be identified as the renewable liquid fuels, derived from biological raw materials, which can be used as a substitute to petroleum fuels. There is huge potential of biofuel production in South Asia in terms of availability of resources, existing processes and technologies.

Vegetable oils can be chemically processed to a less vicious form called esters or what is commonly known as biodiesel. Biodiesel has emerged as one of the more viable options among the biofuels.

India has taken biodiesel programme on a priority basis. With a view to blend diesel with biodiesel, the Government of India has launched the

National Mission on Biodiesel to address socio-economic and environmental concerns. The first phase of the programme intends to replace 5 per cent of diesel consumption soon with 2.6 million tons of jatropha biodiesel.

Complementarity and Gains

Sri Lanka's growing energy needs offer an opportunity for cooperation with India as in Sri Lanka both the public and the private sectors are focusing on bio-diesel as an alternative fuel. Sri Lanka has recently shown interest in this area of cooperation and it should be given adequate consideration for reaping bilateral trade gains as well as joint venture opportunities.

Sri Lanka is seeking Indian support to develop bio-diesel plants in the island's Puttalam region, north of the capital Colombo. The bio-diesel project, which is to be launched soon, will use the Jatropha plant (enduru). Right now the emphasis is to import Jatropha seeds from India and use a 5,000 acre area in Puttalam to grow the plant. The plant grows on infertile, marginal land with minimal care. It has a very high oil extracting capability and produces seeds with oil content of 37 per cent. The oil can be combusted as fuel without being refined. The plant also grows quickly and lives producing seeds for about 50 years.

There is further potential for exports of biodiesel manufacturing equipments from India to Sri Lanka. Once again the imports from India to Sri Lanka are estimated to be much cheaper as it would cost as little as 2.2 million Indian rupees (6.3 million Sri Lankan rupees). Furthermore, technical expertise will be acquired from India, which has perfected the production process. Jatropha cultivation is expected to generate an income of 25,000 Indian rupees (71,800 Sri Lankan rupees) per hectare and 150,000 Indian rupees (430,000 Sri Lankan rupees) from the fifth year onwards.

B. Food

Issues relating to food need to be considered in a holistic manner. There are four main issues related to this, viz. availability of food, accessibility to food, affordability of food and nutritional value of food. Subregional cooperation to launch projects that can focus on these issues by taking into account the locational specifics could prove to be useful.

- **Bangladesh-Bhutan-India-Nepal (BBIN) Agricultural R&D Centre**

An Agricultural Research and Development centre for Bangladesh, Bhutan, India and Nepal can be established for innovating new techniques that bring higher productivity in the agriculture sector.

Complementarity and Gains

Complementarities among the four countries exist due to climatic and geological reasons as far as the agriculture and allied activities are concerned. Thus, such an R&D centre can work on inventing new varieties of seeds, fertilizers usage, collect and disseminate information on proven agricultural technologies and effective farm practices. Such a centre can also provide training to the farmers for applying new technology to their farm holdings. This centre could concentrate on developing scale-neutral technology, as these four countries do not have a uniform land structure. Also, in these countries the crop production is largely rain-fed which poses several challenges for the agriculture. Thus, the R& D Centre may need to concentrate on the issue of irrigation. Several agricultural extension services also required to be focused upon. Integrated Pest Management (IPM) is another area of research and collaborative attention.

- **BBIN Contract Farming in High-value Food Items**

The dietary pattern of consumers in South Asian countries is rapidly shifting from cereal-based to high-value food commodities. High-value agricultural goods are generally defined as agricultural goods with a high economic value per kilogram, per hectare, or per calorie; and these goods include fruits, vegetables, meat, eggs, milk, and fish.

Nowadays contract farming is a popular technique for enhancing productivity in agriculture, especially relevant for high-value food items. Studies have revealed that contract farming benefited farmers by providing them with specialized inputs, technical assistance, credit, and an assured market, thus solving a number of problems smallholders typically have in producing new high-value commodities.

Complementarities and Gains

Some of the areas in which Bangladesh, Bhutan, Nepal and North-eastern

India offer rich trade complementarities on an intra-commodity basis include vegetables, fruits, milk and milk products and fish. Contract farming could thus be explored in a wide-ranging manner on dimensions of agribusiness, horticulture, sericulture and aqua farming.

Case studies highlight that, as a result of contract farming, transaction costs are reduced by over 90 per cent for milk and vegetables, and 58 per cent for broilers. The net revenue realization by contract producers was two to four times higher for milk and vegetables and 1.1 times for broilers. Smallholders benefited most from such arrangements, as they have low marketable surplus and their marketing costs are extremely high.

The governments of BBIN can encourage private firms to undertake such projects at sub-regional level. Tax concessions can be provided to those companies that give their contracts to farmers living in underdeveloped areas. But at the same time proper legal system should be in place to ensure its effectiveness. Moreover, the project needs to set in place adequate food safety and quality standards.

• **India-Sri Lanka Fisheries Project**

For India and Sri Lanka fisheries industry is an important industry in terms of food-source, exports, employment and income generation. There are various dimensions amenable for tapping complementarities.

Complementarities and Gains

For instance, the present exploitation of marine resources is confined to the inner continental shelf. The entire deep-sea resources remain largely unexploited. An intergovernmental joint venture should be launched to acquire technology for developing deep-sea fishing and providing necessary training to the fisher folk in Sri Lanka. India's strengths in these areas complement well with the Sri Lankan needs.

The other prospective areas for investment are development of infrastructural facilities such as refrigerated transportation and storage and modernization and expansion of fish processing units for tuna, shrimp and lobsters.

Fisheries harbor development, laboratory testing, enhancing product value, and resources surveys are some of the other areas where Indian expertise could be tapped by Sri Lanka.

C. Environment

The growth process of a country involves a trade off between clean, healthy environment and high-income levels through economic development. Countries of the South Asian region are trying to follow the path of sustainable development so that at least similar living standards can be maintained for future generations while aiming at economic growth. However, environmental issues necessitate cooperation among countries, as it is not always a country-specific issue but often location specific, which may have implications for more than one country. Thus, similarities in eco-systems make this dimension quite amenable for subregional cooperation.

• BIMS Coastal Disaster Management Initiative

The five SAARC nations, viz. Bangladesh, India, Maldives and Sri Lanka, have remained vulnerable to adverse effects on their coastal environment. The coastlines of these countries are an essential part of the life support system that remains vulnerable to common threats of cyclones, floods and tsunamis. Thus, a BIMS Coastal Disaster Management Initiative could be launched which would be distinct from the SAARC regional initiative on the subject inasmuch as it would be focusing on a common geographical area faced with common natural calamities. The regional initiative may include coastal and seismic zones whereas the proposed initiative would only focus on the problems relating to the coastal areas of the countries under consideration.

Complementarities and Gains

Primarily, the complementarities exist in terms of Indian expertise in this area ranging from information gathering, monitoring, and early warning system, among others through satellite links and use of ICTs. All this can contribute to evolve disaster reduction mechanisms in the coastal areas common to the participating countries.

The proposed Coastal Disaster Management Initiative can work on managing coastal resources by contributing to reduction of threats through exchange of information and experiences; building capacities at local level; and development of appropriate research and monitoring processes. The initiative would also need to focus on the post-disaster rehabilitation and relief packages.

- **Conservatory Foundation of India and Sri Lanka**

A Conservatory Foundation for these two countries can be established that aims at restoring the depleted and endangered species.

Complementarities and Gains

Such a Foundation can provide consulting and technical services to governments and help forming educational, scientific and economic partnerships to expedite habitat and species preservation projects. This Foundation can create a cell employing experts in the field of finding rare species, initiate programmes for managing the endangered species, hire people for writing scientific papers on this specific issue for wider dissemination.

Amphibian biologists and amphibian conservationists among other experts available in these countries could be provided an interface through the Foundation for capacity building and specific-project execution. Similar biodiversity zones in Sri Lanka and Southern India would provide for locational complementarities in launching joint projects.

D. Water

Three of the world's mightiest rivers flow through countries of the Indian subcontinent. Despite strife and war, several landmark agreements have been reached. However, subregional cooperation on river waters could significantly improve the lives of millions of people as well as improve the connectivity for facilitating movement of goods and people.

- **India-Bangladesh Brahmaputra Water Ways Project**

In the case of the Brahmaputra, it is not so much a question of sharing the

waters as of tapping the waterway profitably for mutual benefit, primarily for transport, commerce and industry.

The TIFAC Technology Vision 2020 report on Waterways brings out a vision for the future of waterways in India. It states that the development of Inland Water Transport (IWT) will depend on the integrated network of rail, road and IWT – a multimodal transport framework to enhance the total transport capacity. It further stresses that India needs to develop ‘Smart Waterways’ – modern waterways with state-of-the-art technological infrastructure.

At present none of the Indian waterways really falls into this category. Ganga-Bhagirathi-Hoogly and Brahmaputra river systems, however, satisfy some of the characteristics. They have the potential to be developed into ‘smart waterways’ since considerable cargo carrying potential exists on these rivers.

Complementarity and Gains

The TIFAC Report for waterways focuses on the possibilities and opportunities with respect to development of waterways in India. It gives a brief profile of the Ganga-Bhagirathi-Hoogly and Brahmaputra river systems. It makes long-term projections on the volume of traffic on inland waterways for the year 2010-11. It brings to the forefront the technological aspects that need to be investigated towards making IWT a significant component of the national transport system.

The report highlights that technological requirements for the development of Smart Waterways are highly location specific and recommends a set of technology imperatives and in-depth studies for their development in areas related to hydraulics, geotechniques, geology, meteorology, hydrography and navigation. The technology implications in the different areas of IWT such as dredging requirements, ship design, barges, bugs, push boats, terminals, cargo handling equipments, lighterage, jetties, navigation and communication aids are also given in the study.

The India-Bangladesh Brahmaputra waterways project could be a win-

win situation for both the countries due to inherent potential for tapping trade and transport complementarities. For instance, Assam's famed tea could be shipped downstream to Bangladesh and exported to ASEAN. Oil from the Numaligarh refinery, also in Assam, can be exported in river barges to meet Bangladesh's energy needs. These simple but effective measures would generate employment and revive the economies of marginalized communities. It is against such mutually beneficial economic opportunities that India-Bangladesh Brahmaputra Waterways Project needs a special attention.

• **Ganga-Brahmaputra Basin Management Project**

The rivers Ganga and Brahmaputra carry an immense flow of water resources which have so far gone unharnessed. These water resources are also unevenly distributed, both territorially and seasonally. As a result, the basin suffers from devastating floods during the rainy season and severe shortage of water in the lean season. In addition, the territories lying in the basin suffer from problems of water logging, soil erosion and the consequent degradation of the environment.

Complementarity and Gains

There is tremendous scope for the optimum development of water resources on a cross-country basis for flood control, energy generation, irrigation, inland water transport, internal water navigation and environmental protection.

The above only suggest that there is immense scope for developmental cooperation in the region and investment complementarities need to be tapped in order to take locational advantages with respect to different projects.

IV.6.2 Trade-Investment Linkages

There are several instances of strengthening trade and investment linkages in the region. India's emerging FTAs with South Asian countries such as Sri Lanka and Nepal have already led to a significant trend of industrial restructuring.

A typical example is an investment made by an Indian tyres company, CEAT to set up a large export-oriented tyres plant in Sri Lanka to cater to its growing markets in Pakistan, Middle East and other countries taking advantage of abundant supply of natural rubber in the country. As a result of the growing trend of investments made by Indian companies to exploit the potential of the India-Sri Lanka FTA, India has emerged as the third largest source of FDI in Sri Lanka. UNCTAD (2003) has highlighted how Sri Lanka attracted Indian investments of US\$ 145 million in a very short period making India as the third largest source of investments for the island. Because of the investments in building supply capabilities in Sri Lanka facilitated by the India-Sri Lanka FTA, the trade deficit of Sri Lanka has come down to less than half. This success has prompted Sri Lanka to seek to expand the scope of the India-Sri Lanka FTA to cover investments and services in a comprehensive economic partnership agreement (CEPA).

Similarly, the India-Nepal trade and transit treaty giving unilateral duty free access to Nepali products to Indian market has also led to some industrial restructuring. For instance, Colgate-Palmolive India Ltd. (a subsidiary of Colgate-Palmolive, Inc.) has set up a venture with authorized capital of Rs 540 million in Nepal for production of 12000 tonnes of toothpaste per annum and tooth powder to feed their markets for the product in North India. As a result tooth paste exports from Nepal to India have grown from US\$ 11 million in 1997-98 to about US\$ 61 million in 1998/9, making tooth paste one of the most important item of Nepal's exports to India. Other companies like Hindustan Lever have followed suit. Dabur India, a domestic Indian group, has invested in a fruit processing plant to produce and package fruit juices for the Indian market. Dabur's principal focus is ayurvedic and herbal medicinal preparations. It has also started using its Nepal venture for these preparations. Dabur Nepal was apparently contributing as much as 15 per cent of Nepal's exports to India. Presently all the fruit juices sold in North India are packaged at its Nepal plant. Kodak Nepal, a venture of Kodak India and Eastman Kodak, USA was planning to service the North Indian market from its Nepalese base (Kumar, 2007). Subsequently, however, this process of industrial restructuring between India and Nepal was disrupted because of the political turmoil in the country. It is

expected that with the peace returning to Nepal and with the revival of the democratic process, the process will be restored again.

Such examples get reflected in empirical estimations on trade-investment linkages that show that the economic fundamentals of a SAFTA member country have a significant impact on inward FDI (UNCTAD and ADB, 2008). Domestic market size, low cost of labour and availability of skills attract FDI from outside the region. Higher trade openness attracts higher FDI. Tariffs with respect to other SAFTA member countries has a negative impact which indicates that lowering of tariffs following SAFTA will attract FDI from outside the region into the region. The coefficient indicates that the impact will be significant, i.e., 30 per cent of the rise in inward FDI may be because of lowering of intra-regional tariffs. This indicates that SAFTA may encourage FDI inflows into the member countries and consequently into the region as a whole.

IV.6.3 Evolving Product Mandates

The South Asian region is amenable to strengthening trade-investment linkages with the help of efficiency-seeking industrial restructuring. Several sectors qualify for such restructuring including textiles, apparel, processed food, pharmaceuticals, and leather products. This may also be possible in several services sectors through linking Mode 1 and Mode 3 such as tourism, medical services, and education, among others. To illustrate, an investment in one country in an educational institution under Mode 3 could generate trade under Mode 1 of educational materials like books, periodicals, CD-ROMs containing data and software, etc.

In this context, both in the realm of trade in goods and services, efforts would be needed to create an institutional and policy mechanism that not only complements liberalization of trade and investment regimes but also facilitates regional industrial restructuring creating product mandates, whereby enterprises restructure their operations on a regional basis by assigning the responsibility for serving specific regional or even global markets in particular product lines to certain affiliates. A strategy of product mandating of this kind can help engender a process of horizontal specialization and vertical integration in South Asia.

An important dimension of such cooperation would be to evolve regional supply chains that can be ultimately get integrated with the global supply chains.

Having identified areas of regional complementarities in trade in goods and services and scope for investment cooperation to make the best use of locational advantages and prospects for product mandating, the following section identifies some of the important challenges that the region faces. It would be against this background that certain policy solutions could be suggested.

Potential for Sectoral Production Integration in South Asia

It has been found that there is ample scope for expanding exports of textiles from Bangladesh to India; exports of textiles from Bangladesh to Pakistan; exports of clothing from India to Pakistan; exports of clothing from Pakistan to India; exports of clothing from Pakistan to Sri Lanka; exports of textiles from Sri Lanka to Pakistan (Ratnayak, 2001).

Further, in the case of various textiles and clothing products, the possibilities of horizontal specialization have been explored. The products amenable for horizontal specialization in different lines of production and exports from one South Asian country to other partners of the region were identified by analyzing the trends in the revealed comparative advantage of each country. In so doing, different stages of processing were kept in mind, i.e. from raw cotton and fibres to yarn and fabrics; and further to clothing. The analysis was undertaken at a three-dimensional level. First, products were identified where a particular South Asian country has gained comparative advantage during the period under consideration. Second, products were identified where a particular South Asian country has lost comparative advantage in the global market for the same period. And third, products were identified where major other developing country-competitors have also gained comparative advantage during the same period. This included countries like China, Hong Kong, Indonesia, Thailand, Turkey, Mexico, Tunisia etc. Finally, a matching of three vectors of products for each South Asian country was undertaken and the possible direction of

industrial relocation from one country of the region to other partners was identified. It is discernible from the results that each South Asian country is amenable for such a restructuring in terms of horizontal specialization (Das, 2004). Each country can become a host of industrial relocation as well as it is also required to shift some of its manufacturing bases to other partners. While the focus of analysis has been to identify products for horizontal specialization, an overall impression can also be had from the same table about the possibilities of vertical integration as well – from one stage of processing to another according to comparative advantage in the value-addition chain.

Adhikari and Weeratunge (2006) argue further in tapping the potential for regional cooperation in this sector in terms of evolving the region as a global hub for trade in textiles and clothing. For this they recommend regional cooperation in trade, investment and skill development.

This is not totally a hypothetical possibility as it is evident from the fact that in several sectors such industrial restructuring is already underway in South Asia (Kumar, 2007) including consumer goods, processed food, medicinal preparations, tyres, tea, light engineering goods, etc.

Relevance for South Asia and Suggested Policy-Steps

The corporate sector in South Asia in sectors other than information technology has remained unaffected by significant developments in the global production system. The South Asian countries, in order to tap trade complementarities and initiate more intensive industrial restructuring need also to simultaneously integrate themselves to the global production chains, especially through brand creation and brand-marketing. This would give them an opportunity to regionalize and globalize the sector at the same time. In order to execute such a plan steps aiming at augmenting intra-South Asian FDI both in terms of quantity and quality need to be taken (Kumar, 2002). This may aim at evolving production-sharing mechanisms in the region. Such mechanisms may focus on identifying the nature of participation that could be rendered by each South Asian country on dimension such as outward investment; location of investment; R&D centre;

sources of technology, human resources and raw materials; designing, packaging and branding; supply and marketing chain, etc. Creation of a regional multi-purpose technology modernization fund for enhancing R&D activities in the region with special emphasis on quality and branding focusing especially on regional technologies needs to be explored within the regional cooperation policy framework.

V. CHALLENGES CONFRONTING SOUTH ASIAN INTEGRATION

The South Asian region faces daunting challenges in exploiting the regional economic synergies that exist. Some of these are structural by nature whereas others are policy-induced. These are briefly highlighted below.

V.1 Policy-Induced Constraints

The two most important policy-induced constraints, as highlighted by various experts, that the SAFTA faces in augmenting intra-regional trade are the sensitive lists and the non-tariff barriers (see Weerakoon and Thennakoon, 2006, Lama, 2006, Dubey, 2007 and Taneja and Sawhney, 2007). These are discussed below along with highlighting as to how a lack of policy-coordination in the region and diffused efforts towards regional economic integration also act as constraints and pose challenges to the integration process.

V.1.1 Sensitive Lists under SAFTA

The sensitive lists under SAFTA have high import coverage which prevents taking fuller advantage of the SAFTA trade integration process. As Table 6 displays, most of the countries maintain high import coverage under their sensitive lists under SAFTA given by the share of imports from SAARC of SAFTA sensitive list items in total imports from SAARC by each country. However, in terms of share of imports from SAARC of SAFTA sensitive list items in total imports from world is very low, especially for India, Pakistan and Sri Lanka. Such a scenario has surfaced due to ambiguity in the concept of ‘substantially all trade’ coverage in WTO parlance. Due this countries did not feel obliged to focus on trade volume coverage and stuck to defining coverage of sensitive lists in terms of number of tariff lines at HS 6-digit level. This poses a challenge and needs to be rectified to augment intra-SAARC trade flows in future.

Table 6: Import-coverage of SAFTA Sensitive List Items by SAARC Countries

	Share of Imports from SAARC of SAFTA sensitive list items in Total Imports from World (%) ⁽¹⁾	Share of Imports from SAARC of SAFTA sensitive list items in Total Imports from SAARC (%) ⁽²⁾
Bangladesh	25.97	55.80
India	5.04	47.82
Maldives	26.98	67.25
Nepal	60.34	29.47
Pakistan	2.34	18.84
Sri Lanka	18.17	26.99

⁽¹⁾ (Country's Total Imports from SAARC of SAFTA sensitive list items/ Country's Total Imports from World of SAFTA sensitive list items)*100.

⁽²⁾ (Country's Total Imports from SAARC of SAFTA sensitive list items/ Country's Total Imports from SAARC)*100.

Source: Calculations based on Data from PCTAS.

V.I.2 NTBs

Existence of Non-Tariff Barriers (NTBs) is another area of policy-induced constraint coming in the way of expanding intra-SAARC trade. However, contrary to popular beliefs, the spread of NTBs across different measures as well as in terms of sheer number of tariff lines subject to tariff barriers, some of the smaller and lesser developed countries maintain higher NTBs (Table 7).

Table 7: Spread of Non-Tariff Barriers across Tariff Lines

Country	Measure Name	No. of Lines	year
Bangladesh	Non-Automatic License	681	2000
	Prohibitions	351	
Bhutan	License	23	1999
	Prohibitions	209	
India	Antidumping duties	47	2006
	Antidumping investigations	12	
Nepal	Prohibition to protect human health	2	1998
Pakistan	Authorization for health reasons	1	1998
	Authorization to human safety	4	

Table 7 continued

Table 7 continued

	Labelling requirements to protect human health	24	
	Licence for selected importers	38	
	Packaging requirements to protect human health	6	
	Product characteristics requirements to protect human health	33	
	Technical regulations	7	
Sri Lanka	Authorization for human health protection	31	2004
	Authorization for plant health protection	1	
	Authorization to ensure national security	33	
	Authorization to protect animal health	1	
	Authorization, n.e.s.	12	
	Finance Measures n.e.s.	1	
	Labelling requirements to protect human health	13	
	Licence	91	
	Licence for selected purchasers	10	
	Licence for specified use	1	
	Marking requirements to protect human health	4	
	Prod characteristics req. to ensure human safety	51	
	Prod characteristics req. to protect animal health	1	
	Product characteristics req. to protect human health	88	
	Product characteristics req. to protect plant health	17	
	Product characteristics requirements, n.e.s.	5	
	Prohibition n.e.s.	3	
	Prohibition to control drug abuse	7	
	Prohibition to ensure human safety	12	
	Prohibition to ensure national security	3	
	Prohibition to protect human health	3	
	Prohibition to protect plant health	6	
	Prohibition to protect wildlife	14	
	Requirement to use specific points of entry	5	
	State trading administration	19	
	Test, inspection and quarantine for human health	57	
	Test, inspection and quarantine for plant health	1	
	Testing, inspection etc. req. to ensure human safety	26	
		516	

Source: Compiled from World Bank, WITS.

Paradoxically, most of the complaints for imposing NTBs have been directed towards non-LDCs. In addition, the debate on NTBs often misses out on the point that the NTBs imposed are generally for all countries and not country-specific. Nevertheless, at the policy level, genuine complaints regarding NTBs must be addressed and eliminated to the extent plausible and needed to step-up intra-regional trade flows.

Table 8: Complaints by South Asian Countries against Each Other on

Countries Imposing NTBs	Commodities on the import of which NTBs are imposed	Types of NTBs
Bangladesh	<ul style="list-style-type: none"> • Indian parent stock chicken • Cotton yarn 	<ul style="list-style-type: none"> • Strictness in issuing visas • Ban and Restriction on import through land routes
India	<ul style="list-style-type: none"> • Ceramic, melamine products, garments, fruit juice, electrical wire, leather and footwear • Edible oil, condensed milk, hilsa fish and traditional jute products • Cement, CI sheets and lead acid batteries • Food products such as biscuits, juice, jam, jelly, chanachur, etc. • Textiles and textile articles such as yarn, fibres, fabrics and clothing products, woollen textiles- certification • Pharmaceuticals, pharmaceutical intermediates, and second hand goods • Molasses, Food and agricultural products • Almonds, pulses, fresh fruits and vegetables food preservatives, additives, milk powder, infant milk foods, certain type of cement, household and similar electrical appliances, gas cylinders and multi-purpose dry cell batteries 	<ul style="list-style-type: none"> • Certification • Lack of testing facilities for hilsa fish at Petrapole • Lack of infrastructure at inland ports • Countervailing duty • Unnecessary and multiple queries on bills of entry • Separate tariffs and federal excise tax schedules • Hurdles in movement of goods through train • Cumbersome procedures for getting visa for business purposes • Import of sensitive items through specified ports and land customs stations • Extensive documentation for customs valuation • Allowed to land goods only at few designated ports • No single official publication that includes all information regarding tariff, fees and additional tax rates

Table 8 continued

Table 8 continued

Pakistan		<ul style="list-style-type: none">• Positive list approach vis-à-vis India• Banks do not recognize L/Cs from some other South Asian banks• Lack of banking facilities of each other's bank• Telecommunication Problems• Trade Logistics: road routes for trade are non-existent, rail and air connectivity has been erratic.• Higher port congestions, higher port and demurrage charges, more paper work, and more issues of trade and transport facilitation• Closure of land routes (Wagha, Khokrapar, and Ganda Singh Wala (near Kasur)• Lack of information: Entry of new firms into trading with Pakistan indicates anonymous entry into trading which is facilitated by modern modes such as the internet.• Visas can be obtained only for specific cities
Sri Lanka	<ul style="list-style-type: none">• Transformers• Cosmetics• Mango pulp• Textile Products• Sanitary ware	<ul style="list-style-type: none">• KEMA Certificates• Testing• Registration of cosmetics in Sri Lanka even if the exporter has registration in India• Health certificate from the Ministry of Health of Sri Lanka for the export of mango pulp

Table 8 continued

Table 8 continued

-
- Certification from its own agencies like Sri Lanka Standards Institution (SLSI) on textile exports
 - Packaging
 - Import licences for over 300 items at the 6-digit level
 - A fee equal to 0.1 per cent of the import price to receive an import licence. mandatory import inspection (for almost 85 items)clearance certificate
-

Source: RIS based on Batra (2005), Karmacharya (2005), Raihan (2007) and various newspapers.

V.1.3 Policy Consolidation

A brief overview of policy initiatives within the South Asian region highlights the imperatives of policy consolidation against the backdrop of several overlapping and diffused efforts. These emanate at two levels. Firstly, within the regional initiatives under SAARC activities under different umbrellas of Integrated Programme of Action, Technical Committees in different sectors, Regional Centers, etc. need to be consolidated and brought under the broad canvass of economic cooperation which deepens the SAFTA process by inducting trade in services and expanding to regional investment cooperation, eventually leading to a South Asian Economic Union, as envisioned by the Group of Eminent Persons (SAARC Secretariat, 1998).

Secondly, the bilateral FTAs and their subsequent expansion in scope also need to be consolidated within the regional framework in the spirit of building block approach. For this the most liberal FTA could become the benchmark and help making the regional process as bilateral FTA plus kind of an endeavour.

V.1.4 Policy Coordination

Another policy-induced constraint in the South Asian region lies in a situation of a total lack of policy coordination. This is evident among the different ministries in one country; between countries and between SAARC Secretariat

and the nodal points in the SAARC members. Unless this is focused upon, the synergies that can be tapped from the presence of Observers for achieving developmental goals in the region would remain unrealized.

V.2 Structural Constraints

Some of the challenges faced by the region are due to structural constraints. One set of such bottlenecks fall in the category of trade facilitation. Others are more of a reflection of underdevelopment at large in the region.

V.2.1 Trade Facilitation

As Table 9 demonstrates, the region is afflicted with procedural delays captured in variables such as documents needed for exports, time taken for exports, container cost in exporting activity. Similar dimensions are documented for imports. This needs concerted policy response and perhaps a medium term strategy needs to be evolved to address these constraints, acting also as NTBs in some sense. Along with addressing the procedural delays, efforts would be required to improve border infrastructure.

Table 9: Non-Tariff Barriers relating to Trade Facilitation

Country	Year	Rank	Trading Across Borders					
			Documents for export (number)	Time for export (days)	Cost to export (US\$ per container)	Documents for import (number)	Time for import (days)	Cost to import (US\$ per container)
Bangladesh	2006	134	7	35	902	16	57	1,287
Bhutan	2006	150	10	39	1,230	14	42	1,950
India	2006	139	10	27	864	15	41	1,244
Maldives	2006	91	8	15	1,000	9	21	1,784
Nepal	2006	136	7	44	1,599	10	37	1,800
Pakistan	2006	98	8	24	996	12	19	1,005
Sri Lanka	2006	99	8	25	797	13	27	789

Source: Compiled from World Bank

V.2.2 Constraints on Services Trade Liberalisation

There are various constraints acting against services trade in the region, preventing it to be fully realized (Kumar, Das and De, 2008):

a) Poor Connectivity and Infrastructure: The biggest impediment to trade in services in the region is the lack of quality infrastructure both within and connecting countries of the region. There are several components of infrastructure that are not up to the required standard. In transport infrastructure there is poor rail, road and air connectivity in the region, increasing transaction costs for trade in services in Modes 2, 3 and 4. This is an area of potential cooperation in infrastructure between SAARC countries, to ensure better connectivity between the respective countries through improved highways, rail and air services which connect the countries. The second major infrastructural gap is in telecommunications infrastructure. Trade in services through Mode 1, which has to a great extent been the major growth segment in trade in services over the last decade or so, relies tremendously on good IT and telecommunications connectivity. As it stands South Asia has pockets of excellent connectivity amidst vast areas of poor or zero connectivity. To take advantage of the most exciting area of trade in services, the mode providing the greatest potential opportunities for trade, it is essential that there is greater internet and telephonic penetration throughout the region. This would require a large investment in infrastructure, but yielding very high returns. The final infrastructural requirement would be access to utilities – electricity in particular, which acts as a constraint to all forms of investment, and Mode 3 investment is no different, particularly as effective service delivery would require consistent access to electricity to power IT facilities. Without development of these infrastructural facilities the region will not be able to exploit the full potential of trade in services.

b) Asymmetries in Standards: Like in trade in goods, trade in services requires some form of harmonisation of standards of service delivery. This becomes most relevant in Mode 4, where service providers travelling to another country will need to fit in to regulatory structures within the host country. If for instance the service standards in the host country are far higher than that of the other, the service supplier will not be able to function in the host country. This is the case in South Asia at present, there is great divergence in the standards of professional qualifications between countries. In order to address this problem it becomes necessary to adopt Mutual Recognition Agreements (MRAs) between countries. However, the problem

goes further as there are divergences in quality within countries as well. Therefore, for more advanced stages of services trade it will be important to upgrade the standards of service delivery in order to be recognized by all countries in the region. There are also divergences between the regulations in countries relevant to service delivery, including intellectual property rights, regulations in key markets such as finance and telecom. Whilst harmonising these regulations is not always possible, nor desirable, it would be required to have a degree of cooperation between the relevant bodies in the SAARC member countries to ensure that what asymmetries that do exist do not act as too great a barrier for trade in services.

c) Language Barriers: Since the delivery of services requires interpersonal interaction, a common language is essential in many sectors. Although South Asian countries in general share common languages and have close cultural links, language becomes a constraint some times. For instance, a Sri Lankan doctor may find it difficult to practice in Bangladesh since he would only be able to interact with patients with a command of English. Similarly, it would be of limited use to have a call centre for a Sri Lankan firm operating in Nepal due to lack of lingual compatibility. Increased proficiency in English might help in not only enhancing trade within the region but also with the rest of the world. Furthermore education would play an important role in terms of providing individuals with the IT skills that would enable them to take advantage of opportunities in Mode 1 in particular.

d) Security Concerns: A major issue that needs to be addressed is the security concerns related to the free movement of natural persons between borders. There have been many problems related to terrorism and full scale war both within and between member countries through the history of the region. There remains a great deal of mistrust between countries on this matter and this has made movement between borders a matter of concern. This will undoubtedly cause problems in the implementation of Mode 4 in particular, where facile movement of persons becomes essential in professions where the service supplier cannot afford to be in limbo due to travel regulations. Another side of this issue is the abuse of concessions that have been made for more fluid movement of individuals. Sri Lanka extended visa on arrival for tourists from SAARC. However, unfortunately many of

those who used this facility overstayed their visas and used it to work illegally in the country. Therefore, it is necessary that immigration, security and labour authorities step up monitoring capabilities so as to prevent abuse of visas, which will in turn make it easier to allow genuine users to move freely.

e) Bureaucracy and Hidden Costs: An impediment to taking advantage of opportunities of liberalization is the hidden costs faced by firms attempting to export services through mode 3. For instance, when a Sri Lankan firm wishes to set up a commercial presence in another country which has liberalized the sector in question, if there are hidden barriers such as stringent regulatory and bureaucratic processes, hidden taxes, and other delays, these may act as prohibitory barriers to service exports. Whilst the importance of regulation cannot be overstated, it is important to rationalize regulation such that it does not act as a disincentive for investment.

f) Lack of Business Information: Another more general concern with regard to taking advantage of opportunities of liberalization is the lack of awareness of opportunities. As mentioned earlier, trade in services remains a new phenomenon and ignorance is very much prevalent. Entrepreneurs have not always been able to spot market opportunities and often lack the technical capabilities to implement whatever opportunities that do arise. This is particularly true in areas where service trade is technology intensive, and the larger more traditional firms along with independent entrepreneurs in Sri Lanka and many other South Asian countries lack the dynamism to grasp these opportunities. The BPO sector is one area where these opportunities have been exploited in many parts of South Asia, but there are still a lot of unexploited opportunities. The media could play a role here in publicizing the innovative efforts of certain successful firms and ideas.

VI Summing Up

The preceding sections have highlighted as to how a lack of conceptual clarity on various dimensions with regard to regional economic integration has somewhat prevented an objective appreciation of the potentials and imperatives of economic cooperation in the South Asian region. It has been brought out that there is immense potential to augment economic linkages

in the region; however, not without adequate safeguards. It has also been highlighted that while trade integration in the region has remained low, it has remained important for different countries on different dimensions and offers further potential to be enhanced. The distribution of trade gains also appear to less asymmetric both in trade in goods and services as often apprehended. The real potential for the region lies in the ambit of investment cooperation that can create production networks and help evolve supply chains by strengthening trade-investment linkages. It is particularly significant in forging developmental cooperation in the region by exploiting locational advantages. This would also be instrumental in creating adequate export supply capacities and help expanding the size of the markets.

Dimensions of SAFTA Treaty

The SAFTA Treaty has 25 Articles and four Annexures. These pertain to the sensitive lists (or the negative lists) of all members, the technical assistance to Least Developed Countries (LDCs), the Mechanism for Compensation of Revenue Loss (MCRL) and the Rules of Origin (RoO). The specific details of these are given below.

Tariff Liberalization Programme (TLP): This differs under SAFTA on the basis of the development status of its members. The Agreement follows the United Nation's definition of 'Least Developed Country'. Thus, Bhutan, Bangladesh, Maldives¹, and Nepal are the Least Developed Countries (LDCs) and are given liberal time frames to bring down their tariffs by way of a special and differential treatment. On the other hand, countries like India, Pakistan and Sri Lanka (the Non-Least Developed Countries (NLDCs) have a different time-schedule. There are two phases of tariff liberalization under SAFTA. The schedules of these two phases are given in Table A.1.

It is noticeable that SAFTA envisages tariff rates among SAARC countries to be brought down to 0-5 per cent within 10 years from entry into force of the Agreement.

Table A.1: Tariff Liberalization Programme under SAFTA

	Countries	Existing Tariff Rates	Tariff rates proposed under safta	Year to be completed
First Phase	India, Pakistan & Sri Lanka	20% & above	20% (Max)	2008
		Below 20%	Annual reduction of 10%	2008
	Bangladesh, Bhutan, Maldives & Nepal	30% & above	30% (Max)	2008
		Below 30%	Annual reduction of 5%	2008
Second Phase	India & Pakistan	20% or below	0-5%	2013
		20% or below	0-5%	2014
	Bangladesh, Bhutan, Maldives & Nepal	30% or below	0-5%	2016

Source: From the text of the Agreement available at <http://www.saarc-sec.org/data/agenda/economic/safta/SAFTA%20AGREEMENT.pdf>

Sensitive Lists: Certain products are kept out of the purview of tariff liberalization under SAFTA to address domestic economic sensitivities. These are the sensitive products kept in the *Negative Lists*. The Non-LDC member states maintain smaller sensitive lists for the LDC member states which also a special and differential treatment. The sensitive lists are subject to review after every four years or earlier with a view to reducing the number of items. Some countries (Bangladesh, India and Nepal) have kept separate negative lists for LDCs and non-LDCs as given in Table A.2.

Table A.2: Sensitive (/Negative) lists of countries under SAFTA

	Sensitive List for LDCs (items under HS 6-digit)	Sensitive List for non-LDCs (items under HS 6-digit)
Bhutan		157
Maldives		671
Sri Lanka		1065
Pakistan		1183
India	763	884
Bangladesh	1249	1254
Nepal	1300	1350

Source: Annex I of the Agreement available at <http://www.saarc-sec.org/main.php>

Rules of Origin: In order to check possibilities of trade deflection (i.e. imports from extra-SAFTA region routed through a SAFTA member under liberalized tariff) tariffs concessions have been made to be available only if the exported products ‘originate’ in the exporting member country of SAFTA. For this purpose, certain rules of origin have been set in place. Separate rules have been laid down for ‘Wholly Obtained’ and Not-wholly Obtained’. The ‘wholly-obtained’ category is of those products that are produced and exported without any imported inputs such as mineral products or fruits. The ‘not-wholly obtained category’ covers those exportables that contain imported inputs. In the case of the latter, the exporting member country desirous of availing of SAFTA tariff concessions needs to satisfy two general criteria applicable on all products viz. Change in Tariff Heading (CTH) at H.S.² 4-digit level and maximum allowable import content (or minimum domestic value addition) in the product of export. These two criteria are considered to ensure ‘substantial transformation’ in the partner country seek-

ing exports at concessional tariffs under SAFTA. Before applying these criteria a set of minimal operations specified in the Treaty would act as a filter to check any imports in a member country on a concessional basis that are likely to be deflected by merely changing their appearance with the help of repacking, etc. type operations that are not considered substantial.

Further, as derogation from the abovementioned two criteria and to promote intra-regional trade, regional cumulation provision is also made in the Agreement. Under this rule, if a product is made in a Contracting State using materials imported from other Contracting States then the import content requirement is relaxed. The import content of products and regional cumulation provisions are summarised in Table A.3.

Table A.3: Maximum Import content or Minimum Domestic Value Addition (DVA) under SAFTA

	RoO	Cumulative RoO
Products exported from India & Pakistan	Value of imported material does not exceed 60% Free on Board (fob) ³ value of exported product ⇒s minimum 40% DVA ⁴ in exporting country	Minimum 20% DVA in exporting country provided total regional value addition not less than 50%
Products exported from Sri Lanka	Value of imported material does not exceed 65% fob value of exported product ⇒s minimum 35% DVA in exporting country	
Products exported from LDCs	Value of imported material does not exceed 70% fob value of exported product ⇒s minimum 30% DVA in exporting country	

Source: From Annex IV of the Agreement available at <http://www.saarc-sec.org/main.php>

Apart from these general RoO (i.e. CTH plus DVA) there are some product specific rules given in Annex IV of SAFTA Treaty. These rules specify CTH at H.S. 4-digit or Change in Tariff Sub-heading (CTSH) at H.S. 6-digit level plus DVA content of 25 per cent, 30 per cent, 40 per cent or 60 per cent depending upon the product.

Technical Assistance to LDCs: Technical assistance and cooperation arrangements are designed to assist LDCs in expanding their trade with other Contracting States and in taking advantage of the potential benefits of SAFTA. These include capacity building in the areas of technical regulations and standards, training and skill development, product certification; development and improvement of tax policy and instruments; legislative and policy related measures, assistance for improvement of national capacity on legislation on anti-dumping, safeguards, competition, trade policy reforms, sanitary and phytosanitary measures, technical barriers to trade measures; export and investment promotion measures; training and human resource development in trade related areas such as product development, marketing; etc.

However, it must not go without a mention that technical assistance in SAFTA is in the nature of ‘best endeavour clause’ without any binding commitments. This needs to be addressed on a priority basis; otherwise the envisaged benefits of SAFTA may remain limited.

A Mechanism for Compensation of Revenue Loss (MCRL): Under this mechanism non-LDC members will provide compensation to the LDCs for loss of customs revenue for undertaking tariff reduction under SAFTA. This provision has been incorporated under SAFTA since many South Asian LDCs are resource-constrained. In SAFTA this compensation is determined by the following formula:

$$RL_{06} = CRNS_{06} - (1 + \alpha) * CRNS_{05}$$

where, RL_{06} = Revenue Lost in year 2006, $CRNS_{06(05)}$ = Customs Revenue of non-sensitive products covered under the Tariff Liberalization Programme of SAFTA in 2006 /2005) and α = Annual rate of growth of customs revenue of non-sensitive items.

Thus, for a particular SAARC country the amount of customs revenue (from import of products that are not in the sensitive list of SAFTA) that it would have had access to, if SAFTA had not come into force in 2006,

will be the magnitude of revenue lost for that country. The non-LDCs will pay this entire amount of compensation (RL_{06}), in terms of US dollar, to the LDCs. This mechanism will remain in force for four years. In consideration of the size of the economy of the Maldives and its heavy dependence on customs duties, the country will get compensation for one extra year, i.e. for five years. In addition, Maldives can claim compensation for revenue lost, especially in the case of imports from India (under SAFTA), for additional two years, i.e. total for six years.

The SAFTA Treaty also has provisions for trade facilitation. Under Article 8 of SAFTA, participating countries agree to consider “the adoption of trade facilitation and other measures to support and complement SAFTA for mutual benefit.” The additional measures suggested have a wide coverage including customs simplification, cooperation and harmonization, standards harmonization and cooperation, simplification of import procedure, facilitating transit requirements, development of transport and communication infrastructure, promoting investment and fair competition and macro-economic consultations.

The Dispute Settlement Mechanism (DSM): under SAFTA forms the basis of enforcement of the agreed rules of the Agreement. A dispute arises when one contracting state feels that another contracting state is violating the SAFTA agreement. If such a situation arises the two parties will engage in mutual consultations to resolve the dispute failing which the matter will be put to the dispute settlement body to give recommendations.

Institutional arrangements: Institutional arrangements are in place for the smooth functioning of SAFTA. The SAFTA Ministerial Council (SMC) consisting of the Ministers of Commerce/Trade of the Contracting States is the highest decision-making body of SAFTA and is responsible for the administration and implementation of the Agreement and all decisions and arrangements made within its legal framework. A Committee of Experts (CoE), with one nominee from each Contracting State at the level of a Senior Economic Official, supports the SMC. The CoE monitors, reviews and facilitates implementation of the provisions of the Agreement and un-

dertakes any task assigned to it by the SMC. The CoE also acts as Dispute Settlement Body of SAFTA. Each Contracting State will chair the SMC and CoE for a period of one year on rotational basis in alphabetical order. The SMC will meet at least once every year or more and the CoE will meet at least once every six months or more. The SAARC Secretariat provides secretarial support to the SMC and CoE in the discharge of their functions.

Endnotes

- ¹ There is a special provision for Maldives under SAFTA. Notwithstanding the potential or actual graduation of Maldives away from the status of a Least Developed Country under UN definition, it shall be accorded LDC status in SAFTA always.
- ² H.S.: Harmonised Commodity Description and Coding System. A coded classification of traded products, managed by the World Customs Organisation and applied worldwide.
- ³ The fob value includes the value of packaging of export product (other than containerization) and excludes freight and insurance costs (c.i.f.) for the overseas route.
- ⁴ The value of imported materials will be either at the cost, insurance and freight (c.i.f.) value at the time of importation of the materials, or the earliest ascertainable price paid for them in the territory of the exporting member country.

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