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# SOUTH ASIA DEVELOPMENT AND COOPERATION REPORT

# 2008

## Executive Summary



**RIS**

Research and Information System  
for Developing Countries

# **South Asia Development and Cooperation Report 2008**

## **RIS**

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# Foreword

South Asia has emerged as one of the fastest growing regions in the world with an average rate of growth of 8 per cent sustained over the past five years. Despite such robust growth, the region is home of more than 40 per cent of world's poor. Large sections of the South Asian people do not have access to education, health, nutrition and such basic amenities like safe drinking water and sanitation. Hence, the developmental challenge faced by the region is acute.

Acceleration of growth is important for the region's ability to fight the menace of poverty and unemployment and needs to be sustained and made more inclusive. For sustaining the dynamism, the region has to mobilize resources for development of physical and social infrastructure and focus on human development.

Regional economic integration has been adopted as a strategy for expedited and balanced regional development in different parts of the world with the formation of the European Union, NAFTA, ASEAN Free Trade Area, COMESA and SADC in Africa, and MERCOSUR and Andean Pact in the Latin America. The experiences of existing groupings suggest that regional economic integration could lead to expedited and equitable development.

With the implementation of South Asia Free Trade Agreement (SAFTA), SAARC region is also moving towards regional economic integration. However, we need to take steps to implement SAFTA in a comprehensive manner and move beyond to exploit the promise of the regional economic integration for sustaining the newfound dynamism of the region to meet many developmental challenges that it faces besides fostering interdependence, shared prosperity and peace.

The *South Asia Development and Cooperation Report 2008*, prepared by RIS on the eve of the 15<sup>th</sup> SAARC Summit presents an analysis of the macroeconomic performance of the South Asia region, highlights the developmental challenges it faces and makes several proposals for deepening regional economic cooperation in the different areas.

I am happy to commend the Report to the leaders, policymakers and development thinkers of the region.

New Delhi

  
Arjun Sengupta, M.P.  
Chairman, RIS

# Acknowledgements

The *South Asia Development and Cooperation 2008* has been prepared by a research team led by Dr Nagesh Kumar, Director-General, RIS. The core team comprised Dr Ramgopal Agarwala, Senior Adviser; Dr S.K. Mohanty, Dr Ram Upendra Das, Dr Sachin Chaturvedi, Dr Prabir De, Fellows; Dr Beena Pandey and Priyadarshi Dash, Research Associates, and Dr Sameer Ranjan Pradhan, formerly Research Associate, RIS (currently Senior Researcher, Gulf Research Centre, Dubai). Inputs have also been received from Dr Saman Kelegama, Executive Director, Institute of Policy Studies, Sri Lanka and Professor Manmohan Agarwal, Adjunct Senior Fellow, RIS.

The Report benefited from the contributions, discussions, comments and presentations made by a number of experts in different contexts and at the events organized by RIS including the Regional Conference on Economic Cooperation in SAARC: SAFTA and Beyond organized by RIS on 19 March 2007 in collaboration with the South Asia Centre for Policy Studies (SACEPS), Kathmandu; Conference on SAARC Economic Cooperation organized in Kolkata on 1-2 September 2007 jointly with Ministry of External Affairs, Federation of Indian Chambers of Commerce and Industry, and the Global India Foundation; the Regional Consultation Meeting on South Asian Trade in Services organized by RIS jointly with the SAARC Secretariat on 6-7 February 2008 in New Delhi; and Seminar on Regional Cooperation and Integration Prospects in Asia, 5 December 2007. These experts include Poonam Barua, Biswa Bhattacharyay, Ramesh C. Chitrakar, Muchkund Dubey, Satish C. Jha, Sultan Rahman Hafeez, Naved Hamid, Sridhar Khatri, Mahendra P. Lama, Deshal de Mel, I.N. Mukherji, S.D. Muni, Rajat Nag, Pulin B. Nayak, M. Rahmatullah, Ananya Raihan, A.N. Ram, Jayant Kumar Ray, Ajitava Raychaudhury, Mohan Man Sainju, Rehman Sobhan, and Ibrahim Hussain Zaki, among others. However, the views presented are those of the members of the core team.

The production of the Report was coordinated by Tish Kumar Malhotra and Priyadarshi Dash with DTP assistance from Pradeep Kumar.

# Preface

The *South Asia Development and Cooperation Report 2008* is fourth in the series of Reports launched by RIS to provide an analysis of the macro-economic performance and outlook of South Asian economies against the background of global trends and the policy challenges faced by them with a special focus on the role that regional economic integration could play.

Since the launch of the first Report in the series in 1999, these Reports have become among the very few sources of comprehensive economic analysis available for the South Asia region as a whole. RIS has also been encouraged to continue the series of Reports by the SAARC Network of Researchers on Global Financial and Economic Issues at its various Meetings. The previous Reports have been presented and discussed in different SAARC capitals and have elicited an encouraging response and feedback.

RIS has an active programme of research on regional economic cooperation in South Asia since the early 1990s when a Report on Economic Cooperation in the SAARC Region: Potential, Constraints and Policies was prepared. RIS also hosted the Meeting of Experts for finalization of the regional study on Trade, Manufacturers and Services that laid out the road map for the economic cooperation in the framework of SAARC. RIS recently completed a regional study on Potentials of Trade in Services in the SAFTA in collaboration with the national think-tanks in each of the South Asian countries as a part of the mandate given by the Dhaka Summit. The Study has since been adopted by the SAFTA Ministerial Council. RIS also brings out the *South Asia Economic Journal* jointly with the Institute of Policy Studies, Colombo under the aegis of SAARC Network of Researchers.

In preparation of this Report, we have benefited from overall guidance of the Chairman of the RIS Governing Council, Hon'ble Professor Arjun Sengupta, M.P. and Chairman, National Commission on Enterprises in the Unorganized Sector. Professor Muchkund Dubey, Chairman, Research Advisory Council of RIS has been an important source of inspiration and advice throughout. We have also benefitted from the guidance from Ambassador L.K. Ponappa, Vice-Chairperson, among other members of the RIS Governing Council.

This Report has been prepared by a Research Team of RIS comprising the senior faculty members of the Institution, as listed elsewhere. I would like to place on record my appreciation for their sincere efforts and hardwork put in the preparation of this Report. We are also grateful to the editorial and production team at the Oxford University Press for publishing it on an expedited schedule.

New Delhi

Nagesh Kumar  
Director-General, RIS



# Executive Summary

South Asia has emerged as one of the fastest growing regions of the world with an average rate of growth of 8 per cent sustained over the past five years. The region has also strengthened its place in the international division of labour with rising share in global trade and foreign direct investment flows besides other impressive achievements in economic and human development. Yet the region continues to be home for over 40 per cent of the world's poor and fares poorly in terms of different indicators of human development such as education, health, nutrition, and sanitation. Although the growth outlook is still robust, the downside risks posed by dramatic deterioration of external environment are serious. The region now faces a threat of slowdown in growth and a sharp rise in inflation which may hamper progress in poverty alleviation and achieving development goals.

This Report argues that South Asia can face these challenges much more effectively with deeper regional economic integration. It makes specific proposals for deepening cooperation in trade and investment, for strengthening transport infrastructure, trade facilitation, energy security and human development within the region for mutual benefit.

By helping to create supply capacities in the poorer and lesser developed parts, regional economic integration can provide new opportunities for fostering trade creation and equitable development. The Report makes a strong case for expeditious implementation of the South Asia Free Trade Agreement (SAFTA) while extending its coverage besides further deepening the scope of cooperation to cover services, investment, industrial development, finance and capital markets while moving towards the cherished goal of a South Asian Economic Union. An integrated South Asia, the Report argues, will be able to secure its due place in the emerging broader regional architecture in Asia and exercise its role in shaping the global economic governance.

For far too long, the economic logic of integration in South Asia has been overwhelmed by geopolitical considerations. Now with deteriorating global environment, renewed efforts must be made to give economic integration a chance in order to realize fully South Asia's potential for rapid and inclusive growth.

## **RESPONDING TO THE DETERIORATING GLOBAL ECONOMIC ENVIRONMENT**

The development prospects of South Asian economies, like those of others, are affected by global economic environment and outlook. After putting in a robust performance for the past five years, the world economy is heading for a slowdown in 2008 largely led by the deepening financial crisis that has thrown the US economy on the brink of a recession.

Continued robust growth in the emerging economies such as China and India is assisting in moderating the threat of the global slowdown from turning into a global recession and the world economy is likely to grow at about 3.7 per cent in 2008. The downside risks to this outlook arise from the deepening of the US recession, re-emergence of inflation, rising oil prices, creeping protectionism in the developed world and

stalled Doha Round negotiations, and slow progress of climate change negotiations. The US financial crisis of 2008 and the risks of global slowdown have created urgency for restructuring in global and regional financial institutions. International cooperation is also needed for disciplining oil prices and for managing climate change with an equitable regime of emission targets and provision of technology and resources to developing countries. Asia as the new emerging power house has to take a leadership role and undertake the dual task of 'democratizing' the global institutions and creating new regional institutions which can address not only the regional but also global problems. In particular, regional cooperation in Asia in the form of a regional financial mechanism for mobilizing foreign exchange reserves for infrastructure development could play an important role in addressing the challenges arising from the ongoing financial crisis. Secondly, in the context of emergence of Asia as the centre of gravity and final demand with the rise of China and India and against the background of stalling Doha Round negotiations, South-South cooperation and broader regional economic integration bringing together different sub-regions of Asia assume a new relevance and urgency besides deepening the sub-regional cooperation. In that context, the comprehensive economic partnership proposed in the framework of the East Asia Summit could be a useful beginning towards creating a pan-Asian regionalism by extending its scope beyond India to cover all other South Asian countries in due course. An integrated South Asia will be able to seek its due place in the emerging broader regional architecture.

### **MACROECONOMIC PERFORMANCE AND OUTLOOK FOR SOUTH ASIA**

South Asian countries embarked on new higher growth trajectory since 2003 with an average rate of growth of over 8 per cent sustained over five years making the region as one of the fastest growing in the world.

This dynamism is broad-based and is a sub-regional phenomenon. Among the contributing factors to the dynamism have been the ability of the region to mobilize domestic resources and structural transformation in favour of services and industry. The outlook for growth continues to remain robust despite the global slowdown although some deceleration in growth is expected. The growth outlook for 2008-9 at 7.8 per cent for South Asia and at 8.2 per cent for India shows a slowdown compared to the 2007-8 growth rate but is still robust. The downside risks posed by, in particular, deepening of the US recession, rising oil and food prices are serious. The acceleration of growth is important for the region's ability to fight poverty and unemployment, and needs to be sustained and made more inclusive. Sustaining dynamism with price stability and inclusiveness becomes a major challenge for the region's policy makers especially in the deteriorating external environment. For facing these challenges, the development strategy in the South Asian countries will have to address the supply constraints on physical and social infrastructure, enhance inclusiveness of growth, address the growing menace of inflation, exploit the potential of non-conventional sources of energy and adopt environmental friendly technologies. This Report argues that deepening regional economic integration should form an important component of such a strategy.

### **TRADE PERFORMANCE AND COMPETITIVENESS**

South Asia's recent growth resurgence has been accompanied by their more vigorous participation in international trade and the region has emerged from the past five years with a deeper economic integration with the world economy. The average growth rate of exports accelerated from 5.3 per cent during 1997-2001 to 14.3 per cent in the subsequent five years. Although they have been able to enhance the share of manufactured goods in merchandise exports, their export structure

is still heavily dominated by labour intensive, highly price sensitive and low value adding goods such as textiles, garments, leather goods, and primary products such as iron ore. Unlike the East Asian countries they have not been able to upgrade their export profile in favour of knowledge-intensive and high value adding goods that are fast moving. Upgradation of the technology profile of their exports would require strengthening technological activity at various levels. Even though India has emerged as a global hub for outsourcing of ICT services, South Asian countries have yet to exploit the full potential of trade in services. Judging from multiple preferential trading arrangements being negotiated by them with different trade partners, South Asian countries seem to have recognized the importance of regional economic integration as in other parts of the world and have adopted a multi-pronged strategy. They need to enhance value addition in the traditional exports by moving up the value chain, sometimes by forming consortia of regional firms doing packaging, branding, and marketing for the partners. The textiles and clothing exporters need to prepare for the post-2008 scenario when the remaining safeguards on Chinese exports will be phased out. Regional cooperation through intra-industry specialization and vertical integration has the potential in strengthening the competitiveness of the region and make it a global hub in textiles and clothing sector. Regional cooperation is also recommended for dealing with the emerging SPS measures and standards in the developed countries and in benefiting from India's lead in ICT for developing outsourcing capabilities in other South Asian countries. A coordinated approach to WTO negotiations can also be highly effective in shaping the trading system in tune with their requirements.

#### **FOREIGN DIRECT INVESTMENT FLOWS AND INVESTMENT CLIMATE**

FDI inflows to South Asia have grown in the recent years in response to policy liberalization and their robust economic

performance. South Asian countries have also been able to increase their share in FDI inflows received by developing countries especially in the past few years although it is still rather marginal. South Asian region has not exploited the potential of intra-regional FDI inflows especially in the context of emergence of South Asia as a significant source of FDI in recent years with Indian companies undertaking relatively large investments in different parts of the world. In this context, South Asia could take lessons from the experiences of ASEAN that are trying to attract intra-regional FDI with the help of ASEAN Free Trade Agreement and ASEAN Investment Area. Deeper regional economic integration in SAARC will also enable the region not only to emerge as a more attractive destination for FDI inflows in general but also for export-oriented FDI as well as intra-regional FDI.

#### **DEEPENING REGIONAL ECONOMIC INTEGRATION IN SOUTH ASIA: SAFTA AND BEYOND**

Different regions across the world have adopted the strategy of regional economic integration to exploit their synergies for mutual benefit in a balanced and equitable manner. The existing patterns of intra-regional trade in South Asia fail to capture the extent of complementarities due to high incidence of informal trade and trade barriers. RIS analysis has found that lesser developed and smaller countries in South Asia lack supply capabilities in tradeable items having demand in larger countries reflected in trade imbalances. However, the intra-regional trade in South Asia has begun to grow and has doubled over the past five years. RIS analysis suggests that nearly three-fourths of intra-regional trade potential remains to be exploited which SAFTA can hope to realize. The available evidence also points to substantial potential of South Asian economic integration in trade creation and fostering strong growth in a balanced manner. The recent experiences resulting from India-Sri Lanka FTA indicate the potential of SAFTA

in fostering balanced regional trade by assisting in creation of supply capabilities through intra-regional investments. To exploit its full potential of regional economic integration, SAARC countries need to expedite SAFTA's implementation schedule, expand its scope by reducing the negative lists and addressing non-tariff barriers. They also need to move on to expand the scope of integration beyond SAFTA to cover trade in services, investment facilitation and industrial cooperation, financial and monetary cooperation including integration of capital markets. SAARC countries should expeditiously move towards creating a South Asian Customs Union by 2015 and further to the South Asian Economic Union by 2020. The deepening of regional economic integration would assist the region to consolidate and sustain its dynamism and attack the menace of poverty more effectively besides strengthening the region's place in the international division of labour and in the emerging broader regional architecture in Asia.

### **TRADE FACILITATION IN SOUTH ASIA**

Trade facilitation measures need to complement the removal of tariff and non-tariff barriers under SAFTA to be effective. Simplification and harmonization of customs operations need to be addressed on an urgent basis. An important step in this direction could be to consider creating a SAARC Single Window which would allow SAARC goods to pass through customs more rapidly. Standards harmonization could be an important step towards achieving a common market. The free movement of goods and services will not be possible if different countries have differing standards on health, environment and safety rules, among others. Along with common standards it is important to harmonize conformity assessment procedures and pre-shipment inspections, product and systems certification and risk management systems. The official process should expeditiously move towards creation of the South Asian Regional Standards

Organization. Finally, implementation of trade facilitation measures, often requires advanced infrastructure such as information and communications technology (ICT) and capacity building in the least developed countries is important for harnessing its potential.

### **TRANSPORT INFRASTRUCTURE FOR DEEPER REGIONAL INTEGRATION**

Given the primacy of transport infrastructure in promoting economic development on the one hand and regional integration on the other, the Report undertook a detailed analysis of the present state of national and cross-border infrastructure and the potential for cooperation among South Asian countries. The major challenge facing South Asia in its quest for regional integration and increasing competitiveness is the poor quality and inefficient transport and communication infrastructure which constrains the capacity of the South Asian economies to gain from a liberal trading environment. RIS analysis suggests that South Asian countries have lagged behind other countries in terms of infrastructure attainment and the gap with the global best practice has widened. Bridging the gaps in infrastructure would thus hold the key to achieve faster growth and poverty reduction. For achieving full regional connectivity South Asia needs a SAARC Regional Transport and Transit Agreement (SRTTA) that would facilitate surface transport links throughout the region. The Report also makes a case for reviving an Afghanistan - Pakistan - India - Bangladesh - Myanmar (APIBM) international corridor, which could emerge as Asia's new silk route, connecting Central Asia with East Asia besides facilitating intra-SAARC trade, and making South Asia as the hub for pan-Asian trade. The potential of intra-regional connectivity through road, railways, civil aviation, inland waterways, and seaports needs to be exploited for mutual benefit and for reducing freight costs in intra-regional trade. The Report recommends a South Asian Common Transport Policy

(SACTP) for providing a comprehensive framework for facilitating full regional connectivity through different modes of transport. The Report also recommends a South Asia Regional Infrastructure Development Facility (SARIDF) as a regional facilitation centre for cross-border infrastructure projects, within the ambit of the South Asia Development Fund.

### **REGIONAL COOPERATION FOR ENERGY SECURITY**

Higher economic growth and demographic pressures have resulted in phenomenal consumption of commercial energy in South Asia. The region is utterly vulnerable owing to inadequate energy endowments and overwhelming dependence on imported fossil fuels. Considering the critical role of energy in modern economies and the pernicious effects of any disruption, it is critical to ensure energy security. The complementary energy resource endowments, viz., natural gas in Bangladesh and Pakistan, coal and petroleum products in India, and hydropower in Nepal and Bhutan, provide a basis for regionally integrated energy cooperation. Regional cooperation for energy security also covers regional transit facilities for energy trade with the neighbouring countries surrounding South Asia. For facilitating regional cooperation, the SAARC Working Group on Energy needs to be strengthened. Regional energy trade should be promoted in hydropower, bulk electricity, petroleum products, natural gas, and coal. SAARC Energy Center (SEC) should foster collaboration with multilateral bodies, with other energy blocs, and also with sources of energy technologies. As energy trade requires costly infrastructure involving huge investments with long gestation periods, the Report makes a strong case for a regional cooperative framework for facilitating transparent trade and investment in the energy sector and recommends that SAARC adopts a SAARC Energy Charter Treaty (SECT) to provide

the legal basis and level playing field to all stakeholders for regional trade and investment in energy sector.

### **SOCIAL INFRASTRUCTURE AND HUMAN DEVELOPMENT IN SOUTH ASIA**

Social sector development in terms of poverty reduction, education, and healthcare has seen significant progress in South Asia. Yet the South Asia continues to be home for more than 40 per cent of the world's poor and fares poorly on human development indicators like education, health, nutrition, and sanitation. Therefore, the region faces a daunting challenge of attaining the Millennium Development Goals and the SAARC Development Goals by the year 2015. It is clear that growth by itself does not take care of human development and supportive policies are needed for poverty alleviation and building social infrastructure for inclusive growth. A number of initiatives have been taken at the national levels, the regional level and by the civil society organizations towards empowerment of the underprivileged people. Concerted efforts need to be made for universal access to primary health and education to empower more than one billion people in South Asia surviving on less than two dollars a day to enable them to share the fruits of the region's dynamism. The Governments should also pay necessary attention to substantially reduce the existing gender gaps in health and education through increased investments in providing basic social services to women. The thrust of the educational system should be on knowledge and skill formation through vocational and technical training for productive employment opportunities. Building an improved social infrastructure base is a gradual process. Given the similarities in the initial social and economic conditions in South Asian countries, there should be systematic, comprehensive and well-coordinated regional mechanisms for timely achievement of MDG targets by 2015.

# SOUTH ASIA DEVELOPMENT AND COOPERATION REPORT

South Asia has emerged as one of the world's fastest growing regions with an average growth rate of 8 per cent sustained over the past five years. It has also strengthened its place in the international division of labour with a rising share in global trade and FDI flows besides other impressive achievements in economic and human development. Yet the region continues to be home for over 40 per cent of the world's poor and fares poorly in terms of different indicators of human development such as education, health, nutrition, and sanitation. Although the growth outlook is still robust, the downside risks posed by dramatic deterioration of external environment are serious. The region now faces a threat of slowdown in growth and a rise in inflation which may hamper progress in poverty alleviation and achieving development goals.

In this Report, RIS argues that South Asia can face these challenges much more effectively with deeper regional economic integration. It makes specific proposals for strengthening cooperation in trade and investment, transport infrastructure, trade facilitation, energy security, and social infrastructure within the region for mutual benefit.

By helping to create supply capacities in the poorer and lesser developed parts, regional economic integration can provide new opportunities for trade creation and fostering equitable development. The Report makes a strong case for expeditious implementation of the South Asia Free Trade Agreement (SAFTA) besides extending its coverage and further deepening of cooperation in services, investments, industrial development, finance, and capital markets, while moving towards the cherished goal of a South Asian Economic Union.

An integrated South Asia, the Report argues, will be able to secure its due place in the emerging broader regional architecture in Asia and exercise its role in shaping the global governance.

For far too long, the economic logic of integration in South Asia has been overwhelmed by geopolitical considerations. Now with deteriorating global environment, renewed efforts must be made to give economic integration a chance in order to realize fully South Asia's potential for rapid and inclusive growth.

*South Asia Development and Cooperation Report* is an invaluable resource for policymakers, business leaders, development thinkers and practitioners in South Asia and beyond.

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